THE POLITICAL ECONOMY OF PUBLIC DEBT:

ECONOMIC DESIGN, PROPERTY RIGHTS, AND WEALTH DISTRIBUTION IN EARLY ISRAELI STATEHOOD

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Summary

Although the growing accumulation of public debt is an undeniable fact of many national economies, relatively little research examines how the legal engineering of public debt affects wealth distribution. This paper investigates this issue through a case-study of government fiscal policy in the early years of Israeli statehood. This period was marked by severe financial difficulties due to the government's deficit spending, with the young state plagued by inflation, unemployment, and an import surplus. To generate revenue and reduce unspent purchasing power, the government imposed mandatory lending on all citizens with liquid funds and demand deposit accounts. Although political leaders presented this arrangement as an act of patriotism, there was strong public criticism of the allegedly disproportionate impact on the poor and working class, even after the scheme was expanded to include asset owners.

The paper examines the political and economic circumstances that shaped the design of the compulsory lending policy and the policy's varying implications for different economic players. The analysis takes two perspectives in exploring these issues: a historical contextual perspective and a distributional perspective. It begins by mining Israel's legal, political, and economic history to identify and understand ideological and political constraints that led the government to adopt this policy. It then analyzes the considerations and processes involved in the adoption, design, and implementation of the compulsory lending scheme, based on archival materials documenting, among other things, the legislative process and protocols of cabinet discussions that culminated in the government's decision to deploy this unusual measure. The analysis shows that issuing public debt was a very adaptable tool by which the government synergized its political goals and economic goals. To this historical layer of analysis, I add a distributional analysis of the policy's costs and benefits from the perspectives of different economic players. The analysis then contextualizes the policy within the broader social

tensions Israel faced at the time, suggesting that the design of the public debt scheme advanced the economic interests of the governing party's electoral base.

The paper makes three central contributions to the scholarship on law and the political economy of public debt. *First*, it demonstrates how the legal design of public debt policies can impact their distributive outcomes. It shows that a potential outcome of a public debt scheme whose structure produces a wide distribution of bond holdings, alongside progressive taxation, is the transfer of wealth from the upper class to the middle class. *Second*, the paper adds to the research on the impact of politics and ideology on economic policy structuring. The case-study examined here illuminates the influence of Zionist ideology on the legal measures adopted in response to the Israeli state's early economic challenges and emphasizes the effectivity of sovereign debt as a mechanism for aligning the public's interests with those of the state, especially in "state-building" moments. *Third*, the paper reveals how post-WWII Keynesian scholars dismissed the distributive implications of public debt from a class perspective, thereby contributing to the depoliticization of public debt and the technocratic discourse surrounding it.

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I. Introduction

> *The public finances are one of the best starting points for an investigation of society ... The full fruitfulness of this approach is seen particularly at those turning points ... during which existing forms begin to die off and to change into something new, and which always involve a crisis ...*[1]

For Israel, 1952 was a year of crisis. In the economic sphere, unsustainable deficit-spending coincided with a short-term debt crisis; and, in the social sphere, the government struggled to integrate thousands of immigrants who had just arrived in the newly-independent state, some of them with nothing but a suitcase. Prime Minister David Ben-Gurion was thus faced with a socio-economic crisis no less severe and unnerving than the war from which Israel had just emerged. The struggle over money itself was the locus of that crisis.

Like many other countries in the post-World War II era, Israel opted to sustain its expenditure through borrowing. Many states that sought to boost their economies deployed policies influenced by the Keynesian paradigm, which gained momentum in those unstable times. Israel was not exceptional in this regard, with its political and economic leadership being influenced by Keynesian thinking. Yet, the case of Israel *was* different. Although the young government did not question the need to intervene in the economy, the kinds of solutions prescribed by the Keynesian paradigm that had evolved in developed economies like the United States (U.S.) and Britain did not match the needs of this new and developing economy. It was time to deploy special measures.

One of these special measures was a mandatory lending program implemented by the government in the period 1952–1953, under which all Israelis were forced to lend a proportion of their money to the government, either deducted from their cash holdings or liquid funds in demand deposit accounts or as a share of their asset-holdings. While this was not the first time

[1] JOSEPH A. SCHUMPETER, THE ECONOMICS AND SOCIOLOGY OF CAPITALISM 101 (Richard Swedberg eds., 2020).

that Israel had relied on domestic borrowing to pursue its fiscal goals, and although it was not the first state to use mandatory lending and other special taxes in the post-World War II era, in the Israel of the early 1950s, this measure was certainly conceived as exceptional. Unlike other cases of government borrowing, the Israeli case was not primarily motivated by a need to increase revenue. In a bid to combat inflation, the government had to absorb the excess liquidity in the market. As this paper shows, it considered several policy alternatives before deciding, in 1952, to require all Israelis to lend 10 percent of their cash holdings, including any monies held in demand deposit accounts. This step was driven by a combination of ideology, necessity, and—no less important, especially in developing states—administrative capabilities. The policy was designed to distribute the burden proportionally across society, as it was based on collecting an even percentage of the population's money. However, in practice, inflation and the class structure in Israel, with its division between newly-arrived immigrants and those who had arrived in the 1920s and 30s, distorted the distribution of liquidity in the market; the lower and middle classes held more liquid money than the upper classes, who held their wealth primarily in assets.

Ben-Gurion's government attempted to correct this distortion in a second forced lending drive, in 1953, which required all owners of liquid and illiquid assets to lend a proportion of their total wealth to the government. Yet, now, the government faced a new problem: after absorbing the excess liquidity, the market struggled with a shortage in its money supply. This change in circumstances created different economic incentives for the economic players in society: many asset-owners from the middle classes did not have access to the liquidity needed to lend a portion of their total wealth to the government. In response, the government enabled people to choose to pay half of the amount of the debt to the government as a one-off, lump-sum, non-refundable payment that acted like a special tax. Once again, the legal design of the policy created different economic incentives for the players; as this paper demonstrates, the

majority of asset-owners from the middle classes chose the special tax option. The upper classes, however, chose the lending option, which acted, for them, as a means of investment, as the loan to the government was interest-bearing. Interestingly, the distributive result of the 1952–1953 lending schemes correlated with the broader socio-economic agenda of Mapai, the leading political party of the time, and with the shift in priorities of its electoral base: the upper working class.

The use of public debt as a strategic instrument of national policy was not unique to Israel. Already in the eighteenth century, Alexander Hamilton conceived debt as a way to protect and advance the interests of the American nation.[2] Few scholars, however, have examined public debt from the distributive class perspective. Although this issue now tends to be approached through the prism of intergenerational equity, public debt has, in fact, important domestic distributive effects from a class perspective. It is this perspective that I adopt in the present paper. In the nineteenth century, scholars scarcely attempted to examine those effects in the context of American or British public debt. This line of scholarship was abandoned altogether after World War II, with the rise of the Keynesian school that dismissed the distributive effects of public debt as inconsequential. Indeed, the economic circumstances in the mid-1940s supported this claim: in that period, the distribution of bond holdings was comparatively broad and many states implemented relatively progressive taxation. The effect was that the pool of bondholders overlapped with the pool of taxpayers, often causing the rich to service the debt held by the middle classes. Nonetheless, by ignoring the distributive potential of public debt, the Keynesian school, I believe, contributed to the depoliticization of public debt and relocated the debate to the technocratic–economic sphere. Recently, some scholars have begun to address

[2] JOHN STEELE GORDON, HAMILTON'S BLESSING: THE EXTRAORDINARY LIFE AND TIMES OF OUR NATIONAL DEBT 198 (2010).

this lacuna in the literature, by suggesting that public debt is a policy mechanism that transfers wealth from the middle classes to the wealthy.

Although today's economic circumstances are very different from those faced by Israel in the early 1950s, I believe that this Israeli case study presents an opportunity to provide a more nuanced account of public debt with regard to distribution and economic planning. This paper focuses on the political–economic context that led the government to design its policy the way it did, and on the implications of this design for the economic players of the day. The analysis takes two perspectives: a historical–contextual perspective and a distributional perspective. Part II begins by mining Israel's legal, political, and economic history to identify and understand the primary ideological and political constraints that led the government to adopt this policy. It then analyzes the considerations and processes involved in the adoption, design, and implementation of the compulsory lending scheme, based on archival materials that document, among other features, the legislative process and protocols of cabinet discussions that culminated in the government's commitment to this unusual measure. The analysis shows that issuing public debt was a very adaptable tool by which the government could synergize its political and economic goals. To this historical layer of inquiry, I add a distributional analysis of the policy's costs and benefits from the perspectives of different economic players. The analysis then contextualizes the policy within the broader social tensions Israel was facing at the time, suggesting that the design of the public debt scheme deliberately advanced the economic interests of the governing party's electoral base.

This approach enables me to build upon the historical data that remain available today, while avoiding the empirical "trap": it evades the limits created by the lack of sufficient data by offering a speculative analysis of the different incentives that the policy created for economic players. Although my initial assumption was that the debt Israel issued harmed the lower and middle classes the most, I show in this Part how I arrived at a more subtle

understanding of the effects of the legal engineering of economic policy on distribution. In particular, I show that certain debt structuring, in fact, had the potential to promote a redistribution of wealth from the wealthy to the middle and lower classes, although it did not fully accomplish this goal.

The paper continues as follows. Part II examines the historical background that is essential to understanding the economic circumstances Israel faced in the early 1950s. This Part examines Israel's political economy and explores how it shaped the legal response to the economic problems. It also explains how the economy was subjugated to the Zionist vision, as it was understood by the leadership. In Part III, I continue to explore the mechanics of the compulsory lending plan itself, including the legislation process and cabinet deliberations that led the government to deploy this extraordinary measure. Here, I rely mainly on 1950s government protocols and those of the Knesset, the Israeli Parliament, and on primary sources from the Israel State Archives (ISA). This Part discusses the legal design of the debt structure and the different policy solutions that were left on the table. It demonstrates how, in the hands of the Israeli regime, issuing public debt became a flexible fiscal tool that synergized the government's national goals and its economic endeavors. Part IV focuses on the distributive question, drawing on the data presented in Part III to present a comprehensive understanding of the different ways in which the policy affected various economic players. Part V concludes.

II. The Birth of the Israeli Economy

a. The Two-Sided War: Warfare and Immigration

> *The ordeal we shall have to undergo now is no whit less serious than the ordeal of war, and it is more drawn-out and, in many respects, more difficult …*
>
> David Ben-Gurion (1949)[3]

On May 14, 1948, Israel declared its independence, following the United Nations (UN) General Assembly's resolution in November 1947 for the intended partition of Palestine into two separate independent states: a Jewish state and an Arab state. The reality, however, took a different path: following the UN decision, a war broke out between the Jews and the Arabs of Palestine, joined later by neighboring Arab countries—known by many as the War of Independence.[4] When the war ended, in 1949, the intended Palestinian state did not materialize, and, instead, most of its territory was forcibly subsumed into the kingdom of Jordan. For the Zionist movement, however, the end of the British Mandate after almost 30 years represented the long-yearned-for opportunity to achieve its goals by establishing a sovereign state for the Jewish people.

The losses brought about by the war were not only physical. During the state's first year, the domestic defense expenditure amounted to 60 million Israeli Lira (IL) (known also as Israeli Pounds),[5] which was equivalent to 40 percent of the gross domestic product (GDP).[6] The war also prevented many people under arms from participating in the workforce, thus

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[3] DAVID BEN-GURION, ISRAEL: A PERSONAL HISTORY 412 (1971).
[4] Referred-to by Israel as the War of Independence but by Palestinians as the *Nakba*—"the catastrophe."
[5] As I will elaborate later, for the first four years following independence, Israel's legal tender carried the name "Palestine Pound." *See* NADAV HALEVI, NAHUM GROSS, EPHRAIM KLEIMAN, & MARSHALL SARNAT, BANKER TO AN EMERGING NATION: THE HISTORY OF BANK LEUMI LE-ISRAEL 121–124 (1981).
[6] About 63 percent of it was obtained via credit from commercial banks, primarily in exchange for treasury bonds, and via some conversion of foreign exchange. *See* Nachum T. Gross, *Israeli Economic Policies, 1948–1951: Problems of Evaluation*, 50(1) J. ECON. HIST. 67, 73 (1990). The total direct costs of the war were estimated to be between 80 and 100 million IL. *See* ROBERT DAVID OTTENSOOSER, THE PALESTINE POUND AND THE ISRAEL POUND: TRANSITION FROM COLONIAL TO AN INDEPENDENT CURRENCY 104 (1955).

causing even more damage to the production cycle.[7] No sooner had the War of Independence ended than the Israeli Government faced its next acute challenge: how to absorb and integrate the vast numbers of new immigrants flooding into the state, impoverished and desperate. As Israel opened its doors to an unparalleled wave of Jewish immigration,[8] its Jewish population more than doubled in just three years, dramatically altering the demographic balance. This was the result of the declaration of independence, the foundation of the Jewish State, and the general immigration policy of the Israeli regime which gives primacy to Jewishness in providing citizenship, therefore allowing thousands of Jewish people to gain citizenship in Israel without any additional requirements.[9] Estimates of the population during the very early days of the war reveal that it comprised 630,000 Jews (33.2 percent) and 1,269,000 non-Jews (mostly Palestinians, about 66.8 percent).[10] However, between 1948 and 1951, almost 700,000 Jewish immigrants entered Israel,[11] bringing the number of Jews in the state to 1,324,000.

