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Daniel Maman

Zeev Rosenhek

האוניברסיטה הפתוחה, הקריה ע"ש דורותי דה רוטשילד, דרך האוניברסיטה 1, רעננה 43537, ouri-ppes@openu.ac.il
The Open University of Israel, The Dorothy de Rothschild Campus, 1 University Road, Raanana 43537 Israel

The Institutional Dynamics of a Developmental State: Change and Continuity in State-Economy Relations in Israel

Daniel Maman and **Zeev Rosenhek**

Department of Sociology and Anthropology
Ben-Gurion University of the Negev

Department of Sociology, Political Science and Communication
The Open University of Israel

The institutional and political dynamics of developmental states amidst conditions of globalization and neoliberal institutional reforms has become in the last decade an important topic of research, which contributes to broad questions concerning current changes in state-economy relations. While some scholars maintain that globalization and the institutionalization of the neoliberal policy paradigm entail the unequivocal dismantling of the developmental state, others present a far more complex picture of change and continuity in which certain institutional traits and practices characteristic of the developmental state still play a pivotal role in the political economy of various countries. This debate is connected to the question of the significance of the institutionalization of a global neoliberal regime for the role of the state in the economy.

The adoption of neoliberal institutional arrangements and policies is commonly understood as connoting a substantial withdrawal of the state from the economic field and a marked diminution in its institutional and political capacities to control economic processes. The notion that the strengthening of neoliberal institutional arrangements and policies connotes the weakening of the state vis-à-vis the market is largely considered as based on firm and undisputable facts; almost a truism. In contrast to this conventional perspective, however, an alternative view posits that in the neoliberal era, the state has not necessarily retreated from the economic sphere. The changes that occurred in the political economies of numerous countries since the 1990s, including those that were characterized as developmental states, should be analyzed not in terms of more or less state involvement in the economy but rather in terms of qualitative changes in its mode of involvement and in its institutional configuration. This perspective allows us to discern that while certain institutional traits and practices of the classic developmental state have indeed vanished, there are also very significant lines of continuity in place that keep imprinting on state-economy relations. It is this combination of change and continuity that determines the modes of action of developmental states under conditions of neoliberal globalization.

We draw on this approach in analyzing the institutional dynamics of the Israeli political economy, focusing on its transformation since the mid-1980s, when an intensive process of liberalization began. This has been a deep and all-encompassing process of gradual change in state-economy relations, which encompassed the adoption of typical neoliberal formulas: deregulation of the labor market; liberalization of the financial markets; lifting of restrictions on the movement of capital and goods; heightened involvement of foreign capital in the local economy; privatization of public assets; and restrictive fiscal and monetary policies. Hence, the Israeli case represents an interesting instance of a strongly state-led political economy that underwent a sweeping and far-reaching process of liberalization during the last decades, and in which a rather orthodox version of neoliberal ideology appears as hegemonic. Yet, we contend that this shift does not necessarily imply the withdrawal of the state from the economy and its institutional weakening. We argue rather that they are indicative of and embedded in fundamental modifications in the state's institutional configuration and in the mode of its involvement in the economy, not its retreat.

In the following section we introduce some central debates concerning the implications of globalization and liberalization for state-economy relations and address the contribution to this topic of the renewed research interest in the developmental state in the last decade. Then we present our examination of the Israeli case, delineating first the basic institutional traits of the Israeli developmental state and its essential instrumental role in broad processes of state-building and the creation of a modern economy until the mid-1970s. We then discuss the political and economic processes that led to the exhaustion and deep crisis of the Israeli developmental state in the first half of the 1980s, which opened the way to liberalization. Finally, we examine the main structural, institutional and political changes in the Israeli political economy since the mid-1980s, with a special focus on the far-reaching shift in the mode of state agencies' involvement in the economic field. We also point out important continuities in this regard, indicating how they affect state-economy relations in the neoliberal regime. We conclude by specifying the contributions of our analysis of the Israeli case to broader questions concerning the dynamics of the developmental state model and state-economy relations under conditions of neoliberal globalization.

Globalization, liberalization and state-economy relations

The processes of liberalization that took place in many core, semi-peripheral and peripheral political economies over the last two decades have generally been seen by both supporters and opponents as connoting, by definition, the weakening of the state and its retreat from the economic sphere (Fourcade-Gourinchas and Babb 2002; Prasad 2006). Conventional wisdom holds that through policies of privatization, deregulation, financial liberalization, fiscal austerity and growing economic openness, states all over the world renounced, willingly or not, their key role in actively shaping economic processes and structures. This substantial weakening of the state's political and institutional capacities in the economic sphere has often been attributed to the overwhelming effects of expanding and deepening globalization, especially in the financial domain. The unprecedented expansion of global financial markets and the freedom of movement enjoyed by capital place massive constrains upon the capacity of states to autonomously govern the national economy, making previous modes of active and extensive state involvement in the economy unsustainable. As a result, the disciplinary power of globalization imposes on states the adoption of neoliberal institutional arrangements and policies, inducing their convergence around the template of a neoliberal market-led political economy, in which the states' power and capacities vis-à-vis the market and global capital are fundamentally eroded (Cerny 1997; Strange 1996).

This conventional view has been adopted in several studies of the current dynamics of the developmental state, particularly concerning the Korean case. These studies emphasize the fundamental incompatibility between globalization and the developmental state, arriving at the unequivocal conclusion that financial globalization has, in effect, dismantled the developmental state's capacities to govern the economy. The enormous growth of global financial flows has shifted the controlling lever to markets and capital, shrinking the state's power, autonomy and ability to command over local big business (Pang 2000). As liberalizing reforms, especially in the financial sphere, were put in effect to adapt to the new reality of the global economy, the ability of the Korean state to control the behavior of big capital was seriously impaired, thus bringing about the certain and inevitable demise of the developmental state (Kim 1999).

Accounts such as these, which posit a simple causal link between globalization and the supposedly indisputable weakening of the state, have been criticized on various grounds. In addition to the mechanistic and deterministic assumptions regarding the omnipotent and uniform effects of globalization upon the state (see Campbell 2004; Sassen 2006), a central limitation of the globalist approach, as well as of other simplistic perspectives on neoliberalism, is the ways in which the changes occurring in state-economy relations are conceptualized as operating within a zero-sum game, thus necessarily connoting the institutional debilitation of the state and its concomitant retreat from the economy. This appropriate criticism was forcefully stated by Linda Weiss (1998) in her book *The Myth of the Powerless State*, in which she demonstrates that the key role of the state in the economy has not diminished in the era of neoliberal globalization. Considering the East Asian developmental state, Weiss rejects the conventional arguments about their demise or obsolescence, emphasizing instead their enduring institutional capacity to promote economic growth based on the formation and maintenance of organizational infrastructures that encourage innovation.

Since the 2000s there is renewed interest in the institutional setup and policies that allow states to play key instrumental roles in processes of economic growth under conditions of globalization. For instance, several studies of East Asian developmental states have stressed the resilience of some of their institutional foundations and the continued effects of institutional legacies, while also observing important changes in their mode of intervention in the economy (Wong 2004a). Within this context of continuity amidst change, the activist role of the Korean and Taiwanese states in influencing industrial development has persisted, though combined with the adoption of policies of deregulation and financial liberalization. While the developmental state and its relations with societal actors have been transformed, the state continues to play a critical role in structuring economic processes through the purposive construction of financial and other markets, supporting technological innovation and commercialization and incentivizing the development of particular economic sectors (Weiss 2003). Wong (2004b), for instance, shows that through policies of active assistance to the emergent biotechnology industry in the 1990s, the Korean developmental state reinvented itself.

