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THE ISRAELI ECONOMY: A NEW ECONOMIC GAME PLAN

Last Spring I presented a set of proposals purported to alleviate the economic crisis facing the Israeli economy. These proposals were seen by some high-ranking Government officials. Aside from evoking sympathy on the part of these people and the reassurance that certain programs were being currently undertaken along similar proposed concepts, very little if anything was ever implemented.

Naturally I cannot expect that a massive overhaul of present economic policies could be undertaken purely on my suggestions. This is so as moving to a new set of policies along the lines I suggest would entail a philosophical reversal in the present thinking. Furthermore, these proposals do not share in the mainstream of current orthodox economic thought.

My views are not new: they have successfully been implemented at different times in countries such as Taiwan and Brazil. The difficulty lies not in their implementation as much as in the Authorities' acceptance of an economic philosophy that stresses the positive aspects of incentives to the private sector (domestic and foreign) and the negative aspects of 'Big Government.'

THE PROBLEMS

One must of course take full recognition of the heavy military and social burdens that the country must bear. Whatever security, absorption and other welfare spending the Government considers essential are assumed to be working constraints in the overall model. Given these constraints however, the economy still suffers from the following redressable problems:-

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(a) A complete lack of entrepreneurial activity demonstrated by well-to-do immigrants coming from North and South America and Europe. Low productivity and inefficiency at all levels, private or public, may be classed in the same category,

(b) A widening payments imbalance resulting from an accelerated flight of capital and an insufficient inflow of capital from the capital-rich Diaspora,

(c) The vicious cycle of currency depreciation - inflation - a case of reverse causation that baffles and then brings to naught any successful stabilization policy,

(d) The ever-growing Public Sector, a bureaucratic monster that is partly to blame for (a) and (b).

SOLUTIONS

These solutions are naturally easier said than done. They are, nonetheless, obvious to any student of social and political economy.

The Authorities must strive to:

- i) end Government's ever-increasing encroachment on the private sector;
- ii) make the earning of incremental profits proportionately less onerous;
- iii) move away from its increasing dependency on charity by offering sound and potentially profitable opportunities to its own constituents and the many million Jews abroad;
- iv) lower the nation's high propensity to consume and raise its savings/investments function, thus fostering much-needed capital formation;
- v) change its set of economic priorities so that Currency Stability is given more weight than Full Employment. The folly of allowing Full Employment to be the nation's Number One economic objective is understood in present Official circles (present budgetary measures are 'planning' 60,000 unemployed). In a vigorous economy, the Public Sector's unemployment will readily be absorbed by the Private Sector. What has as yet not been realized is that Currency Stability lies at the very heart of an economic system that praises trust, thrift and hard work. The converse will slowly destroy the social, moral and political fabric of any society.

The disintegration of Weimar Germany and, more recently, Argentina as a result of currency debauchment should alert the Israeli Authorities to the fact that they can no longer ignore the accelerating depreciation of the lira.

POLICIES FOR IMPLEMENTING PROPOSED SOLUTIONS

The Government must publicly proclaim-

(1) (In response to (i) and (ii) of above) That it is disposed to reduce its share of the total GNP, presently at 46%, to an ideal 25% over the next 10 or 15 years. The Government's present absorption of such a huge percentage of total resources fosters ever-increasing fiscal delinquency, and reduces significantly working incentives.

The present system of progressive taxation should stop at the 35-40% level for the individual and remain at that level for any subsequent earning increments. In order to achieve a much higher degree of capital formation, corporate taxes must be reduced to an effective 20% rate, provided that retained earnings are being re-invested. Generally speaking, re-investments could include the company's own expansion and modernization activities and/or other equity ventures such as investments in other businesses or publicly traded shares to the exclusion of deposit-type investments.

The country's horrendous flight of capital problem would thus be partly resolved as capital will find it advantageous to seek high domestic returns.

As a further step to de-emphasize the Government's encroachment on the Private Sector, the authorities should dispose of all of its non-essential, non-classified businesses by selling shares in these companies to domestic and foreign investors. Iran and Chile are presently undertaking such a reversion and the idea is therefore not novel. Furthermore, these distributions to the Private Sector would presumably raise substantial amounts of funds that will go some way towards covering budgetary deficits resulting from lower taxation. It must be clearly understood that low rates of taxation will in the long run enlarge the tax base sufficiently to cover for any current loss of revenue.

If the Government can communicate a high degree of credibility in espousing this programmed reduction in fiscal take, it will undoubtedly end up with a far more vigorous, vibrant, and productive economy than at present.