The rate of immigration reached a peak in the first half of 1949, when a wave of Jewish refugees from eastern Europe arrived after the Holocaust. A second peak occurred in the middle of 1951, with immigrants arriving mostly from Jewish communities in Asia and North Africa, from countries including Iraq, Iran, Yemen, and Morocco.[12] The Palestinian population in Israel shrunk dramatically: during the War of Independence, thousands of Palestinians fled to

[7] About 7 percent of the Israeli population at that time were doing military service and could therefore not participate in the economy. *See* HAIM BARKAI, THE BEGINNINGS OF THE ISRAELI ECONOMY 22 (1990) [Hebrew]. *See also* DON PATINKIN, THE ISRAEL ECONOMY: THE FIRST DECADE 58 (1960). Nevertheless, during 1948, the year of the war, Israel's GDP grew by 4 percent, mainly thanks to convenient access to the ports, which enabled Israeli farmers to export their production. *See* BARKAI, *id*., at 23–24.
[8] PATINKIN, *supra* note 7, at 21.
[9] Enacted in 1950, The Law of Return guarantees immediate right of entry to every Jew who comes to Israel. *See* Yoav Peled, *Ethnic Democracy and the Legal Construction of Citizenship: Arab Citizens of the Jewish State*, 86(2) AM. POL. SCI. REV. 432, 435 (1992).
[10] NADAV HALEVI & RUTH KLINOV-MALUL, THE ECONOMIC DEVELOPMENT OF ISRAEL 11 (1968) [Hebrew].
[11] PATINKIN, *supra* note 7, at 20.
[12] I*d*., at 21; MICHAEL MICHAELY, FOREIGN TRADE REGIMES AND ECONOMIC DEVELOPMENT: ISRAEL 7 (1975).

crowded refugee camps in neighboring Arab countries, and, by 1950, fewer than 160,000 Palestinians remained in Israel. Of these, only 63,000 were immediately granted citizenship.[13]

Unlike many of the Jewish immigrants during the interwar period, the immigrants of the 1948–1951 wave were, in general, less educated and they arrived in Israel with scant personal resources. Most of the immigrants from eastern Europe arrived after several years as refugees in concentration camps and had therefore been denied education for a considerable time. Similarly, the educational level of immigrants from Asian and African countries was, on average, lower compared to the "veteran" Jewish immigrants—those who had come to Israel in the earlier wave, during the 1920s and 30s.[14] But it was not only the level of education and literacy of the new immigrants that proved worrisome for the Israeli economy. Upon arriving in Israel, the vast majority (more than 50 percent) reported that they had no gainful occupation,[15] and even the ones who had had a previous occupation abroad were perceived by the absorbing strata as lacking the necessary skills for the developing economy.[16] Many of those who had had some prior occupation were traders, clerks, craftsmen, artisans, or engaged in personal services.[17] The Israeli economy, however, needed laborers for agriculture, industry, and construction. Thus, 60 percent of immigrants had to change their occupations, essentially becoming unskilled laborers.[18]

Absorbing the wave of immigration was comparatively easy until the middle of 1949, since most new arrivals were called to join the army or were absorbed into the war economy, while

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[13] Peled, *supra* note 9, at 435. Most of the Israeli Palestinian population lived under a system of military rule. *See* ASSAF LIKHOVSKI, TAX LAW AND SOCIAL NORMS IN MANDATORY PALESTINE AND ISRAEL 188 (2017); Sreemati Mitter, "A History of Money in Palestine: From the 1900s to the Present" 152 (Ph.D. dissertation, Harv. University) (2014).

[14] Michaely indicates that the median duration of schooling for the veteran immigrant population was ten years, whereas for the 1948–1951 Jewish immigrants it was 7.7 years. MICHAELY, *supra* note 12, at 7–8. *See also* PATINKIN, *supra* note 7, at 25–27.

[15] MOSHE SICRON, IMMIGRATION TO ISRAEL 1948–1953, 66 (1957).

[16] ARIE KRAMPF, THE NATIONAL ORIGINS OF THE MARKET ECONOMY: ECONOMIC DEVELOPMENTALISM DURING THE FORMATION OF THE ISRAELI CAPITALISM 98 (2015) [Hebrew].

[17] PATINKIN, *supra* note 7, at 27–28.

[18] MICHAELY, *supra* note 12, at 10.

the rest were temporarily directed to immigration camps.[19] In addition, the rapid flight of thousands of Palestinians from Israel enabled a partial accommodation solution, as the government directed some of the new immigrants to houses left vacant in the cities.[20] The situation changed dramatically in 1950, when the number of occupants in the immigration camps reached a peak toward the end of that summer.[21] The growing population created a production problem. While, in 1947, local production accounted for 62.5 percent of total consumption by the local population, in 1952, it covered less than 55 percent, and thus necessitated more imports.[22]

Together, the burden of war and intense immigration called for extraordinary spending that was not designed to increase consumption. And, influenced by the Keynesian paradigm, the Israeli political and economic leadership did not question the need for government intervention in the construction of the economy.[23] In the first half of the twentieth century, the political acceptance of Keynesian thinking, which endorsed the constant maintenance of aggregate demand, created a policy alternative to the dichotomy of free markets and nationalized planned economies: a regulated and governed market in which governments act through direct monetary and fiscal intervention to stabilize the economy. More specifically, the Keynesian paradigm prescribes spending and deficits during recessions, which should be counterbalanced in times of economic prosperity.[24] Indeed, this was an era in which public debt became an increasingly popular feature of fiscal policy. This was also true with regard to stimulating the development of the Global South and semi-peripheral countries.[25]

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[19] URI BAHRAL, THE EFFECT OF MASS IMMIGRATION ON WAGES IN ISRAEL 11 (1965).
[20] BARKAI, *supra* note 7, at 32–34; PATINKIN, *supra* note 7, at 24.
[21] BAHRAL, *supra* note 19, at 11.
[22] OTTENSOOSER, *supra* note 6, at 105.
[23] MICHAELY, *supra* note 12, at 5; *see, for example*, Government Meeting, September 4th, 1950, 30 [Hebrew].
[24] RICHARD M. BARKAY, THE PUBLIC SECTOR ACCOUNTS OF ISRAEL: 1948/49–1954/55, vol. 1, 1 (1957).
[25] DESTIN JENKINS, THE BONDS OF INEQUALITY: DEBT AND THE MAKING OF THE AMERICAN CITY 45 (2021); JOCHEN KRASKE, BANKERS WITH A MISSION: THE PRESIDENTS OF THE WORLD BANK 91 (1946).

In the 1930s and 40s, these ideas helped the Zionist movement to frame and envision its policy.[26] As one socialist economist of the time noted, "Jewish colonisation in Palestine has achieved its economic success, precisely because it has possessed the two elements which are essential for all colonial development—a free capital supply, and a planned economic policy based on the expansion and supply of the home market."[27] Later, when Israel declared independence, the political and economic strata did not challenge the notion that a fiscal and monetary interventionist policy was needed.[28] But it was not through a mere application of Keynesian policies that the Israeli economy developed. Keynesian ideas were designed to address the specific problems that post-industrialized developed economies faced: a skilled but unemployed workforce, idle production facilities, and untapped credit sources.[29] Hence, it was the mass unemployment in the American economy during the Great Depression and the following decade that advanced the acceptance of the Keynesian paradigm, which was subsequently adopted by Britain and other advanced economies.[30] The Israeli economy, in contrast, was dealing with a completely different set of problems: how to achieve rapid economic growth while thousands among its potential workforce—homeless immigrants—lacked the necessary skills a developing economy demands.[31] These circumstances prompted the Israeli Government to opt for deficit spending and inflationary policies.

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[26] ARIE KRAMPF, THE ISRAELI PATH TO NEOLIBERALISM: THE STATE, CONTINUITY AND CHANGE 40 (2018).
[27] Rita Hinden, *Palestine and Colonial Economic Development*, 13(1) POL. Q. 91, 91 (1942). Hinden wrote her doctorate at the London School of Economics under the supervision of David Horowitz, who later became the first Governor of the Israeli central bank, The Bank of Israel. *See also* MICHAELY, *supra* note 1212, at 5–6.
[28] Haim Barkai, *Don Patinkin's Contribution to Economics in Israel*, in MONETARY THEORY AND THOUGHT: ESSAYS IN HONOUR OF DON PATINKIN 3, 5 (Haim Barkai, Stanley Fischer, & Nissan Liviatan eds., 1993); Gross, *supra* note 6, at 69–70; MICHAELY, *supra* note 12, at 4.
[29] KRAMPF, *supra* note 26, at 32–33, 61.
[30] Hans W. Singer, *Keynesian Models of Economic Development and Their Limitations: An Analysis in the Light of Gunnar Myrdal's 'Asian Drama,'* in THE STRATEGY OF INTERNATIONAL DEVELOPMENT: ESSAYS IN THE ECONOMICS OF BACKWARDNESS 23 (Sir Alec Cairncross & Mohinder Puri eds., 1975); *see also* Nicholas H. Dimsdale, *Keynes on British Budgetary Policy 1914–1946*, in PRIVATE SAVING AND PUBLIC DEBT 207 (Michael J. Boskin, John S. Flemming, & Stefano Gorini eds., 1987).
[31] BARKAY, *supra* note 24, at 1–2. For the applicability of the Keynesian paradigm to developing countries, *see* Singer, *supra* note 30.

Arie Krampf describes how this rapid development was based on three premises, all of which favored Zionist national considerations. First, the demographic premise: Zionist thinking held that Jews had to be brought to Israel *at any cost* to ensure and sustain a Jewish majority. Second, in view of the first premise, Israel followed a full employment policy that entailed the subjugation of the market to the needs of the newly-arrived immigrants;[32] under a "productivist" ideology, good citizenship was associated with participation in the labor market even when salaries exceeded workers' contribution to production.[33] Thus, the production capabilities of the Israeli economy had to be stretched, even at the cost of unproductive labor, to eliminate the 11.5 percent unemployment rate.[34] In order to achieve this goal, the government implemented a variety of policies, including fiscal expansion, allocation of resources to labor-intensive industries, delivery of occupational training for workers, and a work relief program for untrained and unemployed workers. Third, the government believed that the economy should serve national needs, and not vice-versa. In other words, the amount of imported foreign capital had to support national needs, rather than economic rationales.[35] Combined with the emphasis on full employment and expansion of production, these policies required constant foreign financial support in the form of capital borrowing, a negative trade balance, and dependence on foreign contributions.

b. Economic Sovereignty

Israel's independence marked not only the emergence of a new political sovereignty but also a new economic entity. Economic sovereignty, though not always translated into economic independence, is a function of sovereignty at large. Aside from the manifestation of fiscal control, the sovereign state is entitled to regulate its own currency. During the British Mandate,

[32] *See also*, on this point, MICHAELY, *supra* note 12, at 5.
[33] KRAMPF, *supra* note 26, at 93; for a critique of this approach, *see* PATINKIN, *supra* note 7, at 34.
[34] *Id.*, at 31; Krampf suggests that this rate stood at 14 percent in 1949. *See* KRAMPF, *supra* note 26, at 78.
[35] KRAMPF, *supra* note 26, at 63–64.

the Palestine Pound (PP) was made the legal tender of the territory, issued by the Palestine Currency Board (PCB) in London. The PP was backed by the Pound Sterling and was equal in value.[36] Even before independence, the Zionist economic leadership had started planning a new currency. One major issue it had to resolve was the public's acceptance of this move, and it endeavored to avoid a potential run on the banks animated by political instability and the war. The withdrawal of the PCB from Palestine a few months before the official end of the British Mandate only added to the economic uncertainty.[37] Nevertheless, when Israel declared independence, the monetary system continued its operation without interference and the feared run on the banks did not materialize. During the first two months of the Israeli regime, the PP remained the legal tender. However, after the PCB ceased its operations in Israeli territory, it was only a matter of time before the market would suffer a shortage in its money supply. It was therefore crucial for Israel to issue its own currency.[38]

In August 1948, the government concluded an agreement with the Anglo-Palestine Company (later renamed the Anglo-Palestine Bank or APB), establishing a monopoly over Israeli banknote issuance and setting up a dedicated issuing department.[39] Founded in 1902 in London, APB was renamed *Bank Leumi Le-Israel* (Bank Leumi) in 1950. The APB was inspired by the vision of Theodore Herzl, known in Hebrew as *Chozeh HaMedinah* ("visionary of the state"), to establish a banking system exclusively geared toward the growing Zionist community in Palestine.[40] Until 1954, it acted as Israel's de-facto central bank and it played a pivotal role in the issuing of the state's new legal tender in 1948. The agreement between APB

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[36] *Id.*, at 112.
[37] BARKAI, *supra* note 7, at 25; HALEVI, GROSS, KLEIMAN, & SARNAT, *supra* note 5, at 113–115. This step coincided with the Mandatory Administration's "hands off" policy of essentially leaving the local administration in chaos. *See* OTTENSOOSER, *supra* note 6, at 108.
[38] BARKAI, *supra* note 7, at 26; an additional reason for issuing a new currency was the fact that the PP also served as the legal tender in some of the territories that were under Jordanian and Egyptian rule.
[39] OTTENSOOSER, *supra* note 6, at 110; MICHAELY, supra note 12, at 2.
[40] MITTER, *supra* note 13, at 49. It was established as a subsidiary of the Jewish Colonial Trust held by the World Zionist Organization. *See* HALEVI, GROSS, KLEIMAN, & SARNAT, *supra* note 5, at 60–66. The APB launched its Jaffa, Israel brunch in 1903, the only Zionist financial institution that operated like a real "bank" back then. *See* MEIR HETH, BANKING INSTITUTIONS IN ISRAEL 7 (1963).

and the government was renewed periodically. The initial agreement demanded that the government's indebtedness to the issuing department would have a ceiling, supported by a 50 percent backing in foreign exchange held by the APB. In fact, the bank promised to retain a 60 percent ratio and was confident it could realistically do so.[41] However, shortly thereafter, it became clear that the government would need more money, and the agreement was amended to make Israeli Treasury bills equivalent to foreign exchange. Thus, in effect, the issuing department was free to lend even more money to the government.

