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Palestine Economic Policy Research Institute (MAS)

Background Paper

Roundtable (8):

The Impact of the recent Israeli economic measures to cover the cost of its War on Gaza on the Palestinian Economy

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1. Background and Justifications

The recent Israeli aggression on the Gaza Strip has led to the expansion of Israel's governmental spending, particularly military expenditures, and to an unexpected deficit in the general budget. These direct and indirect military expenditures and budget deficit were covered through several means; the most important of which is hiking of taxes, reduction of spending on some social programs and services and deferring some exemptions that were to be given to a number of Israeli community segments and groups.

In addition to the increased military expenditures and the resulting financial burdens, the Israeli economic activities and indicators have been subjected to some changes that carry both short-term and medium-term implications and which require the introduction of new economic and social measures. Indeed, there was the actual ratification of a part of the economic measures while other measures are currently being discussed or awaiting ratification. Due to the multiplicity and depth of the intertwining channels between the Palestinian and Israelis economies and the delicate Palestinian economic reality with regard to the political, security and economic changes in Israel, it is expected that the Palestinian economy and its various components would be affected by the actions and measures adopted by Israel.

The current complex links between the Palestinian and Israeli economies present us with a number of questions about the impact of the Israeli government's actions and measures on the Palestinian economy with its various activities and sectors and; as well as questions about the effect of the decisions and policies that are currently being discussed and examined by Israel. In particular, questions are being raised about the economic sectors that are most prone to being affected by the Israeli measures and what precautionary measures are needed by the Palestinian National Authority with regard to these effects.

As part of its mission and objectives, discussing the economic and social issues of priority among policy-makers and others concerned with the Palestinian economic affairs, the Palestine Economic Policy Research Institute (MAS) seeks to hold a roundtable session where there would be a serious discussion between the various stakeholder and specialists while attempting to find answers to the questions posed during the discussion. This Paper is intended to provide a basis for focusing the discussion on three main topics: The First is the cost of the recent Israeli aggression in relation to the Israeli economy and this includes both the direct and indirect costs. The Second tackles the measures that were taken or are about to be taken by the Israeli government in order to address the shortages and cover the costs pertaining to the aggression. The Third is concerned with studying the impact of the Israeli measures on the Palestinian economy.

2. The Cost of the Aggression in relation to the Israeli Economy

The moment the recent Israeli war on the Gaza Strip came to an end, the facts and results of that war started being unveiled. Any person who follows political affairs is able to monitor the political consequences and effects that Israel sustained, particularly the damage to its image in world public opinion. Additionally, it is possible to discern that a sizeable damage befell the internal Israeli front due to the war; and in particular the difficulties suffered by the Israeli government when dealing with the residents of what is called the "Gaza Envelope" settlements. But, in parallel with the political impact and the damages done on the internal front, there have also been multiple effects that affected the economic and financial aspects, which are not less important. These effects can be divided into two main parts: 1) The direct and immediate effects mainly related to the direct costs of military operations, military spending and material damages; and 2) The indirect (implicit) effects related to the impact of the government's orientations translated on the ground through decisions and policies and pertaining to the economic and social spheres in the context of dealing with the financial burdens and additional military spending resulting from the war.

✧ Direct Financial Effects:

The Israeli economy suffered some direct losses and damages as a result of the Israeli aggression on the Gaza Strip. These losses were primarily represented by the direct financial costs of funding the military operations. According to Israeli sources[1], the aggression's costs reached approximately 9 billion Shekels spent on the war effort during the military operations. From another aspect, the Israeli government allocated special funds for the Israeli families that were directly affected from the war; and specifically the families that were living in the settlements adjacent to the Gaza Strip as well as the companies operating there. The overall amount of financial allocations reached around 2 billion shekels[2].

In general, there are no accurate and reliable estimates of Israel's direct financial losses due to the recent war on Gaza as the sources of these estimates vary and differ. The estimates of the overall direct cost ranged from 6.5 to 9.0 billion Shekels[3]. It is important to note here that the estimates pertaining to the cost of this war have been subject to political tensions between Israeli factions and are affected by them. Therefore, there were differences in the estimates of the two main institutions of the Israeli government. Thus, whereas the Defense Minister estimated the cost of the war to be around 9 billion Shekels, the estimates of the Finance Minister were much less at around 6.5 billion Shekels. Therefore, the estimates pertaining to this matter remain subject to discussion and refutation by analysts and specialists. However, these numbers could still give us an idea or indication about the size of the damage and economic costs to Israel of its recent war on Gaza.

