**Chapter 22**

**The markets after the 1985 Economic Stabilization Plan**

**1986–1996**

Compared to the “lost decade” preceding the 1985 Economic Stabilization Plan, the period from 1986*–*1996 saw far-reaching market and economic reforms that greatly changed the way Israel’s economy functioned. The hyperinflation crisis was still fresh in public memory, and the unity governments of 1984*–*1990 gave political backing to economic reform. The reforms continued during Yitzhak Shamir’s premiership (1990*–*1992) and gathered steam under Yitzhak Rabin’s second government (1992*–*1995), which was resolute in making economic and social changes in order to boost the development of a market economy, accelerate privatization and Israel’s participation in globalization, expand the welfare state, and advance the peace process.

While still recovering from the hyperinflation crisis, Israel absorbed two large waves of immigration from the former Soviet Union and Ethiopia, built a high-tech industry, coped with the First Intifada, and made regional political agreements with the Palestinians and Jordan that served as leverage to reopen the economic ties with Eastern Europe, Asia, and Africa that had been severed following the Yom Kippur War. The events of this formative period would influence Israel economically and socially for many years to come. It was during this time that Israel enacted a number of key market reforms that helped it transition toward a competitive economy. In particular, the exposure of the domestic market to competing imports was completed, the foreign exchange market was reformed, and the financial and capital markets were liberated after four decades of nationalization. A free market developed, as the reforms bolstered the private and commercial sector. Significantly, it was during this period that Israel’s high-tech industry developed, aided by the government’s establishment of the “Yozma” venture capital initiative for investment in Israeli high-tech ventures.

These crucial years also saw significant reforms of Israel’s higher education system, with the establishment of new colleges that made higher education accessible to a wider cross-section of the population. A state health law was enacted that created a stable financial and competitive infrastructure for the healthcare system. These and other reforms, together with the injection of educated immigrants from the former Soviet Union, enriched Israel with skilled human capital, which had a positive effect on the country’s economy and society.

In this decade, the government’s involvement in the economy decreased, and the Histadrut and the Jewish Agency ceased their commercial activities. Macroeconomic, fiscal, and monetary policy shifts brought Israel closer to the standards accepted in developed Western economies. The most prominent expression of the processes and changes that the economy had undergone was the A- rating given to Israel by the international rating agencies in November 1995, reflecting Israel’s strength in the international capital market.

The cancelation of the IAI Lavi fighter jet project in 1987 was an important test of budget rationalization in the area of defense. Growing investments in transportation, water, and sewage infrastructures began to close the large gaps between different communities in these areas. Another important event came in 1991, with Israel’s unilateral decision to lower import tariffs across the board. The government, on the initiative of the Ministry of Finance, opened the economy to imports from countries with which Israel did not have free trade agreements, including China. Import tariffs dropped by dozens of percentage points to around 8–12 percent. This move streamlined Israeli industry and opened the door to inexpensive imported goods, which benefitted consumers. The decision provoked a great deal of debate and opposition among Israel’s industrialists, who feared the influx of cheap imports would harm their interests. They argued that traditional industries with low added value could not compete and would go out of business. However, the move meant that less wealthy Israelis were able to buy imported goods that had previously been too expensive for them to afford because of high import taxes.

The exposure of Israel’s manufacturing industry and markets to imports was spread over an entire decade, and allowed factories time to organize, train, and retrain laid-off workers. The fact that the economy grew in the 1990s helped smooth the successful implementation of this move, and paved the way for a new economic structure centered on high tech and business services. Factories producing textiles and clothing, simple electronic goods, and plastics ceased to operate in the face of competition from Asia. These were areas in which Israel had no comparative advantage, and whose long-term existence was therefore doomed.

Toward the end of the 1980s, the economy experienced another change in the form of an influx of foreign workers into the labor market in need of inexpensive workers. Their numbers swelled in the wake of the 1993 Oslo Accords due to an increase in terrorism that prevented Palestinians from working in Israel, and it took time for the establishment to digest and supervise the situation effectively.

**1997–2009**

The first government of Binyamin Netanyahu (1996–1999) did not make significant changes to Israel’s economy, but continued the reforms set in motion by the previous administrations. The Ehud Barak administration (1999–2001) was predominantly concerned with political matters, rather than economic policy. However, in 2001–2003, Israel was catapulted into an acute economic crisis as a result of the outbreak of Second Intifada and the wave of severe violence that followed the breakdown of the Camp David talks. The crisis sparked a significant slowdown in economic growth, alongside an increase in inflation and capital flight, exacerbated by the dot-com crisis and the aftermath of the September 11 terrorist attacks in the United States. Unemployment rose to 10.2 percent, the exchange rate slumped to around five shekels to the dollar, while per capita GDP decreased in real terms—a rare phenomenon in Israel.

