ישראל יוזמת

ISRAELI REGIONAL INITIATIVE

Economic Analysis

Effects of a Regional Agreement On Israeli Economy and Society

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CREATING A POWERFUL REGION

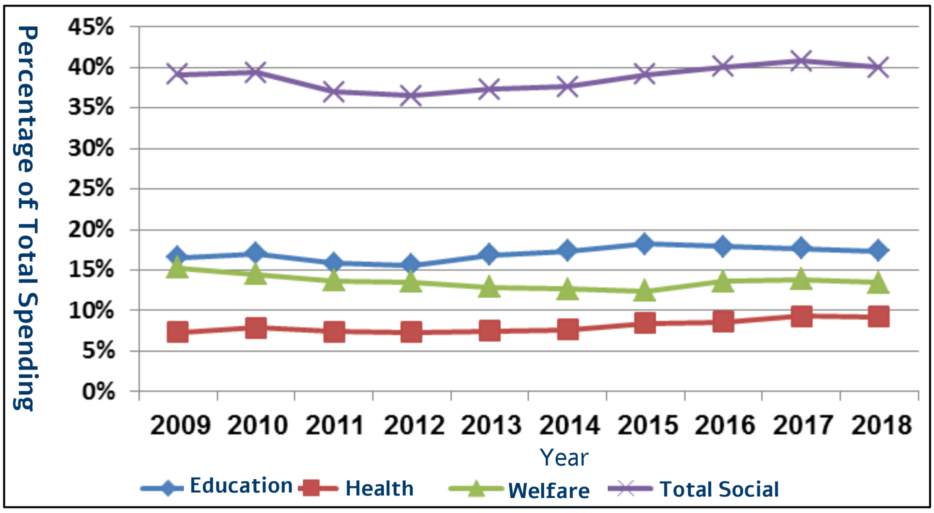
This document is a summary of the research work done by the Israel Regional Initiative economics desk, which was conducted in October-December 2016. The study is intended to present an assessment of the dramatic effects of a regional agreement on the economy and society in Israel. The study's main conclusion is that a regional agreement, leading to economic ties with the region's Arab countries, has far-reaching positive implications for the Israeli economy. It will spur unprecedented economic growth, which will be felt at every level of society. It will lead to growth in disposable income, raise household living standards, narrow social inequalities, and improve the quality of public services delivered to the ordinary citizen.

Introduction

This document is a summary of the research work done by the Israel Regional Initiative economics desk, which was conducted in October-December 2016. The study is intended to present an assessment of the dramatic effects of a regional agreement on the economy and society in Israel. The study's main conclusion is that a regional agreement, leading to economic ties with the region's Arab countries, has far-reaching positive implications for the Israeli economy. It will spur unprecedented economic growth, which will be felt at every level of society. It will lead to growth in disposable income, raise household living standards, narrow social inequalities, and improve the quality of public services delivered to the ordinary citizen.

An analysis of the individual components of the State budget over recent years, as well as examination of the two-year budget for 2017-2018, and especially the budgets following the 2011 social unrest, are proof that besides the analysis of the growth forecasts for the Israeli economy, Israel faces a budgetary "glass ceiling", which will hamper its ability to resolve the fundamental issues underlying Israel's economy and society. It will also thwart Israel's future potential as a prosperous, leading regional economic powerhouse. It is, therefore, impossible to deal with Israel's socio-economic challenges through reshuffling allocations within the budget. The only realistic option is to increase it substantially.

The budgetary glass ceiling – Israel's welfare, health and education budgets have been stuck at a fixed percentage of the budget throughout the entire 2009-2018 period.

