ISRAEL

A HISTORY

9 STATE BUILDING
ECONOMY, DEVELOPMENT, AND BIG GOVERNMENT

Establishing the state gave its leaders the chance to put into practice the utopian plans that had enriched Zionist thinking from its inception. The Mandatory government's restrictions on Zionism's vision of building and development enterprise had come to an end. "We will dress you in a gown of concrete and cement, and lay for you a carpeting of gardens," wrote Nathan Alterman in the early 1930s in "Morning Song," which the children of Israel sang as a sort of second national anthem describing the Zionist plan for the country. In the headiness of independence everyone thought more about possibilities and less about limitations. Then reality arrived and sobered them up.

In the first three years of the state, everything was subordinated to two principal objectives: victory in the war to ensure Israel's existence, and immigrant absorption. The war lasted until the spring of 1949. More than 100,000 people had been mobilized since the summer of 1948 and consequently had not contributed to the economy. On the other hand, 100,000 new immigrants had arrived during the war, more than in any previous year. This was the first hint of what would happen later. In the first forty-two months of the state's existence, the average monthly number of new immigrants reached some 16,000. All in all 690,000 immigrants arrived in Israel, and within three years the Jewish population doubled. The vast scope of this immigration relative to the size of the host population—unheard of in any immigrant country—created tremendous pressures on the economy.

In February 1948, in a display of opposition to implementing the UN resolution of November 29, 1947, Britain removed the Palestine pound from the sterling bloc, which meant that the local currency was no longer supported by the pound sterling. The Jewish population reacted with restraint; there was no run on the banks, and the inhabitants did not withdraw their deposits. The Anglo-Palestine Bank made sure that its coffers held an available supply of cash in Palestine pounds to prevent shortages that might impair local economic activity. At the same time, the bank got ready to print the new national currency, the Israeli lira (pl., lirot), even before the state had been established. The Israeli lira—yet another expression of independence and sovereignty—first saw the light of day in summer 1948. To prevent loss of public trust in the new lira, the old exchange rate of 1:1 between the Palestine pound and the pound sterling was maintained. This rate had been unrealistic since World War Two, since during the war the rate of inflation in Palestine was far higher than that in Britain, thus devaluing Palestine's currency.

Maintaining the nominal value of the Israeli lira required financial control, governed by regulation. These were the first steps in a planned or directed or (as the Israeli economic system was described at the time) managed economy. This system had its roots in the Yishuv period, but now the sovereign state could enforce it on all citizens.

Between the two World Wars the British government adopted a laissez-faire policy in Palestine, which meant that the country had a free economy. There were no selective protective tariffs on imports that gave preference to countries purchasing Palestinian produce, there was no progressive taxation, and interference in market forces was minimal. This nonintervention policy provided no incentive for developing Jewish industry and enterprise.

World War Two brought about a dramatic change. Following the lead of the British government, which instituted both rationing and controls on economic activity, the Mandatory government instituted food rationing and price controls. It set economic controls and priorities—for example, prioritizing investment in industrial production vital to the British war effort in the Middle East while prohibiting housing construction—that facilitated the development of Jewish industry. That industry began to grow without having to compete with European imports, which the war made unavailable. Solel Boneh, the Histadrut's construction firm, moved into the military construction market all over the Middle East, building roads, airfields, and army camps, and became a huge company.

The control and rationing system in Palestine was relaxed when the war ended, and its legal basis was annulled by the withdrawal from the sterling bloc. But after six months of galloping inflation in 1948, the controls were reinstated, at the same time as the Mandatory legislative system was adopted in Israel.