The introduction of the new Israeli currency was an improvisation carried out by the APB's management. Over the course of 1948, it grew increasingly evident to the APB's leadership that a chaotic situation was about to erupt; indeed, in the months leading up to independence, there was a surge in withdrawals of bank deposits, and the bank's management team raised concerns about the potential for its currency reserves to be bled dry. The reasonable solution seemed to be to issue a new temporary currency.[42] With the Israeli political leadership entirely occupied with the process of founding the state itself, the APB's management took the reins by authorizing the printing of new notes in the U.S. even before independence was formalized. As they lacked formal statist authority to carry out this operation, the notes could not carry the name "Israel." Instead, they carried the name of the APB and the inscription "Palestine Pound" in Hebrew, Arabic, and English, despite the fact that the latter was about to lose its status as an official language.[43]

[41] MICHAELY, *supra* note 12, at 2; HALEVI, GROSS, KLEIMAN, & SARNAT, *supra* note 5, at 116–121.
[42] HALEVI, GROSS, KLEIMAN, & SARNAT, *supra* note 5, at 115.
[43] The question of the exchange rate of the IL notes and the PP was also a result of an improvisation. The new IL was introduced in August 1948 and the public was given one month to replace all the circulating PP notes (on a par with the new IL). Less than a month later, 27 million PP had been exchanged for IL. The new currency was so stable that even Palestinians who held the old PP notes but were not residents of Israel attempted to exchange them for the new Israeli money. *See* OTTENSOOSER, *supra* note 6, at 111–112; BARKAI, *supra* note 7, at 28.

c. An Economy in Transition: Unemployment, Deficit, and Inflation

The stability of the Israeli regime in its early years proved to be highly conducive to the government's pursuit of its political and economic agenda. Since that very first government, Mapai (today known as The Israeli Labor Party), had run the coalition. As Mapai also governed the Histadrut, the general workers' organization, which was established in the early 1920s, it thus had significant power over national economic matters.[44] Indeed, Mapai consolidated its control over the economy and was able to undermine opposition parties who were dependent on small businesses and service-providers for their support.[45] The first government, led by Prime Minister David Ben-Gurion, pursued its economic goals primarily by relying on the trade deficit. Israel thus had to finance its net imports through different sources of foreign currency, including aid contributions, and borrowing from other sovereigns and private lenders.[46]

But, the decision to borrow was less an expression of sound economic planning and more the combined result of ideology and inevitability. On the level of ideology, as mentioned earlier, the Zionist regime's priority was the rapid development of the state as a *Jewish* state. Thus, during the foundational years, mainstream economic discourse refrained from challenging the immigration policy and the huge financial problems it entailed.[47] Only in the mid-1950s did voices calling for balanced fiscal policy start entering the consensus, when the government's main interest became the state's economic independence—an interest that aligned with that of the upper middle classes. In terms of the need to promote rapid economic development, the circumstances surrounding Israeli independence, particularly the recent war

[44] MICHAELY, *supra* note 12, at 3–5.
[45] DANIEL SCHIFFMAN, WARREN YOUNG, & YARON ZELEKHA, THE ROLE OF ECONOMIC ADVISERS IN ISRAEL'S ECONOMIC POLICY 9 (2017).
[46] KRAMPF, *supra* note 26, at 75. Note that the expedience of borrowing may depend not only on the direct price of foreign capital (i.e., the interest payments); it may also be influenced by international trade regimes. *See* John Gerard Ruggie, *International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order*, 36(2) INT'L ORG. 379, 398–404 (1982).
[47] Jonathan Louis Katzman, *A Dependent 'Special Relationship': Jewish American Economists and the Liberalization of the Israeli Economy*, HARV. JUDAICA COLLECTION, STUDENT RESEARCH PAPERS NO. 19, 23–24 (2023).

and the ongoing immigration influx, led to a shortfall in the government's financial resources, especially to fund its high-intensity investment plan.[48] The government thus had to rely on an import surplus to fund its ambitious development plan,[49] as well as to service the debt it had accrued, if it was to avoid prompting a sharp decline in private consumption levels.[50]

Government spending during these early years was largely financed by inflationary measures, as the APB's issuing department was regarded as an almost unlimited source of funds.[51] In addition, the government financed its spending by internal borrowing, mainly from commercial banks against Treasury bills.[52] Consequently, the currency supply more than tripled in less than three years.[53] But, instead of attacking the causes of inflation, the government attacked its primary symptom—namely, rising prices. During 1949–1951, it implemented a strict austerity policy, imposed price controls, and rationed food, clothing, building materials, and foreign exchange, leading to a widespread black market.[54] These policies were successful in suppressing the effects of the overly large money supply in the market, and they achieved a fairly equitable distribution of basic necessities across the entire

[48] Measured in 1950, Israel's domestic investment per capita was $1,150, higher than that of West Germany, Netherlands, Austria, Italy, Ireland, and the UK. *See* PATINKIN, *supra* note 7, at 81.
[49] *Id*., at 54. In the late 1940s and early 50s, the annual import surplus was about $300 million, roughly 50 percent of Israel's GDP. *See* KRAMPF, *supra* note 26, at 78. During the early 1950s, the U.S. Government was a relatively important source of revenue, in addition to the money borrowed from the American Jewish community through the purchase of special government bonds (called "Independence Loans" and, later, "Development Loans"). *See* MICHAELY, *supra* note 12, at 14. In 1951, the government obtained $48.4 million from the Independence Loan, a $361.1 million loan from the Export–Import Bank of the United States, and $14 million in American aid. *See* OTTENSOOSER, *supra* note 6, at 127. Apart from this, it is worth mentioning also Germany's restitution payments to both the Israeli Government and, subsequently, Israeli individuals. *See* MICHAELY, *supra* note 12, at 15; YOUNG & ZELEKHA, *supra* note 45, at 8.
[50] MICHAELY, *supra* note 12, at 13–18, suggests that the structure of imports was composed of 25 percent of consumer goods, a similar percentage of investment goods, and 40–45 percent of raw materials, the rest being fuel.
[51] HALEVI, GROSS, KLEIMAN, & SARNAT, *supra* note 5, at 130–131.
[52] *Id*., The total sum collected between 1949 and 1955 was $183,319,000. *See Income from Foreign Currency, 1949–1955* [in Hebrew] (ISA-5526/5-G), 2. Borrowing from the Israeli public was relatively insignificant in this period. By the end of 1950, it was estimated that 82 percent of the public debt was held by banks, credit cooperative societies, and the APB's issuing department. *See* OTTENSOOSER, *supra* note 6, at 121–122.
[53] HALEVI, GROSS, KLEIMAN, & SARNAT, *supra* note 5, at 130–131.
[54] PATINKIN, *supra* note 7, at 108–109; MICHAELY, *supra* note 12, at 40–45; YOUNG & ZELEKHA, *supra* note 45, at 8–9; BARKAI, *supra* note 7, at 35–40. *See also* Government Meeting, August 31st, 1950, at 2–3, account of the Minister of Finance, Eliezer Kaplan, of the price level of consumption goods on the Tel Aviv black market [Hebrew].

population. However, in the hands of the public, the augmented cash flow created growing unspent purchasing power that found its way to the black market.[55] The result was "suppressed" inflation, which was almost completely absent from the official price-index records.[56]

In 1952, foreign balances decreased sharply, eventually leading to virtually-zero foreign reserves.[57] The outbreak of the Korean War made the situation even worse, and the public reacted by making heavy bank-account withdrawals.[58] By mid-1950, the Ministry of Finance came to the realization that inflation was not the result of a shortage in consumption goods but, rather, the result of the trade deficit and the expansive monetary policy it conducted. This had a severe policy implication: the government was forced to make a choice between low inflation and a low trade deficit or continuing its unbalanced spending to support the mass absorption of heterogeneous immigrants from different socio-economic backgrounds while *increasing* inflation.[59]

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The first three years of the nascent Israeli State's economy were characterized by remarkable achievements but also by thorny challenges: an unbalanced budget, inflation, high unemployment, and a constant struggle to meet the basic needs of the newly-arrived immigrants.[60] In the years following independence, the newly-formed state did successfully absorb a large volume of incomers while maintaining its ideological preferences for a managed economy and an equitable distribution of burdens, excluding the Palestinians who were left in

[55] PATINKIN, *supra* note 7, at 109.
[56] *See id*; MICHAELY, *supra* note 12, at 18. Michaely estimates that, had prices been free to change, the increase in the price index would have probably been 30–40 percent higher than recorded; *see also* KRAMPF, *supra* note 26, at 78–79.
[57] KATZMAN, *supra* note 47, at 24.
[58] OTTENSOOSER, *supra* note 6, at 125; *see also* Government Meeting, *supra* note 54, account of the Minister of Finance, Eliezer Kaplan, of a withdrawal of 6 percent from bank deposits [Hebrew].
[59] KRAMPF, *supra* note 26, at 79.
[60] Gross, *supra* note 6, at 79.

Israel.[61] It turned out, however, that integrating the newly-arrived immigrants was a much more difficult task than absorbing them; in order to eliminate unemployment while maintaining its Zionist immigration policy, the government employed an interventionist approach based on deficit spending. This did, indeed, help sustain its development plan. However, the costs were high, particularly in the form of *suppressed* inflation, which was triggered by the import surplus combined with an austerity policy and price control. "The funds received from abroad were not capable by themselves, however, of sustaining and developing the economy," one contemporary economist observed, describing the severity of the situation. "Government income from internal taxation and loans failed to keep pace with expenditure, and the choice had to be taken between acquiescing in the collapse of the development and defense programs or creating new means of payment."[62]

Short-term credit was used to finance the severe deficit when special-aid grants and long-term loans proved insufficient. Consequently, in early 1952, the government faced a brief but severe debt crisis when it was unable to pay for its more than $100 million short-term debt. In April of that year, the Israeli regime approached the U.S. Government for immediate assistance, which was granted in part.[63] "I knew we were on the verge of bankruptcy, when sometimes the difference between stability and financial disaster was the mere time difference between New York and San Francisco," wrote David Horowitz, the first Director-General of the Israeli Ministry of Finance and the first governor of Israel's central bank. "The deadlines for paying off the bonds pressured us … and we reached the peak of financial acrobatics by taking

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[61] *Id*., at 83.
[62] I*d*., at 74.
[63] For a detailed account, *see* Raymond F. Mikesell, *Israel's Short-term Debt Crisis of 1952–53: A Memoir*, 42(1) ECON. Q. 208 (1995) [Hebrew]. Mikesell was sent by the U.S. Government to Israel in 1952 to examine the financial situation there. *See* YOUNG & ZELEKHA, *supra* note 45, at 11, explaining that the U.S. Government was not in favor of granting additional funding to Israel to service the import of consumption goods. Rather, the American Administration preferred its grant to support investment expenditures; KATZMAN, *supra* note 47, at 25–27.

advantage of the time differences between parts of the United States."[64] The introduction of a new economic policy was inevitable, and, in mid-1951, conditions were such that precisely this move seemed feasible.[65]

III. The Compulsory Lending Schemes of 1952–1953

a. The Politics of Economic Policy

> *In order to understand the relationships between economic quantities in terms of which the problem is defined, one must understand the underlying, generative, relationships between social groupings–and that these will themselves present further "problems" of a kind which are not open to merely technical resolution in light of economic science*.[66]

In 1952, the pace of immigration into the country started to decline, foreign investors became more interested in Israel, as did foreign tourists, and both the domestic and international economies started growing.[67] In 1948–1950, the establishment of a Jewish majority in Israel had been an essential building block of the government's agenda. By 1951–1952, with this goal achieved, and now that the state was struggling not just to absorb the immigrants but, more acutely, to integrate them, the time had come for the political leadership to re-examine the series of choices the Mapai Government had deployed in the three years since independence. Most economists pushed the political leadership to rethink its economic policy, arguing in favor of a balanced monetary–fiscal policy that would reinforce citizens' trust in the Israeli currency, as well as that of foreign investors.[68] This was not, however, an easy task. Prime Minister Ben-

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[64] DAVID HOROWITZ, LIFE AT THE EPICENTER 103 (1975) [Hebrew]; Government Meeting, *supra* note 54, at 59 [Hebrew]. *See also* YOUNG & ZELEKHA, *supra* note 45, at 11–17, suggesting that a default could have inflamed the conflict between the Jewish and Palestinian populations in Israel.

[65] Gross, *supra* note 6, at 78.

[66] John H. Goldthorpe, *The Current Inflation: Towards a Sociological Account*, in THE POLITICAL ECONOMY OF INFLATION 186, 212 (Fred Hirsch & John H. Goldthorpe eds., 1978).

[67] The Israeli economic policy of the first three years succeeded in raising the standard of living of thousands of immigrants. During those years, GNP grew and unemployment fell. *See* HALEVI & KLINOV-MALUL, *supra* note 10, at 75. 1952 witnessed yet another decline in GNP, and in other parameters, after the implementation of the New Economic Policy.

[68] KRAMPF, *supra* note 26, at 76; *see* KRAMPF, *supra* note 16, at 100–101.

Gurion's priority was the development of the country and he was suspicious of economy-led policy considerations: "I disbelieve in inflation," he commented to economic experts at one of his weekly meetings, maintaining that it is governments that cause inflation, not the "economy" itself. "People who came to Israel need to have a place to sit here, they need to eat and they need to work. … Economic considerations should not have the last word. … This matter of economic science was proven to be wrong."[69] So, what happened in mid-1951 (and later, in 1952) to enable a change in policy, despite Ben-Gurion's initial reluctance?