In order to resolve the controversy surrounding the estimation of the direct costs and losses of this War and in light of the circulated figures and estimates, the Israeli Army sent an official letter to the Ministry of Finance requesting the increase of Army Budget allocations by the amount of 18 billion Shekels. This number consists of the contingent increase on the current year's budget (NIS 7 billion), in addition to an increase in the next year's budget (NIS11 billion). In case there is an agreement regarding these additions, the Army's budget of 2015 will reach 70 billion Shekels in comparison with 58.4 billion Shekels in 2013[4].

✧ Indirect Effects:

The Israeli losses from its war on the Gaza Strip were not limited to the direct financial costs emanating from the war, but they also included other economic and social aspects that were strongly affected. Estimates pertaining to the effects on the Gross National Product (GNP), with its various components, are considered to be the most expressive indicator showing the implicit and indirect costs of this Israeli war. One of the most important implications of this war is the drop in the level of optimism regarding the economic growth that was observed in the beginning of 2014. The Central Bank of Israel's forecasts noted that the current year will see a decline of economic growth of more than half percent (from 3% reduced to 2.5%)[5]. Moreover, the actual data covering the Israeli economy's performance points out that the achieved rate of growth in the year's first quarter was 2.8%, whereas this rate fell to 1.7% in the second quarter[6]. According to some analysts' estimates[7], Israel's Gross Domestic Product will see a decline of between 1.5% and 2.0% in the third quarter in comparison with the previous quarter. Also, the forecasted economic growth for the upcoming year (2015) decreased from 3% to 2.8%[8].

1 http://www.timesofisrael.com/gaza-war-cost-2-5-billion-yaalon-says/
2 http://www.ibtimes.co.uk/gaza-strip-crisis-war-costs-total-6bn-palestine-2b-israel-1459985
3 http://www.israelnationalnews.com/News/News.aspx/185126
4 Palestine Economic Policy Research Institute (MAS), Economic and Social Monitor, Volume 37, September 2014.
5 http://www.israelhayom.com/site/newsletter_article.php?id=19397
6 http://www.businessweek.com/news/2014-08-24/gaza-war-risks-pushing-slowing-israeli-economy-into-contraction
7 ibid
8 ibid

In formulating estimates and forecasts relating of Israel's economic performance, specialists relied on the past and future impact on the main components of Israel's GNP. Estimates show[9] that the Israeli exports were affected by the climate which preceded the war, whereas the Israeli exports (which constitute about one-third of the Israeli economy) saw an 18% decline in the second quarter of this year and this is an indicator that shows the economic performance being affected even before the start of the aggression on Gaza. In another indicator covering the economic performance that was affected during the aggression on Gaza, data showed[10] a 1.2% decline in the Tel Aviv Stock Index whereas the world stock indices witnessed an average increase of 1.2%. In the same context, the Tourism sector – which accounts for about 7% of Israeli economy – was also significantly affected during the 51-day aggression. Data also showed[11] that the number of tourists coming to Israel in July 2014 was 26% less than the same month in the preceding year. The same source pointed out that the losses suffered by the Tourism sector as a result of the war amounted to 566 million Dollars.

In relation to prices in Israel, estimates show[12] that the Israeli Economy saw a sudden drop in the prices of goods and services whereas the rate of inflation fell to zero. These analyses attribute this decline to the reduced level of general consumption by Israelis.

Consequently, despite the varying estimates of losses and damages suffered by Israel's economy due to its aggression on Gaza, these figures -regardless of their precision- will surely be reflected and translated into new Israeli governmental decisions and measures, and the government will need a number of instruments to implement them. The aim of the Israeli governmental measures is to compensate for the incurred losses and to fill the financing gap that emerged as a result of the increased spending on the Gaza war.

