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The Economy of Israel:

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So much at stake.

Israel's Economy: The Challenges Ahead

Israel's survival as a free nation will ultimately depend as much on its economic viability as on its military might. Yet, while most Americans recognize the continuing threat to our ally's physical security, many are not aware of its deep economic problems.

From its inception, Israel's record as a developing nation was dazzling. Its real output grew at nearly 10 percent a year from 1950 to 1972, while its output per worker more than tripled. Inflation was higher than elsewhere in the West, but, by the late 1960s, it was lower than in America. In the last decade, however, productivity has not increased, and in some years it has decreased. Inflation has increased steadily, and is now in the triple digit *range, with no end in sight. Israel's foreign debt continues to mount alarmingly, while its capacity to service this debt through export earnings has not kept pace.*

Increased defense costs, energy prices, and a world recession are among the reasons typically given for Israel's poor economic performance. Nevertheless, a growing number of economists believe that domestic policies and institutions are also crucial. Defense needs, energy prices, and the world economic condition are typically functions of outside forces, while lifting government controls and regulations and reducing government spending are within Israel's capacity to change. Yet, having been exposed for so long to intense anti-capitalist attitudes, and having come from countries in Eastern Europe and the Arab world where autocratic governments are the rule, many Israelis find it difficult to understand the importance of competitive institutions for resuming high growth, and the intimate connection between economic and political freedom.

A year ago, a group of Israeli academicians and other interested citizens organized the Israel Center for Social and Economic Progress *to study market processes and their applicability to Israel's economy. The Center has launched an extensive program of research, publications, and other educational activities (such as conferences, seminars, and debates) in Israel. In America, prominent public figures and scholars have established the* Friends of the Center *to assist the Israel Center's work and to educate Americans about Israel's economy.*

At a recent luncheon jointly sponsored by the Manhattan Institute and the Israel Center, five Israeli economists assessed the challenges their country faces in the coming years. The first part of this Manhattan Report *is based on that discussion. Despite Israel's economic problems, there is a thriving, if not very well known trade between the two countries, particularly in the high technology sector. The* Manhattan Report *explored the growth and conduct of this trade with a number of leading businessmen who operate in Israel and America. The second part of this* Report *presents excerpts of these interviews.*

MANHATTAN
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"It has become clearer and clearer that a large part of the responsibility for Israel's economic problems is due to inflexible domestic institutions and policies."
—David Levhari

Herbert Stein—There are many reasons why we should be interested in Israel's economic problems and prospects. Because she is America's friend and ally, we should be concerned for the well-being of her people—and because of Israel's continuing military problems, the importance of a strong economy is obvious. For economists, Israel presents an interesting example of a developing country which has grown rapidly, yet faces serious problems. And for businessmen, Israel may present possibilities for trade and investment that have been relatively neglected. For these reasons, we are very fortunate to have with us today five individuals who can discuss the Israeli economy with deep knowledge and understanding.

Our first speaker is David Levhari, Professor of Economics at Hebrew University. Professor Levhari studied economics at the Massachusetts Institute of Technology. His research interest has been economic growth, and he has published many articles in major academic journals in America. He will give us an overview of Israeli economic policy.

Craig Jerry

David Levhari

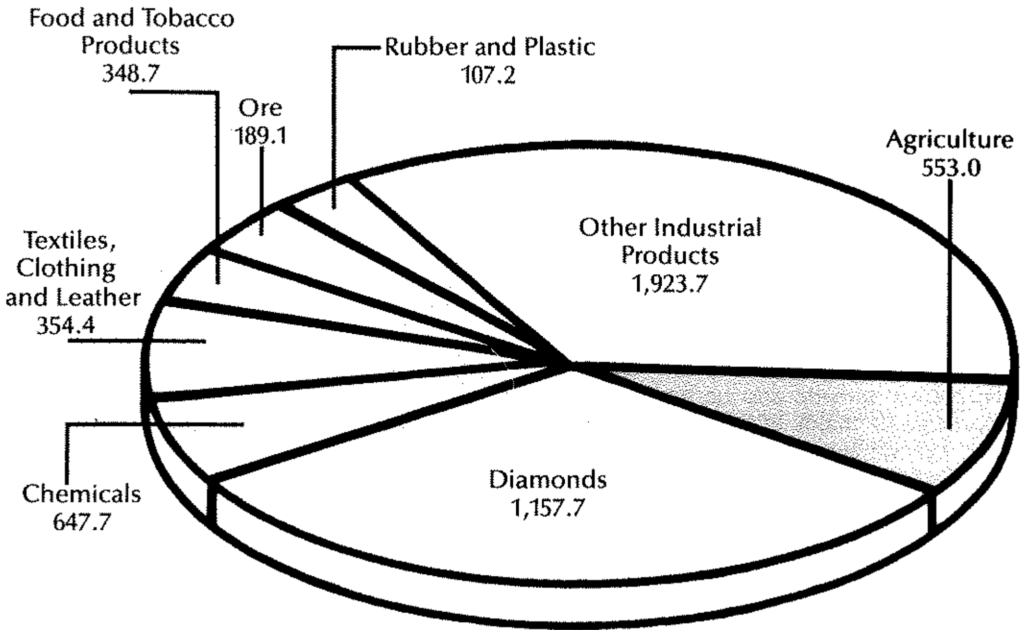
David Levhari—The Israeli economy grew extremely rapidly in the years after 1952, fed by a large population increase through immigration, and by a large capital inflow from private investment, American economic and military aid, German reparations payments, and the philanthropic contributions of world Jewry. In fact, in the period down to 1972, the Israeli economy grew at rates which were the envy of the developing world. But from the time of the Yom Kippur War (1973), the economy has slowed down considerably. There has been hardly any growth at all for quite a few years. Inflation is now in the triple digit range, productivity is stagnant, and there is a deep crisis in the international trade sectors. The deficit in the civilian balance of payments has grown from $500 to $750 million per quarter. This deficit is being covered by foreign aid or loans, but the situation cannot continue indefinitely; clearly, growth in exports is necessary.

The temptation to blame economic deterioration upon the enormous military needs in the aftermath of the Yom Kippur War, and upon the explosion of energy prices that followed, should be resisted. It has become clearer and clearer that a large part of the responsibility for Israel's economic problems is due to inflexible domestic institutions and policies. Simply put, economic decisionmaking is far too heavily politicized. The government is omnipresent.

Israel's economy, of course, is not centrally planned in the sense of the communist countries. And its society is free, pluralistic, and robustly, even rambunctiously democratic. No one interest group or party completely dominates all the others, and thus political decisions about economic affairs result from an equilibrium of interest groups jockeying ceaselessly for position—for favors, subsidies, concessions, etc. However, this political equilibrium comes very much at the expense of economic rationality. Too many resources are allocated for political and not for economic reasons. The result is that Israel has not developed as much as it could have.

Moreover, the whole system fosters a generally cynical and unhealthy social attitude toward achievement, effort, and innovation. People or enterprises do well economically by obtaining special privileges and favors, and only secondarily (if at all) by performing well for the benefit of consumers. Inevitably, productive ability trades at a discount, relative to "pull" and "connections." People come to regard wealth as something to be extracted through politics, not created through enterprising effort.

Israeli industry, for instance, developed under what you in this country might call an "industrial policy." There was a "Law for the Encouragement of Capital Investment," requiring entrepreneurs to first submit their investment plans to a bureaucracy, the "Government Center of Investment." Approval meant access to all sorts of special tax breaks, credit, and other benefits. But this system facilitated uneconomic transactions. Decisions were not always based on rigorous demonstration of economic viability, and there was always the temptation to submit inflated costs in order to get subsidized loans. Firms and industries tended to become dependent upon aid and lose the competitive discipline necessary to keep costs down and productivity up.



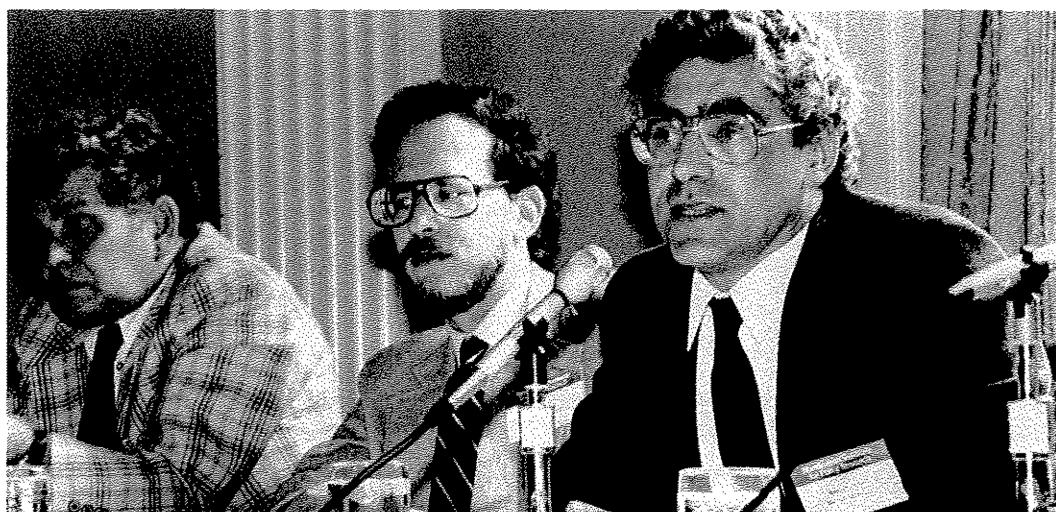
SOURCE: Israel, Central Bureau of Statistics, *Monthly Bulletin of Statistics*, XXXIV, 4 (April 1983) p. 31.

