A Brief History of Israel's Economy

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The story of the Israeli economy was initially one of remarkable growth during a long period of socialism in the 1950's and 1960's. But when the socialist system stagnated in the 1980's, Israel overcame financial crisis and returned to robust growth through privatization in the 1990's. Today, with the country's transition from socialism to capitalism nearly complete, the upward trajectory continues through further reform that is moving Israel's economy from monopolism to competition.

Israel's Founding Economic Institutions

Israel's economic institutions were founded by Eastern European socialists in the early 20th century. Pre-state Palestine came under the control of the British in World War I, allowing the leaders of the Yishuv (meaning "settlement" in Hebrew, designating the Jewish community in pre-state Palestine) to establish several organizations that would eventually provide a framework for the future State of Israel. In addition to institutions for governance such as the Jewish Agency or the Haganah for defense, the most important economic institution was the Histadrut ("Federation" in Hebrew). The Histadrut was a federation of labor unions which also became the preeminent employer in the Yishuv.

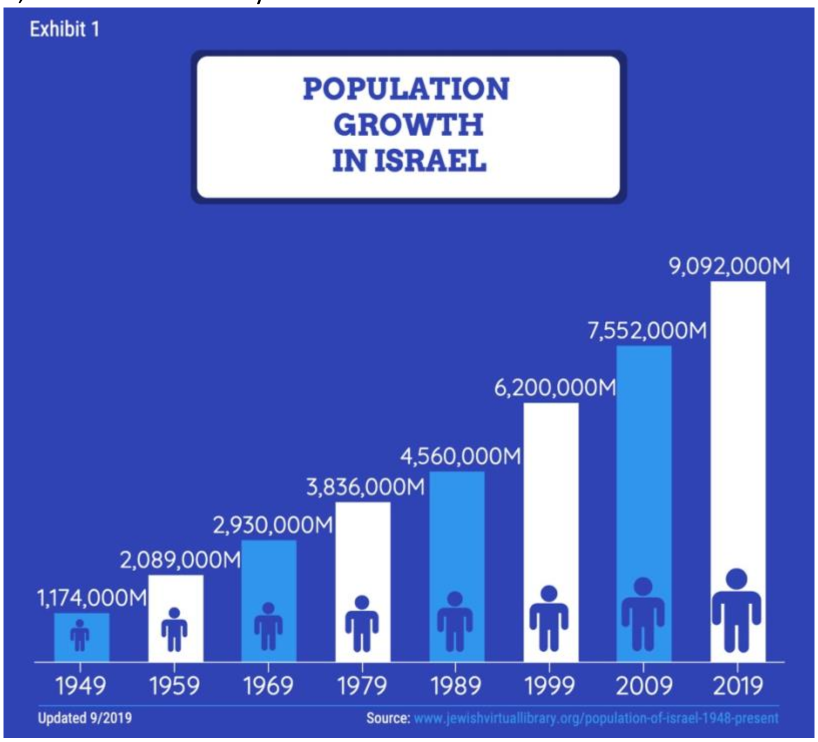
The history of labor unionism in the Yishuv was unique. In other countries, entrepreneurial capitalists created business enterprises, and their employees organized unions to demand improved pay and working conditions after the fact. In the 1920s, during the early years of the British mandate in Palestine, the Yishuv numbered fewer than 100,000 Jews who possessed limited capital and natural resources. As a result, the Histadrut adopted an entrepreneurial role, organizing cooperatives in almost every niche of economic activity, including manufacturing, distribution, transportation, and banking. Even the famous collective agricultural settlements known as "kibbutzim" largely distributed their produce through Histadrut organized cooperatives.

Histadrut businesses generally became monopolies in their fields. Despite this highly monopolized economic structure, most Histadrut enterprises were remarkably efficient. They served a very small but rapidly growing population. These two characteristics – small scale and rapid growth – kept the Histadrut's monopoly powers in check, since the Yishuv could not support large scale competition during the 1930s and 1940s.