In Europe the transition from a wartime to a peacetime economy was made slowly and cautiously in order to avoid a repeat of the shocks created by the discharge of soldiers after World War One. Furthermore, until the Marshall Plan was instituted in 1948, there was a shortage of cash that made importing vital commodities difficult. In Britain the Labour Party was in power; it nationalized key industries and did not hesitate to intervene in the national economy. Basic commodities were rationed, on the grounds that the state must take care of all its citizens and ensure equal distribution of the foodstuffs and energy sources the country had available. This policy was driven by the bitter experience of the Great Depression, which was thought to derive from the state's failure to intervene to regulate the economy. Unlike the Western democracies, which had difficulty dealing with the crisis, the USSR and even Nazi Germany seemed to have planned their economies prudently, and to know in particular how to combat the destabilizing factor of unemployment, which had hit the democratic countries hard. The theories of John Maynard Keynes, who supported state intervention by channeling resources into the economy to ensure employment—thereby creating demand to drive the wheels of production—were applied in the United States during Roosevelt's presidency and later in devastated postwar Europe.

In the decade after the World War, the principle that the state should play a central role in directing the national economy was prevalent in Western countries. The Israeli government's directed economy was therefore not exceptional. To the country's leadership it seemed natural and obvious. Graduates of the various socialist schools of thought, these leaders saw state involvement in the economy as the way to achieve just distribution and create the egalitarian state they aspired to. And above all, centralized control of capital allocation seemed to be the way to ensure planned, accelerated development.

The leaders tended to be skeptical of the various economic theories. Since the beginnings of Zionist settlement in Palestine, most of the experts who had examined the economic feasibility of the Zionist enterprise had said it would never work. But these prophecies of doom had not come to pass. Accordingly the political and social leadership believed that the laws of economics did not apply to the Zionist enterprise. This notion was particularly evident in Ben-Gurion's skeptical attitude toward the economists' recommendations. When an advisory committee appointed to plan a city in Beersheba concluded that it was unfeasible, he simply dismissed the committee and established a new one. To such skepticism he added deep suspicion of the free market, driven as it was by the goal of financial gain, not the need to build the nation.

The state's first years were marked by severe shortages. Foreign currency reserves were very low. The government used accounts in sterling that had been frozen in Britain during the War of Independence and were gradually released, so that Israel had access to all of them by 1952, to purchase food and fuel abroad. Import of capital, which was based on donations by world Jewry, was far below the needs of the war and immigrant absorption. The government printed money in an inflationary manner to cover its local expenses. In 1948, 40 percent of the gross domestic product was invested in war costs. Imports, however, were dependent on the availability of foreign currency—and it had simply run out. Between 1949 and 1952 stocks of food and fuel were close to zero. The country's ability to function rested on the manipulative talents of the economic leaders, who managed to bring in fuel tankers and grain ships on short-term credit.