Public discussion about the proper economic regime for Israel has always been intense. In the early years, controversy raged between supporters of David Ben-Gurion's MAPAI party, whose platform was "Socialism in Our Day," and the advocates of "Free Enterprise." The *dirigiste*, socialistically oriented parties were clearly ascendant, however, and ruled the country right down to 1977. As a result, the public sector was quite large in relation to the private sector, even taking into consideration the big defense budget. Transfer payments in the Israeli government budget are higher than in most western economies; a great deal of credit is allocated through government mechanisms; and some 93 percent of the land is owned by the government.

During the years following the Yom Kippur War, however, public dissatisfaction with the country's economic performance was among the reasons that led to the victory of the Likud Party—the first real change in government in twenty-nine years. Most people, supporters and opponents alike, expected there would be a greater reliance on market forces, since this had always been part of Likud's platform and appeal. Likud's platform, for instance, described the Labor Party's system as a "melange between capitalism, socialism, and anarchy designed to perpetuate the ruling party," while it, on the other hand, promised to "strive to establish a free economy based on efficiency, initiative, and competition."

Nevertheless, except for the liberalization of the foreign exchange market in October 1977, the structure of the economy hasn't changed in any fundamental way. No substantial change of policies toward reducing the size of the public sector has been made. When Likud took power, for instance, about 28 percent of the labor force was employed by government. Now it is about 30 percent. Reduction of government subsidization of the production and marketing of commodities has either not occurred or has not gone very far. Transfer payments to households or nonprofit institutions have risen from roughly 9 percent to 14 to 15 percent of GNP. There was a lot of talk about selling government-run enterprises to the private sector, but little action.

As I mentioned earlier, there is a deep crisis in the international trade sector. I would say that probably most of it is government-made. The government decided that its inflation problem was being imported via the depreciation of the Israeli currency. So the argument has been that the way to reduce the inflation would be to slow devaluation of the Israeli currency. Therefore, the Bank of Israel and the government have been trying to


Craig Terry

Haim Barkai, Steven Plaut, Menachem Brenner

manipulate the foreign exchange rate. What happened is that exports have fallen dramatically for the first time in Israel's history while imports have grown dramatically. Hyperinflation has continued.

I have talked quite frequently with the governor of the Bank of Israel and tried to convince him to carry on a more vigorous monetary policy of controlling the money supply. After all, hyperinflation is at bottom simply the phenomenon of too much paper money chasing after goods. There is a great deal of resistance, however, to an active monetary policy. In fact, unlike in the U.S. or elsewhere, monetary policy in Israel hardly exists as an independent part of economic policy. Besides some direct determination of credit ceilings, the Bank of Israel has no active policy, but merely acts as a passive agent of the Treasury, issuing indexed bonds to monetize the debt. The banks also sell their own stocks, absorbing capital from the private sector.

In fact, indexation is fairly pervasive in the Israeli economy. Even so, hyperinflation has resulted in the necessity for almost continuous wage negotiations in the public sector. The accompanying turbulence in the labor market does not help entrepreneurial planning.

While I have tried to give some picture of unpleasant realities, there is no inherent reason why Israel cannot once again grow rapidly. It has survived many grave threats in the past, and with a highly educated, ambitious citizenry, it will no doubt surmount its present problems. The Israeli public, in my opinion, is not very well-informed about how free markets work. But it is well-informed about how politically manipulated markets don't work.

Herbert Stein—Menachem Brenner is currently a visiting professor at the New York University Graduate School of Business. His permanent position is Senior Lecturer on Finance at Hebrew University. He received his degree from Cornell University and has served as a consultant to the Comptroller of Banks at the Bank of Israel. He will talk about capital markets in Israel.

Menachem Brenner—Imagine, for a moment, that credit in the United States was allocated jointly by the American government, the banks, and the AFL-CIO. If you find that prospect preposterous, or at least very unsettling, imagine as well that all the banks in the United States were concentrated into a cartel of three members. Generally, that has been the situation in Israel. Most resources are controlled directly or indirectly by the Israeli government, or its government-controlled companies; the Histradrut, Israel's labor federation and the employer of roughly one quarter of the labor force; and the bank cartel [The Bank Leumi, the Bank Hapoalim, and the Israel Discount Bank].

This institutional arrangement grew out of Israel's history. When the state of Israel was founded, it faced many problems: absorbing a large immigration, settling the country, building a defense force, developing an infrastructure, etc. At the time it seemed natural, even necessary, for the government, with the help of the Jewish Agency [the social service agency of the World Zionist Organization], to undertake the main effort in advancing the economy. And since so much of the capital available for investment came in from abroad and was channeled through the government and the Jewish Agency, the public sector was predominant. Hence the allocation of most resources was done by government, either through direct investment (government-owned com-

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Herbert Stein, *American Enterprise Institute*

panies) or through various forms of subsidization. At the same time the government borrowed from the public at inflation-linked rates by issuing fully indexed bonds.

The banking sector served as the intermediary for these transactions, and hence took over the functions of modern capital markets. Unlike this country after 1933, there is in Israel no Glass-Steagall Act to prohibit banks from investing in non-bank enterprises. Israeli banks are involved in equity markets at all levels and on all fronts. The government gives subsidies to industries through outright grants or cheap loans. The loans, of course, are intermediated by the banks, who take their cut. On the other hand, the government also issues indexed bonds to the public to raise funds. What develops, however, is that industries find it profitable to invest in indexed bonds rather than in productive assets. They also get unindexed loans from the government at artificially low interest rates.

As the economy has grown, the demand for funds has increased, and the proportion of subsidies has decreased. More companies have turned to the stock market to raise money, but they have had to compete with a dominant government-subsidized banking sector, and with the government.

Israel has, therefore, a very centralized capital market basically controlled by the government and three banks. Inefficient allocation of resources results. Israel has a lot of examples of industries that were promoted for noneconomic reasons. It was not to our comparative advantage to have a textile industry or build our own home appliances. Nevertheless, a lot of capital was squandered on projects which the government decided, for one reason or another, were important.

I think that there should be a major reform in the structure of the capital markets, making them much more competitive. If there are applications for opening new banks, they should be approved. Insurance companies, which in America are becoming a major force in financial services and banking, are drastically restricted in Israel; they are required to invest upwards of 90 percent of their premiums in government bonds. They should be permitted, along with other financial institutions, to become more directly involved in banking-type services. And government must in the future abolish subsidies to inefficient industries, or keep them to an absolute minimum.

I'd like to close with an often-told story which exemplifies the kind of misallocation of capital you get in a system where government instrumentalities are involved in subsidies. It involves the late Mr. Sapir, who was Finance Minister of Israel in the 1960s. One day an industrialist came to him and said, listen, I want to open a textile factory which will employ "x" number of people. I need a loan of $1 million; in six months I'll pay it back, with interest. So Sapir wrote out a little note and gave him a $1 million loan. Six months later the industrialist ran into Sapir in the street and said, how much do I owe you? Sapir says, $1 million plus interest. The industrialist says, well, make it $2 million, and I'll give it back to you in another six months. Another six months pass, and again the

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Dan Galai

Israel's Economy: Selected Indicators

	Inflation Rate	Rate of Change of Real Wages	Rate of Growth of GNP	Public Consumption (% GNP)	% of Labor Force in Public Sector	Total Taxation (% GNP)
1970–73	15.4	3.1	9.4	10.7	24.3	35.7
1974–77	39.6	1.8	2.5	11.4	27.3	44.6
1978–81	95.8	4.3	3.7	12.7	29.6	45.0
1977	42.6	10.6	1.0	12.5	28.0	47.8
1978	48.1	1.5	4.4	12.4	29.2	44.7
1979	111.4	9.5	3.7	13.2	29.5	45.9
1980	132.9	−3.2	2.7	12.6	29.6	44.7
1981	101.4	9.8	4.2	12.5	30.0	44.4

SOURCE: Israel Economic Quarterly, December 1982

industrialist meets Sapir and asks him, how much do I owe you? $2 million? Well, let's make it $4 million, and I'll pay it back in six months. And so on. After about another year, the industrialist runs into Sapir on the street, looks at him, and says, Oh, Sapir, well, how much do I owe you? Sapir looked back at him and said—nothing, absolutely nothing!

Herbert Stein—I think we might all keep that story in mind while we watch the negotiations about the present LDC debt crisis.

Our third speaker is Dan Galai, who is now a visiting professor at UCLA, and a Senior Lecturer on Finance at the Hebrew University. Professor Galai received his Ph.D. in Finance from the University of Chicago. His specialty is research and development, and he will discuss high technology—whether Israel can become the Switzerland of the Middle East.

Dan Galai—Switzerland is usually associated with three images: beautiful snow-covered mountains, banks, and watches. The first image, while attainable geographically, is politically ruled out. The Israeli banking industry was discussed by my friend and colleague, Menachem Brenner. I'll concentrate on Israel's potential to achieve industrial prominence.

