



ISRAEL'S FINANCIAL FIREPOWER

How low debt, high savings, and strong growth provide Israel significant financial firepower to fight and win a war



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I. THE WORST TERRORIST ATROCITY IN ISRAELI HISTORY

Starting in the early hours of Saturday morning, October 7th, during Shabbat and Simchat Torah, Hamas perpetrated the worst terrorist atrocity in Israeli history. More than 1,200 Israelis died in the attack and approximately 240 were kidnapped and taken captive by barbaric criminals in the Gaza Strip. There are no excuses for this attack, no justifications, and no ambiguities about Hamas' motivations. Like the Nazis before them, Hamas must be defeated, and the perpetrators prosecuted. Despite obvious failures of intelligence and military defense, we believe Israel must – and will – reestablish security and, hopefully, eliminate the threat.

Israel's mission will be very difficult. Hamas uses Gaza's civil infrastructure – including homes, schools, hospitals, and mosques – as shields for their terrorist activities, and is deeply embedded in Palestinian society. According to an opinion poll released on November 14, 2023 by the [Palestinian AWRAD research organization](#), 63% of Palestinians in the Gaza Strip and 83% in the West Bank support Hamas' October 7th attack on Israel.

Overcoming setbacks, addressing challenges, and moving forward despite tragedy are the secrets to Israel's ultimate success.

This support for Hamas' immoral ideology will not deter the Israel Defense Forces (IDF) from pursuing its military objectives. Unfortunately, despite Israel's adherence to its long-held ethos to reduce risks for non-combatants, we fear casualties will be very high on all sides of this war as Israel fights to prevent the future atrocities promised by Hamas.



Israel will win this fight because it is strong militarily, but also because it is strong economically. By necessity, economics will take a back seat to military considerations for a while. It is important to remember that Israel's superior military power rests upon an advanced economic foundation, which funds Israel's expensive, but necessary, military capabilities. Following this attack – in the days, weeks, months, and years ahead – Israel will build much stronger defenses against its enemies, which will necessitate increased government spending. This must

be accompanied by significant economic reforms to accelerate growth and prosperity.

Although unimaginably huge, October 7th was not Israel's first terrorist murder or abduction; Israel has experienced losses in all of its wars. Overcoming setbacks, addressing challenges, and moving forward despite tragedy are the secrets to Israel's ultimate success. A look back

to the last major wave of terrorism – the Second Intifada – is perhaps instructive for Israel’s current situation.

a. Looking Back to the Second Intifada

The beginning of this century witnessed the devastating violence of the Second Palestinian Uprising or “Intifada.” Four years of Palestinian suicide bombings, shootings, and stabbings, followed by Israeli reprisals killed more than 1,000 Israelis and 3,000 Palestinians. The violence finally ebbed after Israel completed its security barrier in 2004. In the depths of the Second Intifada, few observers would have predicted that the Israeli economy would flourish as it has over the past 23 years.

Casualties on both sides were tragic, and the economic toll was painful. In 2000, just prior to the Second Intifada, Gross Domestic Product (GDP) per capita in Israel was \$34,000 (in 2023 inflation adjusted dollars). Over the next three years, per capita income fell 4.5% measured in shekels and foreign tourism collapsed by half. Per capita GDP did not recover to its year 2000 peak until 2005. The economic downturn was exacerbated by the bursting Internet bubble and global recession following the September 11, 2001, terrorist attack.