In a similar vein, Sean O Riain (2004) forcefully rejects the notion that the state has became obsolete and irrelevant as an agent of development under conditions of globalization, suggesting instead that its active involvement in building and sustaining institutional frameworks that encourage innovation can serve as an essential factor promoting economic growth and capital accumulation (see also Levy 2006). He distinguishes between the classic model of the developmental bureaucratic state and the recently institutionalized model of the developmental network state. Just as the Japanese and later the Korean and Taiwanese political economies were the empirical cases that served as the basis for the formulation of the theoretical model of the classic developmental state, the Irish case serves O Riain for elaborating his model of the developmental network state as a type of state developmentalism particularly well fit to the new challenging conditions induced by global post-Fordism. This new mode of state involvement in the economy, with which, according to O Riain, the Israeli and Taiwanese political economies also conform, is defined by its ability to initiate and nurture local networks of technological innovation and promote their tight-knit integration within global technology, business and financial networks. This is achieved by a myriad of programs and activities aimed at encouraging the growth of an innovative and global oriented local high-tech sector, such as funding of research and development, provision of initial capital for start-ups, and institutional support for the establishment of extensive and intensive technological, financial and commercial links with global business. Fred Block (2008) has lately used O Riain's concept of the developmental network state to examine the role of the American state, in particular of its military apparatus, in the growth of the high-tech sector. State agencies have been intensively involved not only in the development of innovative technologies, but also in financially and institutionally assisting the private sector in the commercialization of these innovations. Thus, Block concludes that beneath the ideological and rhetorical surface of market fundamentalism, since the 1980s has in fact emerged in the US, a rather activist "hidden developmental state" that plays an essential role in supporting the expansion of the private high-tech sector.

A major conclusion emerging from the recent literature on state-economy relations under conditions of neoliberal globalization is that the changes in the political economy should not be conceptualized in terms of more or less state involvement in the economy, but rather in terms of qualitative differences in the modes and ways through which the state structures the economic field and affects the constitution and conduct of economic actors. Similarly, in contrary to conventional arguments about the implications of globalization and neoliberalism for the state, the important question to be addressed is not one of more or less state power, but rather one that focuses on the changes in the state's institutional architecture (Jayasuriya 2001). A particularly important dimension in the shift to a neoliberal regime is the transformation of the state's institutional configuration: as the state's involvement in the economy takes on a different form, important changes take place in the power relations between various state agencies (Sassen 2006).

In the following analysis of the Israeli case, we show that the shift in the political economy towards a neoliberal model has connoted a fundamental change in the state's mode of involvement, in its institutional configuration, and in the institutional tools and polices that its agencies use in shaping and regulating economic processes and relations. Furthermore, we show that these new patterns of state-economy relations are structured by complex dynamics of change and continuity, so that in many respects, the Israeli state maintains its central role in governing the economy.

The State-made Israeli Economy

As in other cases of semi-peripheral political economies, the state in Israel was decisive in developing a capitalist economy through activist policies of industrialization, the formation of local capital, and the construction of markets; a pattern of state-economy relations that was anchored in the post WWII dominant institutional model that saw the state as the major agent of socio-economic development (Helleiner 2003). During its first decades of existence, from its establishment in 1948 until the 1980s, the Israeli state largely functioned in the socio-economic field according to the institutional principles of the developmental state model (Levi-Faur 1998), so that its extensive involvement in economic processes were in fact foundational to the building of the Israeli economy.

State agencies were widely and deeply involved in all dimensions of the economic sphere, both directly and indirectly, with their main aim being to ensure high levels of economic activity and industrial development, as well as guaranteeing full employment for the country's Jewish population. To this end, the state completely controlled the allocation of important economic resources, such as land and other natural resources. The state also exerted a great deal of centralist control over matters of infrastructure development, agricultural and industrial production, foreign trade, investment and credit (Levi-Faur 1998), the structuring and management of the labor market (Grinberg 1991), and the differential incorporation of particular social groups in its various sectors (Rosenhek 2003). The state's institutional and political control over the distribution and redistribution of economic resources was further enhanced as a result of the occupation of the Palestinian territories in the 1967 war, as state agencies played a key role in shaping and regulating the economic relationship between the Occupied Territories and Israel (Grinberg 1991; Shalev 1992). This role was particularly salient in the state-led constitution of the Palestinian population under military occupation as a captive market for Israeli products and as a large reservoir of cheap and unprotected non-citizen workers, two processes that significantly contributed to the economic boom that began in Israel following the war.

The processes of resource allocation and the tight regulation of economic activity and relations were certainly driven by the political interest of ensuring the continuing hegemony of the Labor party, which controlled the state apparatus uninterruptedly from 1948 to 1977. But far more fundamentally, the actions of the Israeli developmental state were determined by the broader and basic political logic of building and consolidating the state and its economy according to Zionist principles and interests (Shalev 1992). This logic of state-building gave rise to the aims of establishing and arming a large military force, absorbing Jewish immigrants and settling them throughout the country, accelerated industrialization, and the development of a segmented welfare state that guaranteed different levels of socio-economic protection to various populations according to nationality, ethnicity, and gender (Rosenhek 2007; Shafir and Peled 2002; Shalev 1992; Swirski 2005). As in other developmental states, such as South Korea and Taiwan (for a comparison, see Levi-Faur 1998), these aims, which were formulated in nationalist terms of constructing and consolidating national strength, were closely related to broader processes of building and institutionalizing a modern etatist socio-economic and political order. As such, they derived from the state's autonomous interests in increasing its internal economic, political and social capabilities, and its external economic and military power.

Typical of the developmental state model (Evans 1995; Lukauskas 2002), one of the pivotal institutional foundations of the operation of the Israeli state was its extensive and deep control of capital mobilization and allocation. State agencies enjoyed virtually full control over capital mobilization from both internal and external sources and its subsequent discretionary allocation to public and private bodies according to a centralized development policy aimed at rapid industrialization. This was facilitated by the fact that the inflow of capital did not take the form of private investment, but rather that of unilateral capital transfers based on political logics and channeled by state agencies: contributions from Jewish organizations around the world, reparation payments from Germany since 1954, and American civil and military aid, particularly from the late 1960s. Private foreign capital, both financial and industrial – over which the state would have found it more difficult to exercise strict control – was almost totally absent in Israel until the 1990s.

Similarly, state agencies controlled the main channels for local capital formation (Levi-Faur 1998). The main savings schemes – pension funds, provident funds and various saving programs – were obliged to invest most of their capital in non-tradable government bonds or to make special deposits with the Ministry of Finance (Grinberg 1993; Shalev 1992). The state's strong control over the capital markets can also be seen in the arrangements that required private companies to seek official authorization to issue bonds and that determined the purpose and conditions of most of those bonds, in the state's specification of the conditions for lending and borrowing in the credit market through different kinds of detailed regulations, and in the strict restrictions imposed on capital mobilization in foreign markets by local firms. In addition, the state had complete control of the foreign currency market through stringent restrictions on foreign currency transactions and on the international movement of capital by both firms and individuals. This strict control, which was not uncommon internationally at the time, was aimed at preventing the export of capital that might put pressure on the fixed exchange rate regime that had prevailed in Israel since 1954, or even cause a financial crisis due to capital flight and a lack of foreign currency.