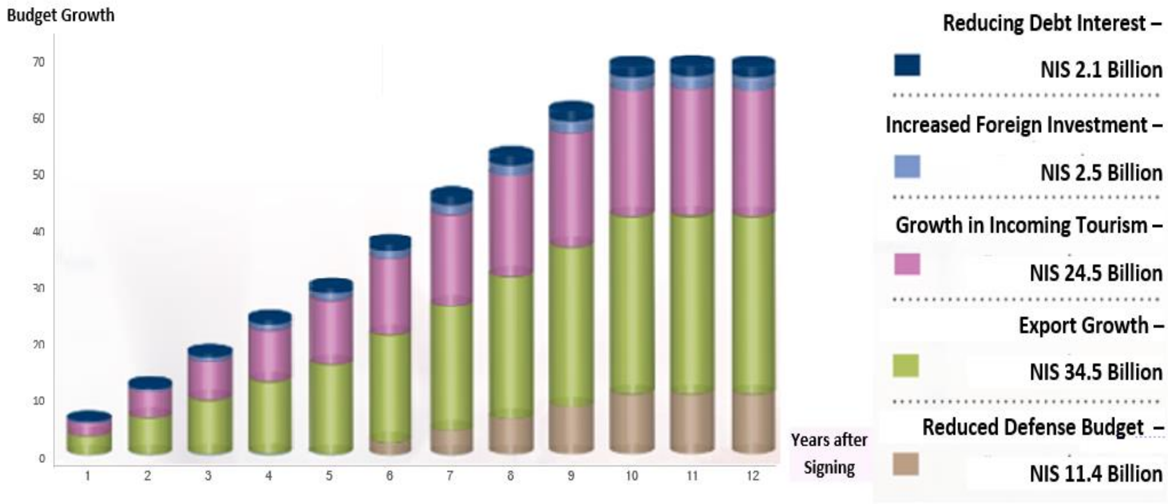


The study shows that only a regional agreement can ensure increasing the available budget, thereby facilitating breaking through the glass ceiling, and allocating the resources enabling the socio-economic reforms Israel needs.

The findings – highlights

1. Without a radical change in the present outline of Israel's economy, the growth rate is expected to slow down considerably, the disparity in the standard of living between Israel and the developed countries is expected to increase, and the budgetary constraints will prevent measures aimed at lowering the cost of living.
2. A regional agreement between Israel and the moderate Arab states can bring about such a change. It can generate dramatic economic impacts through which the solution to Israel's fundamental economic and social problems will come within reach. This will include:
   a. **A $55.3 billion per annum growth in GDP (19% growth).**
   b. **An addition of NIS 75 billion to the state budget sources per year**
3. The economic growth will bring about a rise in the standard of living, which will be felt across all levels of society, creating the necessary resources for reducing the cost of living, improving the lot of the middle classes, reducing poverty, lowering taxes and massive investment in infrastructure, research, education, and health.

Addition of NIS 75 billion to the state budget sources per year



Reference scenario analysis - Israel's economy without a regional agreement

Israel's economy is among the most advanced and developed in the world. The economic development since the state was established is a tremendous achievement, both for Israel's citizens and its governments. There is a lot to be proud of in terms of its many accomplishments in science, research and development, agriculture, medicine, high-tech industry and much more. At the same time economists claim that without a fundamental change, **achievable only through growth and increasing budgetary resources, Israel's economy is in danger.** This is not the place to list all of the issues underpinning this prediction, however we shall focus on some of the most pressing fundamental issues:

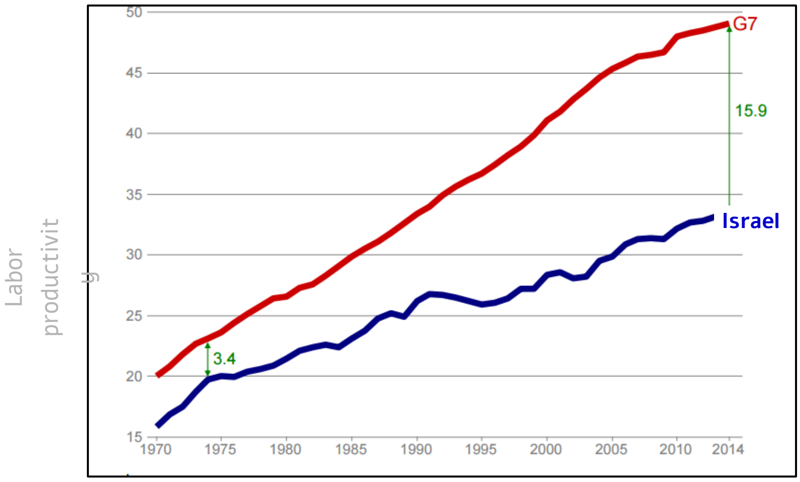
1. **<u>Israel's growth rate is expected to slow down considerably</u>**