3. The Israeli Measures

The Israeli political scene witnessed a huge controversy in the period following the aggression on Gaza. It is also clear that some political factors and factional aims are standing behind the differences in the estimates among the different parties. Additionally, it seems that these differences are related to the nature and impact of the measures and actions that are currently being discussed.

In any case, the official data of Israel's 2014 General Budget showed that the deficit level in the three months (June-July-August) witnessed a dramatic surge. While there was a Budget surplus in the month of May totaling around 1,927 million Shekels, the month of June recorded a deficit of 5,076 million Shekels to have the cumulative deficit reach 4,314 million Shekels. So if we add to that the deficits of 2,242 million Shekels and 1,899 million Shekels for the months of July and August respectively, this would have the overall cumulative deficit in the Israeli Budget reach 8,454 million Shekels at the end of August 2014. This deficit constitutes around 5.8% of the overall Budget as of that date. It is also worth noting that the beginning-of-year's estimates show that the expected rate of Budget deficit would be only 2.5% of the Budget (see Figure 1).

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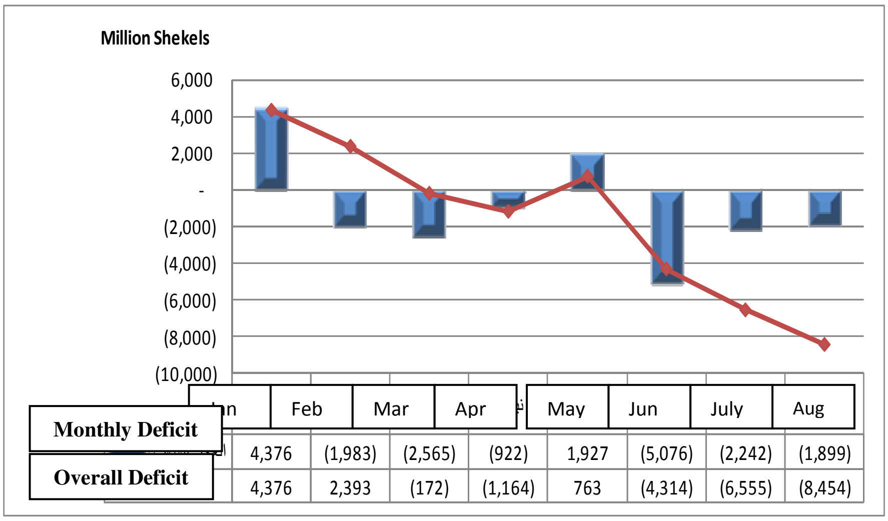
9 ibid
10 ibid
11 ibid
12 http://www.bloomberg.com/news/2014-09-15/israel-finance-ministry-cuts-gdp-growth-estimate-for-2014-2015.html

Figure (1): Monthly and Cumulative Deficits in the Israeli Budget in the First Eight Months of 2014 at the Current Prices

(Million Shekels)



	n	Feb	Mar	Apr	May	Jun	July	Aug
Monthly Deficit	4,376	(1,983)	(2,565)	(922)	1,927	(5,076)	(2,242)	(1,899)
Overall Deficit	4,376	2,393	(172)	(1,164)	763	(4,314)	(6,555)	(8,454)

Source: The Israeli Finance Ministry Website (www.financeisrael.mof.gov.il)

Discussions in Israel related to estimating costs and the ways of covering the deficit (approximately 8.5 billion Shekels), at times diverging or contradictory propositions were put forward. Some of the propositions aim to increase the revenues in the general budget by imposing additional taxes or fees, or increasing them, or canceling the tax exemptions for some groups.. Other propositions aim to reduce spending and canceling allocations for social projects and programs. Table (1) lists the most important propositions made and the corresponding savings or the increase in revenues expected as a result of that.

