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Israeli Elections: Economic Reform will be High on the Agenda

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Israelis went to the polls on March 17th giving a surprise victory to Benjamin Netanyahu and his Likud party. Israel has a 120 member unicameral parliament based on a party list system. Voters mark their ballots for political parties rather than individual candidates. As you can see in Figure 1, the Likud won 30 seats. Mr. Netanyahu must now create a coalition government that can command a Knesset majority of at least 61 seats.

Parties on the right side of the political spectrum control 57 seats. Of particular interest is a new centrist party called Kulanu headed by Moshe Kahlon (a former member of the Likud). Unlike the two largest parties, i.e. the Likud or the Zionist Union, with broad political agendas including national security, the Palestinians and economics, Kulanu ran on a narrow platform of economic reform. Its 10 seats would give Mr. Netanyahu the majority he needs, but only if he agrees to appoint Mr. Kahlon Finance Minister with authority to enact his plans.

Figure 1

Israel elections 2015: Results

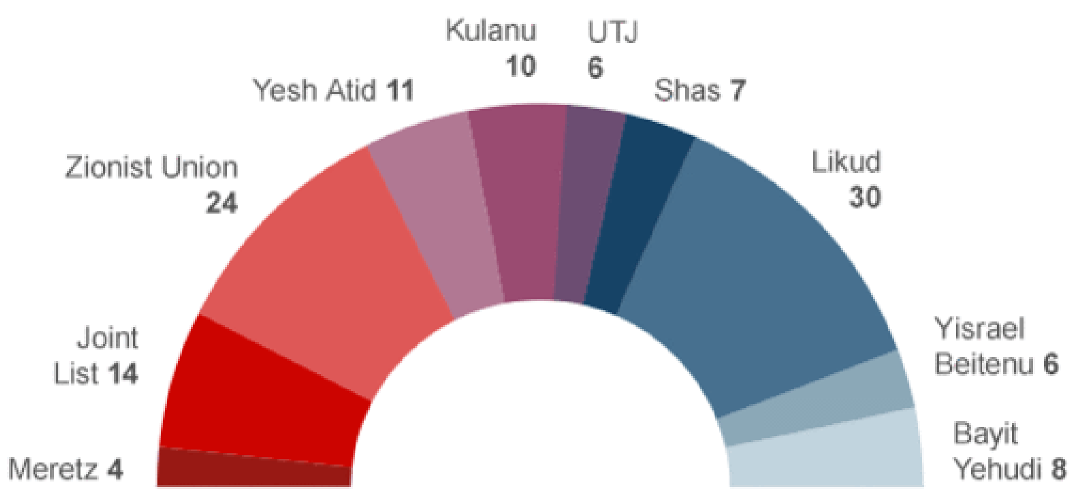


Chart general indicator of political positions
Source: Israel Democracy Institute

Source: www.bbc.com

Prime Minister Netanyahu and Moshe Kahlon are economic reformers

Moshe Kahlon gained a reputation as a reformer while serving as Minister of Communications under Prime Minister Netanyahu from 2009 to 2013. Under his leadership – and with the blessing of the Netanyahu government – Israel licensed two new companies to compete with the incumbent mobile telephone oligopoly. Since then Israeli carriers have waged price wars pushing subscription costs down by 50% or more. Kahlon became an instant hero to the phone obsessed Israeli population. He promises to bring competition to other economic sectors such as food, banking and housing.

While Kulanu and Moshe Kahlon appear to be in an excellent position to play the role of kingmaker in the coalition government, Prime Minister Netanyahu is not opposed to economic reform. In fact, he earned a reputation as a "Thatcherite" free market reformer when he was Finance Minister under Prime Minister Ariel Sharon in the early 2000's. In addition to spearheading a major wave of privatizations (including the major Israeli banks and El-Al Airlines), Mr. Netanyahu enacted budget discipline, tax reform and labor market liberalizations.