   On the face of it, Israel appears to be enjoying the highest per-annum per-capita GDP growth rate among western economies - 2.3% in Israel compared with 0.6% on average in the G7 states. This figure is misleading, since it is a result of cyclic, non-synchronous fluctuations - whereas Israel's economy underwent a recession in 2002-2003, most western countries that went into recession in 2008 are still in the process of recovering from it. A long-term perspective indicates that the periodic cycles in Israel and in the west have revolved around a consistent growth trajectory since the 1970s, leaving Israel behind with a substantially lower Gross Domestic Product than the G7 and with an inability to bridge the gap. Nowadays Israel's GDP per capita stands at $35,330 compared with an average of $43,451 in the G7 and $55,837 in the USA. These figures fail to show the full picture - first of all, they represent the average, which does not take into consideration the gaps between the upper and lower percentiles; secondly, when factoring in the tax burden and the level of services provided by the state, then the negative balance between the disposable income in Israel and the G7 is even wider.

   Not only is the GDP not growing at a rate fast enough to close the gap against the west, many forecasts predict that **the growth rate in GDP will be slowing down considerably in the coming years.** According to the Governor of the Bank of Israel's 2015 report, following the exhaustion of the contribution of immigration to education in the last 40 years, the growth rate is expected to slow down to **1.2% per year only.** According to the report, even if the Haredi population were to enter the workforce, growth would still remain at 1.3% only.

   Another indicator reflecting a forecast reduction in growth is productivity (GDP per work hour). This is the main factor influencing the economy's growth rate and wages. The growth rate **in productivity in Israel is slow, resulting in an ever-widening gap between Israel and the G7:**

Labor productivity, 1970-2014 (source: Dan Ben David, Shoresh Institute and Tel Aviv University)



This is due to the ever-increasing gap between those parts of the population who are competent enough to join the modern economy and those ever-growing parts that are not, as well as from reaching peak exploitation of the growth engines of the advanced technology industries.

These troubling data are expected to **exacerbate the disparities in the standard of living between Israel and the western countries.** Many educated Israelis will no longer have the option of staying in Israel, where they will be bearing an ever-increasing burden of responsibilities without getting paid according to their potential - this will further harm the state of the economy. At the same time, the slowing growth is expected to result in **an increase in unemployment and a drop in household income**. More families will be forced to rely on the state welfare system, whereas the state budget will not be able to find new budgetary resources to pay for them.

If we want to prevent these pessimistic predictions from coming to pass, we must urgently develop **new growth engines**, and find budgetary sources for massive investment in our physical and human infrastructures.

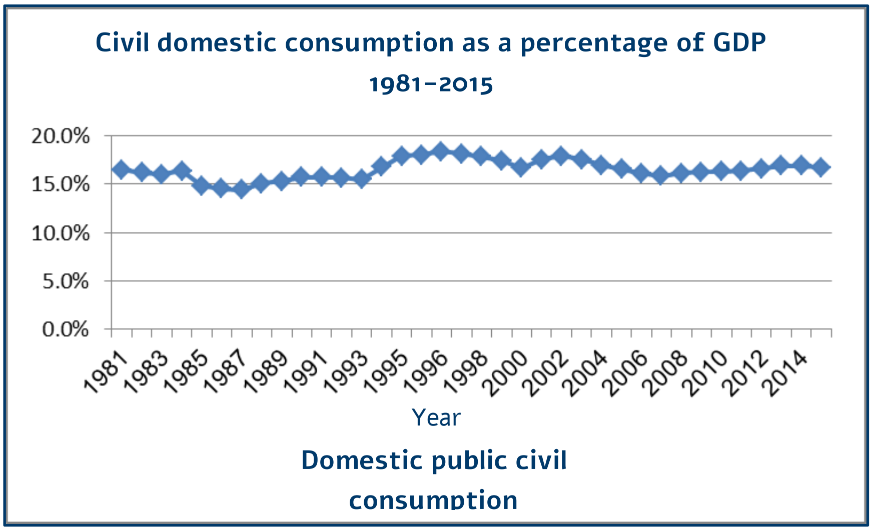
2. **Economic boycott of Israel**

   A deterioration in the political situation might also result in economic sanctions being imposed on Israel and in boycotts of Israeli exports. Even mild sanctions or a consumer boycott abroad might **severely cripple the Israeli economy**, which is an open economy where imports and exports **contribute 80% of the national product**. Economic sanctions and/or a boycott will cause the economy to contract, cause massive unemployment and the national foreign debt will skyrocket, eroding quality of life and national resilience. For every 10% less exports, the economy's growth rate and the private consumption will decrease by 1%.