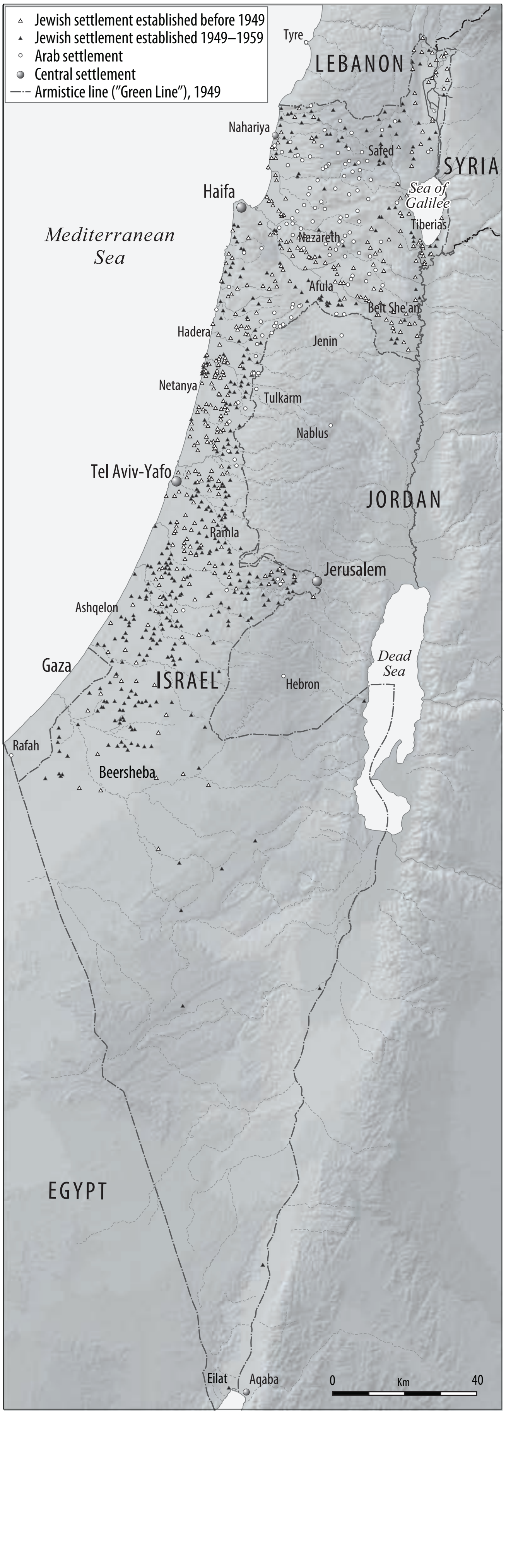
The urgency and pressure felt by the heads of the Israeli Finance Ministry, compared with the reckless optimism of the political leadership, which, as we have seen, tended to deride the laws of economics, was expressed in a famous quote attributed to a senior Zionist leader: "I'm talking about the budget and they're singing 'Hatikvah.'"[1] In 1949, to deal with the shortages and price increases, the government decided on an austerity policy—food rationing and price controls. A year later the system used in Britain was adopted, and footwear and clothing were also rationed. The austerity policy was appropriate to the socialist concept of sharing the burden of immigration absorption equally among the entire population. Yet no freeze was imposed on wages, which were linked to the cost of living index (a system instituted during the World War in response to inflationary price increases), which also increased annually, due to the annual negotiations between the Histadrut and the employers.

At first the veterans among the population accepted the austerity measures with understanding, but not for long. After the armistice was signed in spring 1949, they felt both relaxation—the war was over—and resentment against the government's regime of controls. The pressure of surplus cash in the hands of a public that had no way to spend it led to the emergence of a black market, an expression of consumer disenchantment and a refusal to accept austerity. Demand pressures eroded the austerity policy, and all attempts at control failed while prompting increased public disaffection toward the government's economic policies—proving that ignoring the laws of economics is not always a good idea. The unrealistic exchange rate between the Israeli lira and the US dollar (0.35 lirot to a dollar) increased import costs, adding to the impact on the dwindling foreign currency reserves. On top of this, the Korean War caused a global price rise.

The result was an insufferable situation of simultaneous controls, rationing, and inflation. In 1952 the heads of the Finance Ministry succeeded in convincing the government that despite opposition from the left, the time had come for a policy change. The government agreed to stop printing money and imposed a 10 percent tax on all cash and deposits held by the banks. The lira's exchange rate was cut threefold, a move that was repeated in April 1953, when it was set at 1.80 lira to the US dollar. This rate was maintained for almost a decade. The suppressed inflation that characterized Israel during the years of austerity was arrested, and although the level of foreign currency reserves was still dire, the rehabilitation of the economy now got under way. In 1950 Israel received its first US loan. Nineteen fifty-two saw the first external financial resources that were guaranteed for a decade: the Independence Loan (Israel Bonds) purchased by American Jewry, an American aid agreement, and a reparations agreement with West Germany (discussed later).

