AID TO ISRAEL: SOME STRINGS NEEDED

Last week the House Appropriations Committee agreed to a $1.5 billion supplemental to the scheduled aid package to Israel, as a stopgap measure to tackle that country's dire economic crisis. While this injection of assistance to America's ally is sorely needed, it is by no means clear that the U.S. is combining this help with a realistic plan to solve Israel's underlying economic problems. The danger is that Israel may be forced to take measures that will slow growth and exacerbate the crisis.

That Israel itself is largely responsible for its economic problems, by encouraging imports and consumption rather than economic growth from 1980 to 1984, is widely acknowledged. The symptoms of Israel's economic problems are staggering. Among them: GNP grew a total of 5 percent from 1980 to 1984 while consumption increased by 20 percent; net foreign debt in the same period increased from $17 billion to almost $24 billion; the inflation rate soared from 100 percent per year in 1980 to over 1,000 percent per year at the end of 1984. Underlying these problems is the government budget deficit of over $3 billion in 1984 (more than 12 percent of GNP).

Confronted with its economic crisis, Israel is turning to the U.S. for help. The $1.5 billion supplemental aid for 1985-1986 is in addition to the $2.4 billion in economic aid and $3.2 billion in military aid for these two years that it already is due to receive. This amounts to about $1,000 in U.S. aid per year for every Israeli at a time when Republicans and Democrats alike are planning to slash U.S. domestic spending to cut the federal deficit. Understandably, the U.S. is setting conditions for this massive and unprecedented generosity. The Reagan Administration mainly is asking Israel to conform to ten confidential conditions designed to improve Israel's economic situation. The trouble is that these conditions may not be good for Israel in the long term if they fail to force Israel to reduce expenditures sufficiently. It would be a serious error were Israel to raise, rather than lower, taxes.

Government expenditures in Israel were equal to about 100 percent of the GNP in the last fiscal year. Even excluding all defense costs and debt repayment, government expenditures were almost 50 percent of GNP. This large budget should not be financed by taxes because higher tax rates in Israel threaten to discourage further productive efforts and to reduce government revenue. And since so much public debt is

already held by Israelis, little more debt can be sold by the government unless it is indexed for inflation or to the exchange rate. Currently the Bank of Israel, the central bank, prints money to cover budget deficits, thus boosting the inflation rate. Moreover, excess government-sponsored demand sucks in imports and more foreign debt, adding to the crisis.

This economic spiral creates a high level of anxiety and struggle over economic policy in Israel and excessive dependence on foreign sources of loans and grants. It destroys the vigor of the Israeli economy. The energies of its people are diverted to coping with hyper-inflation. It discourages foreign direct investment and encourages the wasteful employment of labor in the public sector. To stop this process, a substantial cut in government expenditures is indispensable. Also needed are reforms that would permit the monetary system to resist inflation rather than to accommodate it. There is a need to reduce marginal tax rates, increase incentives and stimulate growth. Privatization of many activities now in the government sector and deregulation of many other regulated activities would promote efficiency and growth in Israel.

Some steps already have been taken. A budget for 1985-1986 was adopted that would reduce expenditures and the deficit somewhat below the actual level of 1984-1985. But there is a long way to go. Expenditures for the current fiscal year may exceed the budgeted amounts and revenue may fall short of projections. To stop the unsustainable rise in government debt relative to GNP there will have to be further budget cuts next year. And there has been only a beginning in establishing an anti-inflationary monetary policy.

While many Israeli leaders seem serious about restoring their economy's health, a recent Israeli tax increase indicates confusion over the best means to achieve it. The recent free trade area agreement between the U.S. and Israel will integrate the two economies by 1995. If this is to be successful, Israel must become a market oriented economy.

For long-term economic health, Israel must 1) sharply reduce expenditures; 2) reduce taxes; and 3) substantially shrink the public sector. Israel must shift resources out of the government and into production for export. U.S. aid can provide a cushion for this unavoidably painful adjustment process. Further, it is not enough for Israel simply to announce a program to restore its economic health. Internal political pressure will discourage tough measures. So steps for assuring execution of the program should be taken and milestones designated to permit Washington to measure performance--Israeli Minister of Finance Yitzhak Modai, for example, has suggested quarterly targets for the annual budget. With such a program and plans for its execution in place, the extremely generous U.S. supplemental aid could be provided with some confidence that it would be temporary.

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