Both Israel and Switzerland are small countries without natural resources, depending to a large extent on foreign trade. Nevertheless, Switzerland has established itself as a stable economy with a great reputation for its industrial products. Can Israel achieve the same? Two questions should be answered in this context: First, *can* Israel produce "Swiss watches?" Second, *should* Israel produce "Swiss watches?" There is another issue, also. Switzerland is one of the great protectionist countries in the Western world, even more protectionist than Japan. Should Israel follow the same route?

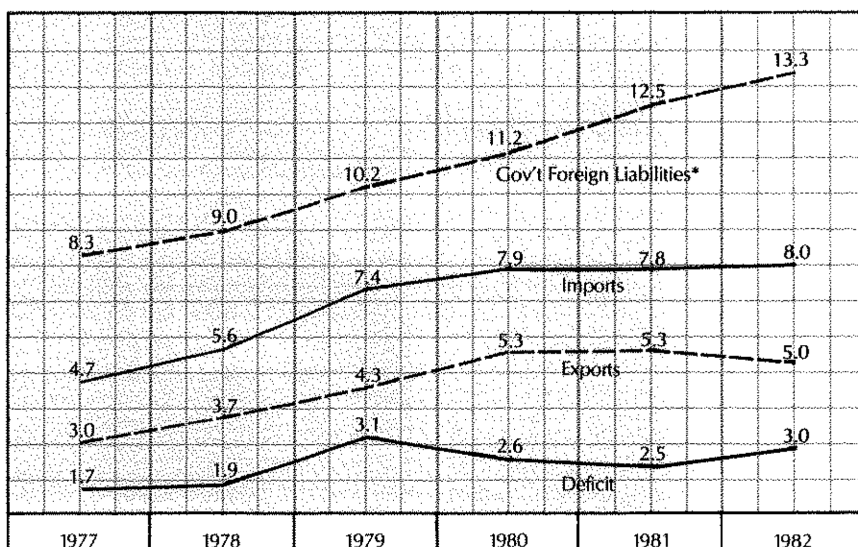
In order to answer these questions, we should review some of the issues. On the negative side, one could list the small size of Israel's economy—a population of four million people and a limited internal market. The local market is too small to support all by itself the products of high technology firms. This problem is even more serious since most of the markets bordering Israel are closed. But even if those markets will open—and we hope they will—they are not target markets for high technology products. For instance, Israel has a formal trade relationship with Egypt. But Egypt is not a prime candidate to buy sophisticated medical instruments, an industry in which Israel is in the forefront. Egypt still needs hospitals and basic medical service. It is far away from the stage where it can consume the sophisticated systems that Israel produces.

Israeli firms are relatively small compared to their world competitors. Also, the political instability of the Middle East means that Israeli firms operating in foreign markets have to guarantee "second sourcing" for their customers, which adds to their cost of doing business. Second sourcing means that Israeli firms have to secure *alternative* sources for their products, services, parts, etc., in case of disruption to normal distribution channels, to reduce the risk otherwise faced by their customers. Therefore, competition on foreign turf starts with a visible disadvantage to Israeli firms.

In its favor, Israel can count a sizeable pool of scientists and engineers. The ratio of scientists and engineers employed in R & D is 48 per 10,000 (20 years old and over) in Israel, compared to 40 per 10,000 in the U.S.A., and approximately 25 per 10,000 in Western European countries. The country also has outstanding institutions of higher learning and an impressive research infrastructure. In

"I strongly suspect that the debt service problem will turn out to be the major impetus for change in Israel's domestic economic policy."—Steven Plaut

Israel Foreign Trade and External Government Debt
($ millions)



*Total Foreign Liabilities of Israeli Government at end of year.
SOURCE: Israel, Central Bureau of Statistics, *Monthly Bulletin of Statistics*, XXXIV, 4 (April 1983), pp. 28, 30.

fact, a strong higher education system preceded the development of modern industry in Israel. That may also explain the relatively low proportion of scientists that are currently employed in industry. In the United States, about 60 percent of the scientists are employed in industry, while in Israel the proportion is about 25 percent. From the industry point of view, the pool of potentially employable talent is large.

The large pool of scientists and engineers living in Israel can be augmented by Israeli scientists and engineers currently residing in and working in the U.S.A. and in other European countries. This group is a potential source for additional skilled manpower that may be needed to sustain a high rate of growth in high technology industries in Israel, as well as a source of new product ideas. To all that, we can add the scientific Jewish community around the world.There is the example of Russian scientists who have emigrated to Israel. Suddenly finding themselves in a different culture with greater commercial prospects for their ideas, they have become very innovative.

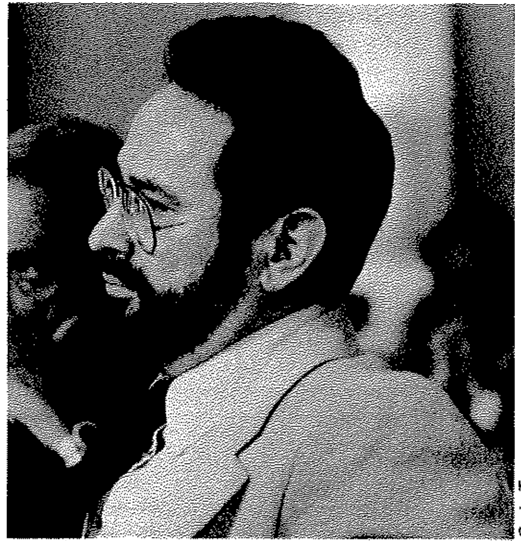
Israel's advantages—especially her skilled manpower—coupled with her lack of industrial raw materials, lead to the conclusion that she should concentrate on high technology industries. This conclusion is backed by a government commitment to encourage investment in industrial R & D. Through a variety of programs, government bodies support industrial R & D by direct financial assistance as well as indirect contributions to the research infrastructure, including major support to defense R & D.

There is no doubt therefore, that Israel *can* produce "Swiss watches." It currently produces electronic systems, computers, instruments, electro-optical devices, and many other sophisticated products that compete successfully in the world market. But should Israel concentrate in a very few areas to achieve world dominance? I don't think so. Specialization can be dangerous in a world of rapid scientific and technological change, since whole industries can become obsolete. Take the Swiss watch. We used to get them for Bar Mitzvahs. Today a Swiss watch would be an insult—the Bar Mitzvah men want an Apple II, or something comparable. There are other reasons why Israel should not put all its eggs in one basket, including the political situation. And in any event, I do not see where Israel can successfully compete in labor-intensive, standardized, batch-produced commodities. Israel has no advantage in producing televisions, radios, calculators, or semiconductors.

Israeli companies should concentrate on de-

Craig Terry

Jeffrey Poelvoorde, *Carleton College*



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Daniel Doron, *Director, Israel Center*

veloping systems rather than components—the diagnostic kits for medical uses, for instance, but not necessarily the enzymes or other chemicals that go in them. Second, emphasis should be put on applications. A standard robot will become a staple good, and Japanese companies are expected to dominate the world market. However, applying the robots for specific uses, and selling a dedicated system with the robot as a component, is a promising approach. Third, due to the relatively high budget devoted to defense R & D, more attention and funds should be devoted to civilian spin-off products. Experience shows that much can be done in this direction. Fourth, more university R & D should be applied to industry. In the last five years it has become more acceptable for university scientists to work with industry, perhaps in collaborative ventures as are occurring in America. Fifth, government should create the conditions for risk taking and entrepreneurship.

Current tax rules in Israel discourage risk taking. Government involvement in the capital market, which Menachem just discussed, leads to diversion of funds away from industrial projects, especially risky projects, to safer, government-backed securities—namely, to the index-linked securities, which guarantee about 3 to 5 percent *real* annual interest rates, with no risk attached. It's hard for R & D to compete with that. Similarly, government involvement in the foreign currency market may discourage joint ventures. Interference with floating exchange rates, for instance, is something American companies don't find very encouraging when conducting business with Israel. My belief is that joint ventures are one of the preferred ways to encourage high technology industries in Israel, linking them to foreign markets via partnerships with foreign firms.

Herbert Stein—Steven Plaut is a Lecturer in Economics at the School of Industrial Engineering and Management at the Israel Institute of Technology, in Haifa. Professor Plaut received his degree in economics from Princeton and has taught at Princeton and Oberlin. His major interest is international currency exchange and trade. He will discuss Israel's foreign trade and foreign debt.

Steven Plaut—A few months ago President Reagan raised the tariffs on Japanese motorcycles by several hundred percent. The reaction among people who favor free trade was outrage, and President Reagan was very stridently criticized. That same week the Israeli government also raised the tariff on Japanese motorcycles, except it didn't raise the tariff by a few hundred percent. It raised the tariff by an infinite percent, simply by banning all imports of Japanese motorcycles. The public reaction in the two countries was very different. Most Israelis probably didn't even know about it. I happened to stumble across a notice in the back pages of the newspaper. I'm sure Israelis who heard about the angry reaction to President Reagan's act were confused.