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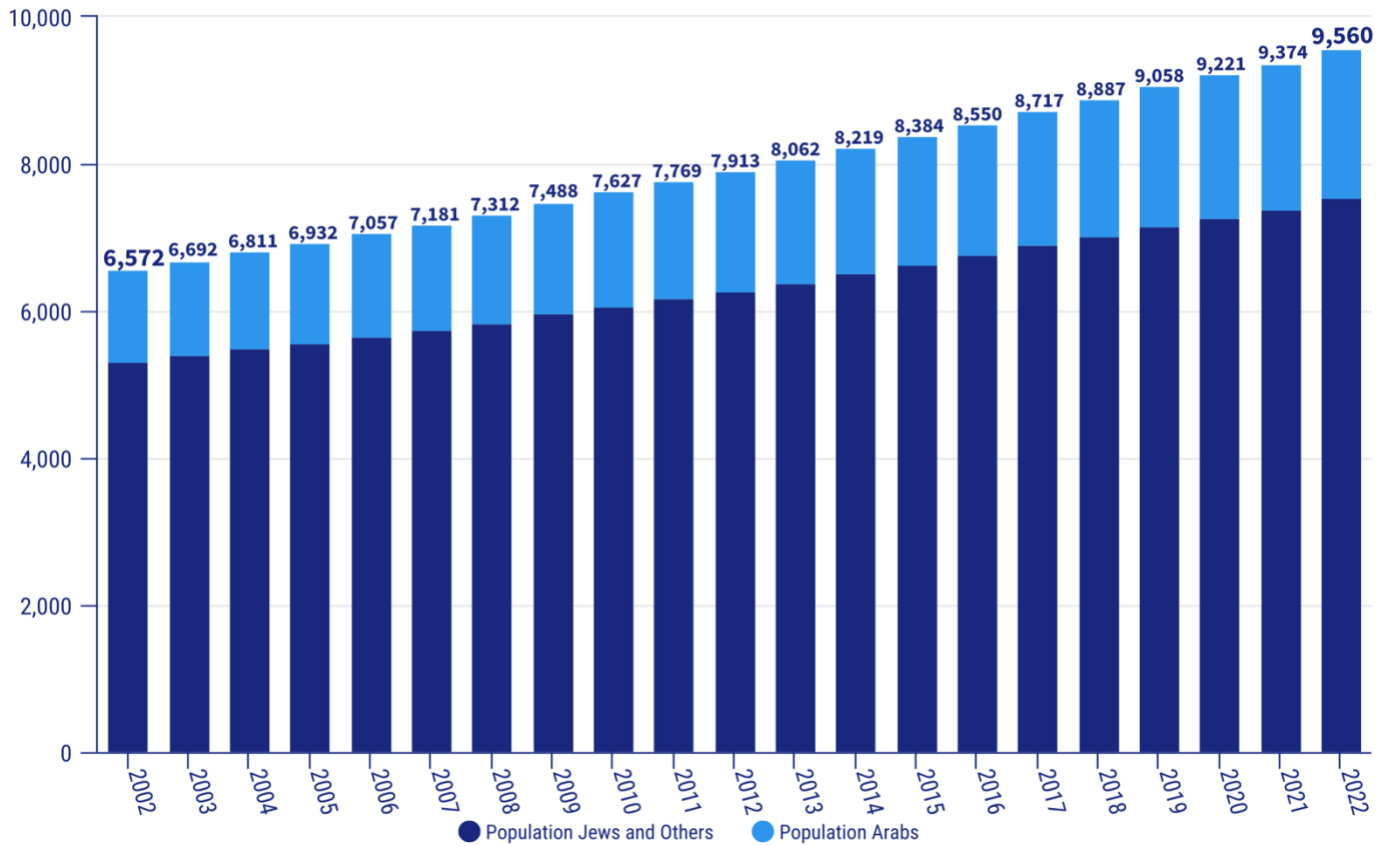
b. Israeli GDP Per Capita Now Exceeds Many Nations

In 1999, one year before the Second Intifada began, the Israeli economy prospered amidst the global technology boom. Even so, Israeli GDP per capita was 28% lower than France, 13% below Italy, and 45% below Japan. Twenty-three years later, by year-end 2022, Israeli GDP per capita of \$54,000 exceeded all three of these countries. Israeli GDP per capita was 55% of U.S. GDP per capita in 1999, while today it is 71% of the U.S level (\$76,000).

Between 1999 and 2023 the Israeli economy grew 4% per year from \$212 billion to \$522 billion. Average household income rose by a robust 2% per year, even as the population expanded 1.9% per year (see [Chart 1](#)). Both Jewish and Arab citizens of Israel benefitted from this long period of economic growth. How, then, did Israel’s economy bounce back from the catastrophic effects of the Second Intifada years, and does this shed light on the likely economic course for Israel over the next decade and beyond?

Chart 1

**Israel Population (Thousands)
2002-2022**



Source: Israel Central Bureau of Statistics

II. PROSPERITY AND SECURITY ARE INEXTRICABLY LINKED

To stanch terrorist infiltration from the Palestinian Authority, Israel started building a separation barrier in 2002. Following completion of the first phase in the summer of 2003, successful suicide bombings dropped precipitously, and the Israeli economy started to recover. Suicide bombings inside Israeli territory eventually ceased as security barrier construction progressed. Imperfect but improved security helped the Israeli economy avoid a deep recession during the Global Financial Crisis of 2008-2009 and maintain relatively steady growth over the past decade.

Israel's security is expensive and, as a result, sustained economic growth is vital to Israel's military defense. Israel currently spends about \$23 billion per year, or roughly 4.5% of annual GDP, to support its military (see [Chart 4](#)). It maintains a standing army of 170,000 troops with estimated reserves of 465,000 (360,000 are currently mobilized; see [Chart 5](#)).