From the Mapai leadership's perspective, the situation existing after the establishment of the state provided the tools for both rapid development and the creation of a welfare state. As we have seen, before statehood most of the capital invested in the country was private, and most of the land in Jewish hands was privately owned. Water sources, electricity, and natural resources not controlled by the British authorities were owned by private companies. Now, with the flight—or expulsion—of the Arabs, 625,000 acres of unowned land now suddenly belonged to the state, which was both the inheritor of state lands and the entity responsible for what was termed "abandoned property." Abandoned property was broadly defined so that it also applied to the land of some Arabs who had remained within Israel's borders. Over 90 percent of the country's land was now state-owned. The government also controlled the import of capital, most of which was now public. All these factors gave the state financial levers and means of production for its planned projects. It could choose the location of projects and the industries it wanted to invest in according to the national priorities it chose. Even when it did not invest directly in specific enterprises, it could use grants, subsidies, import licenses, and allocation of foreign currency to direct foreign investors to invest in industries and locations of its choosing. There were not many such investors in those first years; they appeared mainly in the 1960s.

Zionist tradition gave precedence to agriculture and construction. In the four years from 1948 to 1951, 270 agricultural settlements were established, of which 100 were immigrant moshavim. The number of settlements founded during this period equaled the number established in the entire seventy years of Zionist settlement in Palestine (see map 5). From 1943 to 1951 the number of people engaged in agriculture doubled, even though their proportion among all those employed did not increase. By the end of the 1950s, 400 agricultural settlements had been created. The goal was to ensure the geographic distribution of Jewish settlements on the extensive tracts of land vacated by their Arab inhabitants—along the borders, in the Jerusalem corridor, and in the northern Negev. Agriculture was also supposed to supply food to the population, which, as noted before, had doubled due to mass immigration. There was also the influence of Zionist ideology, which viewed agriculture as a therapeutic occupation since it brought alienated Jews closer to the soil of the homeland, helped them strike roots in it, and habituated them to manual labor. The availability of means of production, land, water, and workers—unskilled new immigrants—made agriculture the quickest and most effective solution to the problem of immigrant employment and housing, while also meeting the state's security needs along the borders and providing food for the growing population. The settlement enterprise during those years was vast. Agricultural production between 1949 and 1952 doubled. At the same time, as part of the effort to disperse the population, some thirty townships were established in different parts of the country that were designated "development towns."



MAP 5.
THE NEW SETTLEMENT MAP, 1948–1959. (SEE PLATE 5.)

The government's control of the import of capital enabled it to initiate and direct the industries it preferred to develop. Until 1955 the chosen sector was agriculture. In 1956 the period of agricultural shortages ended and a period of surpluses ensued. At the same time, it became clear that agriculture wasted water, an important and scarce resource. The appointment of Pinchas Sapir as minister of trade and industry marked a new direction: investing in the development of local industry. Industry was built with the aid of subsidies, friendly currency rates, protective tariffs, and government investment. Most of the factories built were devoted to textiles based on a local raw material, cotton grown in the northern Negev. Staffed by unskilled workers, these factories provided employment for the inhabitants of the development towns, which had been created without a productive infrastructure.

According to socialist theory, the infrastructure of production should be in government hands so that it can be exploited for the benefit of the nation. The government controlled energy sources, transport, and water. It acquired the Palestine Potash Company and founded the Dead Sea Works. It acquired the Electric Corporation. It founded El Al Israel Airlines and the Zim Navigation Company. It built a new port at Ashdod. It acquired the Haifa oil refineries. The road and rail networks underwent accelerated development. In line with the Zionist vision, the government invested national capital in major irrigation projects: the Yarkon-Negev project and the National Water Carrier (see maps 5 and 6). The latter project, which brought water from the Sea of Galilee to the Negev, turned extensive arid tracts into fully irrigated land, providing farmers with means of production that raised their standard of living. The draining of Lake Hula—thousands of acres that had been part lake and part marshland—seemed to be a good example of a Zionist dream come true. In this case, however, the initial enthusiasm for developing the area turned out to be based on a fallacy. The drained soil was uncultivable, and draining the lake destroyed a unique natural habitat. Part of the Hula area was reflooded in 1990. In this respect Israel resembled other countries engaged in accelerated development during the 1950s, without awareness of the ecological cost (e.g., the Aswan Dam in Egypt and development projects in the USSR).