Israelis, by the way, think that Americans are very strange creatures. They can't understand, for example, why so many Americans would have voted against Jimmy Carter for letting the American inflation rate go up to 13 percent a year. Thirteen percent inflation! That's reason to get rid of a

(Continued on page 21)

An Economy in Mind: Israel as an Export Mecca

Despite serious inflationary problems and the Arab boycott threat, Israel, as a growing number of American firms have learned, is an attractive place to do business. Well over 150 American companies have a substantial investment there, and the list is growing. Alternatively, Israeli firms, which have always been export-oriented, have come to expand here as well. For American firms, Israel's highly skilled labor force and its membership in the European Economic Community are big pluses. For Israeli firms, the enormous size of the domestic American market is a glittering prize. The Israeli government, mindful of the necessity to reduce its dependence on U.S. financial assistance and worried about its staggering debts, has also accommodated the needs of foreign investors.

In order to explore the little known subject of trade between America, Israel, and Europe, the Manhattan Report *interviewed a number of leading American and Israeli businessmen. Elmer Winter, former President and founder of* Manpower, Inc., *the world's largest temporary help service, has served since 1976 as Chairman of the Committee for Economic Growth of Israel, a binational organization consisting of over 110 business executives working to foster trade between the two countries. Dr. Felix Zandman, President of* Vishay Intertechnology, *and Dr. Leon Riebman, President of* American Electronic Laboratories (AEL), *head outstanding medium-sized, high technology firms in America that have successfully invested in Israel. Joe Nakash is an Israeli who emigrated to America in the 1960s. He, along with his brothers, founded* Jordache, *the popular fashion clothesmaker which sells in 35 countries, including Israel. Finally, we present an interview with Dr. Ron Biran, Vice President and Chief Operating Officer in America of* Elscint, *an Israeli-based high technology firm well known for its CAT Scanners and for other computer-based medical diagnostic imaging equipment.*

Israel-American Trade: An Interview with Elmer Winter

Manhattan Report—What has your experience been in stimulating American firms to invest in Israel?

Elmer Winter—It has been very difficult to find new American companies willing to operate factories in Israel, particularly in the last several years. The biggest reason is the recession. Many U.S. companies are operating at only 60 to 65 percent of capacity. They are not interested in going abroad. As our economy recovers, I think this will change.

On the other hand, there are over 150 American companies that are doing substantial business in Israel. Intel is heavily involved, as are GTE and Motorola. There's a lot of development by American companies that really isn't well known. I would say that the success of American firms in Israel is one of this country's best-kept secrets.

I don't believe that there's an American manufacturing company doing business in Israel that would stay there unless they were making a high return on their investment. Why would they stay? They could go to Ireland, or Puerto Rico, or any one of the dozens of countries that are actively bidding for foreign investment.

MR—Where are the American firms' markets?

Elmer Winter—Many of the American companies that operate in Israel sell either directly to the government of Israel, which is a big buyer, or use Israel as an offshore export base, particularly to Europe. Because Israel is a member of the EEC, American firms can derive substantial advantages from operating in Israel.

Let me give you an example. Suppose an American company is manufacturing electronic parts in the U.S. that they want to sell to France or Germany. The duty may exceed 10 percent. If the product is manufactured in Israel, however, it can be shipped duty free to EEC countries. Moreover, the distance is far shorter, so there may be substantial savings in transportation. The labor costs may well be lower than in America or in the European country.

MR—Do American firms in Israel have any persistent complaints?

Elmer Winter —Sure, and some of them have been magnified over the years with the retelling. In any foreign operation, I can tell you from my own experience, there are always problems of licenses and permits. There are problems getting telephones, getting land, problems with labor, and getting things constructed according to a timetable. Our Committee (CEGI) has kept pushing the government of Israel to implement "One Stop Service." By and large, they have done that. In other words, an American company seeking to open a factory will now, for the most part, if not entirely, only have to deal with one government agency, the Investment Authority, to get land, water, and telephones, and the permits.

There is bureaucratic red tape in Israel but it is often worse elsewhere. I met Anwar Sadat when he was in America for the Peace Signing Ceremony. He had heard of our work in Israel and asked me to go to Egypt to study their investment laws. I can tell you that Israel was far ahead of

Consulate General of Israel, N.Y.

Jaffa Oranges being loaded for export

Egypt in many respects. Israel doesn't limit repatriation of profits, as many countries do. An American firm can maintain complete ownership, which is not the case in Mexico, or for that matter, in Canada.

MR—What kinds of firms in Israel do well here?

Elmer Winter—The science-based, or high technology industries do very well. Elscint, for instance, is on the cutting edge of nuclear medicine and instrumentation. Scitex is another well known firm, in the electronics field. It designs, develops, and manufactures interactive computer graphics systems. Its founder, Efi Arazi, headed the R&D Department at Itek, an American company, before he returned to Israel. There are a number of software companies and fiberoptic companies that are emerging at a rapid pace in Israel.

There hasn't been a great deal of growth in the consumer products field in the past few years. There are certain apparel lines that sell well; Gottex and a few other companies are well regarded. But after you leave the first four or five top firms, there aren't too many exporters.

MR—Do you feel this is a function of differential labor costs?

Elmer Winter—I think the greater problem is marketing, a lack of style and design tuned to the American market. All too often there's an attempt to try to sell here what sells in Israel or in Germany. Very often the American consumer won't accept that. The food field is somewhat limited. Certain food products are well accepted here, but I think Israeli firms will have to break away from thinking that their products should be sold in the kosher sections of the store. They need to get into the regular food departments.

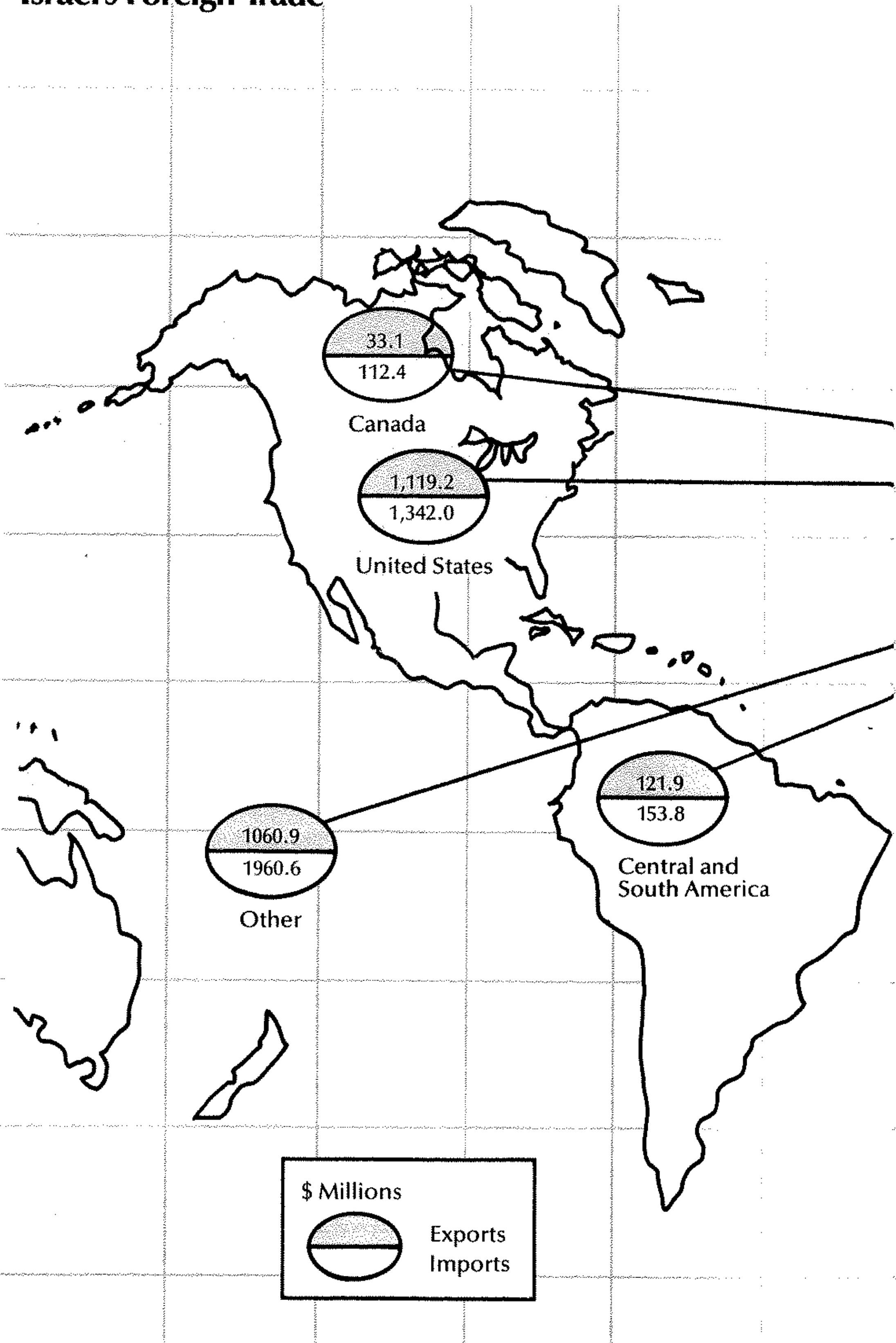
MR—We know that Israel's educational system trains scientists and engineers well. But how about middle managers?