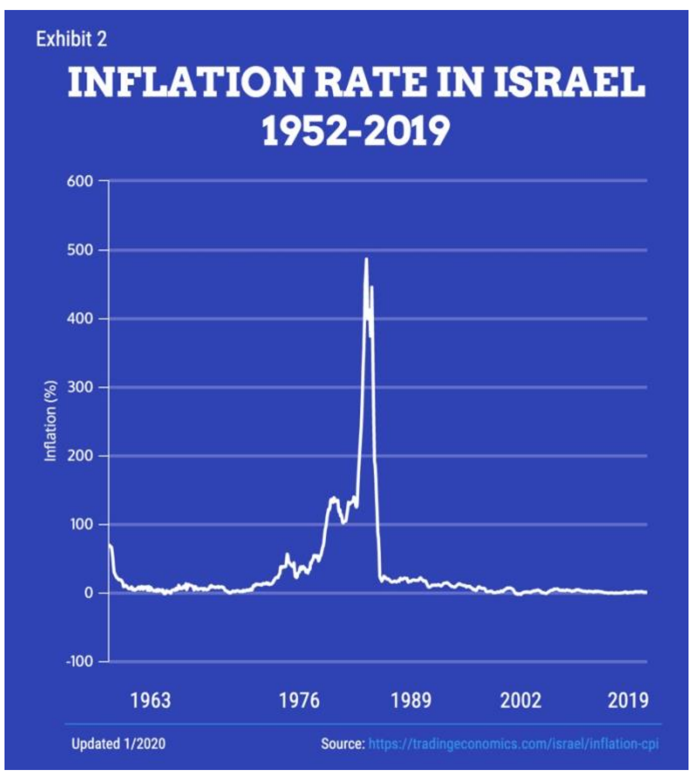
Following independence in 1948, the newly formed government established state-owned enterprises as a complement to the Histadrut's business activities. Together the government and the Histadrut controlled about two thirds of Israeli economic activity. The private sector remained small and interconnected with the government but nonetheless dynamic, given Israel's rapidly expanding population and economy.

Stagnation and Crisis

By the early 1970s a larger Israeli population (about three million people in 1970; see Exhibit 1) exposed the inefficiencies of the mature socialist system. Economic growth stagnated, exacerbated by global economic stagflation and mounting military expenditures in the aftermath of the 1973 Yom Kippur War. State-owned enterprises, Histadrut companies, and the Kibbutzim were losing money, propped up by escalating state subsidies and higher taxes. By the early 1980s, the Israeli economy was in crisis.



Life became very difficult for the average Israeli in the early 1980s. Per capita income for Israel's 4.2 million people was a meager $6,000 per year, and inflation averaged 500% (see Exhibit 2). Government expenditures exceeded 60%



of gross domestic product (GDP) with government debt approaching 160% of GDP (similar to Greece during the euro crisis). Despite a costly military burden compounded by the 1982 Lebanon War, only 20% of government expenditures were allocated for defense. The remainder supported generous subsidies and social insurance programs. The Israeli government subsidized certain food products, insolvent public sector companies, and the kibbutzim. The banks collapsed in 1983, prompting an expensive government bailout and takeover.