These massive state investments in infrastructure led to unprecedented growth in the Israeli economy, at an average annual rate of 10 percent over fifteen years. The government did not nationalize the companies that built the infrastructure, a step that might have put off potential investors. It bought them, and then many became limited liability companies, under public control. The government provided state guarantees and also set product prices. In 1951 the defense budget was cut drastically to divert resources to immigrant absorption. But after 1955, given the need for military procurement following the Egyptian-Czech arms deal (discussed later), the defense budget was increased to 7.5 percent of the state budget. A large part of this defense budget went to the local market, thus increasing government involvement in it even more. The establishment of the defense industry added yet another arena to state involvement in the economy. During this period the public (government) sector constituted some 20 percent of the Israeli economy.

At the same time, the Histadrut sector also developed. The Histadrut construction arm, in the shape of Hevrat Haʿovdim, became stronger and grew in agriculture, construction, and industry. Between 1949 and 1954 the number of kibbutzim doubled and their population increased by 60 percent. Their production capability and output also doubled, and some saw the beginnings of industry. Most of the immigrant moshavim also came under the Histadrut umbrella. Marketing and purchasing in this sector was cooperative, giving it considerable bargaining power. Solel Boneh was the state's contractor of choice on major projects, since it had the required experience and know-how. It built public housing, power stations, roads, and settlements. No other company in the market was able to compete with its means of production or even its implementation capacity. In the second half of the 1950s, Hevrat Haʿovdim also began to establish and acquire companies in the areas of defense, heavy industry, and consumer goods. During this period the Histadrut sector, at about 20 percent of the economy, was as large as the public one.

Ben-Gurion's and his colleagues' former notion that private capital was directed solely toward profit, with no national goals, moderated as the years passed. The Jewish investors in Israel Bonds and the major Diaspora donors to Israel had a capitalist outlook and viewed the public economy and the state's control of it with suspicion, even distaste. After 1950 economic relations with the United States became closer, further softening Israeli attitudes toward private capital. Tax regulations were enacted to encourage capital investments by nongovernment investors. In the second half of the 1950s, private capital began flowing into Israel, both from Jewish investors and as individual reparations from Germany. Private entrepreneurs received government assistance if they went into industries that the government sought to develop, in the development areas it defined. The policy was to encourage building factories in the outlying areas or close to maʿabarot (transit camps) and development towns, in order to provide employment for the immigrants. The government invested heavily in these enterprises, and in some cases this investment was economically indefensible. But for Minister of Trade and Industry Pinchas Sapir, employment and development came first; he was not concerned about profitability until later. The Investment Authority he initiated was designed to enlist Jewish investors abroad for industrial development. In the first half of the 1960s, it raised hundreds of millions of dollars. Thus a cooperative model developed that included both private and public economies. The two types of economy relied on government aid through a policy of tariffs and taxation against competing imports, special rates of exchange that benefited the developing industries, grants to development areas, and so forth.

A high percentage of the capital that flowed into the country was channeled into investment and development. But a considerable part of it was diverted to consumption. During these years the standard of living of the entire population rose substantially: between 1955 and 1966 per capita consumption increased by 221 percent. The issue of finding the correct balance between raising the standard of living—which over time benefited the vast majority of the population, who took part in a growing festival of consumption—and allocating resources for development is one that economists still ponder. Had part of the resources not been diverted to consumption, it is quite possible that a huge wave of people would have left the country. However, this allocation did divert foreign capital from the investment in infrastructure and development for which it had been designated, in order to raise the standard of living.