(2) (In response to (iii) and (iv) of above) While correct in its own assessment that the nation's high propensity to consume must be lowered, the Authorities have erred in the means of achieving it. Indeed while heavy taxation does temporarily lower consumption, it also impoverishes the consumer. Eventually the consumer will rebel against such a forced imposition on his living habits and will try to regain his previous standard of living by going more heavily into debt. Partly aided by an accommodating Central Bank, this increase in private debt expands the money supply and its velocity of circulation, thus creating more inflation. It also causes the private sector to become increasingly illiquid. Finally, it tends to reinforce the Israeli citizens' attitude of "Enjoy today for tomorrow you will die".

The public must be allowed to choose between saving and consuming. If savings will provide a high enough rate of return - i.e. a positive rate of return that will cover the progressive loss of purchasing power. By voluntarily choosing to save/invest rather than consume, money velocity will subside and the individual will become wealthier; this wealth effect will definitely make for higher work incentive. As the Government slowly and hopefully moves into budgetary surplus, it will liberate investment funds for use in the private sector. The initial "crowding out" effect of heavy and costly Government borrowing on the financial markets is a necessary evil resulting from the priority assigned to guns over butter. It will however be a far more equitable form of capital allocation.

The Government's initial budgetary deficits should be covered by borrowing domestically and abroad in the form of Treasury Bills at highly competitive rates (preferably denominated in Israeli lira). As an example, one month Treasury Bills will be issued yielding the investor a positive real rate of 3% per annum. At the present time and assuming present taxation rates, such bills will yield approximately 50% per annum. Alternatively, tax-free Treasury Bills may be issued to yield 30-35% per annum, thus equalizing returns to domestic and foreign investors.

These Treasury Bills should also be offered in the Diaspora through private underwriting channels alongside with the continuing Israel Bonds campaign. They will undoubtedly attract a fairly sophisticated and moneyed clientele while, at the same time, they will not derail present traditional fund raising methods. The Bills should be issued in Bearer form so as to allow the repatriation of enormous amounts of Israeli capital and also raise very considerable amounts of Diaspora's 'anonymous' capital.

Beginning with very short maturities (such as one month), the Bills will be slowly rolled over into lengthier maturities at reducing rates.

This budgetary technique is the cornerstone of an effective Stabilization Policy and was tried rather successfully in Taiwan in the late 50's and early 60's.

(3) (In response to (v) of above) Lower monetary expansion to just below the present inflation rate and continue to tighten monetary creation until a moderate 4-6% annual rate is achieved. This policy is now followed in most OECD countries and has already shown some success in lowering high inflationary rates.

Monetary authorities have erred in their diagnosis of the foreign exchange situation. They have thus applied the wrong medicine. Indeed the recent policy of periodical devaluations - forced in turn by parallel market developments - does little to improve the nation's trade imbalance. This is so primarily because

(a) most imports such as defence goods are highly unelastic; and (b) imported items in themselves become inflation hedges and are sought after regardless of present costs. The drop in the external value of the lira then is non-equilibrating in a balance of trade sense. Moreover, it is highly inflationary; directly so by raising the cost of imported items and straining the productive capacity of the export industry. Indirectly, by raising the cost of domestic manufacture whenever local industry uses imported raw material. Finally, on a purely psychological level it creates an atmosphere of distrust in the currency raising monetary velocity and thus feeding inflation.

In my view the lira's recent accelerated decline may be attributed almost entirely to a heavy flight of domestic capital concerned about

- (a) heavy level of taxation,
- (b) lack of incentives to the private sector; and
- (c) the political military situation.

While little can be done along economic lines about (c), a great deal can be done about (a) and (b).

Summarizing our argument, currency devaluations are not taking place as a result of - nor are they likely to improve - the balance of trade deficit. The only method of halting the agonizing and extremely harmful decline in the lira's external value - which breeds further domestic inflation - is by inducing domestic capital to remain in Israel.

Stop taxing it to death. Stop putting bureaucratic stumbling blocks to the further development of private industry.

While the above suggested program is being carried out, the lira must be allowed to float freely. The parallel market will no longer be necessary. The immense sucking power of Government borrowing abroad by paying competitive rates will slowly firm up the sagging Pound and eventually stabilize it. The flight of capital partly due to currency depreciation will also be substantially reduced.

Present economic policies have failed. The multiplicity of subsidies, taxation, exchange rates and controls breed distrust, cheating, inefficiency, low productivity and finally is partly responsible for net emigration. The battle on the domestic front must be fought with new strategies and new weapons. We cannot allow, G-d forbid, that domestic failure accomplishes what 100 million Arabs have not been able to do for 25 long years of struggle and survival.

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