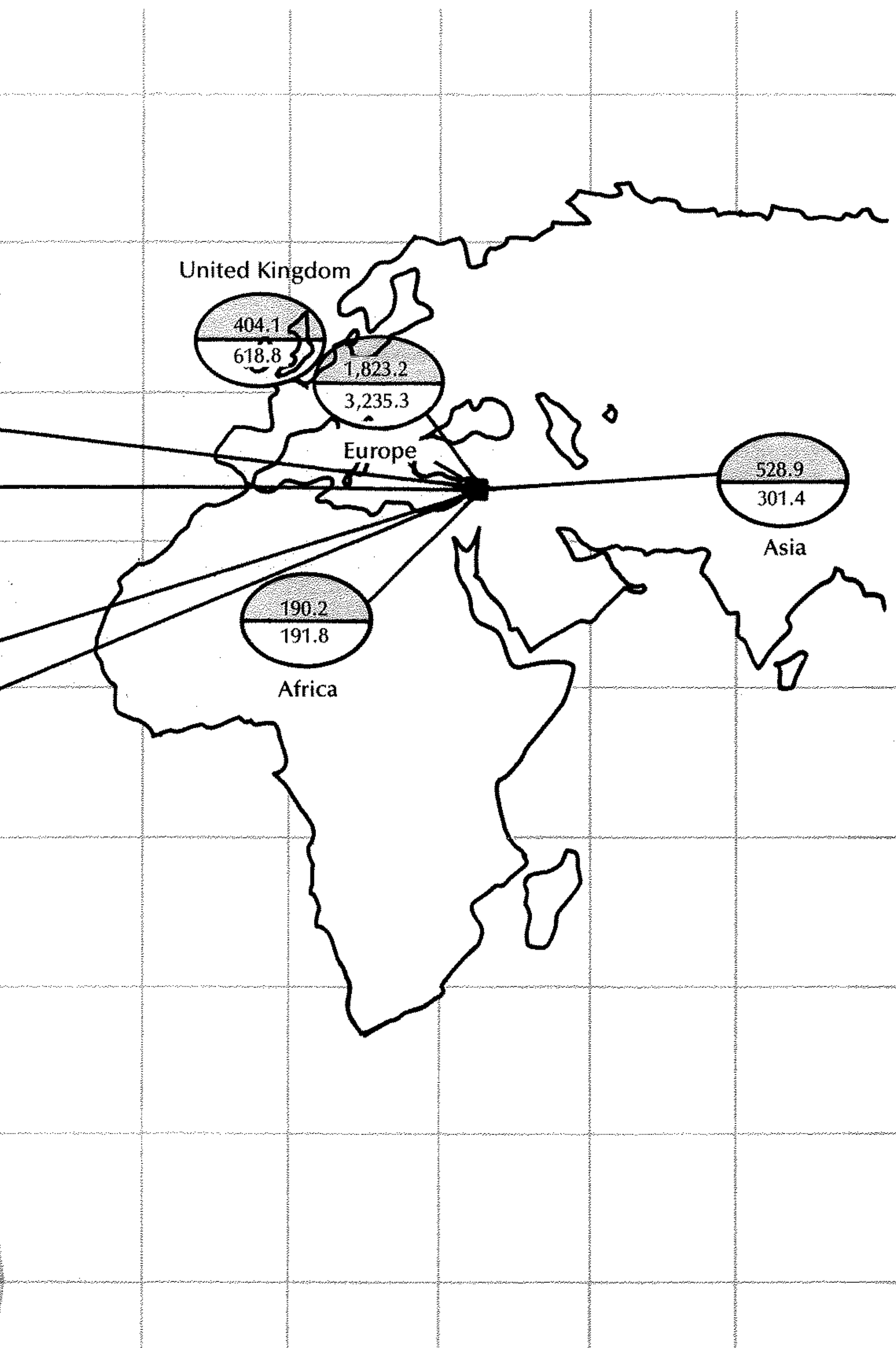
Elmer Winter—There are a number of well qualified middle managers in Israel, many of whom have been trained in the U.S. There are good management schools in Israel. The Recanati School of Management is highly regarded. Harvard has a program at the Jerusalem Institute of Management. But there is need for more management schools in Israel.

MR—The Israeli government is one of the most socialistic in the West. Do private sector businesses face competitive problems from government-owned or -controlled industry?

Elmer Winter—The Israeli government either owns or has a financial interest in about 181 companies. When the Likud Party came to power it talked about privatization, but very few government-owned companies have been sold to date. By divesting themselves of some of these companies, Israel can eliminate the losses it incurs from operating them. Yet I rarely encounter complaints from American firms in Israel about unfair government competition. Moreover, I hear few complaints in America about Israeli firms here who are unfairly subsidized by the Israeli government. □

Israel's Foreign Trade





SOURCE: Israel, Central Bureau of Statistics, *Monthly Bulletin of Statistics* XXXIV, 4 (April 1983) p.32.

Worrying About Stress: An Interview at Vishay Intertechnology

Felix Zandman is a survivor of the Holocaust in Poland. He was educated in France after World War II and holds a doctorate in physics from the Sorbonne. Developing a new, optical method of stress analysis especially useful for aircraft, Dr. Zandman was brought over to America as a consultant to the major aerospace companies, and then became Director of Research at the E.C. Budd Company in Philadelphia. In 1962, he struck out on his own, improving "strain gages" and other stress analysis methods capable of precisely measuring structural stress in aircraft, buildings, automobiles, bridges, light bulb filaments, and even on the chewing surface of human teeth! The new company also developed precision resistors, insensitive to extreme temperatures, that are highly useful in defense, aerospace, computer, and telecommunications markets. Vishay began with an investment of $4,000. Today it has sales in the $40 million range.

Manhattan Report—How did Vishay come to invest in Israel?

Felix Zandman—The company started to grow in the late 1960s. I was concerned about competition and wanted to secure a base of relatively inexpensive but highly specialized labor. Taiwan, Hong Kong, or the Caribbean, while having inexpensive labor, do not have the technical and managerial personnel needed for our kind of products. Our products are not mass produced, and our customers demand flexibility and very fast response time. We looked around and came to the conclusion that Israel, for many reasons, was good for us. Very cheap labor was not, per se, necessary. Intelligent, highly skilled labor was, and is. For this, Israel was ideal. In addition to lower operating costs, we could get organized easily because I knew many people in Israel well; there was a trust element involved. Although we now operate in West Germany, the U.K., France, Japan, and Italy, as well as in the U.S., a substantial portion of our sales and earnings come from our plant in Holon, Israel, which employs some 400 people.

MR—Is your major customer the government of Israel?

Felix Zandman—No, our products are manufactured in Israel for sale in Europe and in America. The Israeli government is also a customer, but we certainly didn't go to Israel because the government was going to buy from us. They buy some 10 percent of our output. The motivation for locating in Israel was to have an offshore base. It worked out well. As a matter of fact, Vishay is very strong because of our Israeli operation.

MR—Did the Israeli government provide incentives?

Felix Zandman—Sure. They gave us all kinds of help, but offshore you could find other places where the labor was very cheap, or where the government held out advantages, which would be equivalent. The main reason for choosing Israel, however, was the quality of the work force and the trust element. I feel at home with the Israelis; not so with the Chinese.

MR—Are the engineers and specialists that work in Israel trained there?

Felix Zandman—Many are trained in our U.S. plant. We have a constant exchange of engineers and managers between the U.S. and Israel.

MR—What outstanding differences are there between operating in Israel and America?

Felix Zandman—If the technical input and cost were equivalent, it would be much more convenient to operate in the United States, because communications are cheaper and better. But the facts of life are different. The cost of production, engineering, etc., is much more expensive here. So we have to operate there to improve our profit margin on some of our most important products. Because profits are greater this way, we can sell our products in a much wider market and at a lower price. We couldn't do that otherwise.

MR—Is government regulation more of a negative factor in Israel than in America?

Felix Zandman—Yes. It is a negative factor. There's no question about it. Any regulation is a pain in the neck. But, on the other hand, what do you expect? If the government gives you subsidies, it has the right to control you to some extent. It doesn't bother us. We've gotten used to dealing with it.

Instability, however—changes in regulations and laws—is upsetting. You function in a given way and all of a sudden the government makes a change to the right or left to correct economic problems in the country. Almost every week, or month, there is a new law or regulation. That's a problem. So is the inflation, which affects labor costs and export prices. Because of that, long term planning is difficult. Early on, the tax policy was a big problem.

MR—Why was that?

Felix Zandman—When inflation and devaluation went into high gear, we, along with other foreign investors, were hit hard. Suppose we have an inventory of $1 million, which is worth, say, one million units in Israeli money. After devaluation, however, overnight it's worth two million units in Israeli money. So it looks like we made a million units profit in Israeli money. On that profit we had to pay taxes. But why should businesses pay taxes on these phantom profits? In fact, such taxes produce losses, when translated into U.S. dollars. Equity would also be eroded through devaluation. You can repatriate the profits, but, while these

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Vishay Israel, Ltd.

> *"Israel is the only country in the world whose tax laws protect foreign investors from losses by currency devaluation."—Felix Zandman*

would be constant in Israeli money, their dollar value would be less and less. Since you can repatriate only retained earnings, the devaluation would erode the dollar value of your equity. This problem exists in any country which devalues its currency.