The control over capital mobilization allowed the state to command capital allocation to specific economic sectors based on considerations of industrialization, full employment, immigrant absorption, regional development, and the geographical distribution of the population, all key tasks in the process of state-building in Israel. These efforts were already underway in 1950, when the Ministry of Finance instructed the commercial banks as to the preferred priorities in providing credit, with industrial and agricultural production at the top of the list. A year later, the Ministry of Finance began to exempt banks from the reserves requirement on credit that they made available to selected economic sectors. Qualitative control of credit via a system of "directed credit" was thus initiated, a system that would become an extremely important institutional mechanism through which the developmental state could allocate subsidized capital and promote the building of a capitalist economy. Starting from 1960, a myriad of special funds operated by the central bank jointly with the Ministry of Finance and the Ministry of Trade and Industry were set up for allocating heavily subsidized credit in local and foreign currency to firms in preferred economic sectors (Maman and Rosenhek 2011). The credit directly allocated by the state through these funds comprised a very substantial part of total credit volume – almost 50 per cent between 1960-1972 (Sanbar and Brunfeld 1973:222), and as much as 69 per cent in 1971-1980 (Djibre and Tsiddon 2002:87) – constituting a major tool for promoting industrial growth.

An extremely important attribute of the Israeli version of the developmental state model, which sets it apart from the typical East Asian developmental state, was the key position in the political economy occupied by the central workers' organization – the *Histadrut* (the General Organization of Hebrew Workers in the Land of Israel) – whose political-economic roles went far beyond those of a trade union and played an essential role in the processes of state-building and economy-building (see Grinberg 1993; Shalev 1992). From the early 1920s until the establishment of the state in 1948, the *Histadrut* functioned as a major component of the organizational complex that led the Zionist project of Jewish settlement and state-building. With the financial assistance of Zionist and Jewish organizations, the *Histadrut* developed a large network of organizations that performed central tasks in a wide array of socio-economic fields: settlement, social services, agriculture, industry, building, retail, and finance. The establishment of the state did not bring an end to this pattern, and the *Histadrut* consolidated its central position in the political economy as a major partner of the developmental state. With the economic and political support of the state, it positioned itself as a key actor in almost every sector of the economy. By the 1970s, it owned some of the largest industrial business groups in the country, as well as the largest construction company, the largest commercial bank, the largest insurance company, and the largest retail chain. Hence, the central workers' organization, which enjoyed a state-sanctioned monopolistic position as workers' representative, was simultaneously also a major employer, second in size only to the state, and a key player in processes of capital formation and accumulation (Grinberg 1993; Shalev 1992).

A notable outcome of the state's centralized command over the economy was the consolidation of an economic structure with a high level of concentration of capital, a large part of which was formally owned by the state, the *Histadrut* and other public organizations. Through a comprehensive set of protectionist practices that comprised high tariffs, import quotas, preferential interest and exchange rates for selected sectors, subsidized credit, tax benefits and investment grants, the state basically engendered and nurtured the major actors in the Israeli political economy. A core of big business took shape in Israel, composed of a relatively small number of corporations that controlled a sizeable proportion of the national product and exports, and that employed a large part of the labor force. For example, in 1984, at the twilight of the developmental state era, the total sales of the top 100 Israeli industrial firms made up 55 per cent of the business sector's GDP, and their total export comprised 70 per cent of all industrial exports (excluding diamonds). Those 100 firms also employed 41 per cent of the entire industrial labor force (Dun and Bradstreet 1985). Situated at the inner core of this structure were a small number of business groups, most of which were headed by the three large banks, and which held a pivotal position in the economy. For instance, the total sales of the *Histadrut*-owned Koor industrial group in 1984 constituted 14 per cent of the GDP of the Israeli business sector; the group was responsible for 16 per cent of the country's industrial exports; and it employed 11 per cent of the total labor force in industry (Dun and Bradstreet 1985). In addition to market power, the key position of these business groups in the economy gave them extensive political influence over the processes of resource allocation conducted by the state, allowing them to obtain heavily subsidized credit and other benefits like tax exceptions that, encouraging horizontal mergers of industrial firms, contributed to the further strengthening of these groups (Maman 2008). Furthermore, the ownership structure of big business reflected the state-led pattern of close cooperation between public and private capital, as many of Israel's largest corporations were jointly owned – in varying proportions – by the state, the *Histadrut* and private capital (Nitzan and Bichler 2002); a concrete manifestation of the embedded autonomy of the Israeli developmental state.

A prominent segment of activity for Israel's big business was the military industry, whose emergence and consolidation as one of the country's most central economic sectors were deeply reliant on state agencies (Maman 1999; Mintz 1985). The state's enormous financial and institutional support gave rise to a powerful military-industrial complex that emerged as a fundamental constituent of the economic structure created and nurtured by the Israeli developmental state. This process was triggered by the French embargo on arms sales to Israel after the 1967 war, resulting in the decision to develop a local armament industry in order to reduce Israel's dependence on foreign sources. This was a clear instance of the state directly creating a local market and a sphere of economic activity from scratch, thereby producing and maintaining the basic conditions that would allow it to direct production to external markets as well. The state nurtured the military industry in a number of ways, such as initiating, conducting and directly financing research and development, making advance commitments to product purchasing, and offering tax exemptions and other subsidies (Maman 2008). For instance, in the late 1960s and 1970s, the Armament Development Authority (RAFAEL), a sub-division of the Defense Ministry, was the leading organization conducting technological research and development in the country; it was in fact the pioneer that led the way to the growth of these activities in Israel (Breznitz 2007b).

In the early 1980s, military manufacturing accounted for over 25 per cent of the entire industrial labor force, and for 28 per cent of Israeli exports. In 1984, more than 65 per cent of research and development in Israel was carried out in the defense industry (compared to 13 per cent in civilian industries), and the sector as a whole employed more than 50 per cent of all scientists and engineers (Barkai 1987; Mintz 1985). The central position of the military industry in the political economy of Israel's business groups is illustrated by the activities of the Koor group. While until the end of the 1960s the bulk of its business was in construction, following the 1967 war it shifted to military manufacturing and, with massive state support, purchased and established a large number of firms in the electronics, communications and sheet metal sectors (Maman 2008). As a result, in 1982, over 50 per cent of Koor's 34,500 employees worked in defense-oriented firms, and armaments and other military equipment accounted for about 17 per cent of Koor's local sales and for about 20 per cent of its exports (Mintz 1985:14-16). As we will show in the next section, the military industry will function as a main technological and institutional foundation for the emergence of the successful Israeli high-tech sector in the 1990s.