Reliable data does not exist for Israel's enemies, but the Iranian military budget is believed to range between \$12 billion (according to the World Bank) and \$20 billion (according to the British International Institute for Strategic Studies). Military analysts estimate that Hezbollah military expenditures are about \$1 billion per year with a potential force of 50,000 to 100,000 fighters and 150,000 rockets. Hamas is thought to have 15,000 to 30,000 fighters with approximate annual expenditures of \$300 million. Apart from Hezbollah and Hamas, Iran funds a variety of militias in Syria, Iraq, and Yemen with capability to attack Israel, not to mention Palestinian Islamic Jihad in Gaza and multiple terrorist cells in the West Bank.

a. Security Threats Motivate Growth-Enhancing Economic Reforms

A growing economy allows Israel to raise living standards for its people while also investing in security. In turn, strong security provides necessary space for the economy to grow. Over the past 23 years, Israel boosted economic growth by adopting politically difficult, but far reaching, economic restructuring and reform policies. Israeli GDP per capita now exceeds Japan, Italy, and France in large part because these countries did not adopt growth enhancing, but politically unpopular, reform policies over the past two decades. Unlike Israel, they lacked acute security threats that often motivate difficult change.

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Security expenditures will balloon temporarily as Israel fights this war. This conflict revealed glaring security gaps that must be resolved. Even when calm is restored, defense spending will shift higher. Israel can afford this conflict as well as the necessary upgrades to its defense profile. Manpower, weapons, and intelligence are critical military assets, but Israel also possesses significant untapped financial firepower.

III. ISRAEL'S ASYMMETRIC SECURITY CHALLENGES

The German Sociologist Max Weber (b. 1864 – d. 1920) defined a state as a political entity that successfully retains a monopoly on the legitimate use of organized physical force. Americans and Europeans sometimes fail to understand that many countries in the world do not meet this minimum threshold. Unlike France, for example, which is surrounded by strong, cohesive, and stable states such as Germany, Spain, Italy, and the United Kingdom, Israel is surrounded by weak or failed "states" and a variety of belligerent non-state or semi-state military organizations.

Although the Palestinian Authority (PA) is the globally recognized governing body in the West Bank and the Gaza Strip, the PA certainly does not successfully claim a monopoly of legitimate force. The terrorist organization Hamas has been the de facto government in Gaza, and well-armed family clans, militias, and other terrorist groups operate in both the West Bank and Gaza. Rarely are governmental institutions of the PA such as courts or police utilized to enforce agreements or settle clan vendettas.



During the wars of 1948, 1967, and 1973, Israel fought to defend itself against coalitions of Arab armies. In the 1973 Yom Kippur War, the initial Egyptian attack involved 200,000 troops, 200 airplanes, and more than 1,000 tanks. Simultaneously, Syria invaded the Golan Heights with 150,000 troops, 1,200 tanks, and dozens of airplanes. In 1973, Egypt and Syria operated a full array of attack helicopters and naval vessels. Egypt and Syria employed devastatingly effective, Soviet-supplied, surface-to-air missile systems that shot down more than 100 Israeli jets in the first few days of the war.

Despite enemies like Hezbollah in Lebanon, Iran and its proxy militias, and Hamas' horrific attack on October 7th, the State of Israel is no longer

threatened with extinction from numerically superior and similarly equipped armies on its borders.

Israel's current security situation is fundamentally unstable and asymmetric. Following its civil war, the Syrian government is enfeebled, and can no longer muster military forces as it did in

1973. Nonetheless, the Syrian military and other militias on Syrian territory are still dangerous. The Iranian regime under the Shah was allied with Israel prior to the Islamic revolution in 1979, but the Iranian people were hostile. The switch from ally to enemy, therefore, was quick and easy for the Ayatollahs.

Despite peace treaties with Egypt and Jordan, therefore, Israel must assess current and future threats from these countries. Installed by military coup, the current Egyptian government is mindful that 75% of the population voted for Islamist parties when given the chance in 2012. Moreover, the Egyptian government cannot always contain Islamist terrorists and criminals operating in the Sinai Desert. While the Jordanian government does successfully assert a legitimate monopoly on the use of force, it also sits on a potential powder keg of domestic opposition to the monarchy, hundreds of thousands of Syrian refugees within its borders, and ongoing destabilization efforts by Iran and its proxies.