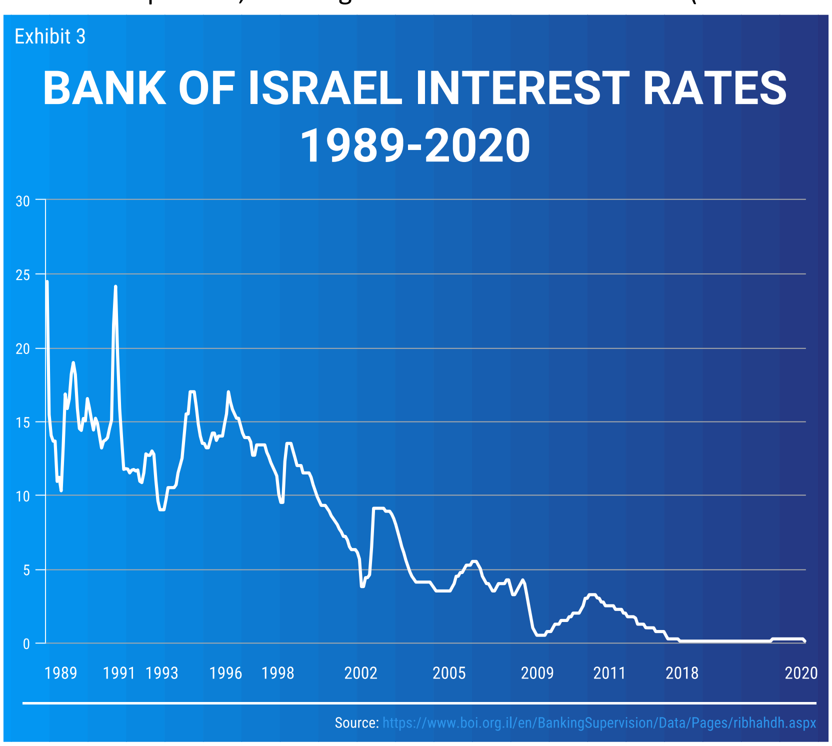
Stabilization and Reform

The economic crisis and the Lebanon War pushed the two leading Israeli political parties (Labor and Likud) into a "national unity" coalition government. The coalition implemented a successful "Economic Stabilization Program" in 1985 which reduced the inflation rate, cut government spending, and restructured public sector companies. Although difficult to discern at the time, the stabilization program inaugurated Israel's long climb out of distress to economic success.

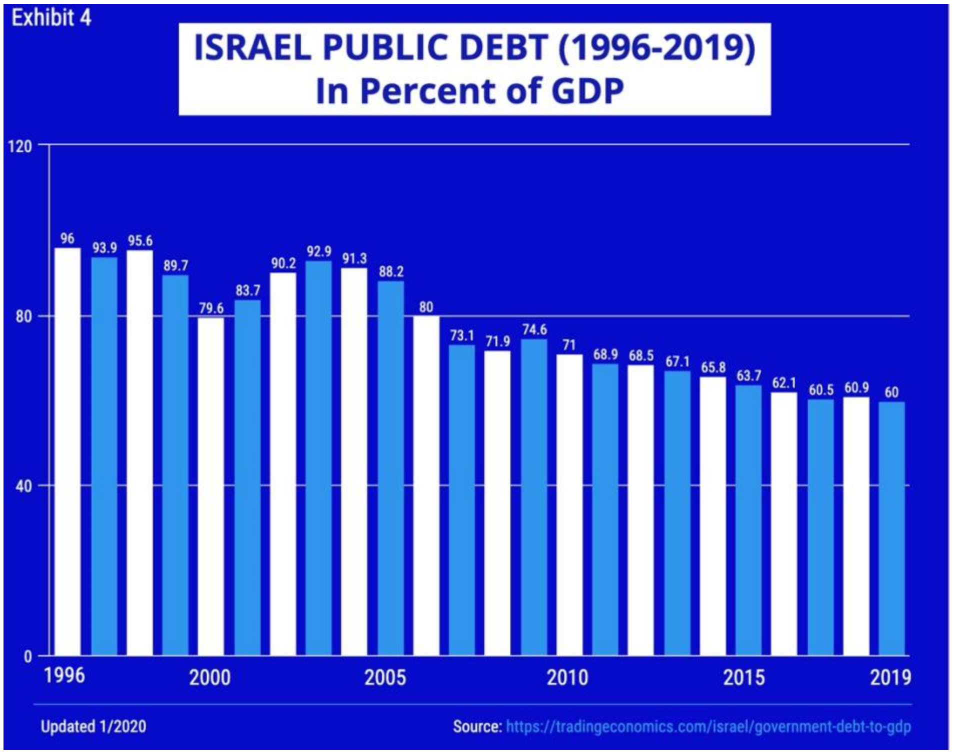
In 1995, the Israeli government nationalized the health insurance system. Israeli history is replete with ironic moments, and this was perhaps one of the most ironic moments in Israel's economic history. One of the first programs established by the Histadrut was a system of national health insurance, known as Kupat Cholim (i.e. the "sick fund"). Over time, Kupat Cholim became the dominant health system in Israel, but it came with a significant catch. In order to obtain coverage, every participant was required to become a Histadrut member. In effect, the Histadrut's health insurance monopoly forced the unionization of the Israeli workforce. Kupat Cholim was the source of Histadrut power.

One year after the government assumed control over Kupat Cholim, Histadrut membership plunged by 65%. Israelis voted with their feet and removed two major sources of Histadrut funding: health insurance premiums and union dues. As losses mounted, the Histadrut sold off its business activities to plug the budget gap. By the end of the 1990s, the Histadrut sector was completely privatized (about one third of GDP) and labor market restrictions liberalized.

