

# Israel's Economic Challenge: How the U.S. Can Help

By Daniel Doron

**E**specially now, when everyone's attention is riveted to the divisive issue of whether the United States should grant loan guarantees to the Israeli government, and if it does should it exploit its leverage to extract economic or political concessions from Israel, it may be useful to step back and consider these questions in a historical perspective. A proper understanding of the Israeli predicament—of how a nation so rich in human capital came to have such a lame economy—and of the steps that must be taken to help it overcome its difficulties may also have a significance transcending the particular case of Israel.

"Of all the lands there are for dismal scenery," Mark Twain wrote in 1867 in *The Innocents Abroad*, "I think Palestine must be the prince. The hills are barren...dull. . . . The valleys are unsightly deserts fringed with a feeble vegetation... [peopled by] swarms of beggars and peddlers [struck with] ghastly sores and malformations..., Palestine sits in sackcloth and ashes.... Only the music of angels...could charm its shrubs and flowers to life again. . . ."

It took, indeed, religious visionaries and, later—when the enlightenment secularized Europe's Jewish intelligentsia—utopian socialists to revive this "hopeless, dreary, heartbroken land." No *Homo Economicus* moved by rational expectations would have submitted himself to hunger, disease, pillage, and murder in lawless Ottoman Palestine in order to resuscitate its "waste of limitless desolation."

Thus I wrote in 1988, thoughtlessly repeating the prevailing myth that socialism played an essential role in the resettlement of what was then desolate Ottoman Palestine. The truth was that from the modern Jewish resettlement, Palestine in the mid-1800s, it was entrepreneurs, later aided by private charities, who established the first agricultural colonies and towns. They took enormous risks because they were moved by a deep religious faith that this was the way to redeem Israel from its atrocious exile.

**Socialist Myth.** After the turn of the century and until 1914, the Jewish population in Palestine doubled from 35,000 to 70,000. During that fourteen year period, private entrepreneurs established or extended in a most hostile environment three thriving towns, ten colonies, rudimentary industry and commerce, and an impressive educational and cultural network. It was during this same period that about 3,000 young, secular, penniless, socialist pioneers also arrived, five hundred of them to establish three collective settlements that were maintained by public support. Yet Zionist mythology credited the young socialist pioneers of the Second Aliyah with founding modern Israel. It obliterated all memory of the true founders, so much so that even though my great-grandfather was among the first settlers, and our family cherished the memory of his remarkable achievements, I, too, thoughtlessly accepted the myth about Israel's socialist origin.

This little episode is worth relating because the story of how socialism came to dominate the Zionist enterprise—reshaping its history, as well as eventually transforming the nature of the Jewish community in Palestine—contains a moral far transcending Israel's particular predicament. An Eastern European ethos has conditioned the development of modern Israel ever since

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Daniel Doron is Director of the Tel Aviv-based Israel Center for Social and Economic Progress.

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the very inception of Zionism about 130 years ago, as I shall later explain. Therefore, the trials and tribulations of the Israeli economy, as it struggles to make the transition from a statist to a market economy, can shed significant light on the challenges and difficulties that Eastern European countries may encounter and can guide friends wishing to help.

I have advisedly chosen to dwell on what might seem as a tangential issue: the secondary role outside influences can play in an economic system's evolution. Many here may be involved in facilitating the transition in Eastern Europe. Israel's case demonstrates that the role of outside influences can sometimes be quite critical in shaping developments and alas, despite the best of intentions, not always in the most salutary manner. For sometimes help misapplied cannot only be counterproductive, but positively harmful and regressive.

**Well-Intentioned Friends.** To return, then, Zionism certainly has a predisposition to contract socialism fever. Historical circumstances, especially the long entrenched autocratic abusive regimes that were legitimized by orthodox Christianity, made all of Eastern Europe, particularly the Jews, vulnerable to revolutionary fervor and utopian temptations. However, this disposition could not have successfully taken over Zionism if not for the well-intentioned intervention of friends, most from the West, many from America, who participated in events in Palestine without much foresight or care.

When in 1920, under the British Mandate, Palestine's doors opened, tens of thousands of displaced European Jews clamored to emigrate. A totally unprepared Zionist organization stopped them, ostensibly for economic reasons, but really because its purpose was to shape the development of Palestine's Jewish community in a certain direction.

Eastern European Zionist leaders such as Chaim Weizman accepted the anti-Semitic calumny that Jewish society was at least partially responsible for its misery because Jews were not a productive, land-tilling people, but parasitic capitalists. They therefore wanted to create a new Jewish person and society, based on "honest" labor, and not the traditional middle class society of entrepreneurs.