Table (1): Propositions considered in Israel that affect revenues and expenditures with view to cover the deficit resulting from the war on Gaza

Suggested Measures for Reduced Spending	Expected Savings (Billion Shekels)
Lowering children benefits by third	2.0
Shrinking budget by 2%	2.0
2% reduction in Public sector wage increase	2.0
Reducing elderly benefits (pensions) by 10%	2.0
Rejection of request to increase pub. Sector wage	1.0
Increasing payments toward pension funds to 7%	0.9
Reducing allowance of chief scientists by half	0.75
Reducing roadwork’s budget	0.7
Student support system completely cancelled	0.5
Student transportation budget reduced by half	0.5
Stopping works on valley train	0.5
Stopping works on Jerusalem-Tel Aviv highway	0.5
Rejecting plan to extend Jerusalem metro	0.5
Rejecting plan to establish Tel Aviv metro	0.5
Rejection of plan to extend Road 6 to north and south	0.5
Rejecting plan to improve higher education sector	0.4
Rejecting plan to reduce waiting times for patients in the health sector	0.3
Reducing immigrant support basket by 50%	0.2
Rejecting project to computerize education	0.15

The Proposed Measures for Increasing the Revenues	Expected Additional Revenues (Billion Shekels)
Cancelling tax-break for education employees mutual fund	4.5
Increasing VAT by 1%	4.0
Cancelling VAT tax-break on vegetables and fruits	3.0
Increasing income tax by 1% on all tiers	2.5
Reducing parent-support budget by half	2.1
Tax on construction permits exceeding 10 million NIS	2.0
Increasing health tax by 0.5%	2.0
Tripling tax on coal consumption paid by electricity company	1.6
Increasing tax on fuels by 0.5 NIS	1.5
Cancelling tax benefits for workers in national developing areas	1.5
Reducing tax benefits for upper 10% income bracket	1.1
Imposing ownership tax of 1% on ownership of third home	1.0
Increasing tax on stock market profits to 30%	1.0
Increasing contribution of employers into national insurance	1.0
Cancelling gradual breaks aimed at improving investment in financial markets	1.0
Cancelling VAT breaks for tourism services	1.0
Cancelling VAT breaks in Eilat	0.8
Increasing corporate tax by 1%	0.7
Doubling payment ceiling for national insurance	0.7

Reference: http://www.calcalist.co.il/local/articles/0,7340,L-3640834,00.html?ref=ynet

There has been an agreement among the Israeli factions regarding the rejection of some programs and proposals and the delayed implementation of some proposed measures to later years; and not for the current year's Budget or that of the next year. So the discussions between the parties settled on the covering of emergency spending through the added allocations for the Army and Military Expenditures by increasing the Budget's deficit (i.e. financing the deficit), which will reach 3.4% of the overall Budget. As we have explained previously, this percentage exceeds the expected deficit for the current year which was estimated at 2.5% in the beginning of the year. It is also worth noting that the set of proposed measures mentioned in the Table above, if approved, would reduce the level of deficit and would prevent it from reaching 3.4%. However, the deficit in the current Budget (2014) will not be less than 3% in all cases.

From another aspect and as part of the Israeli effort to protect the Israeli exports, the Central Bank of Israel declared on 28 August 2014 the reduction of the Interest Rate on the Shekel from 0.5% to 0.25%, , the lowest ever in Israel. Also, the continuing rise in the price of the U.S. Dollar since July 2014 and the decline in the exchange rate of the Shekel, which dropped by 7% in the last three months, presented a great opportunity for increasing Israeli exports and saving its sector of Tourism.

4. The Impact of the Israeli Measures on the Palestinian Economy

The Palestinian economy is largely affected by the political-security developments and the Israeli economic policies. This is due to the multiple linkages between the two economies and the Palestinian economy being part of the Israeli Customs envelope, in addition to the Economic Agreement (Paris Protocol) that governs the economic relations between the two sides. This Protocol includes several articles that link the Palestinian trade policy with that of Israel, in particular policies relating to indirect taxation. As a result, it is expected that the Palestinian economy would suffer various effects as a result of the economic measures taken by the Israeli government. Despite the non-ratification of some of the proposals contained in Table (1) and deferring some of them for later years, the mere fact of posing these proposals motivates the Palestinians to study their impact even if they were not adopted yet, and to seriously think about the possible options and alternatives so as to preempt their negative ramifications. The following are the main spheres that influence the Palestinian economy:-

✧ **The Value-Added Tax (VAT):**

The Economic Agreement (Paris Protocol) stipulates that the Value-Added Tax in the Palestinian Territories shall not be more than 2 points below that in Israel. This means, that any increase on this tax in Israel will be followed by a similar change in the Palestinian economy, noting that the current difference in the VAT between the two economies has reached to its maximum of two percentage points, being 18% in Israel and 16%in Palestine.