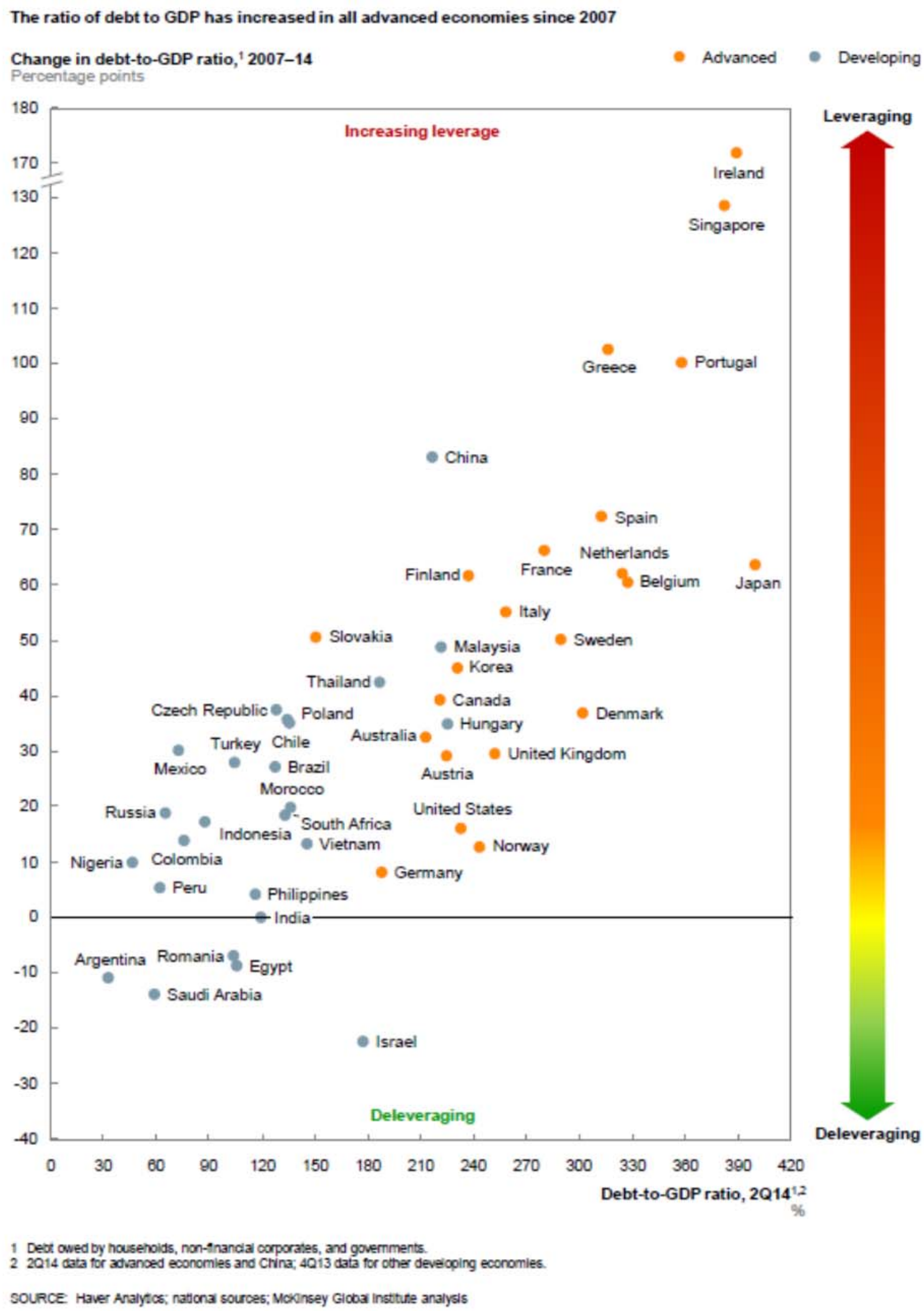
During his tenure as Finance Minister the Israeli government implemented gradual reductions in personal and corporate income tax rates while simultaneously cutting the budget deficit and government debt. All Israeli governments over the past 30 years - whether led by left or right coalitions – have maintained legally enacted targets for Israel's debt-to-GDP ratio. As a result, Israel is only one of five countries to actually reduce its government debt burden in the years following the financial crisis (see Figure 2). The current target is 60% by 2020. Israel now has a smaller debt burden than the United States (see Figure 3).