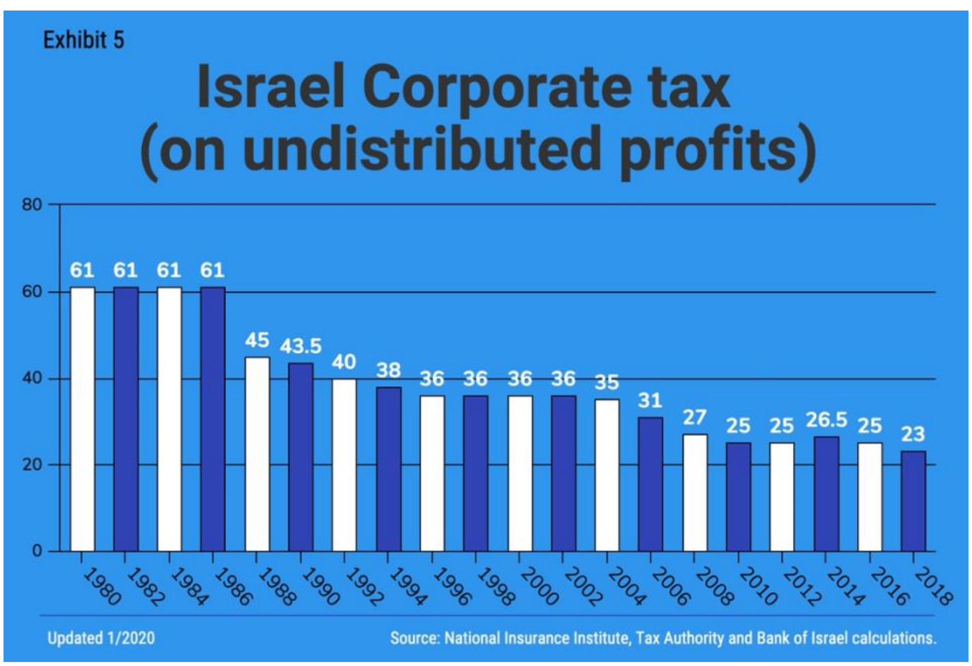
Israel shifted from a socialist to a market economy during the 1990s, and economic growth accelerated in response. To further cement its new capitalist foundation, Israel gave its central bank – The Bank of Israel – more independence, allowing it to maintain its disinflationary policies. As a result, the inflation rate in Israel dropped from 20% per annum in the late 1980s to less than 2% at present, allowing interest rates to fall as well (see Exhibit 3).



Although not always consistent or without acrimony, successive governments kept deficits and debt under relative control. Over time, Israeli government debt declined from 160% of GDP to 61%. The Israeli government is now substantially less indebted than the United States (see Exhibit 4). Debt is no longer high by world standards, and Israel can comfortably service its debt and maintain its AA-credit rating.



Since Israel can experience sudden and unexpected defense expenditures, bond markets are likely to maintain pressure on the Israeli government to further reduce its debt as a percentage of the economy. Remarkably, Israel maintained debt discipline in recent decades while simultaneously reducing personal and corporate income tax rates (see Exhibit 5). During these years, infrastructure spending lagged, but ongoing economic growth is allowing the government to once again prioritize infrastructure projects such as railroads, light rail systems, airports, and roads without boosting its debt level.



Despite increased security costs during the Second intifada in 2000, the Second Lebanon War in 2006, and Operation Cast Lead in Gaza in 2009, Israel maintained budget discipline in part because of revenue from privatization. Sales of state-owned companies began in the 1990s but accelerated after the Histadrut was finally dismantled in the early 2000s. The government privatized the banks, telecommunications, the national airline, oil refineries, and a variety of other major industries. This process is mostly complete with a few additional initiatives related to land sales, electricity, infrastructure and defense industries pending.

Israel's Economic Future

Privatization removed the state from a dominant position in economic life, but in many cases, it merely transferred monopolies from state to private ownership. Further reforms are required to promote a more competitive marketplace. The Israeli government took its first step forward in this direction with the passage of the Bachar Committee reforms in 2005. The Bachar Committee (named for its chairman Dr. Yosef Bachar, former director general of the Ministry of Finance) examined the problem of capital market concentration. The government understood that concentrated financial markets restricted access to capital and was a critical contributor to monopoly problems throughout the economy.

The reforms directly attacked the historical domination of the financial services industry by the three largest banks (Bank Leumi, Bank HaPoalim, and Israel Discount Bank). In addition to traditional commercial banking services, these banks also dominated securities underwriting and asset management (including pension and mutual funds). The Bachar reforms required the large banks to sell their asset management subsidiaries, limit their underwriting activities, and promote competition in lending.