Some scholarly works have sought to explain the shift in Israeli policy in these two periods as not merely the result of economic necessity but also as the outcome of a change in the ideological priorities of the dominant elite. Krampf, for example, asserts that the policy turn cannot be understood as the mere incorporation of liberal economic ideas into the socialist society that had characterized Israel since its independence.[70] Krampf argues that, in fact, the socialist policy of the early years was not driven only by ideological adherence to socialism but, rather, by the need to support the interests of the Jewish working class. Indeed, in the late-1940s, that collective's priority was to see unemployment eradicated. Thus, the government led by Mapai had followed an interventionist policy aimed at swelling the pool of available jobs while supplying large-scale training for the job-seeking immigrants. The result was inflation and uncompetitive exportation. By the early 1950s, when the government was pursuing more liberal policies, it was not only because of the influence of American pro-free-market economists who interacted with the political strata. Although their considerable influence is undeniable,[71] they succeeded in shaping the Israeli economy only because liberal policies happened to align with the new priorities of the evolving coalition between the

[69] Government Meeting, *supra* note 54, at 61–62 [Hebrew].
[70] KRAMPF, *supra* note 16, at 222–240.
[71] On this specific point, *see* Arie Krampf, *Economic Planning of the Free Market in Israel during the First Decade: The Influence of Don Patinkin on Israeli Policy Discourse*, 23(4) SCI. IN CONTEXT 507 (2010); KATZMAN, *supra* note 47; YOUNG & ZELEKHA, *supra* note 45.

economic and trade ministries, economic experts, the banking system, and the private sector. All of these protagonists supported the liberalization of the market, including a gradual transition from a policy of "full employment" to one of "natural employment."[72]

Dov Khenin, a political scientist and a former Israeli politician who, as a Knesset Member, represented the central committee of Maki (the Israeli Communist Party), portrays a similar picture. He describes the switch in economic policy as having a close connection to the shifting interests of the "veteran" Jewish working class who had arrived as early as the 1920s.[73] Khenin contends that, during the late 1940s, the priorities of that collective matched the interests of Jewish low-wage workers, newly-arrived immigrants, and skilled-workers from among the veteran immigrants. During 1951, Mapai deployed a discourse that aimed at "forming a social coalition wherein 'Us' were the workers and the immigrants, and 'Them' were the bourgeoisie," Khenin maintains. This terminology was not meant to intensify the social struggle but, rather, to naturalize it. "This was done in two ways: through a world outlook provided by the national setting, and by detaching social development from the struggle and activity of the workers themselves and attributing it to the party leadership … alone."[74] During the early 1950s, when Mapai had to deal with the question of how to fully integrate the newly-arrived immigrants, many of them from Asia and North Africa, it had to choose between two conflicting policies: constructing a labor market on an equal basis for all citizens, or having a split labor market consisting of two "castes" of workers, veterans and newcomers, the latter being low-wage, unskilled laborers. Khenin concludes that Mapai chose the latter option, in part, because the alternative would have forced the party to transgress the bounds of "advancing the workers' interests within an unchallenged capitalist framework."[75]

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[72] KRAMPF, *supra* note 26, at 92–94.
[73] Dov Khenin, *From "Eretz Yisrael Haovedet" to "Yisrael Hasnia": The Social Discourse and Social Policy of Mapai in the 1950s*, in THE NEW ISRAEL 71 (Gershon Shafir & Yoav Peled eds., 2018).
[74] *Id.*, at 78.
[75] *Id.*, at 85.

The changing political priorities of Mapai brought about concrete political results. In early 1951, Ben-Gurion took a strategic risk by resigning, hoping to trigger renewed support among the electorate and better position himself in the forthcoming July general election. It was a political season dominated by social and economic issues. The General Zionist Party—the main bourgeois party at the time and Mapai's main rival—attacked the austerity regime. Mapai, on the other hand, argued that austerity was the only viable, appropriate, and proper response to food shortages and reiterated its commitment to maintaining austerity for as long as necessary. Before the elections, Mapai built its electoral base on thousands of immigrants who had arrived in Israel before March 1951. In opposition to its right-wing rivals, which were portrayed as promoting the interests of a narrow social class, Mapai presented itself as representing the voice of the working classes.[76]

Mapai's efforts bore fruit in those elections. Although the party lost some of its support among "veteran" workers, it won the elections with the support of newly-arrived immigrants, and Ben-Gurion, having been re-elected continued to lead the government. However, the General Zionists also increased their political representation from seven to 20 members in the Knesset. By forming a coalition with the General Zionists, Mapai made an ideological choice: a restructured split labor market, in which many workers, primarily new arrivals, were forced to work in low-income jobs. In this way, Mapai abandoned the idea of forming a social partnership with immigrants after they had brought the party a political victory.[77]

The steps taken in the economic sphere after the elections reflected this change. In February 1952, Prime Minister Ben-Gurion took the opportunity to speak before the Knesset regarding what he described as "The New Economic Policy":

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[76] Khenin, *supra* note 73, at 73.

[77] *Id*., at. 86; *see also* KRAMPF, *supra* note 16, at 103–104. Krampf suggests that the increasing import surplus was a major concern not only for the central–right-wing parties but also for the left-wing ones. Critics from the Left were mainly concerned with the broadening influence (and, to a certain extent, economic control) of the American Administration over Israel's economic priorities and policies.

> There is one fight in which we are almost at the beginning, and that is the economic campaign. This campaign is the longest and most difficult … The economic campaign [is waged by] each one of us without exception. … There is hardly a single movement and action that we do every day that does not determine our economic campaign.[78]

Ben-Gurion distinguished between the defense efforts of the new state and the economic ones, a differentiation that marked-out the government's new set of priorities:

> There is another main and essential difference between the military campaign ... and the economic one. [The first] is done ... in the public domain … and under the supervision of the state. The economic fight to a large extent … is mainly one of the individual. With all the intervention of the state in the affairs of the economy, and every modern state intervenes more and more in the life of the economy ... this intervention is limited and should be limited as much as possible.[79]

The New Economic Policy was predominately animated by those new political–economic priorities: to eliminate inflation, to increase exports and reduce imports, and to stabilize the country's balance of payments.[80] The government believed that stabilization could best be achieved through liberalization of the market, coupled with restrictive monetary and credit policies. It thus decided to cut its defense expenditure and, further, cease its funding of development needs by "printing money."[81] Rather, these demands would be covered by taxation, issuing public debt to domestic lenders, and, if needed, relying on foreign capital from donors and long-term creditors.[82]

These steps were accompanied by a decision to dismantle the rationing system and most of the price controls. Aside from the restrictive steps the government took, it introduced a major currency devaluation with a system of three different exchange rates between the IL and the

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[78] Divrei Haknesset (Knesset Protocols), 1952, 2nd Knesset, 55th session (February 13th), at 1318 [Hebrew].
[79] *Id.*
[80] OTTENSOOSER, *supra* note 6, at 32; YOUNG & ZELEKHA, *supra* note 45, at 11.
[81] This, in fact, had already stopped gradually in 1951. *See id.*; *see also* BARKAI, *supra* note 7, at 62–63.
[82] Divrei Haknesset, *supra* note 78, at 1320.

U.S. Dollar.[83] This political maneuver aimed to smooth the increase in prices after the government's withdrawal from the policies that had created "suppressed" inflation.[84] Using differential exchange rates, the government was able to demarcate, even if temporarily, the New Economic Policy's immediate effect on the price of essential goods. For a limited period, the old exchange rate was retained as the formal rate for imports of essential goods, enabling the government to regulate the prices of such products.

b. The Compulsory Lending Scheme of 1952

The New Economic Policy helped tackle the pressure caused by the suppressed inflation and also contributed to curtailing the trend toward increased liquidity in the market. Nevertheless, the contractive government policy was less efficient at absorbing the market's excess purchasing power. For this task, the government had to employ different measures. Taxation seemed the best option as it would also generate revenue for the development plan, now that the government had decided to drop its reliance on printed money. However, this was no easy solution, not least because of the inherent challenges of tax collection and evasion. These were partly due to the lack of enforcement ability of an immature tax mechanism,[85] but were also the result of inflation; people attempted to defer their nominal tax liabilities to the future, when their purchasing power was expected to decrease in real value.[86]

Cognizant of these dynamics and knowing that taxation alone would not be enough to support its needs, in 1950, the government explored several other solutions, including the

[83] In April 1953, the government introduced another, higher, exchange rate. Eventually, in January 1954, the two lower rates were eliminated. *See* BARKAI, *supra* note 7, at 65; *see also* OTTENSOOSER, *supra* note 6, at 136–137; MICHAELY, *supra* note 12, at 22–23.
[84] BARKAI, *supra* note 7, at 62.
[85] MICHAL KALECKI, DEVELOPING ECONOMIES 118 (1993). Michael Kalecki, a Jewish Keynesian economist working for the UN, was asked by the American Ministry of Finance in 1951 to prepare a report on Israeli economic trends. *See* Krampf, *supra* note 71, at 512; *see also* HAROLD C. WILKENFELD, TAXES AND PEOPLE IN ISRAEL 6 (1973).
[86] Government Meeting, September 14th, 1950, at 53–56 [Hebrew].

issuance of domestic debt or the imposition of a mandatory savings plan on all owners of demand deposit accounts.[87] But these ideas were still outside of the consensus in the political atmosphere of the time.[88] In 1951, the Marxian economist Michal Kalecki, who visited Israel to report to the American Ministry of Finance (which provided Israel with financial aid), suggested using a compulsory loan to fight inflation. "The most appropriate form for such an operation is, I think, a compulsory loan for, say £150 million," he wrote in his report.[89] Kalecki suggested that the loan should bear interest but should be absolutely non-transferable and not usable as collateral, to avoid creating fresh liquidity in the market. He further proposed that the amount collected from each payer should:

> … [not] be fixed in the basis of income-tax returns which are frequently fictitious, or on the basis of the value of bank deposits which may be irrelevant for the purpose, but on all kinds of varied information, quantitative and qualitative, such as actual likely income in the last few years, liquid and illiquid wealth, inclusive of probable foreign holdings, etc.[90]

The ministers, however, opposed the idea of deploying a compulsory measure with regard to individuals' money. For some, the notion of such a move, outside the general tax system, evoked unpleasant memories from their former lives under communist regimes in eastern Europe. Others were concerned that such a policy would harm the relationship with foreign investors, undermining their trust in the government.[91] "We don't live in a closed pool, but in a state into which we want to bring a lot of money from foreign investors," said Aaron Bart, APB's chairman. "And we are not allowed to throw out the people from whom we want money for investments," he asserted at one of the government meetings.[92]

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[87] Government Meeting, *supra* note 54, at 22–24 [Hebrew].
[88] Government Meeting, *supra* note 86, at 56–67.
[89] KALECKI, *supra* note 85, at 120.
[90] *Id*., at 120.
[91] Government Meeting, *supra* note 23, at 13, 34 [Hebrew]; Government Meeting, *supra* note 87, at 36, 76a, and 104 [Hebrew]; Government Meeting, November 25th, 1951, at 40 [Hebrew].
[92] Government Meeting, *supra* note 54, at 44 [Hebrew]. For different views, *see id*., at 84 and 94.

As the financial crisis intensified, the voices opposing compulsory lending were replaced with new ones justifying the policy. By 1951, Prime Minister Ben-Gurion sounded more supportive of the plan, deploying two justifications. First, based on a moral rationale, Ben-Gurion regarded it as unfair to ask Jews settled in the U.S. to lend their money to the Israeli Government without asking the Israeli citizens themselves to do the same. Second, he was in favor of incentivizing the wealthy to lend money to the government, thereby leveraging their private economic interest in gaining a return on their lending (investment) to meet the nation's most pressing needs: to increase revenue and to absorb the excess in liquidity in the market.[93]

In March 1952, the Israeli labor organization Histadrut's newspaper *Davar* suggested that compulsory lending be imposed on all asset-owners, especially real-estate owners.[94] The problem, however, was that this idea did not offer an immediate solution to the excess cash circulating in the black market. To address this problem, the government wanted to impose mandatory lending on all liquid funds and money held in demand deposit accounts. The introduction of new Israeli banknotes thus seemed like the ideal moment to force the loan. As mentioned earlier, since 1948, Israel had used banknotes that carried the APB's name instead of the legal sovereign name.[95] The obligatory exchange of the old notes for the new ones was deemed to be the perfect opportunity to force all holders of cash and demand deposit accounts to lend 10 percent of their liquid money to the government.[96] Since the government was keen to contain the public furor that the compulsory lending would provoke, it allocated less than two weeks to the entire exchange process and declared that it would not accept the old money

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[93] Government Meeting, October 11th, 1951, at 24 [Hebrew]. For the 1952–1953 fiscal year, the government needed 115,000,000 IL to support its development plan. These funds were to be used for investment in agriculture, industry, tourism, transport infrastructure, and housing for immigrants and state employees. Since the government had already decided to cease its inflationary spending, it relied on 35,000,000 IL from the compulsory loan, 40,000,000 IL from the Independence Loan, and another 40,000,000 IL from special revenue streams. *See The Development Act, 1952–1953* [in Hebrew] (April 9, 1952) (ISA 5411/12-G), 44–45.

[94] Natan Ben-Natan, *The Time for a Compulsory Loan Has Come*, DAVAR (March 19th, 1952) [Hebrew].

[95] HALEVI, GROSS, KLEIMAN, & SARNAT, *supra* note 5, at 135. In 1951, all the APB's assets and liabilities had been transferred to Bank Leumi, which could manage the plan of introducing new paper banknotes to replace the old ones.