3. **Lack of budgetary resources for executing social policies**

   Since the 2011 protests, public calls have become ever more assertive to enact a social government policy to solve the high cost of living crisis, to curb the spread of poverty, and to ramp up the meager investments in social welfare services. Under the current circumstances the government cannot embark on real measures to bring about an improvement in the middle classes' standard of living, that will lower the cost of living and will grapple with the nation's poor. An example of this is the social reforms the government carried out after endorsing part of the recommendations of the Trajtenberg Committee, which was set up following the 2011 protests. These measures resulted in limited easing of the burden on households, especially among young families, but since **the existing budgetary sources to pay for these measures could not be found, the government was forced to increase taxes.** Ultimately, the public paid for the concessions it was granted.

As can be seen in the chart below, since the 1980s public civil spending has remained at a virtually fixed proportion of the GDP. In other words, it is clear that civil public spending cannot be increased substantially unless there will be a significant increase in the GDP.



Furthermore, as we have shown above, it is clear that the proportion of government spending on welfare, health and education has indeed not grown despite the 2011 demonstrations.

Finally, the reference scenario shows that if a new way to increase the budgetary pie without raising taxes is not found, then we will continue to be hobbled by the **budgetary glass ceiling, which will prevent the government from carrying out the moves necessary to bring about meaningful change in the level of poverty and in the standard of living of the middle classes**.

The Opportunity for a Regional agreement

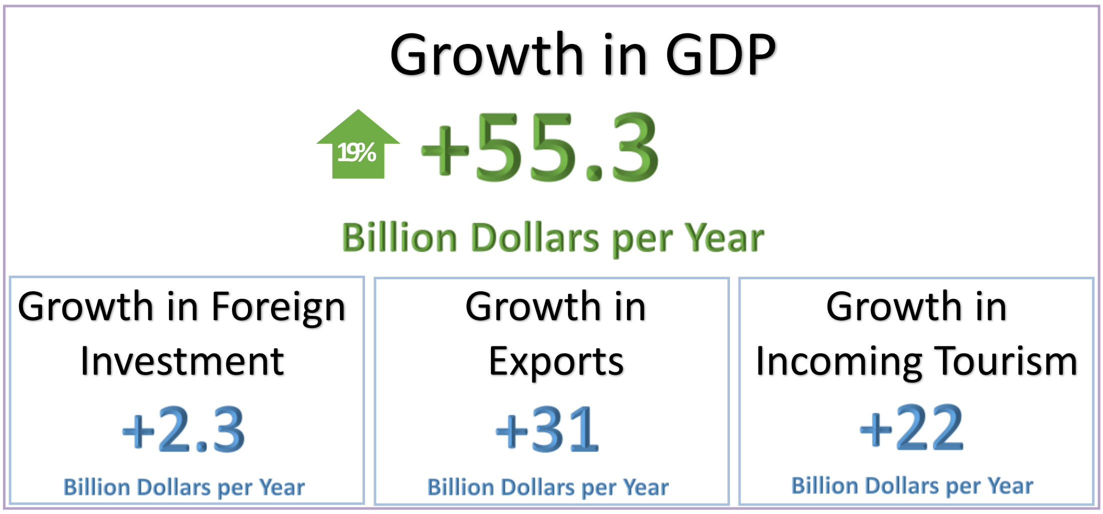
The changes and turmoil now engulfing the Middle East present a new opportunity for a regional agreement. The pragmatic Arab states understand that Israel is not their enemy, but rather a powerful ally in the struggle against the terror organizations and the Iranian threat, and a partner for economic cooperation that will better the lot of all peoples of the region. It should be noted that regional economic cooperation is important both for the Israeli economy and for our national security, since the economic instability and the growing unemployment in the neighboring countries constitute a security threat to Israel.

It becomes possible, therefore, to leverage the shared interests of the states in the region, and to advance a “regional package deal”, which will enable gradual disengagement from the Palestinians into two separate states, will enable regional security arrangements, and will facilitate regional security arrangements along with an economic plan for reconstruction of the Middle East. The result will be a regional alliance, which will weaken Iran and radical Islam, will spur economic growth, and will fight radicalization and escalation of regional instability.