The wider the Hevrat Haʿovdim's wingspan extended, the more pronounced were the internal contradictions between the Histadrut's role representing the trade unions (salaried workers) and its role as an employer. During the period of mass immigration, when thousands of unemployed exerted pressure on the labor market to lower wages, the Histadrut contended that immigrants must be absorbed into the economy on the same pay rates that European workers got. It vehemently refused to agree to a wage cut, even during the deep unemployment of the early 1950s. Local workers' councils prevented workers from the transit camps from offering to work at lower wages. This policy benefited the veterans and well-to-do workers, and harmed the weaker workers and new immigrants. At the same time, Histadrut enterprises were supposed to be profitable, and applying Histadrut wage principles, coupled with rigid rules on hiring and dismissal, did not make it easier for these enterprises to stay profitable. The Histadrut deserves credit for its dedication to its national mission, and for establishing factories in development areas where private capital refused to go, despite promised government support. But tensions among salaried workers, factory managements, and the Hevrat Haʿovdim executive were endemic in the Histadrut from this point on, and ultimately caused a clash of interests within it.

The National Insurance Law, enacted in 1953 on the initiative of Minister of Labor Golda Meir, was at the time considered wasteful, something the country could not afford. But this law became the basis of Israel's social safety net, which guaranteed the entire population old-age and disability pensions, paid maternity leave, occupational accident insurance, and later, additional rights. Impressive economic growth combined with maintenance of low wage differentials among salaried workers made late 1950s Israel one of the most egalitarian noncommunist countries. The Israeli welfare state considered educating its citizens for productive work a premier national mission. Thus, for example, both the government and the Histadrut strongly opposed unemployment insurance, which was perceived as encouraging a life of unproductive decadence. Instead there was a policy of full employment, even though it meant introducing workfare, which had no economic value.