[96] BARKAI, *supra* note 7, at 64; HALEVI, GROSS, KLEIMAN, & SARNAT, *supra* note 5, at 133.

after the set date. Only a small group of people in Bank Leumi knew about the plan in advance and made all the necessary arrangements in great secrecy.[97]

A few more observations are important here. It is imperative to recall that, in the run-up to this radical move, Israel had been battling tax evasion and had made attempts to build its tax-enforcement capacity. However, the problem was not just the embryonic nature of the collection system; it was also that there was not yet any widespread civic commitment to pay taxes. This challenge was deepened by the need to absorb the masses of immigrants. Many of these refugees, Assaf Likhovski explains, "had little ideological allegiance to the Zionist ethos, and did not share the civic republican notions of solidarity that characterized the pre-state Jewish community."[98] Besides the ideological challenges, many of the new immigrants came from countries where there was no collective trust in the government, and they were thus accustomed, whether legally or illegally, to *not* paying taxes. In Likhovski's words: "Those who came from 'enlightened' countries were apparently willing to pay taxes; those who came from 'primitive' and 'backward' countries tried to evade them; and those who came from countries where Jews were legally persecuted had turned their habit of not paying taxes to the government into second nature."[99] A large part of the Jewish population, then, still had a "diasporic" mentality and did not view tax evasion as a moral error.[100]

The government's policy of absorbing the excess money was thus faced with this unfortunate reality. In response, the design of the lending scheme was made to render evasion virtually impossible and certainly undesirable from the point of view of the lenders: their only legal scope to exchange their old money for new had to go hand-in-hand with lending a portion of it to the government. Of course, the government still could have chosen to absorb the spare

[97] *Id.*
[98] LIKHOVSKI, *supra* note 13, at 153.
[99] *Id.*, at 156.
[100] *Id.*, at 156–159.

money by selling "regular" bonds to the public, but it seems plausible that the same reasons that prompted people to evade tax payments would have caused them not to buy the bonds, at least not in the amounts the government sought to collect. Further obstacles with regard to the levels of availability of money for investment in the hands of the general population, combined with the still-fresh memories of inflation, suppressed savers' willingness to hold government bonds.[101]

Compulsory lending offered an additional benefit: by issuing bonds, public creditors gained an interest in the successful tax-collection system. Thus, the government could synergize citizens' private interests as investors with the state's interest in tax collection, which was fundamental during the formative years of the regime.[102] As Christine Desan explains, albeit in a different context: "the innovation of public debt made citizen-investors out of subjects. Action in one's self-interest could further the public cause; the … institution of public credit thus legitimated private concerns as motivators."[103] Although it was far from perfect, the compulsory lending program seemed like a sound way for the government to achieve its fiscal results by tying them to Zionist sentiments.

The economist Thomas Piketty observes that similar policies of imposing exceptional taxes on private property had become commonplace among states that struggled with severe levels of public debt-financing between and after the World Wars.[104] Piketty suggests that such extraordinary taxes have the advantage of being more evenly distributed, partly because they can vary with wealth (with outright exemptions for owners of the meagerest assets), and partly

[101] For a general discussion on the relationship between inflation and government debt, *see* Tim G. Congdon, *The Link between Budget Deficits and Inflation: Some Contrasts between Developed and Developing Countries*, in PRIVATE SAVING AND PUBLIC DEBT 72, 89 (Michael J. Boskin, John S. Flemming, & Stefano Gorini eds., 1987).
[102] CHRISTINE DESAN, MAKING MONEY: COIN, CURRENCY, AND THE COMING OF CAPITALISM 276 (2014).
[103] *Id.*, at 280.
[104] THOMAS PIKETTY, CAPITAL AND IDEOLOGY 441–442 (2020). The levy imposed in Japan during 1946–1947, with rates as high as 90 percent on the largest portfolios, was one of the largest such taxes ever seen. In 1945, France also enacted the national solidarity tax, although its revenues were incorporated into the general budget rather than used to reduce debt.

because they are usually applied to all kinds of private assets, including buildings, land, and financial assets. As a result, such policies can counteract inflation, which tends to act like regressive taxation. Nonetheless, Piketty's argument is mostly relevant to situations where states face enormous amounts of debt incurred during times of war—for example, when the implementation of such exceptional taxation policies could help them avoid tough distributional decisions. In contrast, although the Israeli plan was partially influenced by other compulsory loan schemes conducted in Europe after World War II, it was not designed to stimulate the economy[105] but, rather, as we have seen, to support the integration of the immigrants and to absorb the excess purchasing power.

On June 10, 1952, the Minister of Finance, Eliezer Kaplan, publicly unveiled the compulsory lending program before the Knesset.[106] The implementation of the plan was quite an improvisation: it was first introduced to the public as an emergency regulation (even though there was no emergency situation in the country), before the legislators discussed and enacted it into law. All holders of old 5, 10, or 50 IL banknotes had to exchange them for the new notes with a 10 percent deduction as lending to the government. Old notes valued at 1 IL or less were exempted. Similarly, each owner of a demand deposit account with 50 IL or more had to lend 10 percent of the total to the government. Foreign banks that held old banknotes had to return them to Israeli embassies. The government sought to collect 25,000,000 IL from the

[105] *See* the speech of the new Minister of Finance, Levi Eshkol, in Divrei Haknesset (Knesset Protocols), 1952, 2nd Knesset, 145th session (November 26th), at 179 [Hebrew]. For a general discussion on policies that states implemented to service post-World-War public debt, *see* THOMAS PIKETTY, A BRIEF HISTORY OF EQUALITY 146–149 (2022); PIKETTY, *supra* note 104, at 441–445. The Netherlands implemented a compulsory loan in 1946–1947 due to a severe shortage in commodities, forcing the government to decrease the purchasing power of the public; in 1944, Belgium conducted a similar exercise, issuing a new currency combined with a special loan to the government; and Denmark enacted a compulsory lending program targeting all capital gains created during 1939–1945; *see* ABRAHAM MANDEL & ASHER ARIAN, THE HISTORY OF TAXATION IN PALESTINE AND ISRAEL 79–80 (1968) [Hebrew]. Compulsory lending was advocated also by economists in the U.S. to reduce purchasing power. *See* RICHARD W. LINDHOLM, PUBLIC FINANCE AND FISCAL POLICY 308 (1950). The idea of imposing a compulsory loan, however, is not a modern one. Venice implemented a similar policy in the twelfth century to service its military spending. Similar practices were adopted by other European states in the sixteenth century. *See* DAVID GRAEBER, DEBT: THE FIRST 5,000 YEARS 338–339 (2014).

[106] Divrei Haknesset (Knesset Protocols), 1952, 2nd Knesset, 92nd session (June 10th), at 2262 [Hebrew].

compulsory loan scheme. "We must move forward, even if it requires sacrifices, towards economic independence," Kaplan concluded in his statement at the Knesset.[107]

Immediately after Kaplan's announcement came the brickbats. From the Right, the General Zionists contended that the plan would fail to eradicate inflation, since the collected monies would actually be used for consumption expenditures. It was further alleged that the mandatory lending would induce people to exchange their old cash money, and money in demand deposit accounts, for assets, including gold specie.[108] (This argument was vindicated by the increase in gold prices immediately after the announcement of the plan).[109] The right-wing conservative party, Herut, alleged that the plan would undermine the public's trust in the regime and that it would disincentivize private saving and production.[110] From the Left, the scheme was criticized as targeting low-wage workers while the wealthy asset-owners would not contribute their fair share to the public coffers. Furthermore, it was argued that the plan was unequal since it considered the amount of liquid funds held on a set date. This created a distortion since it allowed sufficient time for those people whose last salary payment was well ahead of that date to consume most of it, whereas people who received their salary in close proximity to the deadline had to pay the 10 percent on the bulk of their wages.[111]

In the days following the announcement of the compulsory loan plan, the government completed the exchange of the old notes—a step that required the help of police officers to avoid public protests and disturbances.[112] For a time, the banks ceased all activity other than

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[107] Divrei Haknesset (Knesset Protocols), *supra* note 106, at 2262 [Hebrew]. Pinhas Lavon, the former leader of the Israeli labor organization, Histadrut, and a minister of Mapai described the loan in terms of debt repayment to the Israeli state: "What has been done ... is nothing more than a modest payment of a huge debt that each of us owes for a period to the state." *See id.*, at 2268.
[108] *Id.*, at 2264–2265.
[109] Irritation Among the Masses of People Affected by the Government's Step, AL HAMISHMAR (June 10th, 1952) [Hebrew].
[110] Divrei Haknesset, *supra* note 107, at 2270 [Hebrew].
[111] *Id.*, at 2265.
[112] MA'ARIV, 9.6.1952, at 1 [Hebrew].

exchanging the banknotes.[113] Small merchants who still sold their goods for the old notes had to raise their prices to avoid the 10 percent loss. Others who had more liquid money than officially recorded (probably tax evaders) endeavored to sell their spare money.[114] Another by-product of the mandatory loan was the predicted tendency of the public to avoid the banks and convert their currencies into tangible assets. This deeply-embedded distrust of bank deposits and currency holdings was not easily dispelled.[115]

While the banking system was still preoccupied with executing the policy, the government turned to enacting it into formal law, replacing the initial emergency regulation it had introduced. Many legislators sought to increase the minimum amount from which the government deducted the levy, thereby exempting more people from the compulsory lending. However, since the banks had already collected the money, exchanged it, and deducted the 10 percent, there were significant practical challenges to amending the policy after its implementation.[116] The 1952 Exchange Bank Notes and Compulsory Loan Law was enacted on August 11, two months after the exchanged was completed.[117] Arguably the most interesting part of the legislation process concerned the exemptions from the levy. These were mostly enacted in a separate order issued by the Minister of Finance.[118] For understandable reasons, the order exempted accounts held by UN representatives, foreign embassies, and foreign states. Other exemptions included local municipalities and prominent Zionist organizations.

More controversial were exemptions that reflected a clear economic and distributive preference. In fact, despite the government's need for money to fund its development plan, and the acute need to absorb the excess liquidity, it wanted to avoid disrupting the industrial and

[113] Al Hamishmar, *supra* note 109.
[114] *Id.*
[115] WILKENFELD, *supra* note 85, at 279–280.
[116] *See, for example,* the Knesset Finance Committee, July 30th, 1952, at 11 [Hebrew].
[117] Exchange Bank Notes and Compulsory Loan Law, 1952, SH 105, 272 (Isr.).
[118] Exchange Bank Notes and Compulsory Loan Order (Exempted Accounts), 1952, KH 801, 32 (Isr.); Exchange Bank Notes and Compulsory Loan Order (Exempted Accounts) (Amendment), 1952, KH 313, 32 (Isr.).

financial sectors. Thus, it had somehow to avoid harming both foreign investors and local capitalist entrepreneurs. With regard to the former, as mentioned above, it was mainly a question of sustaining the trust relationship with them by signaling that they would not be subject to the government's internal policy. The protocols of the discussions at the Finance Committee of the Knesset suggest that this policy decision was driven by economic experts, whereas at least some of the legislators, mainly from the left-wing parties, opposed the exemption of corporations and attempted to have social–civil organizations exempted. This latter request was responded-to by Dr. Kurt Mendelson, the Commissioner of Treasury Revenue:

> In my heart, I agree with all the proposals made by the members of the Knesset … However, I ask the members of the Finance Committee to understand what the criterion for this list [of exemptions] is. The criterion takes into account our special situation and our dependence on foreign capital. ... Where we encountered foreign investors ... there, we were obliged not only morally, but also practically, to release them from the compulsory loan.[119]

Thus, the order eventually exempted both the accounts of those foreign companies that gave credit to the government and also other bank accounts held by foreign companies that invested in Israel in foreign currency. These exemptions reflected an attempt to avoid any economic harm to foreign investors and to ensure the constant flow of investment into Israel. At the same time, the government exempted investments by certain Israeli investors in local manufacturing companies.[120]

Banks also were exempted, despite the fact that both right-wing and left-wing legislators supported the inclusion of banks in the compulsory lending scheme.[121] Defending the exemption, the Chairman of the Finance Committee of the Knesset, Yisrael Guri, a member of

[119] Knesset Finance Committee, September 2nd, 1952, at 5 [Hebrew].
[120] *See supra* note 118.
[121] Divrei Haknesset, 1952, 2nd Knesset, 118th session (August 11th), at 2891–2892 [Hebrew].