The Target Scenario - Effects of a Regional agreement on Israel’s Economy

The study has come to unequivocal conclusions regarding the dramatic effects of a regional agreement on Israel’s economy. 10 years after signing such a regional agreement, GDP is expected to grow **by $55.3 billion per year**. Additionally, new disposable sources will become available to the state budget, **totaling NIS 75 billion per year (a 20% growth in the national budget)**, which will be able to serve for realizing a far-reaching social economic policy, including implementation of the Germann, Alalouf, and Trajtenberg Committees’ recommendations. The economic effects of the settlement will be felt throughout the entire population, bringing **about a considerable improvement in the economic standing of all Israeli households**. These are the main social effects:

1. <u>Increased Gross Domestic Product:</u>

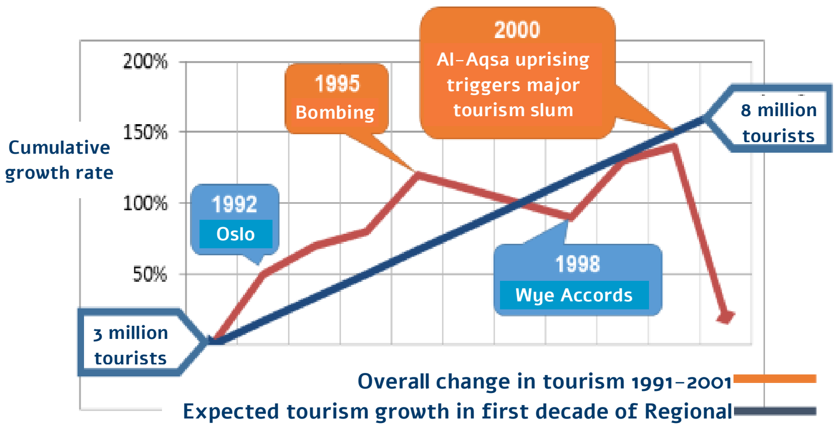


   a. <u>Increase in incoming tourism</u>

Israel's geographic location, its mild weather, its historic value and its position as a holy land for the three monotheistic religions, position Israel as a world-class tourist destination. Fears and concerns over the security situation, as well as the fact that Israel has been subjected to boycotts by numerous countries, has so far constricted this status. By reaching a regional agreement, all obstacles will be removed, the floodgates for investment in tourism infrastructure will open and will doubtless dramatically increase incoming tourism to Israel, including tourism from the region's countries.

To estimate the growth rate expected following a regional agreement, we shall consider several test cases. Between 2010-2015, 3.37 million tourists entered Israel on average every year. The number of tourists entering Egypt in 2010 reached a record 14 million, mostly from Europe. There is no reason why, in future, in a state of stability and security, the incoming tourism to Israel should not reach the same proportions. Additionally, in a study published by Dr. Yaacov Sheinin and Noa Zvi in January 2008, the religious tourism potential for Israel up until 2025 is estimated at about 7.5 million per year, not taking into consideration the potential effects of a regional agreement. Lessons can also be drawn from past political agreements and the positive impact they had - incoming tourism to Northern Ireland in the decade following the 1998 Good Friday agreement increased 6-fold (from 1.47 to 7.74 million tourists per year), and in the years of the Oslo accords, between 1992 and 1995, the number of incoming tourists to Israel rose by 47% in three years (from 1.5 million to 2.2 million).

With the above in mind, a conservative estimate, accepted by the professionals in the field, is that during the 10 years following the finalization of a regional agreement, the number of incoming tourists to Israel will reach about 8 million per year (an increase of about 5 million). The following chart shows our estimate of the growth in incoming tourism based on the growth experienced during the Oslo period:



Assuming direct tourist spending in Israel is about $1500, this is a direct increase of $7.5 billion to the GDP, from the tenth year onwards. If we factor in also the derivative output (output of industries producing products and services for the tourism industry), and the output from consumer spending by those employed in the tourism industry, then tourism's contribution to the GDP (according to a 2.91 multiplier) would be $22 billion.

b. **<u>Increased exports:</u>**

Many countries in the region have an interest and desire to expand their economic ties with Israel. These countries are aware of the fact that Israel's technological knowhow and experience in fields such as agriculture, water, health and energy could potentially help to improve their own economies and the welfare of their own citizens. However it is clear that the progress in the political process and resolution of the Israel-Palestinian conflict will be a prerequisite for any breakthrough in this matter.

During the last decade, the Middle East has been one of the regions with the highest economic growth in the world, second only to eastern Europe and south-east Asia in terms of increase in product and international trade. Whereas between 2003 and 2011 global imports of goods and services rose by 130%, imports from the Middle East rose by 250%. All Muslim countries combined import goods worth $1.9 trillion per year.