In 2001–2005, two successive governments of Ariel Sharon addressed this general crisis with an economic policy dubbed “Economic Defensive Shield.” The policy was first implemented by Minister of Finance Silvan Shalom in 2002 and continued by his successor, Netanyahu, in 2003. The sudden economic crisis had reawakened an old bogeyman—the foreign exchange reserve deficit—forcing Israel to turn to the United States for guarantees of $9 billion to shore up its foreign currency reserves and prevent shocks and capital flight. Netanyahu, as Minister of Finance, pursued a neoliberal capitalist policy that aimed to change the very essence and structure of Israel’s economy and society. It accelerated Israel’s transition from a public to a market economy, provoking considerable public debate. Netanyahu’s policy was based on the arguments that “high taxes are not good for the economy,” “big government is a problem,” and “governments do not know how to manage business,” which echoed the famous line of former United States President Ronald Reagan from the 1980s that “the government is the problem, not the solution.” Israel’s welfare state shrank as child benefits, unemployment benefits, and income support were slashed, with the aim of encouraging welfare recipients to join the workforce. The number of income support recipients fell from about 160,000 in the 1980s to about half that in the 2000s. The policy also shrunk the public sector, with Netanyahu often referring to the parable of the thin man (the private sector) carrying the fat man (the public sector). Taxes were cut on the assumption that they would “finance themselves” and accelerate growth (based on the controversial Laffer curve theory, also used by the Reagan administration as a basis for tax cuts in the 1980s, which hypothesized that tax income does not grow as tax rates increase, as high taxes are a disincentive for workers to earn wages). This despite the fact that studies have shown that there is no connection between tax cuts and growth. Pension rights under the old pension fund schemes were reduced and the government raised the retirement age from 65 to 67 for men and from 60 to 62 for women. The so-called Israeli “Wisconsin plan”—a welfare to work scheme based on an American program of the same name—was put in place with the aim of integrating people on a guaranteed minimum income into the workforce. However, the program was heavily criticized, and ultimately scrapped, because it was run by a private concession. These measures resulted in increased in labor force participation, mainly among the ultra-Orthodox, alongside a decrease in gross income inequality and an increase in net inequality (in disposable income). The plan curbed the crisis and growth resumed following the end of the Second Intifada and a recovery in the global economy.

This period saw two more political and security events that impacted on Israel’s economy: the disengagement from Gaza in 2005, and the Second Lebanon War of 2006, which, like the Second Intifada, damaged the lives of Israeli civilians due to the firing of rockets at population centers. Until then, wars had been fought within the country’s borders or in enemy territories. The disengagement from Gaza did not bring peace to the region, and after the rise of Hamas in 2007, Gaza became a hostile and aggressive entity that threatened the lives of residents of the south and later the center of the country, and in response military operations were carried out, the first being Operation Cast Lead in 2008.

The Second Intifada increased the need to replace the cheap labor of Palestinian workers with foreign workers. Together with migrant workers from Africa and tourists who overstayed in Israel (mainly from Georgia, Ukraine, and Moldova), the importing of foreign labor raised the proportion of non-Israeli workers in the economy. In the mid-2000s, over half a million non-Israelis (including Palestinians) worked in Israel, about half of them illegally (i.e., without a permit)—a record number, which harmed poorer and disadvantaged Israeli populations.

**2010–2019**

Israel’s increasingly strong economy meant that it was hardly affected by the global financial crisis of 2008–2009, and passed through this turbulent period relatively unscathed. Unemployment in 2009 stood at about 8 percent, rising to 8.5 percent in 2010, and then falling to less than 4 percent by the end of 2019. The financial system remained stable due to its conservatism and effective regulation, and because it was able to draw on the lessons learned from previous crises. There was little effect on Israeli exports, largely due to the strength of Israeli high-tech industries following the decades of market reform. The damage to growth was minimal.

In 2010, Israel joined the OECD, an achievement made possible by the results of the economic efforts and improvements made in the quarter century since the 1985 Economic Stabilization Plan. Israel now had a developed economy that maintained fiscal discipline and international openness, with a positive balance of payments, price stability, and a solid financial system. However, there were growing social disparities and inequalities. In July 2011, a cost-of-living crisis that impacted the middle classes sparked widespread public protests calling for “social justice” and “a new set of social and economic priorities.” The protests were short-lived, ending when the government responded to a number of issues, including minimum wages, negative income tax, and the expansion of social programs. The protests helped increase social awareness and draw attention to social issues, which helped result in a decrease in inequality from 390 points in 2006 to 350 points in 2018–2019—breaking a 20-year upward trend. Israel still has one of the highest rates of social inequality among OECD countries.

In the period 2010–2019, GDP rose by about 40 percent, the average monthly wage by 35 percent, and prices by about 12 percent. Unemployment dropped from about 8.5 percent at the start of the period to less than 4 percent at the end. However, Israel had a per capita GDP (23rd place) similar to that of the 1980s, mainly because it had seen only a moderate increase in productivity of about 11 percent. Meanwhile the GDP to national debt ratio shrunk from 75 percent at the start of the decade to around 60 percent in 2019, a result of economic policy and budgetary discipline (although some of the drop can also be attributed to the Central Bureau of Statistics’ updated methods of calculating GDP and the appreciation of the shekel that eroded foreign currency debt by 15 percent).