Mapai, suggested that banks should not contribute to the lending, since all the deposit accounts they managed already contributed the 10 percent.[122] This justification was, in fact, quite misleading. Guri suggested that all the money that the banks held belonged to the depositors, without acknowledging that banks, of course, make a profit out of their business. Nonetheless, the decision to exempt the banks was consonant with the overall tendency of the plan to draw a line between the generators of cash inflow to the economy, including banks and foreign investors, and everyone else. Bank Leumi, in particular, actively benefited from the compulsory lending since it received one percent of the total amount collected in payment for its services.[123] The government's decision to require all banks to provide confidential information about their depositors was yet another step that fueled the public's distrust of the banking system.[124]

Other exemptions from the levy reflected the government's preference for *domestic* investment, saving, and production. For example, it exempted special five-year savings plans held in bank accounts. At a time when at least some of the population did not trust banks, this exemption effectively constituted a "perk" for more "sophisticated" savers who held their savings in bank accounts. Other private savings, whether held in bank accounts or not, did not receive similar treatment. This discrimination was clearly compatible with the interests of Mapai's electoral base as it favored mainly the upper sectors of the labor market—skilled workers, technicians, and the majority of public service employees.[125]

Finally, under the formal enactment, the lending would bear an interest of 4 percent, to be repaid within 15 years. The first payment was scheduled for June 1955. It was also agreed that the government could advance the repayment of the principal before 1955, should it see fit to

[122] *Id*., at 2892.
[123] Exchange Bank Notes and Compulsory Loan Order (Order Regarding Commission), 1952, KH 326, 472 (Isr.).
[124] Divrei Haknesset (Knesset Protocols), 1952, 2nd Knesset, 119th session (August 12th), at 2905 [Hebrew].
[125] Khenin, *supra* note 73, at 88.

do so, and repay it with a tax voucher for the amount of the principal itself *without* interest. In total, the government's scheme collected 11,000,000 IL in liquid money.[126] It further collected about 14,000,000 IL from demand deposit accounts but returned about 3,600,000 IL in monies collected mistakenly.[127] Although the intervention was a fiscal maneuver, it effectively acted as a restrictive monetary policy. The results were quite evident in the economy: for the first time since its independence, the amount of money in the state stopped increasing, and even declined at the end of the exchange plan in June 1952.[128]

The government's decision to deduct the 10 percent from both liquid money and demand deposit accounts can be attributed to its determination to absorb the surplus of liquid money in the black market, as well as to the administrative and practical difficulties associated with designing the loan as a percentage of total wealth, as Kalecki had proposed in 1951. In pursuing this route, the government diverged from the pro-worker approach it had implemented during Israel's first years. At least with regard to the low-wage workers, the loan acted like a tax and reduced the resources available to them for consumption. This was also the reason that some legislators tried (unsuccessfully) to hasten the repayment of the loan to the "small savers."[129]

More than anything, the government's keenness to secure the interests of foreign investors was the driver of three principal trends that developed in the Israeli economy in the years to come, starting with the promotion of economic independence. That theme was highly encouraged by the technocratic economic stratum and was eventually embraced in the second half of the 1950s by the political leadership as well, including Mapai.[130] During the 1950s, the notion of economic independence was articulated—in part, under the influence of American

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[126] This amount represents 10 percent of the 108,000,000 IL in circulation minus 8,000,000 IL that was held in small change. *See* Divrei Haknesset (Knesset Protocols), 1952, 2nd Knesset, 98th session (June 24th), at 2418 [Hebrew].
[127] MANDEL & ARIAN, *supra* note 105, at 80.
[128] BARKAI, *supra* note 7, at 64.
[129] Divrei Haknesset (Knesset Protocols), *supra* note 123, at 2903 [Hebrew].
[130] KRAMPF, *supra* note 26, at 77, 82.

economists[131]—as necessitating a liberalization of the market, which was evidently favorable to the interests of Mapai's new voters.[132] Second, the exemptions that were granted to private investors and domestic producers reflected an understanding of the need for cooperation between the government and the productive private sector. And, third, the exemption of foreign capital from the lending scheme expressed a latent dualism in the Israeli economy that would be reflected in its future development. On the one hand, it envisaged the establishment of an independent liberal economy within a globalized world; and, on the other, it displayed interventionist economic thinking that was harnessed to support the Zionist agenda.[133]

c. The Compulsory Lending Scheme of 1953

Almost six months after the implementation of the 1952 compulsory lending plan, the government fulfilled its promise to execute a second such plan, this time targeting the owners of assets such as real estate, equipment, and inventory. After the first tranche of lending, the growth rate of money circulating in the market had decreased significantly and the economy suffered a money-supply shortage. Thus, there was no further need to absorb any spare liquidity in the market.[134] Although the government still had to find revenue sources to fund its development plan, it was clear that the decision to pursue another forced lending drive was merely an attempt to avoid criticism with regard to the distributive effects of the 1952 lending plan.[135] In fact, in the early deliberations about this second drive, Kaplan, the Minister of Finance, presented three policy alternatives for generating more revenue.[136] The first was to conduct some kind of compulsory lending program, similar to the 1952 one, however this time

[131] *Id.*, at 83–87.
[132] KHENIN, *supra* note 73, at 88.
[133] KRAMPF, *supra* note 16, at 241.
[134] BARKAI, *supra* note 7, at 64; Divrei Haknesset (Knesset Protocols), 1952, 2nd Knesset, 146th session (December 1st), at 195 [Hebrew].
[135] Divrei Haknesset (Knesset Protocols), *supra* note 106, at 180 [Hebrew]. *See also* the criticism from the General Zionist Party in Divrei Haknesset (Knesset Protocols), *supra* note 133, at 196 [Hebrew]; *see also* Divrei Haknesset (Knesset Protocols), 1952, 2nd Knesset, 148th session (December 2nd), at 218 [Hebrew].
[136] Government Meeting, June 15th, 1952, at 3–4 [Hebrew].

among all asset-owners. The second was to impose a special property tax to be collected over ten years. And the third was to implement an immediate general tax increase. The problem with both the first and the third alternatives was that, due to a generalized decline in liquidity, people no longer had the money to pay the government. The second alternative could have avoided this complication, but the ministers thought that a ten-year timeframe would make the government look unserious in its urgent request for the money under extraordinary circumstances. Thus, Ben-Gurion vetoed this option.[137] A last-resort option would be to force at least some asset-owners to sell their property or to mortgage it to free-up cash to pay the government loan. Ben-Gurion even suggested that people who did not have the necessary liquid funds would have to mortgage their homes to the direct benefit of the government itself, which would be legally able to sell the properties if needed.

Not everybody supported the Prime Minister's drastic approach. Minister Bechor-Shalom Sheetrit, another Mapai member, suggested that mortgaging people's homes would be an unwise move with major legal repercussions.[138] Haim-Moshe Shapira, the Minister for Welfare, asserted that, as the public would not even differentiate between lending and taxation, it would be better for the government to impose another tax instead of increasing its debt liabilities.[139] He further warned that another bout of compulsory lending would likely cause panic among the public and increase the risk of evasion and wealth smuggling. In the event, the government opted to implement a version of the first option mentioned above: a further compulsory lending scheme. However, this time, it added the option to pay half of the amount owed as a one-off, non-returnable special tax—a decision that reflected a political compromise

[137] *Id.*, at 7.
[138] *Id.*, at 19.
[139] *Id.*, at 10–12.

between the ministers who advocated for a tax increase and those who advocated for the mandatory loan.[140]

When this plan was announced, Ben-Gurion provided yet new justification for the lending: since people had made their wealth thanks to the government's interventionist policy, it was justified in asking them to respond to the state's continued financial needs.[141] The government had initially sought to collect about 60,000,000 IL but quickly had to revise its estimate down to 30,000,000–35,000,000 IL.[142] Like the 1952 mandatory loan scheme, the new plan drew heavy criticism from both Left and Right as being discriminatory.[143] Leftist legislators argued that the plan favored foreign investors and placed the majority of the burden on the middle classes, which had to deal with an increase in the cost of essential goods in addition to financing the loan.[144] In contrast, legislators from the Right claimed that the plan would harm the private sector and damage trust in the government.

Interestingly, the main policy dilemma the government faced was how to distribute the lending burden between owners of productive assets (such as equipment and inventory from factories and workshops) and owners of other assets such as real-estate, land, and consumer goods.[145] While the government did not want to unsettle the productive sector, nor could it impose an excessive burden on homeowners, who had already suffered a drop in income because of the restrictions it had imposed on rental revenue. In this debate, industry representatives delivered yet another persuasive argument: they claimed that it was better to

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[140] Compulsory Loan Law, 1953, SH 123, 70 (Isr.).
[141] Government Meeting, July 7th, 1952, at 3 [Hebrew].
[142] Government Meeting, July 27th, 1952, at 23 [Hebrew]; MANDEL & ARIAN, *supra* note 105, at 81.
[143] Divrei Haknesset (Knesset Protocols), *supra* note 133, at 196–203 [Hebrew].
[144] Yossi Goldstein, *Eshkol and the "New Economic Plan" in Historical Perspective: The Price and Return to the Recession Policy as a Solution to the Economy's Problems – The First Attempt*, 57(2) ECON. Q. 241, 243 (2010) [Hebrew].
[145] Divrei Haknesset (Knesset Protocols), 1953, 2nd Knesset, 212th session (March 23rd), at 1026 [Hebrew]; MANDEL & ARIAN, *supra* note 105, at 80.

leave the money in the hands of the capitalist entrepreneurs, since they knew better than the government how to invest it.[146]

The parliamentary discussions about the loan from asset-owners were much more complex than the 1952 compulsory lending debates. The Finance Committee of the Knesset conducted no fewer than 30 meetings over a two-month period to thrash-out the procedure for asset valuation. First, it would be necessary to prepare a survey of all assets subject to the new levy in order to determine the amount that would be raised by the compulsory loan.[147] But the primary challenge was how to assess the value of plots of land, homes, and other real-estate when nominal prices were so distorted due to inflation and, subsequently, the New Economic Policy. For the assessment of buildings, the number of rooms was prescribed as the basis. Equipment was to be determined by its original cost (without depreciation), but equipment purchased before currency devaluations in 1952 and 1948 was to be valued higher than equipment purchased more recently.[148] There was also an administrative problem with distributing certificates to the public denoting the amount of the compulsory loan that would ultimately need to be repaid.[149]

The levy was calculated as a percentage of the total valuation of non-liquid assets. However, this time, the government implemented a progressive scale, according to the sum of total assets owned (roughly 4.5–10 percent), with an exemption mechanism for people owning assets worth less than 5,000 IL. The law included an unprecedented provision that enabled the Minister of Finance to retrospectively up the percentage of the lending, should the overall amount collected deviate from the estimated target by five percent or more. This provision was never put to use.[150]

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[146] Sub-Committee of the Knesset Finance Committee, February 18th, 1953, at 8 [Hebrew].
[147] WILKENFELD, *supra* note 85, at 279.
[148] *Id.*, at 267.
[149] *Id.*, at 279.
[150] MANDEL & ARIAN, *supra* note 105, at 84.

The primary innovation of this plan was its option feature. As mentioned, owners had the choice of either paying the whole sum as a loan, with 2.5 percent tax-free interest for 18 years,[151] or paying just half the sum, in the form of a non-returnable special tax. The tax-free-earnings element was due to the government's plan to allow the bonds to circulate on the capital market, meaning that ministers did not want to harm their valuation.[152] This provision attracted criticism from left-wing legislators who claimed that, effectively, it would reduce the fair-share contribution of wealthy individuals to the total revenue, relative to the middle classes and the poor.[153]

The option feature was heavily criticized from all sides. Both Left and Right argued that, amid the dearth of liquidity, this design left most of the population with little genuine choice. It was argued that many people would not have sufficient liquid money available to pay for the lending and, thus, they would be forced to take up the tax option—even perhaps at the price of having to undersell their assets.[154] These criticisms notwithstanding, eventually, the government collected about 29,000,000 IL through this second compulsory lending plan. This sum was about 18,000,000 IL less than the amount it could have collected without the option of the special tax in lieu of the lending.[155] The legislators' concerns regarding the option feature turned out to be partially justified. By the end of the collection process, of the 50,000 people subject to the levy, less than 20 percent had chosen to lend their money to the government.[156]

In the next Part, I turn to a distributional analysis of the overarching compulsory lending scheme, comprising both the 1952 and 1953 initiatives. Though not all the relevant data are

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[151] The interest paid in the compulsory lending scheme of 1952 was subject to tax.
[152] Divrei Haknesset (Knesset Protocols), *supra* note 143, at 1037 [Hebrew].
[153] *Id.*, at 1036; MANDEL & ARIAN, *supra* note 105, at 80.
[154] Divrei Haknesset (Knesset Protocols), *supra* note 134, at 219 [Hebrew]. A similar concern was discussed in the government meeting. *See* Government Meeting, July 7th, 1952, at 5 [Hebrew].
[155] MANDEL & ARIAN, *supra* note 105, at 95–96.
[156] Divrei Haknesset (Knesset Protocols), 1956, 3rd Knesset, 158th session (July 19th), at 2325 [Hebrew]. *See also* WILKENFELD, *supra* note 85, at 279, suggesting that about two-thirds of the target population chose the special tax option.

available, I pursue a speculative analysis that builds on the data I was able to access, to examine how the plan affected the economic behavior and wealth distribution of the different players.

IV. Distribution and Politics

a. Methodology

Designing economic policy and codifying it in law can be a challenge without a realistic understanding of how policy is affecting different stakeholders, sometimes in unexpected ways. This is especially true in developing countries, where it may be more difficult to obtain accurate data. In the Israel of the early-1950s, for example, the government struggled to gather reliable information about black-market activity and the amount of money circulating in that sphere. The suppressed inflation made it even more difficult to assess price increases in real time, while the limitations of the then tax-collection system created another impediment to the acquisition of valid information about the true financial situation in the market—as did the smuggling of money out of Israel. It was thus extremely difficult for the government to evaluate how its policy decisions were affecting the distribution of wealth between sectors and classes. With regard to the national compulsory lending scheme, it was clearly beneficial to be a foreign investor. But, for everyone else, the distributive effects of the policy were less clear. The lengthy timeframe between the initiation of the plan and the repayment of the debt (approximately 15-18 years from the implementation of the plan to the final repayment), along with changes in the taxation levels throughout this period and fluctuations in the rate of inflation, exaggerated this problem.