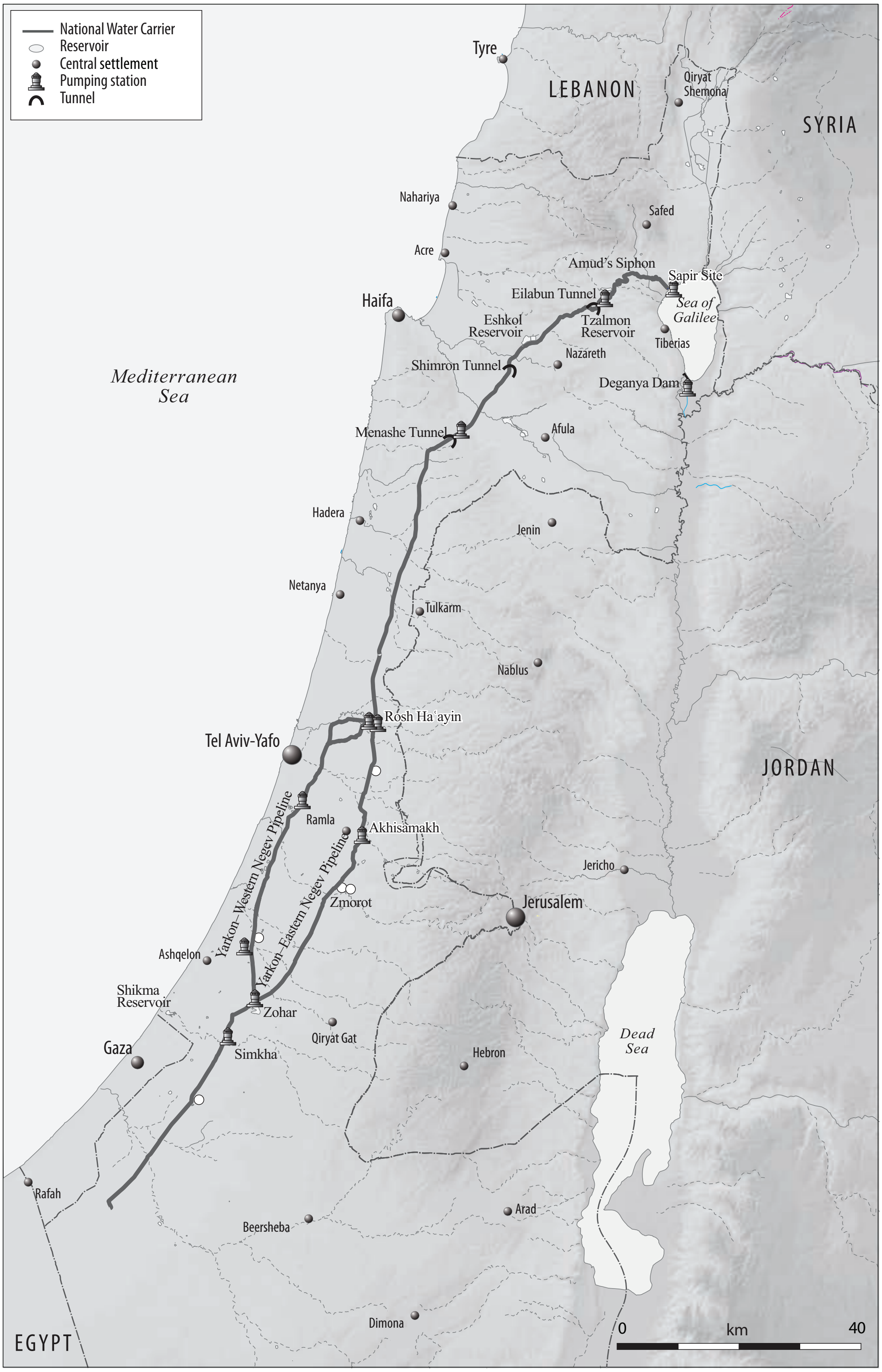
But as the economy, and the division of labor within it, became more sophisticated, groups of workers began demanding their own separate organizations and wage scales. They rejected the Histadrut wage scale, which tied pay levels mainly to seniority and the number of family members. In the late 1950s engineers, doctors, and high school teachers all demanded guarantees of higher wages relative to blue- and white-collar workers. The Histadrut had difficulty accepting these claims, which it believed would harm its policy of relative equality. It tried to demand that the wage agreements would freeze the existing differentials between the various professions, so that if one group got a raise, all the other groups would get raises in the same proportion. However, it was completely unrealistic to expect the professionals to agree to such a proposal. Given its historical socialist-Zionist perception that divided the professions into "productive" and "nonproductive," the Histadrut was more inclined to support wage claims in industry, agriculture, and construction than in service professions. But the service sector was growing and Histadrut control was waning.

Part of Ben-Gurion's statism concept was recognition of the importance of science as a national resource. Given the tremendous demographic superiority of the Arab states, he had always believed that one factor that would guarantee Israel's existence was its ability to harness the population's intellectual, technological, and scientific abilities to benefit society. This perception was based partly on deep-rooted pride in the Jewish genius, expressed in constantly citing the high percentage of Jewish Nobel laureates and the Jewish contribution to world culture. Promoting science and scientists agreed with statism in that its goal was the creation of a meritocracy based on individual achievement. The idea was to position Israel among the countries of the modern, secular, progressive West. The policy of nurturing the scientific elite was manifested in considerable investment in higher education during the first years of the state. When Israel was established there were two institutions of higher learning, the Hebrew University of Jerusalem and the Technion–Israel Institute of Technology in Haifa. The Weizmann Institute of Science came later as a research institute. Recognition of the state's needs for an educated population to fill posts in public administration and to create a stratum of engineers and technicians, researchers and inventors, led to national investment in developing higher education and making it accessible to the Israeli middle class. In just a few years several more universities appeared: Bar-Ilan University, Tel Aviv University, the University of Haifa, and Beersheba University (which later became Ben-Gurion University of the Negev).