Yet the government of Israel responded to this problem when we complained. The Finance Minister called Dr. Riebman of AEL, myself, and some other people to meet with a group of high government officials. We sat down in a hotel room for 10 hours and hammered out a set of solutions. It took the government one year to write the law, but now there are two laws, the Equity Law and the Ronnell Law, which protect foreign investors from an inflationary erosion of their investment and profit. In other words, you can put a million dollars into an Israeli business, change it into shekels, and in spite of continuing devaluation, the million dollars is not affected. The investment is protected, provided the business is profitable. The maximum tax is 30 percent for foreign investors. During the devaluation period, whatever is eroded, the way we discussed—through phantom profits and the erosion of equity—the Equity Law compensates the investor through reduction of the 30 percent maximum tax.

Israel is the only country in the world whose tax laws protect foreign investors from losses by currency devaluation. Not so in other countries. Take France, for example, where the franc slid from 4.2 to 7.7 for the dollar. We lost money in France because of this devaluation. France was in fact partly confiscating foreign investments! The only country which has corrected this devaluation problem is Israel. □

Jamming, But No Jazz: American Electronic Laboratories

"The Styx missile," Leon Riebman, President of AEL explains, "sank much of the Pakistani navy during the Indo-Pakistan War." Yet "in the Yom Kippur War, over 50 of these missiles were fired at the Israeli navy. Not a ship was hit." The reason was electronic warfare devices which jam missile radar control, and even disrupt the fuse which explodes the missile. AEL, a $100 million firm operating in America since 1950 and in Israel since 1966, is one of the leading firms making these anti-weapon weapons.

Manhattan Report—How did AEL come to invest in Israel?

Leon Riebman—In the late 1950s we were already producing equipment here for the government of Israel, licensed through the United States government. In the early sixties Israel explained to us on several occasions that they needed more of our equipment than they had hard currency to buy. But if we set up in Israel, they could afford more, since they would pay in pounds.

After two years of discussions and looking into where to locate, we set up Mr. Zalman Shelev, who retired from the Signal Corps in Israel. We started with two people in Tel Aviv. At the same time we started interviewing Israeli engineers in the United States who were interested in going back to Israel. We hired a total of twelve such engineers and trained them in the different parts of the company here so that they'd be able to go back to Israel and use our techniques.

MR—A reverse brain drain?

Leon Riebman—Israel in the early sixties had a tremendous outflow of engineers, because there were no real high technology companies in Israel other than a couple of government-owned companies. We were able to attract top men to go back to Israel and live where they wanted to live and do the kind of work they wanted to do.

MR—Did they stay?

Leon Riebman—I think we've lost two of the original twelve, to other companies. But none have left Israel.

MR—Are there any profound differences in labor relations between the two countries?

Leon Riebman—Our plant in Israel is modern. It's air conditioned, and we have employment practices there similar to what we have in the United States, as far as making sure that the people are well-treated and well-paid by Israeli standards. So we've never had a strike in our company in Israel.

MR—Would American businesses contemplating opening up in Israel be threatened from government-owned companies?

Leon Riebman—Not in the electronics sector. The largest electronics company in Israel is Tadiran. It is 50 percent owned by Koor and 50 percent owned by GT & E, the United States company.

MR—Are your products in Israel sold only to the government?

Leon Riebman—Between 30 and 40 percent of our business is for export. We originally set up to produce military electronic equipment for the Ministry of Defense. Around 1970 we got the license from Siemens A.G. to produce their telephone equipment in Israel. To get that license we brought in a partner from Switzerland, the Migros Bank, which became a 50 percent owner of our plant in Israel. They brought with them the license for telephony, and we started manufacturing telephone equipment in Israel. Now AEL Israel is 26 percent owned by Tadiran, 37 percent by Migros Bank, and 27 percent by AEL U.S.

MR—What are the greatest positive and negative factors facing a firm in this country that wants to locate in Israel?

Leon Riebman—The first consideration of any company that wants to go overseas is their return on investment and their risk. Now just the fact that they're going overseas means that the risk is a bit higher than in this country—simply because it's far away—along with the problems of customs, language, and so forth. So unless a company can satisfy itself that it will make a better return on investment overseas than it can make here, or unless there are no further investments it can make here that it can foresee, it shouldn't go overseas.

These are the criteria that we used. In the early sixties, our Board felt we should consider something overseas. I visited Italy, England, and France and examined the possibilities there. I visited Israel also, and finally presented a report to the Board recommending Israel. They had a need for our equipment and they were willing to guarantee us a certain amount of business every year for so many years, to get started. The financial incentives and inducements were attractive at that time. Moreover, in 1965–66, Israel was in a severe recession, so we were able, for example, to buy buildings at relatively reduced prices.

We were one of the first high technology firms to go into the country, so in that respect it was good and bad. It was good because they wanted us. But they weren't prepared for us because the tax laws at that time in Israel were not set up for high technology companies like ours. For example, they gave loans based upon fixed assets. There are few fixed assets in electronics, or inventory upon which they could take a lien to provide us with working capital. They would have to take a lien on the research reports underway. That was something they didn't understand. So it took a year or so to get this clearly understood. Vishay came in about the same time, and together we paved the way for high technology in Israel, especially after

"... I've never had a government official go back on his word in Israel."—Leon Riebman

AEL Industries, Inc.

their tax laws adjusted for devaluation of the currency.

MR—How about red tape?

Leon Riebman—I really can't complain. When you bring a problem to their attention, they listen, and act quickly. Also, I've never had a government official go back on his word in Israel. Whenever I've shaken hands on an agreement, it's been implemented, and very closely.

MR—So, you think that Israel is potentially an attractive area for American investment?

Leon Riebman—Our company in Israel today has a $100 million backlog of orders, most of it for export. I think we are able to export equipment from there far more easily than from the United States. Getting licenses is easier, certainly.

MR—Would you say it's important to have Israelis manage the business on a day-to-day basis?

Leon Riebman—I would say yes. In our business it was an absolute must, because we deal with the Ministry of Defense. I'm not cleared for Israeli security, so our manager, who is, has to be Israeli. But even if you were going to make consumer products to ship to Europe, it would still be highly desirable to have an Israeli, because he will better understand their thinking. For example, there's a much greater tendency to negotiate over everything in Israel compared to here, where you like to go in and buy something for a fixed price. We don't like to spend as much time haggling. I think it's important to have an Israeli manager to handle a lot of this sort of thing, because he's accustomed to it. He doesn't get angry and upset over the endless bargaining.

MR—What problems do you think Israeli firms face expanding into the international marketplace?

Leon Riebman—Israel has a large number of very, very small companies, and I don't see how they can ever export. You need large organizations to compete in the international marketplace. But if you want to make a merger in Israel, it's difficult.

MR—Because of antitrust policy?

Leon Riebman—It's not antitrust so much, but the labor union—the Histadrut—can tie a company up with the severance pay situation. If you let a person go, for whatever the reason, in Israel, he can collect a month for every year of service, if he's a professional, or two weeks for every year of service, if he's an hourly person. If you attempt to make a merger, the Histadrut demands a share of the future profit. So they demand, negotiate, and get a *multiple* of severance pay. If you were to close down the two companies and start a new company, normally you'd have to pay each group their severance pay. Well, they say that's not enough, because the severance pay expense was already put away in an insurance fund—so they see it as already figured in the past. They want one-and-a-half, two, two-and-a-half, three times the legally guaranteed severance pay. They can ask for any amount. This can get prohibitive. It is a problem Israeli firms have to face. □

Success Runs in the Genes: An Interview at Jordache

Jordache

Ralph Nakash, Joe Nakash, and Avi Nakash, *Jordache*

Manhattan Report—Would you tell us how you and your brothers Ralph and Avi came to this country?

Joe Nakash—When I came to the United States I was around twenty years old. That was in 1962. When I was fifteen or sixteen, before going into the Israeli Army, I used to go to the movies where I saw young people, particularly in the United States, having a good time. I wanted to have the same life that they had. That became my dream as a teenager, to go to the United States.

After my service in the Army, I came to the United States. I had a one-way ticket and $25 in my pocket.

MR—What did you do then?

Joe Nakash—After a few days I had just about run out of money, but I found a job in a retail soft goods store on the Lower East Side. That was enough to start.

MR—So you came over alone?

Joe Nakash—Yes. My two brothers arrived after I was established, a little over four years later. By that time I had learned a great deal about the clothing business, and had become a store manager and a buyer.

My brothers came over and, like myself, worked for retail stores. In 1968, we opened our own business, a retail blue jeans store.

We were retailers for about ten years, by which time we had built up four or five stores. The stores only sold jeans. We thought that we knew the business much better than the giant, established companies. At that time, the well-known firms made only one kind of jeans—the sloppy, heavy-weight, work-style jeans.

We thought that there was a real market for more expensive, fashion jeans.

MR—Were there any other jeans-makers involved in fashion?

Joe Nakash—There were a few, but they were very, very small companies. So, in March of 1978 we established a new company called Jordache: the name is an amalgam of Joe, Ralph, and Avi Nakash. We made tight, sexy looking jeans—the Jordache Look. At that time we arranged to have them manufactured in Hong Kong. They cost about twice as much as the standard American jeans.

Initially, we advertised regionally, in places like the *New York Times,* and in magazines. The demand for our jeans was huge. We were growing enormously, doubling and tripling our sales from month to month. If we shipped $100 thousand one month, we had orders for $300 thousand the next month.

MR—I take it that competitors soon appeared on the horizon?