The proposed Israeli measures include increasing the Value-Added Tax in Israel to reach 19%. This of course means that the VAT percentage in Palestine would therefore have to increase to 17% at least. Such a move, if implemented, would reflect a direct increase (subject to specific conditions) in the prices of both domestic and imported products. Consequently, the prices of the local and imported production inputs will be affected by the proposed increase since the VAT is imposed on both domestic and imported goods.

Also among the proposals is to cancel the exemption from the Value-Added Tax on fruits and vegetables, hence this decision would lead to the increase of the prices of these products in Israel and in the countries that it exports to; primarily the Palestinian Territories.

✧ **The Israeli Shekel Exchange Rate:**

The Israeli Shekel is considered as one of the main three currencies in circulation inside the Palestinian economy, and its share constitutes more than 90% of the total cash transactions[13]. As a result of the successive declines in the Israeli Shekel's exchange rate in relation to other currencies, the imported goods that are sold in Shekels will become relatively more expensive for Palestinian consumers who earn their salaries in Shekels.

✧ **Foreign Trade:**

Foreign trade is affected by the majority of economic policies and indicators. So in light of the significant decline of the exchange rate of the Israeli Shekel, it is theoretically expected that the Palestinian exports would increase while the imports would decrease. However, the indicators related to the Palestinian foreign trade show that about 87% of Palestinian exports go to Israel while about 72% of Palestinian imports are either Israeli products or products that are imported through Israel. Thus, the impact is very limited as it relates to the reduced trade between Palestine and the outside world.

✧ **Health Insurance and Subsidy Cuts:**

The rising cost of Health Insurance premiums in Israel will only affect the Palestinian Jerusalemite residents who benefit from the health services covered by Israel's Health Insurance system. Such a decision would increase the economic burdens of the Palestinian residents of Jerusalem or could oblige some of them to optionally leave the Health Insurance system in order to avoid a rise in the cost of health insurance. In such cases, these persons will face tremendous difficulties in bearing the cost of treatment in Israeli hospitals and health centers. This could therefore put some pressure on the Palestinian health system as an alternative which is less costly than the Israeli health system. The case of Health Insurance largely applies to all the measures related to the reduction of subsidies and community allocations designated for poor and marginalized community groups, or the increase in income taxes on the various tax brackets.

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[13] This percentage was calculated based on the Shekel's share in the Check Clearance activities in three currencies.

- **Electricity and Fuel Prices:**

The Palestinian Territories depend on Israel in supplying 88% of the overall Palestinian consumption of electric energy. Hence, any rise in the prices of electricity in Israel shall directly affect the electricity prices in the Occupied Palestinian Territory. It is possible for the electricity prices in Israel to be affected by the proposed measures through the suggested increase in the Income tax and Corporate Profit tax, increase of the VAT, reduction of the tax benefits of large companies including the Israel Electric Company, increase of the Excise Tax (called the “Blo” Tax) on Fuel, and the increase of taxes on the Israeli companies that use coal to produce electricity..

The increase of electricity prices in Palestine beyond their current level could lead to the increase of production costs in the Palestinian economy, increase of local product prices and the decrease of demand for these products. It is also important to note in this context that one of the main problems suffered by the economic establishments, particularly the industries, is the increase of the price of electricity designated for commercial and industrial consumption; and this has a huge impact on the cost of production. From another aspect, the Palestinian households will be affected by the rising prices of electricity for domestic use. It does not seem that the Electricity Distribution companies in Palestine are able or even willing to carry a part of the expected increase in electricity prices in light of the chronic financial crisis that these companies suffer from.