The leading role played by state agencies in building and consolidating a centralist capitalist political economy had far-reaching implications for patterns of socio-economic inequality. Indeed, the state-managed allocation of economic and social resources was foundational to the formation and institutionalization of the national and ethnic hierarchy that still characterizes Israel today. The state's activities related to the geographical dispersion of the population through housing policies, patterns of industrial development, institutional arrangements related to the incorporation of different groups within a segmented labor market, the differential regulation of employment conditions in different labor market segments, and dualistic patterns of allocation of education and other social services – all these led to the creation of a mostly Ashkenazi (Jews of European origin) middle and upper-middle class that occupied managerial, professional and bureaucratic positions in the state and *Histadrut* apparatus, as well as in the big economy enterprises (Rosenfeld and Carmi 1976), and the constitution of the Mizrahim (Jews of Middle Eastern origin) as a subordinated ethno-class that nonetheless enjoyed a relatively substantial degree of protection by the welfare system (Bernstein and Swirski 1982). Explicit and often formal exclusionary practices by the state in all relevant policy domains pushed the Palestinian citizens of Israel – and even more so the Palestinians from the Occupied Territories after 1967 – to the bottom of the social hierarchy (Rosenhek 2003; Shafir and Peled 2002; Shalev 1992).

According to common criteria for evaluating macroeconomic performance, compared to most other countries established after WWII, the developmental state in Israel was remarkably successful. From the early 1950s to the early 1970s, the Israeli economy generally enjoyed rates of growth among the highest in the world (the annual average real growth per capita between 1954 and 1973 was 6 per cent), relatively high levels of employment (the average unemployment rate for those years was 5.3 per cent), and relatively low inflation (an annual average inflation rate of 7.2 per cent for the same period). However, the model appears to have exhausted itself by the mid-1970s, when the performance of the Israeli economy began to decline, and a serious crisis that would deepen and reach its peak by the mid-1980s started to develop.

The Crisis of the Israeli Developmental State

The renowned Israeli economist Michael Bruno has referred to 1973 as marking the end of the "Golden Age" of economic growth and the beginning of the "lost decade" of the Israeli economy (Bruno 1993:24). Indeed, after the 1973 war, a period of deteriorating macroeconomic performance got underway that would reach crisis dimensions by the first half of the 1980s. The period between 1974 and 1985 was characterized by rather low levels of growth (the annual average real growth per capita for this period was just 0.3 per cent). By 1980, this caused the beginning of an upturn in unemployment, which rose from 2.9 per cent in 1979 to 6.7 in 1985. Furthermore, the fiscal deficit grew staggeringly: while its annual average in 1960-66 represented 1.3 per cent of GNP, it reached an annual average of 12.6 per cent in 1967-72, jumping to 17.3 per cent in 1973-84. Even more pronounced was the extremely steep increase in inflation (from an annual average of 42 per cent in 1974-78 to 185 per cent in 1979-85), that reached 445 per cent in 1984 (Bruno 1993:32). From the end of 1983, when monthly inflation began running in double digits, hyperinflation became a major political-economic problem high on the Israeli public agenda, as both the elites and the general public began to see it as threatening the state's ability to run the economy and its very legitimacy, as well as the stability of the socio-political order (Grinberg 1991; Shalev 1992).

Besides the immediate effects of the 1973 war and the subsequent intensification of the arms race between Israel and surrounding Arab countries as a significant factor behind the increase in fiscal deficits, the deeper political-economic roots of the developmental state crisis paradoxically lie in its own earlier success. The crisis emerged when the very economic and political forces that the developmental state created and nurtured – especially the privately- and publically-owned industrial and financial corporations that composed the core of big business, and to a certain degree, the strong workers' unions in the public sector – began to challenge the state's autonomy, thereby undermining the institutional foundation of its ability to regulate resource allocation and manage the economy (Grinberg 1991; Shalev 1992). These actors deployed their growing economic and political power to embark on rent-seeking behavior, making ever-increasing claims on the economic resources under the state's control, which the latter could not meet without this leading to increasing fiscal and balance of payments deficits and inflation. This political-economic crisis – the essence of which was the state's loss of autonomy vis-à-vis powerful societal actors and its loss of command over economic processes – reached its zenith in the hyperinflation of 1984-85. This process also had important effects on the power balance within the state apparatus and on its level of cohesiveness. The pivotal position within the state institutional configuration enjoyed by the Ministry of Finance was jeopardized by the crisis, as it started to lose its ability to control other state agencies, to command their activities and their relations to particular clienteles, and to manage the overall mode of state involvement in the economy. As a consequence, in comparison to previous decades, the state agencies' actions lacked cohesiveness and became erratic; a factor that contributed to the deepening of the crisis.

The deep crisis and its perception as a basic threat to the socio-political order certainly damaged the political status of the existing pattern of state-economy relations and its institutional underpinnings, opening up an ample opportunity structure for political actors that strove for liberalization of the political economy. Like in other cases of sweeping liberalization, this legitimation crisis created a large political space for actors hoping to promote an alternative model of political economy (Campbell and Pedersen 2001; Fourcade-Gourinchas and Babb 2002).

After several failed attempts to halt hyperinflation, policy makers' response to the mounting fiscal and legitimization crisis of the Israeli developmental state was the implementation of a rather comprehensive program of economic stabilization in 1985, which was formulated with the active involvement of the US government and a network of Israeli and American academic economists (Maman and Rosenhek 2011). Aiming at reining in hyperinflation, the basic short-term aims of the plan were to drastically reduce the fiscal deficit, to improve the balance of payment and to neutralize the self-reinforcing inflationary dynamic through the removal of mechanisms of automatic indexation of wages and the anchoring of inflation expectations. These goals were achieved through extensive budgetary cuts, a contractionary monetary policy, pegging the local currency to the US dollar after a sharp devaluation, and the temporary freezing of salaries and prices of basic products and services. The plan was successful in halting the inflationary dynamic, rapidly reducing its annual rate from 445 per cent in 1984 to moderate rates of around 20 per cent between 1986 and 1991.

On a deeper level and from a broader perspective, however, the rationale of the emergency program and additional policy and institutional changes effected in following years was to reconfigure state-economy relations so that the state could reclaim its autonomy and its institutional capabilities to regulate economic processes

(Shalev 1992). Likewise, a key purpose of the program and associated steps taken afterwards was to reinstate the pivotal positioning of the Ministry of Finance within the state configuration and to restore its power vis-à-vis other state agencies, mainly by "tying its own hands" through various institutional arrangements that were meant to lock in fiscal restraint and other anti-inflationary policies. Hence, the implementation of the emergency economic program in 1985 signifies the commencement of a deep and all-encompassing process of gradual change of the Israeli political economy, especially in relation to the modes of state involvement in the economic sphere and to its institutional configuration. As we examine in the next section, this process, which encompassed important ideological, political and institutional changes, had far-reaching implications for state-economy relations, though not necessarily signifying the actual withdrawal of the state from the economic sphere or a significant decline in its active involvement in the regulation of economic processes.

State-economy relations in a transformed political economy

The transformation of the Israeli political economy has been studied by scholars from different disciplines and theoretical perspectives, who tend to conceptualize it in terms of the state's withdrawal from the economic sphere and its reduced political and institutional ability to shape economic processes and to regulate the activities of economic actors. Thus, in Israel, as well as elsewhere, the adoption of neoliberal practices is commonly understood by both opponents and supporters of the process, as indicating the gradual but undeniable weakening of the state vis-à-vis the market and private economic actors (Ben-Bassat 2002; Filc 2006; Ram 2008; Shafir and Peled 2002).