Conversely, Judge Louis Brandeis and his followers in American Zionism were convinced that only the encouragement of private enterprise could provide a sound economic basis, and that a collectivist system would pose a danger to democratic society. But they remained a minority. The Utopian collectivist ideology prevailed; Brandeis resigned from the Zionist Organization of America, and Weizman and his supporters were able to channel all Zionism's resources into the collectivist sector, thus turning it from a tiny minority to the dominant economic and political force in Zionism.

**Inhibiting Entrepreneurship.** The Zionist settlement department and its considerable resources were devoted to the promotion of a socialist-dominated society, while great handicaps were devised to inhibit the growth of middle class entrepreneurship. This occurred despite repeated failures of the collectivist sector, which survived only through constant infusions of public money. Public money was raised, ironically, mostly from middle class American Jews who sincerely wanted to help, but could not really bother to learn the issues facing Zionism or to act carefully to prevent their help from tilting the balance in favor of socialism.

As it has had elsewhere, socialism has had a devastating effect on Israel. In the thirty years preceding the State's establishment, and in the forty years following it, Israel created, with the benefit of huge capital inflow (over \$70 billion since the State's creation), with back-breaking work and with sometimes superhuman sacrifice, a laggard economy incapable of offering the Israeli worker more than a measly \$1,000 monthly average salary. Instead of permitting the Jewish people to invest their considerable talents and resources in creating an urbanized, highly-industrialized center with advanced service industries and a sophisticated financial industry

capable of absorbing millions of highly-educated Jews, Zionism established, before independence, only a small community based on a weak, agrarian economy. After independence, it spawned a centrally-dominated and collectivist economy, which made Israel economically dependent on foreign help.

Zionism's inhibitions on urbanization and industrialization, which could have assured a high standard of living to all the inhabitants of the land, had serious repercussions. The backward collectivist economy, with its essentially discriminating political manipulation, sharply increased social and ethnic divisions. Incessant struggles over the division of the pie corrupted politics and degenerated economics. It also gravely damaged productivity by the wholesale misallocation of resources and by channelling so much energy into the seeking of privileges.

The economy's politicization also aggravated the Arab-Israeli conflict. Concentrating the Zionist effort on agriculture inhibited economic growth and naturally intensified the confrontation with the Arabs, who were mostly rural. It focused the struggle on land and water, which are limited resources that are difficult to share. And slow economic growth and sluggish demand for labor also sparked a struggle over employment in Mandatory Palestine.

**Economic Discrimination.** Later, in independent Israel, when much of the economy belonged to national or public entities, with economic benefits a political coin, the Arab population, lacking political clout, was subject to the economic discrimination inherent in excessive politicization, much in the same way and for the same reasons that the Sephardim were discriminated against. To this day, lack of opportunity and economic discrimination strain the fealty of Israeli Arabs.

By the time of the creation of the State, socialism was, of course, well entrenched, but its repeated economic failures forced Labor governments slowly and painfully to reduce their total control of the economy, though not nearly speedily enough. In the late 1970s, growing discontent with the malfunctioning of the Israeli economy was a major factor in Labor's loss. A reformist party siphoned off enough Labor votes to gain sixteen Knesset seats, thus enabling Likud to become the majority party and form a government for the first time.

Ostensibly pro-private enterprise, Likud made a hasty, ill prepared and tentative attempt to reform the economy. It was so ill conceived and executed that it caused skyrocketing inflation. Also, soon enough the allure of power and the strength of populist elements in the party led it to greatly increase the government's involvement in the economy. It had far more involvement than labor, by exploiting increased foreign aid to greatly extend social benefits, the welfare system, and huge subsidies to industry and the consumer. Even today, when economic aid mostly covers the repayment of debt and is therefore merely a bookkeeping exercise, it still enables the government to delay vital structural change.

**Tangle of Regulations.** Under Likud, then, government intervention in the economy reached new heights. The government owns over 200 corporations in all economic spheres. Despite some very halting steps toward privatization, it still controls the import of many staples. It sanctions dozens of monopolies. The government has recently moved to lift many import regulations, but in too many cases, it has simply switched from bureaucratic restrictions to high duties to protect inefficient Israeli industries from competition. One can scarcely engage in any profession or trade without a government permit or compliance with a tangle of regulations, an especially serious impediment to the Russians wishing to enter the economy.