Joe Nakash—Many. A new market was uncovered, and there was such a shortage in the early days. In 1978, we essentially began at zero. Today, about five years later, our sales are about $500 million. We manufacture about half, and we license others to make the rest. We are in about thirty-five countries, including Israel and some Arab countries. But not in Europe, yet. The European market is too big and too rich to license. We would eventually like to operate in Europe ourselves, without agents and distributors.

MR—When did you get into Israel?

Joe Nakash—We began with an agent about four years ago, a year after our beginning in the United States. The Israelis demanded Jordache. There is a great deal of trade and communications between the two countries, and successful products in the U.S. are often immediately in big demand in Israel.

MR—As an Israeli and a businessman who operates in the Israeli market, do you feel that government policy has adversely affected the economy's performance?

Joe Nakash—The most obvious problem is inflation, of course. But indexing has insulated the citizens from most of this pain. Israel's economy has had trouble, but after all the whole world has been in trouble.

MR—Have you observed any Israeli companies who have tried to operate in this country running into problems?

Joe Nakash—I can't say that I know a great deal about this subject, but I know that some Israeli firms are handicapped by their lack of size—or perhaps by their lack of ambitiousness. It costs a great deal even to start up in this country. An exporter can have a hard time unless he is willing to think big. □

"Seeing Outside What's Inside, Without Cutting": Elscint, Ltd.

The Elscint Company is a world-renowned, Israeli-based company which designs, manufactures, sells, and services computerized diagnostic medical instruments. Best known for computerized tomography—the CAT Scanner—Elscint is on the frontiers of all the medical imaging technologies, like ultrasound, nuclear medicine, integrated digital radiography, and nuclear magnetic resonance systems.

Elscint was founded by one of Israel's "innovation millionaires," Dr. Avraham Suhami. Like many American entrepreneurs in science-based industries closely associated with major university centers in the Boston-Cambridge and Silicon Valley areas, Dr. Suhami was a professor of science at the Israeli Institute of Technology [I.I.T.] in Haifa who left teaching in 1969. He assembled a team of individuals with advanced degrees and established a scientific instrumentation company which entered the rapidly expanding field of nuclear medicine in the 1970s. Elscint now operates world-wide, with facilities in the U.S., Canada, Europe, South Africa, Australia, Brazil, and Mexico.

The Manhattan Report *interviewed Dr. Ron Biran, a holder of a doctorate in physics from the I.I.T. who joined the company at its inception and is now the Chief Operating Officer of Elscint's U.S. subsidiary.*

Manhattan Report—How did Elscint get involved with nuclear medicine?

Ron Biran—Dr. Suhami really started Elscint as a scientific instrument company. Even though we had a large percentage of the market in Israel, this market was very small in volume. Moreover, the total world market for our instruments was small, something on the order of $10 million or $20 million a year. Dr. Suhami was essentially looking for different avenues of growth, and the nuclear medicine market at that time looked far more promising. The world market was on the order of $100 million a year. And, of course, there was no question that in order to grow, we would have to basically be an exporter. The domestic market in Israel does not provide enough opportunity alone.

MR—Did you target any particular market, that is, did you decide that it should be America or Europe?

Ron Biran—I don't think we necessarily decided on the U.S. versus Europe, or vice versa. Obviously we needed large markets. We also realized very early on that in order to be in touch with our markets, we would have to operate with our own employees in wholly owned subsidiaries and not through distributors or representatives.

MR—Do you manufacture equipment in each subsidiary?

Ron Biran—No. The subsidiaries were, and many still are, primarily for sales and service. Today we have four manufacturing facilities outside of Israel: the U.S. (where we produce ultrasound equipment), France, England, and Italy. More than 90 percent of our sales are made outside of Israel.

MR—Elscint is associated with CAT Scanners.How did you get involved with them?

Ron Biran—CAT Scanners accounted for more than 60 percent of the company's sales revenues last year. We were involved with other nuclear medicine instrumentation in the early 1970s when the CAT Scanner appeared around 1975. It was introduced by EMI of England. Helmsley received half a Nobel Prize for it. Seeing a large opportunity, Elscint undertook a major research and development project to develop our own Scanner. From there, we have branched into other imaging

Consulate General of Israel, N.Y.

products.

Imaging basically means, in layman's terms, seeing outside what's inside, without cutting into the body. Conventional X-ray is one modality, computerized tomography and ultrasound are others. There are new technologies as well, like nuclear magnetic resonance, digital fluorscopy, and digital radiography, that the company will grow in. Digital radiography, for instance, is a modality which uses less radiation than conventional X-rays and eliminates the need for conventional film.

MR—Is EMI your biggest competitor?

Ron Biran—EMI no longer manufactures CAT Scanners. Our major competitors in imaging are General Electric, Siemens A.G., Technicare (a subsidiary of Johnson and Johnson), and some others, like Toshiba Corporation and Picker.

MR—These are fairly substantial companies. Are capital resources a problem for companies like yours, or other Israeli firms who want to compete in the world marketplace?

Ron Biran—I don't think so. It's much easier to raise money today than it was fifteen years ago for high technology industries. There is a lot of venture capital out there. A crucial factor is brains.

MR—Where did you get the brains for the company?

Ron Biran—Our major pool of engineers and scientists are Israelis, but we do have R&D groups in the U.S., England, and France. Israel is the major R&D and manufacturing base for Elscint.

MR—Would you say that inflation is the greatest economic problem Israeli policy makers have to resolve?

Ron Biran—Yes, I think if they solve inflation, that would lead to a solution to all of our problems. But I want to stress that inflation is not the only important problem that an Israeli manufacturer has. In my opinion a major problem is distance from the market. As a result, the manufacturer will not keep abreast of change unless he sends people out all the time to be his "ears." Also, being far away from the market and from the source of supplies means keeping higher inventories. Another problem is that in the United States there are many small satellite firms to support the larger companies. In Israel a lot of the time you have to do it yourself.

MR—What about wartime interruptions?

Ron Biran—The company has minimized the effects of hostilities in the Middle East by having second source manufacturing capabilities, and large depots of spare parts around the world. During the Lebanon War last year, for instance, the company stood by its commitments to customers. □

Israel's Economy: The Challenges Ahead

(Continued from page 9)

president? Just this past April, inflation in Israel exceeded 13 percent, *in one month.*

Something on the order of 50 to 60 percent of the Israeli GNP is traded abroad, a figure proportionally four times that of the United States. In the United States, Reagan's change in tariff was an isolated event; in Israel, it's the general policy. I'm really not exaggerating if I say that in Israel there are probably no two imports that are taxed the same. There are probably no two industries or sectors that enjoy equal rates of effective protection. This leads to all sorts of crazy resource misallocations. There are sectors getting resources that probably shouldn't get them. There are other sectors that don't, but which ought to. This is because resources are not flowing to sectors where their productivity is higher, but to sectors where the government priority is higher.

My favorite example occurred in the 1960s. There were some attempts to create a local automobile industry. This was very interesting because metal is very expensive in Israel, so the automobiles were manufactured primarily of fiberglass. The experience, needless to say, was unsuccessful. Incidentally, when I related this to my students, one of them jumped up and exclaimed that I didn't understand what the government probably had in mind. These cars would have had a very important advantage: they couldn't be picked up on radar!

Basically, the policy of massive intervention in foreign trade matters goes back to 1948. Little has changed since 1977 in the way of liberalization, and in some respects the situation has worsened. Domestic industries in Israel which compete with imports have traditionally enjoyed high protection rates. Since 1977, this protection has actually grown.

The major change has occurred primarily over the last year and a half. The government has been experimenting with a newly discovered way of fighting inflation by suppressing the exchange rate—that is, keeping the Israeli currency overvalued. Basically it hasn't worked. Inflation rages untamed; all that has been accomplished is to penalize Israeli exports, and cause a deterioration in the balance of payments.

This deterioration in the balance of payments comes on top of a fairly large debt problem. Israel has always had a large foreign debt, which isn't necessarily bad, if one is borrowing in order to finance growth (and the domestic social rate of return is higher than the rate of interest one has to pay to one's foreign creditors). Then it makes sense to borrow; and at least until 1972, Israeli borrowing probably made a great deal of sense. The debt looked large, but it was financing a very rapid rate of growth. Since 1972, however, the economy has *not* been growing, yet the debt has continued to mount.

I strongly suspect that the debt service problem will turn out to be *the* major impetus for change in Israel's domestic economic policy. The danger is not that Israel will default on its loans. The problem is that the resources necessary to service the debt will come at the expense of investment and consumption. The Israeli taxpayer will be bearing a higher and higher burden.

I think the solution to the debt problem, and in general to Israel's economic problems, is a large reduction in the extent to which government intervenes in the economy—principally by a massive reduction in government spending. So far, unfortunately, we haven't seen signs of this happening, but I think sooner or later it will have to happen. When it does, I believe Israel will once again enjoy the growth rates it did before 1972.

Herbert Stein—We will conclude with brief comments by Haim Barkai, who is now a visiting professor at Harvard. His permanent position is Professor of Economics at Hebrew University. Professor Barkai served for many years on the Advisory Council and Committee of the Bank of Israel and was Chairman of the Israel Government's Committee on Wages in the Public Sector. He has also been associated with the Falk Institute, Israel's major economic think tank. Professor Barkai will discuss the situation in the public sector.