Indeed, the ideational principle that served as main legitimizing device for the transformation of the Israeli political economy concerns a reformulation of the desired relationship between the state and the economic field in accordance with neoliberal market fundamentalism, whose basic ideological tenet is the retreat of the state from the economy and the free operation of market forces and private economic actors. An extremely orthodox version of this doctrine soon became dominant in the Israeli political field, particularly on the ideological and rhetorical levels. Neoliberal policy formulas seen as leading to state shrinking – such as privatization, reduced taxation on capital and high earners, financial liberalization, flexibilization of the labor market and contraction of the welfare state – were all portrayed by virtually all influential political actors as absolutely necessary measures to ensure the efficient functioning of the local economy and its successful integration within the global economy.

Changes on the level of institutional arrangements and policies, however, were far more complex (Shalev 2000), and rather than suggesting the state's withdrawal from the economic arena, they actually indicate a shift in the mode and purpose of its involvement, as well as in its institutional configuration. If previously, the state had been directly involved in allocating capital and other resources aimed at developing a managed capitalist economy and creating both private and public economic actors, in the current neoliberal era, its involvement is mainly realized through the indirect tools of regulation, by building and supporting the functioning of "free" markets, and assisting private actors, often by means of significant subsidies and other benefits, in accumulating capital through them. Furthermore, institutional changes of neoliberal character were effected side by side with significant lines of continuity in practices that characterized the developmental state.

This neoliberal pattern of state-economy relationships in which the state nevertheless maintains a significant level of involvement in the economy supporting private capital accumulation is evidenced in various ways and with differing degrees of salience in diverse domains of socio-economic policy. Some of its main manifestations included the privatization of state- and *Histadrut*-owned industrial, commercial and financial corporations, the liberalization of financial markets and international trade, the partial privatization of social service provision and the deliberate creation of state-sponsored quasi markets in this realm, and the growing number of public sector workers who are employed through sub-contractors and manpower agencies, that liberates the state from the budgetary and political burdens resulting from the employment of large numbers of workers (Ajzenstadt and Rosenhek 2000; Shalev 2000).

As we have noted, a basic dimension of the broad shift in the political economy is changes taking place in the institutional configuration of the state and in the power relations among its agencies. Characteristic of the changing institutional architecture of the state under neoliberalism (Jayasuriya 2001), in Israel a noticeable strengthening of state professional agencies responsible for regulating and overseeing economic activity took place: the Israel Antitrust Authority at the Ministry of Industry, Trade and Labor, the Supervisor of Banks at the Bank of Israel, the Supervisor of Capital Markets, Insurance and Savings at the Ministry of Finance, and the Israeli Securities Authority. Similarly, the presence of the state's legal arms – the courts and the Attorney General – in the economic arena became increasingly felt, especially in relation to the establishment and enforcement of the legal rules of the game, which, according to the "law and economics" school, aim to create a legal environment supportive of the efficient operation of "free markets" (Maman 2004). The activities of these seemingly apolitical agencies embody an important logic underlying the state's involvement in the economy in neoliberal regimes, namely, the depoliticization of institutional arrangements and policies that direct the course of economic action (Hay 2007). Hence, the state continues its vital role in sustaining and encouraging the orderly operation of the markets and providing conditions for capital accumulation while simultaneously obscuring the political character of these processes.

In this regard, the remarkable strengthening of the central bank is of extreme importance. Similar to processes that occurred in many other countries (Marcussen 2009), in the last two decades, the Israeli central bank accumulated a great deal of institutional and political power, successfully positioning itself within the state configuration as an allegedly autonomous agency insulated from politics, that is seen as functioning according to definitive and undisputable scientific knowledge. On the basis of this political resource, the Bank of Israel has played a critical role in the initiation and promotion of institutional changes aimed at ensuring the implementation of economic policy in accordance to neoliberal formulas. For instance, during the 1990s, it was instrumental in the adoption of inflation targeting as an institutional arrangement aimed at locking-in fiscal and monetary discipline, as well as initiated and led the process of financial liberalization and the adoption of a free-floating exchange rate regime. While promoting these changes, the central bank relied on the power of seemingly apolitical professional expertise to boost the notion that under conditions of globalization, the adoption and institutionalization of the principles of a market-driven economy are an absolutely necessary condition for the success of the national economy (Maman and Rosenhek 2011).

One of the most important pillars of the transformation of state-economy relationships has been the fundamental reconfiguration of the financial system, which aimed at developing and strengthening market mechanisms for capital allocation. These reforms, which led to the integration of the Israeli economy into the global financial system, represent an essential factor in the institutionalization of the neoliberal political economy, in which international financial activity serves as a principal source of capital accumulation (Epstein 2005). Until the mid 1980s, the Israeli financial system was a credit-based system dominated by the state in close alliance with its partners: the commercial banks and the *Histadrut*. Starting in 1986, a determined coalition of state agencies headed by the Ministry of Finance and the Bank of Israel, and including the Israeli Securities Authority, the Israel Antitrust Authority and the Ministry of Justice, advanced a series of important institutional changes that led to a significant contraction in the state's direct roles in the financial system, especially those related to the governing of processes of capital mobilization and allocation (Blass and Yosha 2002). This state-led process resulted in the growing financialization of the economy; that is, the greater importance of financial activities and transactions as a major source of capital accumulation for private actors (Krippner 2011). In fact, the process involved the development of financial markets almost from scratch.

A fundamental component of financial liberalization was the ending of the government's and the Bank of Israel's direct involvement in allocating subsidized finance to the business sector through targeted credit programs. The stabilization plan of 1985 put an end to all directed credit in local currency, as well as significantly reduced the credit in foreign currency provided by various state-run funds, and in 1991, the entire system of directed credit was abolished. As part of financial liberalization, the state also brought about the cessation of the *Histadrut*'s dominance over the pension funds system though a series of reforms that established new private pension funds and privatized the old *Histadrut*-owned pension funds. The new owners of the privatized funds were mostly insurance companies, which, by the end of 2004, controlled 93 per cent of the total assets of the funds (Ministry of Finance 2005:10). This measure was an important component in the state-led project of constructing and enlarging "free" financial markets, as it injected enormous amounts of money into the financial circuits: while in the past the *Histadrut* pension funds invested almost all of their assets in non-tradable earmarked government bonds, the privatized pension funds invest most of their capital in tradable government and corporate bonds and in the stock market (Ratson 2010). In addition, steps were taken to rein in the dominance of the Israeli banks in financial markets through a series of measures aimed at limiting their ownership and control of real and financial assets. In 1995, the banks were forced to sell their holdings in non-financial corporations, and in 2005, they were further required to sell their holdings in provident and mutual funds.