This is not to suggest that we should avoid analyzing Israeli economic policy from a distributive perspective. But we should be cautious about the methods used and the conclusions drawn. In what follows, I examine the Israeli plan from the perspective of the costs and benefits it created for the people themselves, with the aim of analyzing to whom it was more (or less)

beneficial. Although the motivation for the plan was not to redistribute money, at least not intentionally, my argument is that it *did* alter the distribution, sometimes in unexpected ways. My method is a cost–benefit analysis, influenced by critical legal thinking. As noted in the Introduction, my cost–benefit analysis avoids the empirical "trap" by mapping the distributional outcomes according to less vs. more plausible scenarios, to mitigate the insufficiency of data. This analysis observes not only what "really" happened (according to the available empirical data) but also what is *reasonable to assume* may have occurred.[157]

In what follows, first, I introduce the literature regarding national public debt and distribution. Although every economic policy is rooted in local circumstances, this literature can serve as a benchmark to assess the Israeli case. Second, I conduct a distributive analysis of the lending from the perspective of the different players. Lastly, I locate the distributive results in the broader political–economic context of the 1950s Israeli regime.

b. Theoretical and Historical Perspectives

Most of the research regarding the distributive effects created by public debt focuses on the intergenerational level. This scholarship suggests that public debt provides a measure of intergenerational equity—that is, it distributes public goods and services across generations (and the expenditure required to fund them). Thus, changes in government debt reflect implicit policy decisions about how public activities are to be distributed across generations. Governments use debt to shift the fiscal burden of current expenditures or reduce the fiscal burden of current taxes by transferring obligations to future generations of taxpayers. Yet, it can also be used to avoid fiscal responsibility in the present.[158] Within any given generation,

[157] *Compare* Janet Halley, Prabha Kotiswaran, Hila Shamir, & Chantal Thomas, *From the International to the Local in Feminist Legal Responses to Rape, Prostitution/Sex Work, and Sex Trafficking: Four Studies in Contemporary Governance Feminism*, 29 HARV. J.L. & GENDER 335, 406 (2006) (implementing this approach albeit in a different context).
[158] ANDREW D. AUSTIN & SEAN M. STIFF, CONG. RES. SERV., NO. R45011, CLEARING THE AIR ON THE DEBT LIMIT 13 (11.10.201).

the question of who bears the largest burden will depend on the policies adopted and how long the policies take to implement.[159]

The lack of research into the distributive effects of public debt from perspectives other than the intergenerational one—such as social class—is somewhat surprising, considering the magnitude of increases in debt accumulation by governments around the world and the long history of debt issuance to fund government investment (and, no less important, to finance war). This was not, however, always the case. As early as 1867, Karl Marx observed the harmful redistributive potential of public debt. In the first volume of *Das Kapital*, Marx discusses how public debt accumulation creates a cycle of re-issuance of public debt in order to avoid raising taxation to service that debt. Nonetheless, when over-accumulation of debt becomes unsustainable, Marx argues, the government *has* to increase taxes: "Over-taxation is not an accidental occurrence, but rather a principle." He argues that this policy renders "the wage-labourer submissive, frugal, industrious, and overburdened with work."[160]

Henry Carter Adams's impressive research from 1887 develops this argument further.[161] Adams suggests that, for a borrowing market to be established, two conditions have to be fulfilled: the prior establishment of a capital market and the creation of a structure of government that would guarantee against repudiation of the debt.[162] In his research, Adams studies the U.S. census data from 1880, revealing a high concentration of government bond holdings in the hands of a few rich individuals and large corporations.[163] Adams argues that the distributive effect of this pattern of bond holdings had to be assessed in relation to the

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[159] CONGRESSIONAL BUDGET OFFICE, THE 2022 LONG-TERM BUDGET OUTLOOK 12 (7.27.2022). Public debt's distributive intergenerational effects are a common research topic in game theory. *See* TORSTEN PERSSON & GUIDO TABELLINI, MACROECONOMIC POLICY, CREDIBILITY AND POLITICS 165 (1990); Alberto F. Alesina & Andrea Passalacqua, *The Political Economy of Government Debt*, NBER WORKING PAPER SERIES 21821, 33–34 (2015).
[160] KARL MARX, CAPITAL: A CRITIQUE OF POLITICAL ECONOMY, vol. 1, 921 (Ben Fowkes trans., 1976).
[161] HENRY C. ADAMS, PUBLIC DEBTS: AN ESSAY IN THE SCIENCE OF FINANCE (1887).
[162] *Id.*, at 7.
[163] *Id.*, at 46–48.

distribution of tax payments.[164] He concludes that, although public debt may not bring with it a "distinct and independent social tendency," it reinforces "such class relations as spring from disparity of possessions, ... [introducing] conflicting interests between citizens."[165] Other works dealing with the distributive effects of public debt in nineteenth-century Britain reached similar conclusions regarding how it redistributes wealth in society.[166]

However, scholarly work about the distributive effects of public debt in the years following World War II did not arrive at such a conclusive result. Mostly, the wide distribution of bond holdings, coupled with unprecedented progressive taxation, mitigated the harmful potential of public debt, from the distributive perspective. Writing in that era, Jacob Cohen found that public debt does have distributive effects but, instead of benefiting the rich, it benefits especially the middle classes and, sometimes, the poor. Examining the distributive effects of public debt in the U.S. in 1946, Cohen's findings, however, were inconclusive with regard to the exact distribution pattern within the middle-class and poor segments, which may vary in accordance with corporations' income and taxes.[167] Indeed, Cohen conceded that the distributional effects of public debt before World War II had favored the upper-income classes.[168] However, the change in the distribution of bond holdings after the war, combined with an unprecedented progressive tax system, generated different results in the mid-1940s.[169]

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[164] *Id.*, at 41–42, 48.

[165] *Id.*, at 50.

[166] NIALL FERGUSON, THE CASH NEXUS 194–196 (2001) (suggesting that public debt in 1820s Britain transferred money from the propertyless majority to the "tiny, very wealthy elite").

[167] Jacob Cohen, *Distributional Effects of the Federal Debt*, 6(3) J. FIN. 267, 273 (1951).

[168] *See also* SEYMOUR EDWIN HARRIS, NATIONAL DEBT AND THE NEW ECONOMICS 156–157 and 178–190 (1974); for a different conclusion, *see* DONALD C. MILLER, TAXES, THE PUBLIC DEBT, AND TRANSFERS OF INCOME (1950); EDWARD D. ALLEN, ECONOMICS OF PUBLIC FINANCE 179 (1954); Hedwig Reinhardt, *On the Incidence of the Public Debt*, 7 SOC. RSCH. 218 (May 1945); PHILIP E. TAYLOR, THE ECONOMICS OF PUBLIC FINANCE 194–195 (1948).

[169] Cohen, *supra* note 167, at 275. *See also* SANDY BRIAN HAGER, PUBLIC DEBT, INEQUALITY, AND POWER: THE MAKING OF A MODERN DEBT STATE 61 (2016). For different results over roughly the same period, *see* RICHARD W. LINDHOLM, PUBLIC FINANCE AND FISCAL POLICY: AN ANALYSIS OF GOVERNMENT SPENDING, REVENUE, AND DEBT 613 (1950). Compare also to Henry C. Wallich, *The Changing Significance of the Interest Rate*, 36 AM. ECON. REV. 772 (1946).

After World War II, scholars ceased to examine the distributive effects of public debt from the perspective of class. But, this turn was not solely the result of the debt structure and tax system of the U.S. and Europe in the postwar years. No less important to economic policy was the Keynesian paradigm that gained momentum during that time. Economists who wrote in the Keynesian spirit, which advocated for increasing government deficit through debt to stimulate the economy in certain situations, ignored almost completely the distributive impact of public debt. Indeed, the conditions of the day supported their argument: as I mentioned earlier, bond holdings were much more diffuse than in the nineteenth century, the tax system was much more progressive, and the majority of the bonds were held domestically. This combination of conditions set the foundations for advocating the Keynesian paradigm and led to a depoliticization of public debt's role in distribution.

The Keynesian Jewish-American economist Abba P. Lerner, for example, did recognize that public debt servicing can, in some cases, generate redistributive results, but he dismissed them as inconsequential, as long as the debt was owed to *domestic* creditors:[170]

> The benefits from interest payments on the national debt do not accrue to every individual in exactly the same degree as the damage done to him by the additional taxes made necessary. … While this is undoubtedly true, all it means is that some people will be better off and some people will be worse off. Such a redistribution of wealth is involved in every significant happening in our closely interrelated economy, in every invention or discovery or act of enterprise. *If there is some good general reason for incurring debt, the redistribution can be ignored because we have no more reason for supposing that the redistribution is worse than the old one than for assuming the opposite*.[171]

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[170] HAGER, *supra* note 167, at 25. *See, for example*, Abba Lerner, *The Burden of Debt*, 43(2) REV. ECON. & STATS. 139 (1961).
[171] Abba Lerner, *The Burden of the National Debt*, in INCOME, EMPLOYMENT AND PUBLIC POLICY 255, 260–261 (Paul J. Strayer eds., 1948) [emphasis mine].

Although Keynes' followers did not identify the distributive potential of public debt from a class perspective, they did contribute major insights to the discussion about public debt. For instance, they suggested that, as long as the distribution of bond holding remained significantly different from the distribution of tax payments, public debt could have distributive effects from a class perspective. Economists Alvin H. Hansen and Guy Greer summarized this point in 1942, suggesting that:

> How the money cost is distributed among our citizens varies according to the method of financing used. If it is all paid out of taxes during the war the distribution will depend on who pays the taxes. If part of it is carried by borrowing, the distribution depends upon who buys the bonds and who pays the taxes levied in the future—taxes needed to service the interest on the bonds.[172]

Hansen, often referred to as "the American Keynes," introduces another consideration to our understanding of how public debt affects distribution. As long as the debt is growing moderately and the government can borrow from "small savers," public debt would not prove unfavorable to an equitable distribution of wealth. However:

> … if the growth in the public debt is very rapid, it will not be possible for relatively small savers to take any large proportion of the new securities issued. They will be absorbed by the rich and the well to do, and by large corporations. A rapid growth in the public debt is, therefore, likely to intensify the inequality in wealth distribution.[173]

This, he concludes, is the most fundamental objection against financing primarily through borrowing. Yet, surprisingly, it seems that economists and policymakers ignored this warning almost entirely. An examination of policy materials produced by the Congressional Budget

[172] Alvin H. Hansen & Guy Greer, *The Federal Debt and the Future: An Unflinching Look at the Facts and Prospects*, 184 HARPER'S MAGAZINE 489, 491 (1942).
[173] ALVIN H. HANSEN, FISCAL POLICY AND BUSINESS CYCLES 179, 184 (1941).

Office, for example, suggests that, with regard to public debt policy, the distributional factor was completely off the table.

Nevertheless, Hansen´s prediction has been fully materialized, as Sandy Brian Hager's examination of public debt in the U.S. suggests. Hager observes a growth trend since the 1980s in the ownership concentration of government bonds, especially in the hands of the top 1 percent of American households and the top 2,500 American corporations (in terms of assets owned).[174] Hager suggests that these findings are closely correlated with the distribution of wealth more generally in American society. The problem with such concentrated holdings is that they do not correlate with the distribution of taxation. Thus, Hager claims, by servicing the interest payments, the U.S. middle classes are transferring money to rich American bondholders, wealthy American corporations, and foreign bondholders. Hager's analysis demonstrates that, although the top 2,500 American corporations and the top 1 percent of American households contribute significantly to the total federal tax revenue,[175] the decline in income tax progressivity means that they pay a lower proportion of effective tax. The result is, according to Hager, that the wealthier households and corporations have more disposable income with which to buy risk-free government bonds than the middle classes. He concludes that:

> In essence, what the debt state means is that governments in advanced capitalist countries come to rely on borrowing from elites instead of taxing them. And in choosing to furnish elites with risk-free assets rather than to levy taxes on their incomes, the debt state comes to reinforce existing patterns of social inequality.[176]

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[174] HAGER, *supra* note 169, at 41, 47; although beyond the scope of the current project, in the context of the U.S., municipal bonds play a crucial role in enhancing inequality. *See, for example*, JENKINS, *supra* note 25; Walter Johnson, *Ferguson's Fortune 500 Company*, THE ATLANTIC (April 26, 2015) https://www.theatlantic.com/politics/archive/2015/04/fergusons-fortune-500-company/390492/.
[175] HAGER, *supra* note 169, at 61–62.
[176] *Id.*, at 66.

Returning to the Israeli compulsory lending drive of 1952–1953, we first face a definitional problem. The small number of scholarly studies that have dealt with this policy-move suggest that, in fact, the lending was a tax.[177] Harold C. Wilkenfeld suggests that, from an economic point of view, there is little practical distinction between compulsory payments that are expressly denominated as taxes and those that, due to their temporary nature, specific purposes, or classification as "loans" or "savings," fall into other income categories.[178] This account assumes that, given that the loan was levied on all taxpayers, it did not affect the wealth distribution within Israeli society significantly—if at all. Following this reasoning, we might conclude that there is nothing interesting to say about the 1952–1953 compulsory lending from a distributive perspective.

I disagree with such a conclusion. First, as we already know, the 1952 loan was levied out of liquid money in small amounts. In other words, it was taken from people who held liquid money and did not necessarily pay taxes because their income or savings were under a certain threshold. Second, when assessing wealth distribution, we should also take into account the economic activity taking place in the informal markets, in violation of the formal legal regimes.[179] Third, as I will discuss shortly, the loan also affected citizens psychologically and induced at least some of them to change their economic behavior. Thus, it cannot reasonably be said that this policy did not affect distribution.

c. The Players and the Stakes

The distributive effects of the compulsory lending schemes that Israel imposed during 1952–1953 were the result of both the design of the lending and the progressivity of the tax system.

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[177] LIKHOVSKY, *supra* note 13, at 156.
[178] WILKENFELD, *supra* note 85, at 6.
[179] This insight is influenced by Duncan Kennedy, *Legal Economics of the U.S. Low Income Housing Markets in Light of "Informality" Analysis*, 4(1) J. L. SOC'Y 71 (2002). The general argument is also influenced by the work of Charles S. Maier on inflation. *See* CHARLES S. MAIER, IN SEARCH OF STABILITY: EXPLORATIONS IN HISTORICAL POLITICAL ECONOMY 213–214 (1988).

Thus, in order to understand what distributive effects the policy created, we have to determine who were the people who held the government bonds, and who were the ones who paid for the debt servicing. My initial assumption was that the progressive tax levels of the Israeli regime would have created a similar situation to the one Cohen depicted after World War II. My findings, however, present a more complicated account.