Israel Charges Toward a Less Monopolistic, More Competitive Economy

The Israeli economy is in the midst of a profound restructuring, reminiscent of Teddy Roosevelt's early 20th century trust-busting in the United States. In December 2013, the Israeli government passed the "Law for the Promotion of Competition and Reduction of Concentration." This law mandated separate ownership of financial and nonfinancial companies. With a deadline of December 2019, the tycoons controlling monopolistic business empires through preferential access to capital are engaged in a flurry of deal-making.

Examples abound. Shari Arison, who controlled both Bank Hapoalim and Israel's largest construction firm, Shikun v'Binui, sold a portion of her Bank Hapoalim shares in a secondary offering on the TASE in November 2018. She will continue selling shares until her stake is reduced to less than 5%, at which time Bank Hapoalim will be entirely publicly traded. She also sold her controlling interest in Shikun v'Binui to a U.S. based real estate company, putting these previously intertwined entities completely at arm's length.

Delek Group, a conglomerate controlled by billionaire Yitzhak Tshuvah that owns Israel's offshore natural gas fields, vast real estate holdings, and a major insurer, signed a deal in May 2019 to sell its stake in Phoenix Insurance to U.S. private equity funds. IDB Group once controlled Israel's third-largest bank, one of its largest insurance companies, and significant non-financial holdings. Over the past six years, regulators dismantled this empire, and its billionaire former owner, Nochi Dankner – the poster child for the excesses of the monopolist moguls – is now serving a three-year jail term for fraud.

What Remains to Be Done

In 2017, the Israeli government passed "The Law for Increasing Competition and Reducing Concentration in the Israeli Banking Market." The law ordered Bank Hapoalim and Bank Leumi to divest their credit card businesses. To meet the requirements, Bank Leumi sold Leumi Card to the U.S. private equity firm Warburg Pincus in March 2019. Bank Hapoalim opted instead for an initial public offering (IPO) of its Isracard subsidiary on the Tel-Aviv Stock Exchange (TASE). Bank Hapoalim sold 65% of Isracard shares in May 2019 and will sell most of its remaining stake by the end of the year to fulfill its lawful obligations. The newly independent credit card companies will be allowed to develop full-service banks at which time Bank Leumi and Bank Hapoalim will be allowed to reenter the credit card business de-novo.

In addition to the reforms outlined above, the Israeli government expanded competition in the cellular telephony market. Predictably, monthly charges for consumers plummeted over the past several years. In summer 2018, the Knesset passed a law to end Israel Electric Corporation's (IEC) near-monopoly over electricity production in Israel. Over the next five years, IEC will divest several plants, reduce bloated headcount, allow new entrants into the market, and moderate prices for consumers.

Most of the reforms to date affect Israel's largest companies and business groups. Even so, a host of anti-competitive business practices remain common throughout the Israeli economy (with the notable exception of the technology sector). To address pervasive monopoly power, the Israeli government passed another landmark piece of legislation in January 2019. The Israel Antitrust Authority will be renamed the "Competition Authority," with a broader mandate to act if it finds that companies or industries exercise and abuse "significant market power."

From Socialism to Oligarchy to Competition

Although early Israeli leaders created an Eastern European-style socialist economy, it was layered on top of Western European parliamentary democracy and a British legal system. As Israel has steadily stripped away its socialist legacy, it is increasingly revealing a dynamic trading state similar to other former British colonies such as Singapore or Hong Kong. If Israel maintains its long-term trend toward capitalist reform, it should continue to improve its standard of living, competitiveness, and the depth of its financial markets.

Exhibit Sources:

Exhibit 1
Updated 9/2019
Source: www.jewishvirtuallibrary.org/population-of-israel-1948-present

Exhibit 2
Updated 1/2020
Source: https://tradingeconomics.com/israel/inflation-cpi

Exhibit 3
Updated 1/2020
Source: https://www.boi.org.il/en/BankingSupervision/Data/Pages/ribhahdh.aspx

Exhibit 4
Updated 1/2020
Source: https://tradingeconomics.com/israel/government-debt-to-gdp

Exhibit 5
Updated 1/2020
Source: National Insurance Institute, Tax Authority and Bank of Israel calculations.