A major result of these measures was the transformation of the Israeli financial system from a state-led and bank-based structure to a far more market-based one, which signified a substantial reallocation of power between economic actors. In 2004, commercial banks still managed 67 per cent of the public's financial assets, 17 per cent was managed by the old pension funds, 13 per cent by insurance companies, and only 3 per cent by private investment houses. By 2008, the picture had changed dramatically: commercial banks managed only 46 per cent, 23 per cent was managed by insurance companies, 17 per cent by the old pension funds, and 14 per cent by private investment houses, some of which are foreign financial corporations (Antebi 2008). Likewise, during the last decade, a non-banking credit market emerged and developed: while in 2000, 83 per cent of corporate credit was financed by the banking system (Bank of Israel 2006:154), in 2007, the figure had dropped to 52 per cent of corporate credit, with the remainder comprised of negotiable and non-negotiable instruments of non-banking credit (Bank of Israel 2008:146).

The growing financialization of the economy is also manifested in the rising importance of the Tel Aviv stock exchange as a key domain of economic activity and profit making. In 1992, 378 companies were listed on the stock exchange with a market capitalization of US $29.6 billion; while in 2010, there were 613 companies with a market capitalization of US $613 billion. In the same period, the average daily turnover in equities grew almost tenfold, from US $59 million to US $547 million. An even more marked trend of growth is observable in the bond market: the daily turnover of government bonds grew from US $27 million in 1992 to US $641 million in 2010. The case of the corporate bonds market is particularly remarkable: while until 2005 it was practically non-existent, with a daily turnover of only US $9 million in 2004, since then, there has been a steady growth trend, reaching a daily turnover of US $170 million in 2010.[1] This is a clear instance of the success of the state adopting institutional reforms with the goal of building a new financial market almost from scratch, in which institutional investors – particularly pension funds, providence funds and insurance companies – play a major role.

In tandem with the liberalization of the local financial market, the state led a process of liberalization of capital flows and growing integration of the Israeli economy into global capital circuits. This was certainly a dramatic change in Israel's political economy, which led to the entrance of private foreign capital into Israel, in the form of both direct and portfolio investment, on a massive scale. In stark contrast to the minimal involvement of private foreign investors during Israel's developmental state phase, since the mid-1990s private capital inflows have become an extremely important factor in the Israeli economy. While the annual average of total foreign investments (direct and portfolio) in 1980-91 was only US $597 million, it rose to US $4.9 billion in 1992-2005, and reached US $17.6 billion in 2006-07 (Central Bureau of Statistics 2008:642). Following the gradual removal of restrictions on foreign exchange and overseas investments by Israeli citizens and companies, particularly during the 1990s, Israel's increasing integration in global financial markets could also be seen in the escalating magnitude of capital outflows. In 1980-91, the annual average of Israeli total overseas investments (direct and portfolio) was just US $256 million, increasing to US $3.3 billion in 1992-2005, and reaching US $17.1 billion in 2006-07 (Central Bureau of Statistics 2008:642). Alongside the significant increase in capital import and export since the 1990s, the business and financial orientation of local corporations has become increasingly global: Israeli companies began mobilizing funding from foreign banks and stock exchanges, and a substantial number of Israeli corporations decided to incorporate in other countries, especially the US. For instance, in February 2011, 58 Israeli companies were listed on NASDAQ -- the

[1] Data is from the Tel Aviv Stock Exchange website, http://www.tase.co.il/TASEEng/Homepage.htm (accessed on March 3, 2011).

second largest number of foreign companies after China – with a total market value of US $74.5 billion.[2]

Despite the rhetoric of "free markets" and state retrenchment, the state continues to be significantly involved in providing direct and indirect financial and other assistance to privately-owned corporations. For instance, in 2005, the Investment Center at the Ministry of Industry, Trade and Labor awarded a total of US $334 million in investment grants to local and foreign firms (Ministry of Industry 2006). In the same year, within the framework of the Capital Investment Encouragement Law, companies received tax benefits worth of approximately US $1.1 billion. It is important to note that this substantial subsidy was highly concentrated on large firms. The benefits received by the top decile of largest firms (in terms of annual revenue) among the 585 firms that were granted tax benefits in 2007 accounted for 87.1 per cent of the value of the total benefits, while the top percentile (five firms) received 57.4 per cent (State Revenue Division - Ministry of Finance 2009).

The direct and indirect state support of business and its important effects are particularly remarkable in the case of Israel's "high-tech revolution" of the 1990s and 2000s, which is often portrayed in the public sphere as a symbol of the efficiency, dynamism and progress that the private sector is capable of when freed from the shackles of the state. As noted by O Riain (2004) in his study of the developmental network state model, it is in the politics of high-tech growth and its integration within global markets where we can see the reemergence of state developmentalism in the most tangible way. The tremendous growth of the high-tech sector in Israel, that during the 1990s and 2000s was triumphantly referred to as the "locomotive" of the entire Israeli economy, is manifested in its contribution to GDP, exports and number of employees. Its share in the GDP grew from 8 percent in 1995 to 14 percent in 2007, and the share of high-tech manufacturing exports increased from 37 percent of total exports (excluding diamonds) in 1995 to 46 percent in 2007. The number of employees in high-tech rose from 115,500 in 1995 to 248,300 in 2007, a much higher increase than in the total number of employed in the Israel economy (115 percent and

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[2] NASDAQ website, http://www.nasdaq.com/screening/company-list.aspx (accessed on March 3, 2011).

40 percent respectively). Moreover, the proportion of employees in the high-tech sector in Israel is substantially higher than in European countries: 9.3 percent in 2007 compared to 6.7 percent in Finland, 6.2 percent in Ireland, and 6.1 percent in Switzerland (Central Bureau of Statistics 2010).

In Israel, as in other countries such as Ireland and Taiwan, the high-tech revolution was largely dependent on direct and indirect funding and institutional support from state agencies, clearly demonstrating some lines of continuity in the state's role as an agent of development (see Breznitz 2007b; O Riain 2004). In the Israeli case, it is important to note first the strong institutional and technological links between a large portion of the new high-tech industry – particularly in the fields of electronics, communications and optics – and the military industry, which, as mentioned above, was built from scratch in the late 1960s and was subsequently developed and maintained by the state. The success of the Israeli high-tech industry in these fields is based to a large extent on the qualified technical and scientific labor force, knowledge, technologies, organizational networks, information infrastructures, and other institutional resources that were nurtured and sustained by the state-led military industry since the 1960s. Currently, the military also plays an important role in the development of high-tech. Certain technological military units serve as greenhouses for the training of a highly qualified labor force in the fields of computing and communication, and the skills and knowledge acquired by veterans of these units in the course of their military service are highly valued by high-tech firms. Furthermore, as noted by Breznitz (2005), these military units serve as an institutional space that generates dense and extended social networks that promote and facilitate the diffusion and collaborative processing of knowledge and information, from which the private high-tech sector greatly benefits. In this way, the military functions as a major node in the Israeli high-tech innovation system, in which social capital, both on the individual and the systemic levels, is created and sustained.

The state also assists the private high-tech industry through a myriad of direct support programs that have been essential to its development and its integration within global professional, business and financial networks (O Riain 2004). Significant tax benefits and exemptions and extensive direct financial assistance in the form of investment grants are awarded to both local and foreign firms. Notable in this respect are the special grants that the government has provided to Intel since 1996 to support the establishment of manufacturing plants, which total more than US $1.5 billion. In addition, Intel was granted special tax benefits worth hundreds of US $ millions.