The rise in social awareness and the needs of an innovative economy shone a light onto Israel’s education system, which was struggling to prepare children and young people for integration into the high-tech industry or entrepreneurship. International comparisons showed that not only was Israel’s education system mediocre at best, the country’s public health system was also suffering from neglect and the private healthcare sector was growing. Meanwhile, housing was proving to be the Achilles heel of the economy, due to a 75 percent rise in house prices over this period. The housing crisis prompted proposals to make it harder for investors to purchase housing stock and increase the supply of land. The government also introduced the Mechir Lamishtaken (“buyer fixed plan”) program to help first-time buyers purchase an apartment with preferential terms, and lowered the price of land for apartments in the geographic periphery, which temporarily and partially calmed housing prices.

During this period, Israel completed its shift to a post-industrial service economy. Exports of software services soared and there was an increase in foreign investments in the high-tech sector. The government initiated offshore natural gas programs, first the Mari B/ Yam Tethys reservoir and later the Leviathan and Tamar gas fields, which cut imports of coal and oil by billions of dollars and reduced air pollution and greenhouse gas emissions. The balance of payments improved as a result of the discovery of natural gas and because of foreign investments in high tech. The doubling of Israel’s high-tech exports created a permanent surplus in the balance of payments and increased foreign currency reserves. Israel shifted from being a net borrower to a net lender, but “suffered” from a problem faced by other rich nations, whereby foreign currency surpluses threatened to absorb the shekel and harm its ability to compete in traditional industries. The situation also affected the high-tech industry, which increased the cost of labor in dollars.

The period also saw several important reforms, among them the Centralization Law, the reforms proposed by the Sheshinski Committee, which was formed to advise on what tax the government should levy on companies producing natural gas, and Resolution 922, a five-year roadmap to accelerate the economic inclusion of the Arab population, which had a budget of NIS 15 billion. However, these reforms did not generate enough momentum to allow the Israeli economy take a leap forward on the international stage. Inequality remains a key issue that demands thorough attention, mainly in the ultra-Orthodox and Arab communities, in particular because the ultra-Orthodox are a rapidly growing population. The effort to increase infrastructure investments via private sector partnerships continues, but the level of investment is still lower than in many developed countries. This is particularly true of land transportation, with the lack of mass transit systems in major cities impairing the quality of life of residents.

**Economic outcomes**

The changes in macroeconomic policy and reforms since the mid-1980s have resulted in an improvement in the performance of the Israeli economy, in terms of the budget deficit, government debt, the balance of payments, growth, per capita GDP, and inflation. Openness to the world has advanced Israel’s economic position in the international marketplace. The economic recovery that began the 1990s took place amid the enormous challenge of the mass immigration from the former Soviet Union (over a million immigrants), two Intifadas, the Gulf War, the Second Lebanon War, the disengagement from Gaza and military operations in Gaza, and significant changes in Israeli society.

Israeli companies have integrated into international capital markets and are traded on leading stock exchanges around the world. High tech has become an important engine of growth and has strengthened the economy with significant achievements in technological innovation, R&D, the proportion of people employed in high tech industries, and the number of patents registered by Israelis. In 2004, the rapid growth in high tech exports allowed Israel’s current account balance to come out of the red for the first time in its history, and to have a surplus by 2006. The shift in external debt as a percentage of GDP from a net of 87 percent in 1984 to about 45 percent in 2021, is testament to the enormous improvements in the external state of the economy.

Israel’s accession to the OECD confirmed its place among the top of the world’s developed nations. Yet alongside its economic achievements, the shadows of Israel’s social problems are threats looming over its society and economy. Social disparities, inequality (as measured by the Gini index), and poverty indices have all increased. Since the 2000s, there has been a trend toward unbalanced growth that has created a dual economy. While there has been rapid growth and high productivity in the high-tech industry, where the economy has a relative advantage, there has also been a falloff and low productivity in traditional industries. Israel’s knowledge-intensive industries benefitted greatly from globalization—their sales spread to expanding markets hungry for high tech products and services. Simultaneously with the expansion of Israel’s export markets, companies exploited new avenues to purchase inexpensive inputs from imports that increased the competitiveness of producers. At the same time, however, Israel’s traditional industries were harmed by globalization. Some were unable to retain their export markets, and were not equipped to deal with competing imports and lost the local markets as well. The key to creating competitive advantages in a global market lies in increasing productivity and creating innovation in processes or products.

The dual economy points to two serious problems. First, low growth in traditional industries has left Israel languishing among the bottom rankings of OECD countries, and has hampered the country from producing sufficient output to raise living standards, provide adequate public social services, and finance security needs in line with the country’s existential problems. The country also significantly lags behind in terms of investing in infrastructure. Second, income disparities have deepened. Although Israel had previously been one of the most egalitarian countries in the world, it now has one of the highest levels of income disparity of all the OECD countries.

Inequalities create social unrest, harm the delicate fabric of belonging and social cohesion, and have a negative impact on growth. There is a huge disparity between the macroeconomic strength of Israel’s economy and household inequalities in terms of early years education, housing, transportation, and health. Improving the growth and productivity of Israel’s traditional industries would prevent the polarization of the dual economy, and help reduce disparities by increasing the incomes of the poorest members of society through employment rather than taxation and state benefits.