Haim Barkai—In my view, one of the important reasons for Israel's economic success in the past is the very high priority it has given to the development of its manpower, particularly through its commitment to education. To this extent, therefore, that portion of the public sector devoted to spending in education has proved to be a positive investment.

Similarly, in looking at the public sector for areas to cut, one cannot ignore a basic constraint, or determinant; namely, the size of the defense budget. The government presence in the Israeli economy is to a large extent determined by the size of the defense budget. Until the Six Day War (1967), total government defense expenditure was on the order of 10 percent of GNP. After the Six Day War and before the Yom Kippur War, it increased substantially, up to about 20 percent of GNP. After 1973, it shot up again to about 30 percent of GNP. Although it declined a bit after 1977, we are once again hovering at about 30 percent.

To put these figures in a different light, we might say that a fairly substantial proportion of public sector spending in Israel has always been determined by Israel's strategic adversaries! But after 1973, the wealth of the Arab members of OPEC caused a basic change. No longer were the Arabs dependent on arms, or the money to buy them, from the Soviet Union. They can, and do,

"I think that most Israelis have not really been exposed to free market thought."—Steven Plaut

buy them any place in the world. The half billion or more in subsidies that the Syrians receive from Saudi Arabia, for instance, almost certainly goes directly to Russia for armaments purchases.

The foregoing remarks should not be taken to imply that mistakes and poor planning elsewhere in the public sector haven't occurred. Israel has built up a number of industrial white elephants, related to random, interest-group-dominated government policies. Moreover, the rampant inflation the country has experienced since the middle 1970s, and the more recent hyperinflation, presents the country with some stark choices that cannot be avoided indefinitely.

One can blame the government for not having come to grips with this basic problem. But in fact, behind this inflation issue is the even more fundamental issue of the role of the Israeli government in its economy. Quite apart from defense, nondefense expenditure of the welfare state variety has increased since 1977 from about 12 percent to about 13 or 13.5 percent of the GNP. So in Israel, as in many other European countries, England, and even America, the question is, what are the limits of the welfare state? Israel may well have reached the limit, perhaps even crossed it. Yet this is not, to my mind, the general opinion of the electorate. I think the general public would support an even greater relative increase in welfare state-type spending. Until such time as the public comes to see greater virtue in spending restraints, the answer to problems such as inflation, uncompetitive industries, a less than competitive capital market, and the like will more likely be in the direction of greater price and other controls, not in government deregulation or disengagement.

Yoram Kafkafi, *Carmel Wine Company*—I would like to ask the panel what they feel about government intervention—actually, I would prefer to use the word "support," since I believe "intervention" is a loaded word—in the export sector. We all realize the importance of improving Israel's trade balance. Yet Israeli exporters are facing government subsidized competitors from many other countries in the world. Does the panel feel that government support for export industries would be beneficial? Would a hands-off policy be dangerous to Israel's balance of trade?

David Levhari—The government would not need to be so directly involved with export industries if its exchange rate policies did not cause so many problems. Moreover, its credit allocation policies—which have been tilted toward import substitution industries—create other distortions as well. The basic problem is not in export industries, but in the competitive allocation of resources to all industries. To this end, the basic aim should be to transfer resources from the public sector to the private sector. It seems to me that this will be better achieved by disengagement of the government as compared with present policies. Any given set of problems can always be "solved," at least in the short run, by steps in the other direction. But that only creates other problems. During a disengagement process, there will be social difficulties, like unemployment. Nevertheless, the non-uniform support of export industries at present actually favors capital-intensive, rather than labor-intensive industries.

Menachem Brenner—This argument about subsidized industries abroad is common everywhere. In the United States, the chief object of worry is Japan. They support their export industries, so people ask, why don't we also? I would answer the question the Jewish way: with another question. What industries should we support and who should decide which industries should be supported? That's the first thing. The second is, when do we know that it is not government subsidies, but actually just cheaper labor in Singapore or Korea, that is the problem? Third, don't we already subsidize our export industries? Where do you stop? Beyond these questions I would follow Milton Friedman—if some country wants to tax *its* consumers to subsidize ours, let them.

Paul Rubin, *Baruch College*—Milton Friedman once asked a question in his *Newsweek* column I'd like someone on the panel to take a shot at trying to answer. For centuries, Jews have had to make their living through free markets, particularly by trading, since they were often shut out of many industries by unfriendly governments, or otherwise disadvantaged by government regulations. Why is it that once they got a country of their own, their government embarked on interventionism and the suppressing of market forces?

Haim Barkai—First of all, one has to put things in an historical context. When Israel got going in 1948, Palestine had been, for seven or eight years, involved in armed conflict. Actually, the Israeli government inherited a war economy. The country, upon independence, was immediately involved in a war for survival. Fifty to 60 percent of its real resources were directed toward the war effort. Also, recall that, coming out of the depressed 1930s, the whole mood of the Western industrialized world was interventionist. Immediately after the War, the British rejected Winston Churchill, the war hero, by a sizeable margin, and elected the Labor Party, which was committed to a welfare-state, socialistic policy. Similarly, the Zionist movement always had a tradition of socialist idealism. Therefore, when the state emerged, big government was an obvious choice. Finally, a massive immigration tripled the size of the population within two or three years. The government had to do a lot to get these people settled.

Tom Bethell, *American Spectator*—Can anyone

Craig Terry

Manhattan Forum on the Israeli economy.

on the panel discuss the tax situation in Israel? I'm particularly interested in the top marginal tax rates on income, and at what income level they take effect. Also, how are savings treated by the tax system in Israel?

Steven Plaut—There's a joke that asks, what is the best way of making a small fortune in Israel? The answer is, first you start with a large fortune. There is a maximum 60 percent marginal tax on personal income. I believe that you hit that maximum marginal tax at approximately a gross salary of $1500 or $1600 a month. The problem is that the law is written in shekels and the exchange rate fluctuates, so it's hard to give an exact figure.

Traditionally, Israeli taxation has been designed, to some extent, in the direction of a consumption tax. Many forms of savings were tax exempt. In the last few months there's been some change in policy under Finance Minister Aridor. There has been some increase in taxation on different forms of savings. I am personally critical of this change. In fact, I believe, along with the supply-siders, that one reason Israel did well for so long was because of its policy of basically exempting large parts of savings from taxation. The result has been a very high private savings rate, similar in some ways to the savings rate in Japan. In both countries the high savings rate helps explain the economic success. But in recent years, the government's "negative savings" have been so large that the country ends up with close to zero for net new capital investment from total national savings.

Jeffrey Poelvoorde, *Carleton College*—Israel, like the United States, has a special problem with disadvantaged minorities, in particular with the Sephardic community [Jews of North African ancestry] and in some respects with the Arab community. Would movements in the direction of a free market economy leave these groups out in the cold?

David Levhari—It is my belief that, since the Six Day War, income distribution has been drastically changed in favor of the lower classes, particularly in the Arab population. That is, if you compare lawyers or medical doctors or other professionals with simple menial workers or others, the lot of the workers has been improved, compared with the higher classes, in the Arab population. I don't see where free trade and a more openly competitive economy would make the income distribution in the Arab population less favorable. If anything, inequality may be reduced, since too much wealth at present accrues to people with political access rather than economic ability.

Menachem Brenner—I am also convinced that the opportunities for the poor are best in a free market system. Tom Sowell's book, *Markets and Minorities,* presented very persuasive evidence for this thesis.

Edward Minor, *S.R. Robinson & Co.*—I think you gentlemen exemplify a growing understanding in the upper reaches of the academic community in Israel about the importance of markets. But does this filter down through the educational system? Are economic truths being taught in Israeli schools?

Steven Plaut—One of the differences between the United States and other countries is that here there is a long tradition of suspicion of government, particularly big government. Americans' suspicion of government is a priceless natural resource. It is a resource many countries do not have and a re-

source that in many ways is alien to Israeli tradition. I think that most Israelis have not really been exposed to free market thought. Economics is a difficult enough subject to discuss at the college level, as at least my students can attest. It's particularly difficult at the secondary school and high school levels. Up until now, what has been taught has tended, predominantly, to be in the anti-free market tradition. I hope that those of us who have chosen to associate with organizations like the Israel Center may help inform Israelis about alternatives.

Tom Bethell, *American Spectator*—Professors Peter Bauer of the London School of Economics and Melvyn Krauss of New York University have argued that foreign economic aid has often harmed the economic development of developing countries. Does the panel have any reaction to that thesis based on Israel's experience? Do Israelis worry about the growing dependence on foreign aid to finance her debt?

Haim Barkai—In the early years Israel received significant foreign economic aid, much of it channeled through the government, yet the economy grew quite rapidly. So, to that extent, the experience in Israel does not seem to support Professor Bauer's thesis—although it may be because Israel didn't squander these vital resources, or unduly tax its citizens, as has unfortunately occurred in many LDC's. For that matter, by the middle to late 1960s, Israel largely graduated from the economic aid experience.

Now, of course, Israel is receiving significantly large amounts of foreign aid, particularly military aid, which is needed to finance defense expenditures. It is, in a sense, a kind of *quid pro quo* for OPEC armament money.

Steven Plaut—The generous aid Israel receives is certainly vitally necessary, and welcome, over the short term, given Israel's military problems. The aid covers only a small part of this burden, most of which is borne by the Israeli taxpayer. But a growing, independent Israeli economy should be the real goal over the long run. Economic independence for Israel will require less government and more freedom. □

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