Government denies free or easy entry to the market and ties the hands of producers with onerous labor laws. It imposes on labor and employers punitive taxes that destroy their competitiveness and nip in the bud new enterprises. As a result, Israel has a very small proportion of small businesses, which in turn curtails competitiveness and efficiency. Israel has over two

dozen different major taxes and dozens of special levies (imposed, for example, on stud rams, camel markers, and reburials). As much as 55 percent of gross national product is taken in taxes, although about 25 percent is returned in subsidies and transfer payments.

**Discredited Statism.** Yet despite the fact that Israel has perhaps earned its bad annual report cards, there are tremendous changes afoot there. In the past few years, statist ideology has been almost totally discredited in Israel. Ironically, even when the government attempts to intervene in a massive way, as in a recent plan to promote employment by granting generous subsidies to industry, it does so putatively to "assist the workings of the market" and to "encourage enterprise." But such excuses do not usually wash, and most of the press and many in the policy community are quick to expose the absurdity of such government assistance. This is light years away from what prevailed even as recently as six or seven years ago, when government proposals were often criticized, but only on the grounds of their ineffective execution, while their necessity or *raison d'etre* was seldom questioned. As a result, a number of major economic initiatives the government planned, that would have cost Israel billions of dollars, have been squashed.

Even though it seems that the political establishment is reluctant to accelerate change, it apparently understands where the wind blows. In September, we witnessed an astounding phenomenon: a Labor party that still finds it difficult to separate itself from its red flag and May Day celebration, launched a massive ad campaign attacking the Likud government for not being friendly enough to free enterprise. A new Labor election platform calls for privatization and reduced government interference in the economy.

The refutation of statist ideology has also brought about other changes in policy. While only a few major reforms have been successfully completed so far, those familiar with political undercurrents can discern significant beginnings for profound future changes.

There were two developments within the Israeli economic and political system that caused many of these changes and that are worth commenting upon because they may contain significant lessons about how the internal dynamics of a statist economy eventually mandates transition to a market economy.

If we were to analyze Israeli politics strictly by the hypotheses of social choice theory, there could be very little prospect for economic reform. Since Israeli politicians are in almost total control of the economy, only revolutionary change could force them to forego their enormous power. Yet it seems that the extensive use of economic favors to buy political influence finally makes the political exploitation of the economy self-defeating.

**Vested Interests.** One can observe an interesting favor-seeking process on the national scene, even, most significantly, within political parties. Having offered so many government favors to their followers, Israeli political parties have in effect, been transformed into unstable coalitions of vested interests vying for government favor. Since even the Israeli government does not possess unlimited resources, party lords cannot ultimately satisfy the needs of all their constituencies, whose expectations keep rising much faster than favors can be granted.

Moreover, even if an attempt was made to satisfy them all equally, it would not prevent a destabilizing struggle from developing, for each group would consider itself more deserving and would demand more favors, not least as a token of its larger political clout. Thus, for every satisfied customer that a leader acquires by dispensing political favors, he creates a number of dissatisfied clients, and several political enemies. Parties then resemble families torn by conflict and intrigues as a result of a sudden inheritance that must be shared. With no objective economic criteria to indicate how such a windfall can be divided and no productive effort to be rewarded,

personal and political ambition become the predominant factors and rivalries and jealousies abound. Finally, they destabilize and break apart the family or the party.

It seems then that while the setting of a constitutional limit on the economic power invested in government and in political parties may be necessary, what will make such a limit acceptable and even desirable to politicians is the realization that the dispensing of political favor is eventually counterproductive. Politicians must recognize that rather than securing their hold on power, in the long run it undermines it. They also must realize that since a nation's strength depends on its economic viability, its political system cannot long survive massive government control of the economy, as we have witnessed in Eastern Europe and even in Sweden.

A second process that holds great promise for spontaneous grass roots and market-generated reform can be witnessed in Israel in the way market forces eroded the political establishment's economic base while empowering previously disenfranchised citizens. Decades of political manipulation and misallocation of resources have finally taken their toll on industrial enterprises owned by government, the Labor Party and the banks, as well as the Labor-affiliated sick fund, pension funds, and agricultural cooperatives. Moreover, the same relentless forces that are finally weakening Israel's statist economy are also beginning to reward, albeit, haphazardly, Sephardic Jews who lacked access to the system and therefore had to make it independently, mostly in the informal economy.

**Healthy Attitude.** A survey of income disparities in Israel between Ashkenazim (Jews of European background) and Sephardim (Jews from Arab countries) discovered that despite extremely high taxes and transfer payments, income gaps kept growing among these groups in the public sector. But among independent wage earners, Sephardim moved up faster and overtook the Ashkenazim. Ashkenazim, mostly well established officials, discovered to their chagrin that while education and contacts gave them access to coveted jobs, they remained highly taxed. The more recently arrived Sephardim, lacking such connections, moved into trades and small businesses where they satisfied rapidly expanding demands and participated in the underground economy. Never having been infected by the ethos of socialism, they were generously rewarded for their healthier attitude toward enterprise.