Turkey is a good example of the economic potential of strengthening economic ties. In the previous decade, Israeli exports to Turkey grew 4-fold despite slumps in bilateral diplomatic relations. Trade grew consistently and encompasses a broad range of industrial and other products. Israeli exports to Turkey between 2013-2015 stood at an average of about 1.02% of Turkey's total imports per year. Based on this Turkish model, the export potential to the Muslim countries can be estimated as well. 10 years after signing a regional agreement, imports from Israel in these economies will also, like Turkey, stand at about 1.02% of the $2.3 trillion - meaning about $23 billion additional Israeli exports per year.

There is no doubt that a political settlement will also have an effect on Israeli exports to the rest of the world. In the past, in periods where it seemed the Middle East was heading toward a political settlement, Israeli exports grew at an accelerated rate - between 1993-1995 (the Oslo process years) Israeli exports grew by about 67% in three years. A similar growth rate, if spread over 10 years, will create a moderate growth of $1.15 billion per year in the first ten years following the agreement, up to an addition of $11.5 billion to Israel's exports from the tenth year onwards.

The bottom line, then, is that an additional $23 billion in exports to countries in the region, plus $11.5 billion additional exports to the rest of the world, means a total of about $34.5 billion per year. If we use a 0.9 multiplier to estimate the contribution of the exports to the Gross Domestic Product (according to a model developed in 2010 by Dr. Amit Friedman from the Bank of Israel's research division and Prof. Zvi Hershkovitz of the Tel Aviv University), the addition to the GDP thanks to the expected increase in exports is estimated at $31 billion per year.

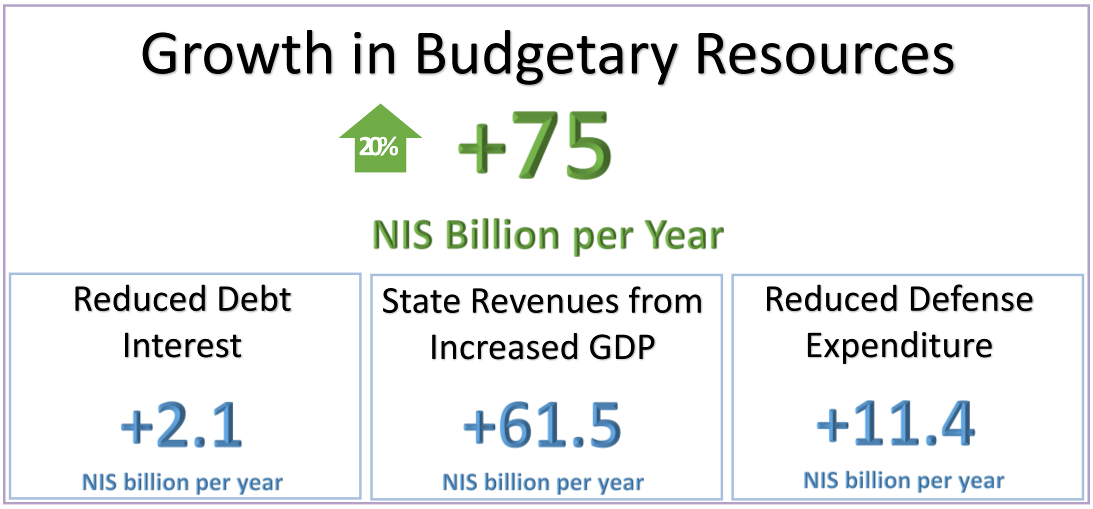
c. **Growth in foreign investments in Israel**

FDI – Foreign Direct Investment - is considered to be one of the main growth vectors for economies in general and of small countries in particular. Israel is known as a hot spot for world-class breakthroughs in a variety of fields, and these turn into world-class success stories, constituting growth engines and sources of profit for Israel's economy.

With the arrival of a regional agreement, once the security uncertainty is lifted and the credit rating is raised, Israel will be an even more attractive destination for investors and companies, including national and private funds, including from Muslim countries, which have so far avoided investing in Israel. Foreign investment in Israel after the acceleration of the political process in the 1990s, can teach us about the potential of a future settlement. Between 1994-1996, investments jumped about 6-fold in two years (from $415 million to about $1.984 billion). Foreign financial investments also grew during those years by 86% (from $183 million to $340 million).