Turning to Fuel, one of the proposed measures is the 50-Agorot increase of the Excise Tax on fuel. The current Excise tax is 3 Shekels[14] and constitutes about 40-50% of the final price of petroleum products. Therefore, the increase of the Excise tax by 50 Agorot would raise the final price of petroleum products by the same amount, which amounts 6%-8% depending on the type of fuel. The increase of fuel prices in that manner will significantly affect the various facets of economic and social life in the Palestinian Territories due to the large relative weight of Energy and Fuel costs in comparison with the overall production costs. This includes the costs of operation, transportation, administrative expenses and other stages of production which require the use of petroleum derivatives.. Hence the increase in fuel costs would lead to a similar increase in production costs, therefore affecting the prices of local products and reducing the competitiveness of these products in the local and international markets[15].

- **The Impact on the Palestinian Budget:**

The Palestinian Budget figures on both the revenues and expenditures sides are affected by the Palestinian economic performance and the trade between Palestine and the outside world. The susceptibility of the Palestinian budget is further increased as a result of the changes emanating from Israeli economic policies, particularly trade-related policies. The first effects on the Palestinian budget appear in the revenues which will possibly sustain a **decrease in the proceeds from Income Tax and VAT** (local revenues) as a result of the shrinkage of the local Palestinian economic activity and the decline in domestic demand resulting from the increased prices of the final products and local and imported intermediate goods. A decision by the Israeli government to increase the direct taxes (Income Tax) and indirect taxes (VAT and Customs) will lead to an increase in the prices of both intermediate and final goods. This will in turn affect the general level of prices in the Palestinian economy as a result of the strong linkages between the two economies. As for the **Clearance-related Revenues** mainly emanating from the net business exchange between the Palestinian and Israeli economies, they constitute more than 75% of the general revenues of the Palestinian Authority’s budget. Therefore, if the prices of Israeli products rise after the increase of the imposed taxes on Israeli products and also due to the growing boycott of Israeli products, it is expected that the Clearance-related revenues would decrease because of the fall of the net business transactions and especially in imports from Israel.

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14 http://paltoday.ps/ar/post/181865

15 The current trends in the world crude oil prices might soften or even reverse the above mentioned expectations.

As for **Expenditures**, it is expected that the affected areas would be limited because the “Salaries and Wages” item constitutes around 55-60% of the PA’s current expenditures. The vulnerability here might be limited to a reduction in the items pertaining to Social Aid, Transfers and Developmental Expenditures financed by the Treasury, in response to the decline in local revenues and the inability to make up for this decline from local or foreign funding sources.

In conclusion, despite the non-ratification so far of the proposed Israeli measures mentioned in this paper, the linkages between the Palestinian and Israeli economies, in their various aspects, will continue to be an element of tension and a source of risks and fear due to impact of Israeli actions and policies on the various facets of life in the OPT. Additionally, the effects of Israeli measures on the Palestinian economy further intensify and influence the structural defects suffered by the Palestinian economy, the continuing lack of asymmetry in the bilateral relations between the two economies, the arbitrary Israeli actions and the system of closure which hampers Palestinian investments, increases their costs, impedes the access of Palestinian products to export markets and hinders the development of direct business relationships with other countries. It is also worth noting that the Israeli measures include the mobilization of human and financial resources to conduct media and public relations campaigns in many countries around the world to improve the image of Israel in the world public opinion and in international forums; which significantly deteriorated after the War on Gaza, and especially with the rise of international boycotting campaigns (both official and popular) against Israel and particularly in the economic and cultural aspects. This has in turn led to huge losses and damages to the Israeli economy and to the image of Israel abroad. This calls for the prevention of misleading Israeli propaganda campaigns from achieving their goals in various countries around the world, which calls for the launching of a counter-campaign by the Palestinian National Authority so as to refute the Israeli claims and spread a Palestinian narrative that contributes to strengthening the boycott against Israel and protecting the Palestinians from the damages that they could suffer from in the various political, economic and other arenas..

Questions and Paradigms for Discussion by the Main Speakers:

The question addressed to the Ministry of National Economy:

- What precautionary actions is the Ministry planning to confront the Israeli measures?

The question directed to the Ministry of Finance:

- What are the measures that the Ministry finds necessary in the face of the Israeli measures?

The question addressed to the Experts:

- What are the ramifications of the expected measures that effect Palestinians in Jerusalem and the Palestinian citizens inside the green line?