One area where scientific achievements were applied was agriculture. Efficient use of irrigation, development of new varieties of crops, adaptation of nonindigenous varieties to local agriculture, and modern cultivation methods made Israel one of the world's most renowned and advanced countries in agricultural development. In the 1960s Israel sold its cultivation methods to developing African states. Scientific capability was also directed to the defense industry. The establishment of Rafael, the Armament Development Authority, was another example of the vision of Ben-Gurion, who was prepared to collaborate with academic researchers and invest in scientific development, even at a time when the state was short of resources in general and foreign currency in particular. Numerous technologies developed for the defense establishment were afterward integrated into industrial production, thus increasing Israel's export capability.

In the early 1960s several major national projects were completed, including the National Water Carrier, the Dead Sea Works, Ashdod Port, and the nuclear reactor near Dimona. Also during this period, there were few candidates for immigration, which usually brought prosperity from investment in absorbing them. Israel's balance of payments deficit increased, and attempts were made to reduce it through devaluation and the abolition of multiple exchange rates (in 1962 an exchange rate of three lirot to the US dollar was introduced), under the banner of "economic independence." But these attempts failed. The plan to reduce the deficit while economic growth continued backfired. After the major projects mentioned before were completed, the government did not embark on new ones. The resulting reduction of economic activity, together with attempts to prevent wage increases, led to a slowdown, a standstill in gross national product, and increased unemployment, which this time hit mainly the relatively well-to-do middle class and young academics. So many people left the country that a joke circulating at the time—about a sign at Lod Airport reading "Last one out, please switch off the lights"—entered national folklore. The planned economic slowdown turned into a recession that spiraled out of control. The recovery occurred rapidly, in the wake of the Six-Day War.

Would development at the level that occurred in Israel, under conditions of war and mass immigration, have been achievable without government direction? This question remains controversial among economists. But under the conditions of the early 1950s, the question was likely not even relevant. Until mass immigration stopped in 1952, Israel was in a state of emergency that resembled a war situation. Even afterward, it could find no private entities that were either able or willing to shoulder the burden of settling remote areas (since that made



MAP 6. THE NATIONAL WATER CARRIER, 1964. (SEE PLATE 6.)

no economic sense); training thousands of unskilled immigrants; absorbing sick, disabled, and uneducated populations; building transport, water, and electrical infrastructures; and providing health services, education, and housing to a population unable to pay for them.

Despite all its drawbacks, the directed economy seems to be what enabled the State of Israel to develop at an accelerated pace that became a shining example for developing nations. In 1963, 97 percent of the population had running water, and 93 percent had electricity. Private consumption had increased by 200 percent since 1948. The number of first-grade pupils rose from 17,137 in 1949 to 55,301 in 1963. The number of hospital beds increased from 4,626 in 1948 to 17,612 in 1964. Per capita gross national product rose by 232 percent between 1950 and 1963. It is doubtful that these achievements would have been possible without a directed economy. It is true that the standards of integrity were different from those of today, and there is no doubt that "our people" received preference in everything pertaining to project or resource allocation and that *protektsia* was standard practice. But there were no such acts of corruption as the theft of national resources, as perpetrated by the rulers of some developing nations and even some developed ones. The heads of government in Israel maintained a modest lifestyle and their integrity.

Yet one cannot dismiss the bitterness, hostility, and alienation engendered by the encounter inherent in such a system between citizen and bureaucrat. In government ministries, the employment service, the sick fund clinics, the Ministry of the Interior, and the Ministry of Trade and Industry, there was perpetual negotiation between all-powerful officialdom and the citizen who needed its services and benefits. One side displayed a lordly attitude, while the other experienced humiliation and dependency. The citizen who had to stand like a mendicant in the corridors of power wound up associating all the system's flaws and weaknesses with the ruling party. Mapai, which had been responsible for the Israeli economy's phenomenal success, drew fire from everyone disillusioned by the Zionist dream. All the malaises inherent in immigration and absorption were laid on its doorstep. In this way impatience with the system turned into anger with the labor movement.

NOTES

1. David Horowitz, *Hayyim bamoked* (At the Heart of Events), Ramat Gan: Masada, 1975, p. 108. The leader in question was Motzkin.

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