Many Sephardim rose in the Israeli political hierarchy through the direct elections of mayors, making them more responsive to public needs and accountable to their constituencies than Members of Knesset who are put on the slate by the executive committee.

However, what might really force the hand of the system and promote change is the massive wave of new immigrants from the Soviet Union. The challenge of housing and providing jobs for tens of thousands of new immigrants can simply not be met by Israel's sluggish economic system. As a matter of fact, already the government has had to forego its intervention in the initial absorption process and allow for direct absorption by handing each immigrant family a subvention with which to purchase housing, food, clothing, and education. As a result, Israel was able to absorb the first wave of almost 300,000 immigrants without initially having to add to the existing housing stock. Suddenly, tens of thousands of empty apartments, which were owned as inflation-proof investments, were put on the rental market, and provided the necessary housing.

In the area of employment, too, markets have operated much more gingerly than statistics reveal. Official figures show an 11 percent unemployment rate in Israel. Yet it is difficult to secure the services of a maid for even \$10 an hour (the average monthly salary in Israel is \$1,000), and there are many thousands of illegal foreign workers from Poland, Portugal, Ghana, Turkey, Romania, and the Philippines (besides the scores of thousands of Arab workers from the West Bank, Gaza and even southern Lebanon) who find employment in Israel. This apparent paradox of jobs going begging while there is apparently such a high rate of unemployment is due

not only to the disincentives provided by high unemployment compensation on the one hand, and significant taxes imposed on low income brackets on the other, but also because much employment is in the informal sector.

Altogether, the existence of a vigorous informal sector, while saving Israel from being torn apart by disruptive social tensions and economic hardships, has also reduced the pressures for reform, especially of the tax system. People often wonder why Israelis, who are among the highest taxed people in the world, have not declared a tax revolt. The reason seems to be that they have "privatized" their revolt, sometimes by individual tax evasion, but more often by sectorial arrangements whereby although the taxable portion of the salary is small, the worker receives various perks, on which often only the employer pays taxes. The unfortunate result is that while take home pay is very low, the cost of labor to the employer is very high.

Once hidden excess capacities in the job and housing markets are exhausted, however, the need to create additional jobs and additional housing for the immigrants will come up against the rigidities inherent in Israel's statist economy.

The greatest hope for rapid employment expansion is small businesses. Their proportion in Israel is much smaller than that prevalent in Western economies, because the Israeli economy is rife with government-sanctioned monopolies, with government bias in favor of large enterprises, with onerous entry limitations (one, for example, cannot establish a pharmacy within a radius of 500 meters from an existing one), and heavy taxation at low brackets preventing capital accumulation. If Israel is rapidly to expand employment, massive deregulation and lower taxation must be instituted.

In housing, too, government interference is the major hindrance to rapid expansion. We have calculated that the average three-room apartment in Israel that now costs \$100,000 contains at least \$65,000 in government-imposed costs: inflated land prices (the government owns 93 percent of the land), capital consuming lengthy planning and regulatory procedures, high taxes on building materials and labor, government-sanctioned monopolies in steel, iron, cement and in contracting services.

**A Blueprint for Reform.** So what can be done besides complaining and issuing bad report cards? In February 1990, my organization, the Israel Center for Social and Economic Progress, held an international conference with the participation of over 2,000 people (including Israel's President, ministers, Knesset members and other pillars of the establishment, and foreign dignitaries, such as Milton Friedman, Justice Antonin Scalia, Trevor DeCleave, Stuart Eizenstat, and others). With their help we were able to produce a blueprint for reform.

- ◆ The government budget and taxes must be cut drastically. We put together a detailed plan that pointed out chapter and verse how to cut 10 percent of the budget simply by eliminating duplication and waste.
- ◆ Tax systems and capital markets must be reformed and hidden capital legitimized so a thriving underground economy can be integrated into the formal one, and thus increasing productivity.
- ◆ Government companies, including those in the defense industry, must be sold, but not through a lengthy piecemeal process that encourages powerful interests to acquire them at preferential terms. They must be incorporated into two or more competing mutual funds whose shares should be offered to the public.
- ◆ Government must release vast tracts of land and sell them to the highest bidder.