In the 1952 lending scheme, every Israeli adult had to lend to the government 10 percent of liquid money and of all monies held in demand deposit accounts, with three major exceptions: first, people who held less than 50 IL in their demand deposit accounts; second, people who held small change worth less than 5 IL; and, third, foreign investors and the holders of special savings accounts held in banks for more than five years. As we saw earlier, in total, the government collected approximately 22,000,000 IL—half from demand deposit accounts and half from liquid money. As most of the newly-arrived immigrants were employed as low-wage workers and arrived with negligible personal resources and belongings, compared to the veteran immigrants who had come from Europe in the 1920s–1930s, they had far fewer assets and, thus, held their scant resources in cash or in demand deposit accounts. This pattern is compatible with findings from other countries; as Piketty explains, those with only cash or bank deposits typically belong to the middle and lower classes, whereas the rich tend to hold their wealth primarily in real-estate, professional equipment, or financial portfolios.[180] Furthermore, as the policy exempted special five-year savings accounts held in banks, it enabled wealthy people with money available for investment to avoid paying their share, even when they did hold their wealth in bank accounts. Thus, it seems reasonable to conclude that middle-class, low-wage workers and the poor ended up lending a greater proportion of their "wealth" to the government during the 1952 compulsory lending scheme than the upper classes. The high enforcement level of that policy, due to its connection to the banknote-exchange and

[180] PIKETTY, *supra* note 104, at 441.

the nullification of the old paper money, supports the conclusion that the 1952 scheme burdened the middle classes and low-wage workers disproportionally.

Other considerations also suggest that the 1952 compulsory lending drive had harmful effects, mostly on the middle and lower classes. First, as mentioned earlier, in some instances, the lending caused merchants to have to raise their prices to avoid the 10 percent loss.[181] This unquestionably harmed the lower classes most of all, especially the increase in nominal prices caused by the move from suppressed to open inflation.[182] Second, since most of the poor and lower classes used their money for day-to-day consumption needs, they had to compensate for the 10 percent loss either by decreasing their consumption or by borrowing money from private creditors.[183] Non-savers generally enjoy less attractive borrowing opportunities from credit institutions, and this was true also with regard to Israel in those days.[184] Thus, for them, the "investment" component embodied in the plan was inconsequential. That said, the upper classes were also harmed by the lending. Even if we assume that these collectives would have invested their money elsewhere, the 4 percent interest that the government bonds bore was significantly less attractive than other investment opportunities available on the market at that time.[185]

The 1953 plan was ostensibly designed to mitigate the class inequalities caused by the 1952 lending. But, as discussed above, this time, there was no additional need to absorb spare money, and one of the main goals of the lending scheme was to address left-wing criticisms of the 1952 initiative. Since the 1953 scheme exempted people with assets worth less than 5,000 IL, it did not affect the very poor. But, by offering people a choice between lending the

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[181] AL HAMISHMAR, *supra* note 109.
[182] PATINKIN, *supra* note 7, at 209.
[183] *Report by the Committee for Examining the Direct Tax Change* [in Hebrew] (March 12, 1975) (ISA-14535/5-G), 12-a.
[184] Ministry of Finance, *Compulsory Loans in Israel* [in Hebrew] (April 1975) (ISA-7244/19-G).
[185] *Id.*, at 33.

government a portion worth 4.5–10 percent of the estimated value of their assets, or paying half of that amount as a non-returnable special tax, it created a conflict between the short- and long-term interests of the payers. Although I did not identify any data specifically indicating how people perceived this conflict, it seems plausible to me that, due to the difficulty that many people would have in acquiring the relevant information, not everyone would be able to evaluate correctly their short-term versus long-term interests. In addition, many, especially the low-wage workers, were in such severe need of money that it may have prevented them from preferring their long-term interests.

From the data available, it is evident that the number of people who chose to pay the special tax was significantly higher than the number who opted to lend their money to the government. As mentioned above, of the 50,000 people subject to the 1953 levy, less than 20 percent chose to lend their money to the government, and the rest chose the special tax option. I also found that, by 1954, a year after the beginning of the collection process, the amount collected as a special tax was fairly equal to the amount collected as a loan (about 15,500,000 IL each). This pattern suggests that, on average, people with more wealth chose to lend their money to the government, whereas people from the lower classes (except the poorest) chose the non-returnable special tax option. This is compatible with the predictions made by some of the Knesset members during the legislation procedures, and is further reinforced when we look at the distribution pattern within different categories. For example, more people owning heavy industrial equipment (that is, upper-level classes or capitalists) chose to lend their money to the government, whereas more people owning stock inventory (merchants or small business owners) chose to pay the special tax.[186] This picture suggests that the middle and lower-income classes chose to pay half of the amount they owed as a tax instead of lending the full amount to the government since they did not have enough liquid money to do so. Furthermore, it is

[186] *The Compulsory Loan Act, part 1(b)* [in Hebrew] (August 31, 1954) (ISA-5412/16-G), 44, 58, 112.

entirely feasible to assume that at least some of them raised the required amounts for the special tax either by selling some of their assets or through borrowing in the private market.

Indeed, while this choice decreased the amount they had to pay by half, it also meant that they missed out on the repayment of the principal and the tax-free 2.5 percent interest, and on the ability to sell the bonds in the capital markets. Nonetheless, these classes, and especially people belonging to the middle classes, did contribute to the general tax revenue that serviced the repayment of the debt to the people who chose the lending option. As discussed above, most of those who chose that option came from the upper classes, meaning that the middle classes also serviced the payment of the debt to the rich. In other words, the option to pay the special tax effectively distorted the proportionate distribution of bond holdings among the general population, without changing the distribution of the tax burden.

And there is yet another consideration that should be taken into account with regard to the 1953 lending scheme. Unlike the 1952 initiative, which was tied up with the exchange of the old banknotes, the 1953 scheme presented major enforcement challenges both with regard to the valuation of assets and, no less important, how to collect the levy. The government faced many administrative obstacles and was hindered by inaccuracies with regard to the precise number of people registered to pay it. For example, almost a year after the initiation of the 1953 collection process, the government was still struggling to collect the money from 15,054 payers—more than 28 percent of the total estimated number participating in that lending scheme. The exact number of people who succeeded in evading the 1953 scheme is not available. However, drawing on Likhovski's analysis, it seems plausible to assume that at least some managed to circumvent the 1953 lending drive. That said, we cannot assume that they did not contribute at all to the total tax revenue that serviced the repayment of the debt. As Israel strengthened its tax-collection capabilities, many of these people probably started contributing their share.

To conclude, it seems that the 1952 lending scheme disproportionally burdened the middle and lower classes, who held significant tranches of their wealth either in cash or in demand deposit accounts. These people were mostly newly-arrived immigrants. The immigrants who arrived from Asia and North Africa, usually referred-to as *Mizrachi*, accounted for large swathes of these classes, and many of them were located outside the urban nuclei.[187] On average, newly-arrived immigrants from North Africa and Asia earned about two-thirds of the amount earned by people who came from Europe, and newly-arrived immigrants earned, on average, two-thirds of the amount earned by "veterans."[188] Many of these newly-arrived immigrants had saved their money painstakingly to buy modest accommodation, when the 1952–1953 policy forced them to face the new financial reality. The middle classes were also the classes that preferred to pay the non-returnable special tax during the 1953 lending scheme. Many of their members were small businessmen and small merchants. With regard to bond holding, the public followed a different pattern compared to the 1952 scheme, with most of those who chose to lend their money coming from the upper classes, many of whom were veteran immigrants who had mainly come from Europe.

Turning to the other part of the assessment, the tax system, here the picture is much clearer. It is true that the tax-collection system of the first half of the 1950s was far from perfect. But, when considering the extent of tax collection, we should examine the period when the borrowed money was repaid: the second half of the 1950s and the 1960s. By that time, the Israeli tax system had significantly improved and the problem of evasion was much less severe. The taxation levels themselves in that period were fairly progressive, with a marginal tax rate of about 60 percent for most of that duration.[189] The effective taxes on corporations were fairly

[187] Moshe Lissak, *Israel in the Fifties: Social and Cultural Cleavage 1 – Between 'Oldtimers' and Newcomers*, in ISRAEL IN THE GREAT WAVE OF IMMIGRATION: 1948–1953 1, 5 (Dalia Ofer ed., 1996) [Hebrew].
[188] PATINKIN, *supra* note 7, at 67.
[189] WILKENFELD, *supra* note 85, at 59–66.

high over that period, reaching more than 60 percent at certain points.[190] This suggests that the upper classes contributed more than the middle and lower classes to the 1952–1953 debt servicing.

Combining the bond-holding pattern and the tax levels, we reach a complex conclusion. While, in 1952, most of the bondholders came from the middle and lower classes, due to progressive tax levels, the upper classes contributed more to the repayment of the debt owed to them with a 4 percent interest rate. While this pattern may seem beneficial to the middle classes, two observations must be made here. First, many of the middle-class bondholders never came to demand the repayment of the sums owed to them,[191] hence they did not take advantage of the investment component built into the 1952 lending scheme. Second, it is crucial to assess the return on investment that bondholders received vis-à-vis inflation. The 1952 bonds bore interest at 4 percent, which was subject to tax. During the repayment period (roughly 1955–1970), the average inflation rate was 5 percent.[192] Thus, effectively, even for those who did receive the government's loan repayment, it is difficult to claim that this investment helped maintain their real purchasing power.

In the case of the 1953 lending drive, most of the bondholders came from the upper classes, since the middle classes preferred to pay the one-off special tax. In this sense, by paying their taxes in the 1960s, they serviced the debt held by the upper classes. This suggests that the 1953 lending scheme created a distributive pattern more similar to the contemporary one, in which the middle classes service the payment of the debt to the rich. However, here again, inflation played a role. That lending scheme bore tax-free interest at 2.5 percent. Compared to the 5 percent average inflation rate, it seems that the return on investment failed to maintain the value

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[190] AMOTZ MORAG, PUBLIC FINANCE IN ISRAEL: PROBLEMS AND DEVELOPMENTS 97–98 (1967) [Hebrew].
[191] WILKENFELD, *supra* note 85, at 80.
[192] Ephraim Klaimen, *Inflation and the Redistribution of the Public Wealth*, 83 ECON. Q. 238, 244 (1974) [Hebrew].

of their money, and the lending may even have prevented the upper classes from investing their wealth elsewhere, domestically or abroad.

With many sectors in Israeli society losing out thanks to the legal engineering of the overarching 1952–1953 plan, it is difficult to understand why public criticism did not translate into effective political opposition. The prime explanation lies in the immense political power of Mapai, which ruled the government at that time. However, it is interesting to note that the legal bifurcation of the lending into two stages also divided the groups of stakeholders affected by the plan. Whereas the 1952 plan affected mainly people who held their wealth in cash and demand deposit accounts, the 1953 round affected mainly asset-owners. The splitting of the plan over time thus demarcated its distributive effects on different subgroups.

Lastly, the compulsory lending brought to the fore not only the tensions between different waves of immigration and different Jewish ethnicities but also intensified the divisions between the Jewish community in Israel and the Palestinian minority that was left in the state after the 1948 War of Independence. The monetary arena was yet another, though not the primary, locus for inequality and discrimination.[193] Herut's representatives in the Knesset alleged that the 1952 lending scheme would not harm the Palestinians, since they had already transferred all their paper banknotes into small change, which was exempt from deduction.[194] This argument was, in reality, baseless. The Palestinians who remained in Israel after the war did not share the same sense of belonging to the Zionist project or trust in the government as the Jewish population.[195] The decision to nullify all the old banknotes held outside of Israel's territory harmed the Palestinian population the most, since they constituted the majority of the holders of the old notes outside of Israel.[196] Meanwhile, for many Palestinians who lived in Israel, the

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193 MITTER, *supra* note 13.
194 Divrei Haknesset (Knesset Protocols), *supra* note 106, at 2279 [Hebrew].
195 Likhovsky, *supra* note 13, at 188.
196 Al Hamishmar, *supra* note 109.

1952 lending plan, in particular, brought about a further loss of money, not least because many of them did not speak Hebrew and were unaware of the need to change the old notes before the set date.[197]

V. Conclusion

The present paper had two major goals: to illustrate how the specific legal engineering of public debt policies can influence their distributive outcomes; and, by using the Israeli case study, to illuminate the influence of politics and ideology on economic structuring. Focusing on the early days of Israeli statehood, I sought to show the crucial role that public debt played in the "state-building" moment; this mechanism enabled the government to align national (Zionist) interests with the economic interests of private individuals. Public debt also revealed itself to be a facilitative measure to avoid political controversies as it enabled the government to pursue its fiscal policy—including increasing its revenue and absorbing the spare money in the market—while masking the distributive effects of that policy.

But the compulsory lending plans of 1952 and 1953 did have distributive effects: despite the potential of the 1952 scheme to transfer wealth from the rich to the middle and lower classes, due to inflation and other problems, it seems this promise was not fulfilled. Furthermore, this policy exempted foreign investors, thus protecting the drivers of the embryonic forms of capitalism in Israel. The legal engineering of the 1953 scheme further harmed the middle classes with its special tax option that did, indeed, halve the amount they lent but required them to service the repayment of the debt to the rich, without ever benefitting, themselves, from a similar repayment of the sums they had contributed to the government. As I have endeavored to show, that distributive pattern significantly overlapped with the greater

[197] *The Special Advisor on Arabs Issues: Tax Payments by the Arab Population 1948–1954, Part A* [in Hebrew] (ISA-17109/18-GL).

pattern of inequality in Israel: in an era of shifting priorities on the part of Mapai, the 1952–1953 plan reflected the priorities of the party's electoral base: the upper classes, composed of Jewish workers who came mostly from Europe.

The Israeli case suggests, however, that public debt does have the potential to serve more egalitarian goals if structured in the right way. I hope to have demonstrated how the legal engineering of the debt structure and its codification into law shaped the policy's distributional consequences in unexpected ways. In the early 1950s, the Israeli Government attempted to dismiss the distributive effects of its policy from a class perspective. It is no less common nowadays to neglect this question. While this study does not offer a comprehensive understanding of this failing—in both academia and policymaking—it suggests that the acceptance of the Keynesian paradigm in the years following World War II contributed to the depoliticization of the distributional issue, leaving this question to policy debates conducted almost exclusively by economic experts.