The importance of state support for the growth of high-tech in Israel, which is based, to a large extent, on innovation, is also reflected in figures on government financing of research and development. Between 1991 and 2003, direct government funding contributed 27.5 per cent of all civilian research and development expenditures, representing around 1 per cent of the GDP, higher than in all other OECD countries (Central Bureau of Statistics 2007:25, 40). In the last two decades, the state has set up several programs of financial and organizational assistance targeted specifically at high-tech research and development. Beginning in the late 1980s, the financial assistance provided by the Office of the Chief Scientist in the Ministry of Industry, Trade and Labor for civilian research and development was considerably expanded, becoming an important instrumental factor in the growth of Israeli high-tech (Avnimelech and Teubal 2004; Breznitz 2007a). Since the early 1990s, the grants provided to private enterprises by the Research and Development Fund have reached the sizable sum of US $250-400 million per year (Ministry of Industry 2005:43; Office of the Chief Scientist 2010). In addition, in 1991, the Office of the Chief Scientist initiated a program of technological incubators to provide new entrepreneurs with physical facilities, financial resources, professional guidance and administrative assistance, with the aim of turning innovative technological ideas into exportable commercial products and setting up business ventures. By 2006, the government's cumulative investment in this program was almost US $430 million.[3]

An additional important means of state support, which was highly instrumental in the growth of the high-tech sector, was set up in 1993, with the introduction of a program for the establishment of venture capital funds based on state-private partnership (the *Yozma* program). The government established 10 hybrid funds, investing US $80 million with US $150 million raised from private local and foreign investors, and an additional US $20 million were invested by the government in a

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[3] Technological Incubators Program Office website, http://incubators.org.il/program.htm (accessed on March 6, 2011).

state-owned fund (Avnimelech and Teubal 2006). Interestingly enough, the regulations of the program defined the participation of at least one foreign financial institution in the hybrid funds as compulsory, with the aim of promoting the involvement of foreign capital. As a result, several foreign financial firms and funds initiated activities in Israel through the *Yozma* funds (Avnimelech and Teubal 2004).

Though these funds were privatized by the late 1990s, the state-initiated establishment of venture capital funds had substantial effects for both the high-tech and the financial sectors. The program not only contributed to the development of a successful start-up sector strongly connected to global networks of technological innovation and commercialization, but also had important impacts on the links between Israeli high-tech and local and global financial actors and markets. The state program was the major factor that put in motion the emergence of a large private venture capital industry, which by the 2000s had become the largest in the world in relative terms (as a percentage of GNP), investing the sizeable sum of US $12.21 billion between 1997 and 2005 (Avnimelech and Teubal 2006:1478). Furthermore, as intended by the *Yozma* program, this industry developed as strongly integrated within global financial circuits, with more than 50 percent of the capital invested originating from abroad, mostly from the US (Avnimelech and Teubal 2006:1488). The growth of the venture capital industry in turn gave significant impetus to the financialization of the Israeli economy in general, and to its growing integration in global financial markets in particular.

The transition to neoliberal formulas involved a basic change in the power relations among classes, as well as between classes and the state. Capital gained in strength and became highly concentrated, as well as more tightly integrated into global markets. The privatization of the large industrial and financial corporations owned by the state and the *Histadrut*, as well as reforms in banking and finance, opened up new avenues for the expansion and strengthening of privately-owned established business groups, and for the formation of new groups owned by a small number of families with control over a large portion of the capital in Israel (Maman 2002). In fact, the privatization of state- and *Histadrut*-owned firms and conglomerates during the 1990s and 2000s, generally under extremely beneficial conditions for the purchasers, was the major factor leading to the emergence and growth of what are currently the largest business groups in the country (Maman 2008), perpetuating the concentrated structure of big business in Israel. As shown by Schamis (2002) for other cases of sweeping privatization, in Israel as well, the transfer of public assets to private ownership has created conditions favorable for rent-seeking, capital concentration and the dominance of central sectors of the economy by a small number of actors. For example, by the mid-2000s, around half of the 100 largest companies listed on the Tel Aviv Stock Exchange (Tel Aviv 100 Index), and almost all of the 25 largest companies (Tel Aviv 25 Index), were controlled by large business groups. Moreover, the largest 10 business groups, all of them family-owned, controlled nearly 30 per cent of the total stock market capitalization, a proportion among the highest in the western world (Kosenko 2007:76).

On the basis of complex structures of interlocking ownership within and among business groups, and particularly through pyramid holding companies, a small number of highly diversified business groups dominate entire economic sectors, such as finance and banking, communication services and infrastructure, retail, and natural resources extraction. By way of illustration, the IDB group owned by the Dankner family, one of the largest and most diversified business groups in Israel, controls the largest retail chain in the country, a leading insurance and financial services company, the largest cellular communications services operator, one of the world's largest agro-chemicals producer, several large real estate companies, a large internet and telecommunication company, the sole manufacturer of cement in Israel, the country's leading manufacturer of paper and paper products, and many other manufacturing, services and retail firms, as well as holding and investment corporations. The IDB group also illustrates the tendency by Israeli big capital in recent years of going global (Maman 2008). Some of its manufacturing companies have plants and local subsidiaries in many countries; it initiated real estate projects and purchased assets worldwide; some of its companies are listed on the NYSE and NASDAQ, and in October 2008, it invested over US $1 billion in the Credit Suisse Group, becoming a leading shareholder in that large international bank. The integration of big local capital in various spheres of the global economy certainly provides a firm foundation for strengthening its position in the local political-economic field.

While considering the high level of capital concentration characteristic of the structure of the Israeli economy, it should be noted that there is a significant degree of continuity between the pattern that emerged during the developmental state era and the current situation. As we have observed above, the development policy implemented in the past gave rise to the formation of a small number of large industrial and financial business groups that controlled the main economic sectors; a situation resembling the current one. Nonetheless, an essential difference is that while up to the 1980s, most of the business groups that dominated the economy were partially or fully owned by the state and the *Histadrut*, today all of them are fully owned by private capital.

Simultaneously, labor was seriously weakened both organizationally and politically vis-à-vis capital and the state, a process that had a number of interrelated causes: the decline of the *Histadrut*, both as a trade union and as the owner of key industrial and financial corporations, and especially the loss of its monopolistic status as the workers' representative; the weakening of collective bargaining over wage and employment conditions and the rise of individual employment contracts; the increasing fragmentation between workers employed in different economic sectors; the emergence of new forms of employment by manpower agencies and sub-contractors; growth in the proportion of part-time workers; and finally, the partial removal of legal protections from market forces provided to the workers by the state (Grinberg and Shafir 2000; Mundlak 2007; Shalev 2000).

The structural and institutional changes that we have observed had far-reaching distributional consequences, especially in terms of growing inequality and class polarization. Similar to the Irish and other cases (O'Hearn 2000; O Riain 2000), in Israel there has been a clear trend of widening gaps between the winners and losers from liberalization and strengthening integration into the global economy. A new upper class of capital owners, senior corporate executives and professionals – whose wealth mainly derives from the liberalization and financialization of the Israeli political economy and its growing integration into global capitalism – emerged and consolidated (Shafir and Peled 2002). For instance, the average salary of senior executives in companies listed on the Tel Aviv 25 Index in 2000 was 49 times the average national salary, reaching a ratio of 107 times in 2006, and declining to 94 times in 2009 (Swirski, Konor-Attias and Abu-Khala 2010a:20). At the same time, the economic and social security of sizable sections of the middle class considerably weakened, and large populations, mostly comprising Palestinian citizens of Israel and Jews from the periphery, were further marginalized.