- ◆ A pending law to encourage rental housing must be finally enacted. This will help make the building industry more efficient and competitive.
- ◆ Once competitiveness and efficiency have been accelerated, municipalities can privatize their services, and so save a large portion of their outlays. This will enable them to reduce local taxes, which are a heavy burden, especially on small businesses.
- ◆ Above all, the Israeli economy must be massively deregulated to become truly competitive. A blue ribbon committee should be established to review all government regulation of economic activity. Those that are not proven cost effective or that impede economic growth should be abolished within a reasonable period of time.

Now that our seven years of work have conspired with circumstances to convince most Israeli decision makers and public opinion molders that economic reform is a top priority, and that only a market economy can assure Israel's viability and security, the hard work has only begun on how to get from here to there. As experts in Eastern Europe point out, it is not enough to convince people that reform is necessary; it is not even enough for them to want it desperately. They still have to develop concrete strategies, adapted to an economy's particular circumstances, to its unique institutional setting and its social relationship, if they wish to see reform not only enunciated but actually carried out.

You have to identify the groups that would cooperate on economic reform and try to win over those resisting it in order to both generate support and eliminate or modify opposition. This requires more than annual rhetorical exhortations telling the government to shape up and do certain things or to refrain from doing others. It takes a much more arduous effort to persuade decision makers that reform is in their best interest in the long run, to teach them the ABC's and the syntax of proper economics so that they can all write a better economic scenario in their own spheres of action. Holding out a foreign model for reformers and expecting them to follow it on faith will just not do the trick.

The setting up of foreign models to be emulated may prove to be counterproductive unless done with the utmost sensitivity and discretion. The particular ethos of different countries, their unique aspirations, institutional dynamics, and even their peculiar semantics may be so different, that those opposing reform could easily seize on such differences in order to discredit the notion of reform.

**Judicious Criticism.** To those who exhort Israel to follow the example of Hong Kong or South Korea, many Israelis would retort that since these are not democratic countries, they can resist the pressure to close great discrepancies in wealth. Also since, at least until recently, large parts of their populations were not well educated, they could not serve as models to a country like Israel wishing to integrate a great mass of very educated immigrants who thought that if the price for democracy and greater equality must be greater government involvement in the economy, so be it.

It should also be remembered that strident, often simplistic, even slanted, foreign criticism of Israel, and attempts by outsiders to twist the arm of its government, even if well motivated, may alienate many Israelis. For they already feel that they are exposed to far too much foreign scrutiny and double-standard criticism. This criticism may play into the hands of those who resist reform by enabling them to recruit patriotic feelings.

So, to be effective, foreign critics must act very judiciously and sensitively and not indulge in generalities and in intemperate rhetoric. They must remember what a daunting task basic economic reform is even in countries which enjoy relatively free market economies and not expect that by acting as visiting firemen they can institute reforms in foreign economies overnight.

This is not to say that foreign friends should keep away and not lend a helping hand. To the contrary, they have a vital role to fulfill in encouraging local advocates of reform. Since official U.S. representatives tend to confine their contacts and attention to official circles and the establishment that is associated with them in statist economies, the population gains the impression that U.S. sympathy and prestige are behind the policies they follow.

It is therefore vital that voluntary U.S. organizations find a way to convey to the people in these countries what the U.S. really stands for in terms of the values and policies associated with the market economy, by establishing their own ties with their counterparts in these countries. Where such counterparts are lacking, as in many autocratic regimes in Latin America, the Arab countries, and the Far East, they might want to emulate the example set by the Open Society Fund which successfully sowed the seeds of a civil society in many East European countries when they were still communist.

Local reformers should be helped by permitting them easier access to the experience accumulated by reformers elsewhere, and the means should be provided to help transmit such knowledge in their native language and in terms assimilable by their own culture. Often it is most difficult for such reformers to raise funds for their activities in their own countries since the source of most wealth is in the government's hands and with those who benefit from government intervention and would therefore oppose reform.

**Rethinking Foreign Aid.** Above all, the time has come for proponents of economic reform to give some very serious and urgent thought to how to neutralize some of the very destructive consequences of government-to-government foreign aid that in the past often resulted in creating in the beneficiary countries an overbearing and injurious public sector. Can government aid be used as a leverage to encourage the private sector of developing countries, and if so, how?

It is clear that most countries wishing to make the transition from a statist to a market economy are facing formidable problems. They urgently need help. But, as the saying goes, it is better to teach them how to fish than to provide them with fish.

Educating people to function in a market economy is a long, arduous process, but there are no short cuts. It is the reformer's task not to hit their opponents over their heads, but to educate them patiently, convince them that through individual freedom and free markets their yearning for a better life can be realized sooner, more peacefully, and even more justly.