Major economic reform legislation was passed in 2013

In 2011 500,000 people took to the streets to protest the high cost of living in Israel. In response Prime Minister Netanyahu's government passed a major economic reform law in 2013. For many years a small group of extremely wealthy tycoons used their control over Israel's financial institutions and privatized companies to build monopolistic business empires. The new law requires these tycoons to divest their financial holdings from their non-financial holdings as well as limit the scope of their business activities. The goal is to diffuse access to capital and inject greater competition into the Israeli economy. The Netanyahu government hopes that policies such as these will help quell public anger by moderating prices and improving economic fairness.

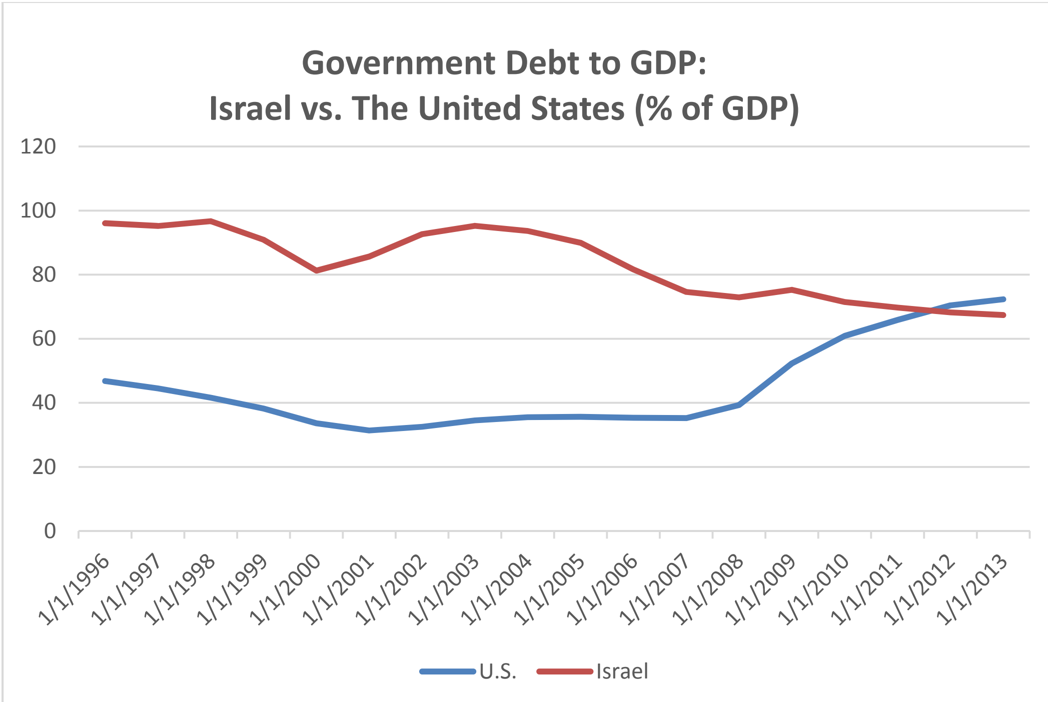
Given both Mr. Kahlon's and Mr. Netanyahu's track records, the next government will likely implement existing reform legislation and broaden its scope. Previous reform initiatives paid long-term dividends. In recent quarters Israel's economic growth slowed from approximately 5% per annum to around 3%, largely due to last summer's Gaza conflict and the economic malaise in Europe. Although sluggish growth in Europe will continue to hurt exports, Israel's strong reform program over the next several years should reinforce domestic economic fundamentals. Europe could certainly learn some lessons from Israel's successful recent history with fiscal austerity, debt discipline and consistent structural reform. The new government looks poised to maintain this momentum.

Figure 2



Source: McKinsey Global Institute, “Debt and (Not Much) Deleveraging” February 2015

Figure 3



Source: The Bank of Israel and Bloomberg, L.P.