This process is clearly reflected in data on income differentials and poverty. A trend toward greater inequality has been discernable in Israel since the mid-1970s, though the process sped up considerably in the early 1990s and further intensified in the early 2000s. Rising unemployment played an important role in the process of growing inequality (Dahan 2002), though gaps in income among employed people have also increased significantly. While the income of high earners has shot up over recent years, the situation of groups at the bottom of the social hierarchy has seriously deteriorated, particularly for the growing number of workers employed through unconventional employment arrangements, like part-time and temporary direct employment or through manpower agencies. The share in total income of the top decile among households headed by a wage earner rose from 23.6 per cent in 1988 to 26.5 per cent in 1996 and to 28.5 per cent in 2009, while the share of the bottom decile declined from 2.8 per cent to 2.5 and to 2.2 per cent, respectively. More generally, the share of each one of all seven bottom deciles declined in those years, the share of the eighth decile remained constant, and the share of the two top deciles rose significantly (Swirski, Konor-Attias and Abu-Khala 2010a:13; Swirski, Yechezkel and Konor-Attias 1998:6). Furthermore, deepening inequality has also resulted from changes in the income distribution between capital and labor: labor's share of income in the business sector dropped from 58 per cent in 2000 to 53 per cent in 2009, while the employers' share rose from 24 per cent to 29 per cent (Swirski, Konor-Attias and Abu-Khala 2010b:10).

It should be emphasized that until the early 2000s, the state's system of transfer payments and taxation, that is, the welfare state, managed to neutralize a significant part of income inequality resulting from economic activity (inequality before transfer payments and taxation). Nonetheless, driven by the principle of cutting budgetary expenditure and flexibilizing the labor market, significant changes in the state's main welfare programs in recent years have led to a considerable reduction in the value of welfare benefits and have tightened eligibility criteria. This has entailed a steep rise in inequality and poverty, even after taking transfer payments and taxation into account (Rosenhek 2007). The Gini coefficient for income inequality after direct taxes and transfer payments rose significantly from 0.353 in 1997 to 0.389 in 2009 (National Insurance Institute 2000:21; 2010:36), and the incidence of poverty after direct taxes and transfer payments rose in those years from 18.2 per cent to 25.0 per cent (National Insurance Institute 2000:10; 2010:16). Considering these trends, a report published by the OECD in 2010 in the context of the deliberations over Israel's acceptance into the organization observed that the country's poverty rate is the highest among all OECD countries and its income inequality level is one of the highest (OECD 2010:16).

The transformation of the Israeli political economy and the policy paradigm shift after 1985 are also reflected in the main indicators of macroeconomic performance. The most prominent and clear-cut trend has been in inflation levels, with the drastic reduction from the hyperinflation of 1984-85 to moderate inflation in 1986-98, and to virtual price stability since then. The political and institutional dynamics underlying the decrease in inflation rates and the attainment of price stability, particularly the role played by the central bank in this process, constitute a major dimension of the transformation of the Israeli political economy, as they reflect a basic change of priorities in macroeconomic management (Maman and Rosenhek 2011). Regarding growth and employment, the trends are less clear, and both indicators show a relatively high level of volatility. Growth rates have oscillated quite rapidly between periods of relatively accelerated economic expansion and periods of slowdown and recession. Unemployment levels fluctuated accordingly, but have never dropped below 6 per cent, and, for most of the period, were considerably higher. Between 1986 and 2007, unemployment reached an annual average rate of 8.7 per cent, representing unprecedentedly high and sustained levels of unemployment for Israel. Moreover, in contrast to the past, since the 1990s, unemployment rates of 7-8 per cent have been considered by Israeli policy-makers as reasonable. This certainly indicates that the goal of full employment, which was an important guideline for macroeconomic management during the developmental state era, lost its prevalence with the institutionalization of the neoliberal model.

To sum up, the political economy and state-economy relations in Israel today are in many ways fundamentally distinct from previous decades. Many of the practices and institutional arrangements of direct involvement in the economy that underpinned the actions of the developmental state have been delegitimized, and neoliberal policy formulas of marketization and financialization of the economy have been adopted instead. This shift, which took place within the framework of significant institutional legacies, does not connote the weakening of the state or its withdrawal from the economic sphere, but rather changes in its inner institutional configuration, mode of involvement, and policy priorities. Thus, despite the conventional understanding of liberalization as state retreat, the Israeli state remains a key actor in the political economy with significant capacities to command economic processes.

Conclusions

Our analysis of the institutional dynamics of the Israeli political economy suggests several conclusions that are relevant to the examination of current processes of change in state-economy relations in general. In the era of globalization and liberalization, state-economy relations have certainly changed. And yet, in contrast to the conventional stance concerning the withdrawal of the state from the economy and the decline of its political and institutional capabilities to shape the structure of economic relations, our analysis has shown that the state has not retreated from the economic sphere. The important shift in state-economy relations lies not in the *extent* of the state's involvement in the economy, but rather in the *mode* of its involvement. That is, institutional changes have to do first and foremost with the definition of the state's objectives in the management of the political economy and the way it uses particular institutional instruments to attain those objectives. As we have shown, state agencies continue to play a crucial role in the economic arena. However, instead of the patterns characteristic of the developmental state – such as knit-tight control over capital mobilization and allocation, and fiscal and monetary policy geared mainly towards industrial development, full employment and growth – in the neoliberal regime, the state tends to use indirect measures of regulation and control in order to create "free" markets, to support and ensure their functioning, and to assist private actors in accumulating capital, often by supporting their integration into global business and financial networks. This shift in the state's action encompasses changes in its institutional configuration, particularly concerning the roles, modes of action, status and power relations among its different agencies. Central banks and other professional regulatory agencies become key actors in the new state institutional architecture, increasing their power and autonomy vis-à-vis other state agencies and societal actors.

Moreover, our analysis indicates not only that the state role in the economy has not eroded, but also that state agencies play a pivotal role in initiating and advancing liberalization efforts, such as the financialization of the economy, and its growing integration into global markets. These processes of fundamental institutional change are more often than not driven by state actors, not by the market or by seemingly omnipotent global capital (Abdelal 2007; Etchemendy 2004).

As also illustrated by other cases of political economies commonly considered as etatist, such as France, Spain, Japan and South Korea, the relationship between state and economy that emerges in the era of liberalization is characterized by a combination of change and continuity (Cioffi 2000; Perez 1997; Weiss 2003). New important institutional arrangements indeed emerged, but this occurred alongside and in interaction with some enduring institutional legacies of the developmental state. This pattern of change amidst continuity is especially evident in the myriad ways, some new and some old, through which the state continues, both directly and indirectly, to support favored economic sectors according to developmentalist logics. Despite the rhetoric of free markets and private entrepreneurship, the state in this new hybrid institutional form remains a key actor whose actions significantly impact upon the dynamics of national political economies.

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