Foreign investment in Israel today amounts to less than one-tenth of one percent of the total Foreign Direct Investments worldwide, meaning the growth potential is immense. A careful estimate is that a regional agreement will double foreign investment in Israel within 10 years. This will occur with a growth rate if $1 billion per year from the tenth year. If we use the model published by Yoel Hecht, Assaf Rezin and Nitzan Shinar for estimating the effects of foreign investments on GDP (a 0.23 multiplier), we will find that this added investment will increase GDP by about $2.3 billion per year.

2. **Growth in National Budget Sources**



a. **Growth in tax revenues**

According to the estimates presented above, in the first 10 years of a regional agreement, the addition to the GDP is expected to be about $55.3 billion per year, meaning a 19% growth in output, **above and beyond the growth forecast in the**

absence of a settlement. According to accepted economic models, the growth coefficient in state revenues from taxes proportional to the growth in Gross Domestic Product is 1.2. Therefore, a 19% growth in GDP will result in a 22.8% increase in tax revenues, which in 2015 stood at about NIS 270 billion per year. From this we can deduce that the growth in tax revenues will be about NIS 61.5 billion per year.

b. **Lowering the interest rate with the upgrading of Israel's credit rating**

Israel's current international credit rating stands at A+. This is quite a good rating, but it is low for a country that weathered the 2008 financial crash better than any other OECD country, and which has since then exhibited the highest growth rate of any of that organization's members. Israel's real economic state justifies an AA credit rating, however the instability in the Middle East raises concerns among investors regarding investing in Israel. Israel's credit rating is dragged downwards as a result.

Israel currently issues bonds worth NIS 33 billion per year on average, its total foreign debt is about NIS 110 billion and its domestic debt is about NIS 600 billion. According to data from international markets today, raising the credit rating to AA will enable Israel to issue bonds at a credit rate of about 0.4% less than the average today, which will save about NIS 2.1 billion every year.

c. **Lowering the defense budget starting from the fifth year after the settlement**

A regional agreement is expected to enable a gradual reduction, beginning with the fifth year after the settlement, in the percentage of the defense budget out of the GDP. It should be possible to reduce the national defense spending between the 6th and 10th year following the settlement by about 3.2% per year. The reduction will be a gradual process, measured and prolonged, and it will begin only 5 years after signing the agreement, to ensure security and stability according to the prevailing conditions in the region. According to this estimate, beginning with the tenth year after signing the agreement, the cut in defense spending will reach about NIS 11.4 billion per year (out of a total spending of NIS 70 billion per year today).

Potential Uses for the Added Sources to the National Budget

Compared with the rest of the OECD countries, Israel is at a considerable disadvantage in terms of resource allocations in several services. This relative shortfall is especially apparent in the health and welfare services. The sources freed up, and those that will be added on to the national budget will be able to bring about a substantial, even dramatic, improvement in these areas, in the hope of reaching parity in our civil service levels with the most advanced western countries.

There can of course be many different uses for these added resources. We have chosen to present one example of potential uses, which address the most acute pain points listed in the Trajtenberg, Germann and Alalouf committees:

1. An addition of about NIS 34 billion to the **health** budget, which will be directed toward rectifying the severe distortions currently pervading the health system and for easing the financial burden currently shouldered by the public: addition of nurses, shortening wait times, addition to the National Insurance for long-term nursing care, building of new hospitals and enlarging the existing ones, increasing the number of hospital beds, dental care for children and the elderly, etc. For example:
   - Hospital beds per thousand inhabitants – 3.4 instead of today's 1.9.
   - Nurses per thousand inhabitants – 8.8 instead of today's 4.8.
   - Occupancy rates – 77% instead of today's 98%.
2. An addition of about NIS 6 billion to the **education** budget would **enable free education for ages 0-3**, reinforcement of the academic research and of the teaching faculty in the universities, slowing down the brain drain from Incremental and even returning them home, and subsidizing students in the academic colleges.
3. An addition of NIS 10 billion to the investment in infrastructures for the periphery as a tool **for lowering the housing costs**.
4. NIS 10 billion to **reduce taxes on fuel and sales tax on new cars**.
5. An addition of NIS 2 billion to the **homeland security** budget, which would go to adding and equipping 3000 policemen.
6. An addition of NIS 4 billion to the **welfare budget**, which would be used to double the ceiling and duration of unemployment benefits, and for raising the average assured income payments to half the national average wage, which would substantially improve the lives of about 100,000 families in Israel. For demonstration purposes only, we can show the following growth at the monthly level:

   General disability allowance of 100% would increase from NIS 2,342 to NIS 4,342

   Surviving family benefits for elderly widowers would increase from NIS 1,617 to NIS 2,617

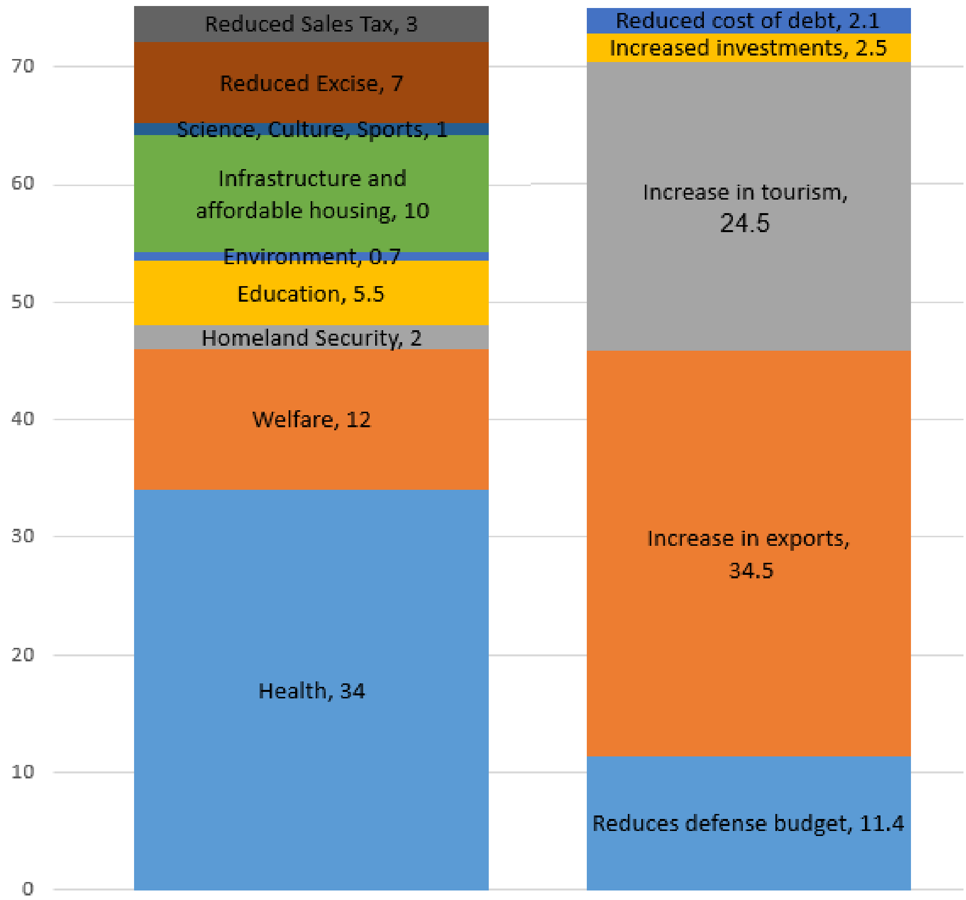
   Old age benefits for individuals would increase from NIS 1,531 to NIS 2,531

   Average guaranteed income benefits would increase from NIS 2,100 to NIS 4,500
7. An addition of NIS 6 billion to **the culture, science, sport, environment, etc.** budgets.
8. To summarize, bases on the family expenditure survey from the Central Bureau of Statistics:
   a. The private consumer basket would increase by 18%.

b. Housing expenditure would drop by about 10%.
c. Health spending would drop by about 20%.
d. Spending on education, culture, and entertainment would drop by about 10%.
e. Private transport and communication expenditure would drop by about 10%.
f. Thus thousands of shekels would be added onto each family's domestic budget in cash or cash equivalent.

Potential uses – NIS 75 billion per year

Growth in Budget Sources – NIS 75 billion per year


Reduced Sales Tax, 3
Reduced Excise, 7
Science, Culture, Sports, 1
Infrastructure and affordable housing, 10
Environment, 0.7
Education, 5.5
Homeland Security, 2
Welfare, 12
Health, 34
Reduced cost of debt, 2.1
Increased investments, 2.5
Increase in tourism, 24.5
Increase in exports, 34.5
Reduces defense budget, 11.4
70
60
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