Former National Security Advisor Yaakov Amidror,

outlines some of Israel's major asymmetrical disadvantages in an essay published in June of 2010, entitled "[The Range of Threats against Israel.](#)" He writes, "the world around us, the Arab world, most of the Muslim world – not necessarily 'most' in the numerical-statistical terms, but in terms of those determining the outlook of this world – does not consent to the existence of an independent, sovereign Jewish state in the heart of the Middle East and will

Chart 2

Entity	Population (millions)	GDP (\$ Billions)	GDP per capita	Military (\$ Billions)
Israel	9.7	\$525	\$54,124	\$23
Gaza	2.1	\$3	\$1,571	NA
West Bank	3.2	\$12	\$3,594	NA
Egypt	110.0	\$477	\$4,336	\$6
Jordan	11.1	\$47	\$4,234	\$2
Lebanon	5.3	\$23	\$4,340	\$1
Hezbollah (Shiites)	1.6	\$6	\$3,750	\$1
Syria	22.9	\$11	\$480	\$1
Saudi Arabia	36.4	\$1,108	\$30,440	\$75
Iraq	44.5	\$264	\$5,933	\$5
Kuwait	4.3	\$184	\$42,791	\$8
U.A.E.	9.4	\$507	\$53,936	\$23
Oman	4.6	\$115	\$25,000	\$6
Qatar	2.7	\$237	\$87,778	\$15
Yemen	33.7	\$22	\$653	\$2
Iran	88.5	\$389	\$4,395	\$12
Turkey	85.3	\$906	\$10,621	\$11
Israel's "Neighborhood"	465.6	\$4,311	\$9,259	166.9
Russia	143.5	\$2,240	\$15,610	\$86.0

Sources: www.worldbank.org, www.cia.gov

do whatever it takes to destroy it.” The 49 majority Muslim member countries of the United Nations routinely vilify Israel in numerous resolutions where they often vote as a block. Approximately 465 million of the world’s 1.8 billion Muslims live within striking distance of Israel’s 9.7 million people (see [Chart 2](#)).

General Amidror says, “because of its small size, narrow configuration, and the fact that enemies, either in theory or in practice, surround it on all sides, all of Israel is a front.” Israel lacks widespread international support; therefore, Israel’s military operations are pressured in terms of timetable and means. Israel’s enemies do not encounter similar international constraints. Hamas can fire rockets at civilian targets without diplomatic rebuke, but, General Amidror writes, Israel “cannot carpet bomb civilian areas. It cannot act like Russia did in Chechnya.”

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The Abraham Accords between Israel, the United Arab Emirates, Bahrain, Morocco, and Sudan, signed in September 2020, offer a glimmer of hope that cracks are forming in the Arab wall of rejection. These are the first agreements between Israel and Arab countries offering not just an absence of armed conflict, but potentially full acceptance. In the weeks preceding the Hamas terrorist attack numerous press outlets reported that Saudi Arabia would soon join the Abraham Accords, an auspicious game changer for Israel’s relationship with the Islamic world. Many Middle East analysts believe Hamas attacked on October 7th to thwart potential normalization between Saudi Arabia and Israel.

a. Israel’s Adversaries Exploit Weak States; Israel Cannot

Stronger states such as Iran, Turkey, or Russia exploit weak or failed states in the region, while Israel cannot. Iran now commands a quasi-empire through its political, military, and religious allies in Iraq, Syria, and Lebanon. The Russian military ensconced itself in a collapsing Syria, turning a losing war for President Assad into a murderous victory. Governments in Iraq, Syria, and Lebanon most certainly do not hold a monopoly of legitimate force. The same is true in Yemen, where Iran built the Houthi militia into another proxy like Hezbollah, but mostly focused on its Sunni rival Saudi Arabia.

Without expensive military investments, Iran can threaten Israel in a variety of direct and indirect ways. Although Israel outspends Iran, Iran can stretch its money further. Iran and Hezbollah joined in a Shiite coalition backed by Russia to defend Bashar al-Assad’s tyrannical regime in Syria. An American-supported coalition with Kurdish forces largely defeated ISIS in Iraq and Syria, but Turkey exploited the opportunity to attack the Kurds. Iran surreptitiously

Since October 7th, however, it is universally clear to Israelis that Hamas, Hezbollah, and the Iranians are deadly serious. A stronger, more proactive IDF is therefore a non-negotiable reality.

filled the power vacuum in Iraq and Syria with infiltrated troops, weapons, and military bases closer to Israel's borders.

As counterbalance, Israel must maintain an asymmetrically stronger state and preserve its alliance with the United

States. Among the countries in the Middle East, Israel is the only full democracy living under the rule of law. It boasts the only industrialized economy in the region, characterized by the highest economic growth rate. Israel's Gross Domestic Product (GDP) of \$525 billion is larger than Egypt's or Iran's even though their populations are 110 million and 89 million respectively.

Prior to October 7th, continuous claims by Hamas, Iran, and Iran's proxy militias that their ultimate goal was to destroy Israel seemed like rhetorical hyperbole to many Americans and other Westerners, even to some Israelis. Since October 7th, however, it is universally clear to Israelis that Hamas, Hezbollah, and the Iranians are deadly serious. A stronger, more proactive IDF is therefore a non-negotiable reality.

b. Economic Growth is Essential to Israel's Security

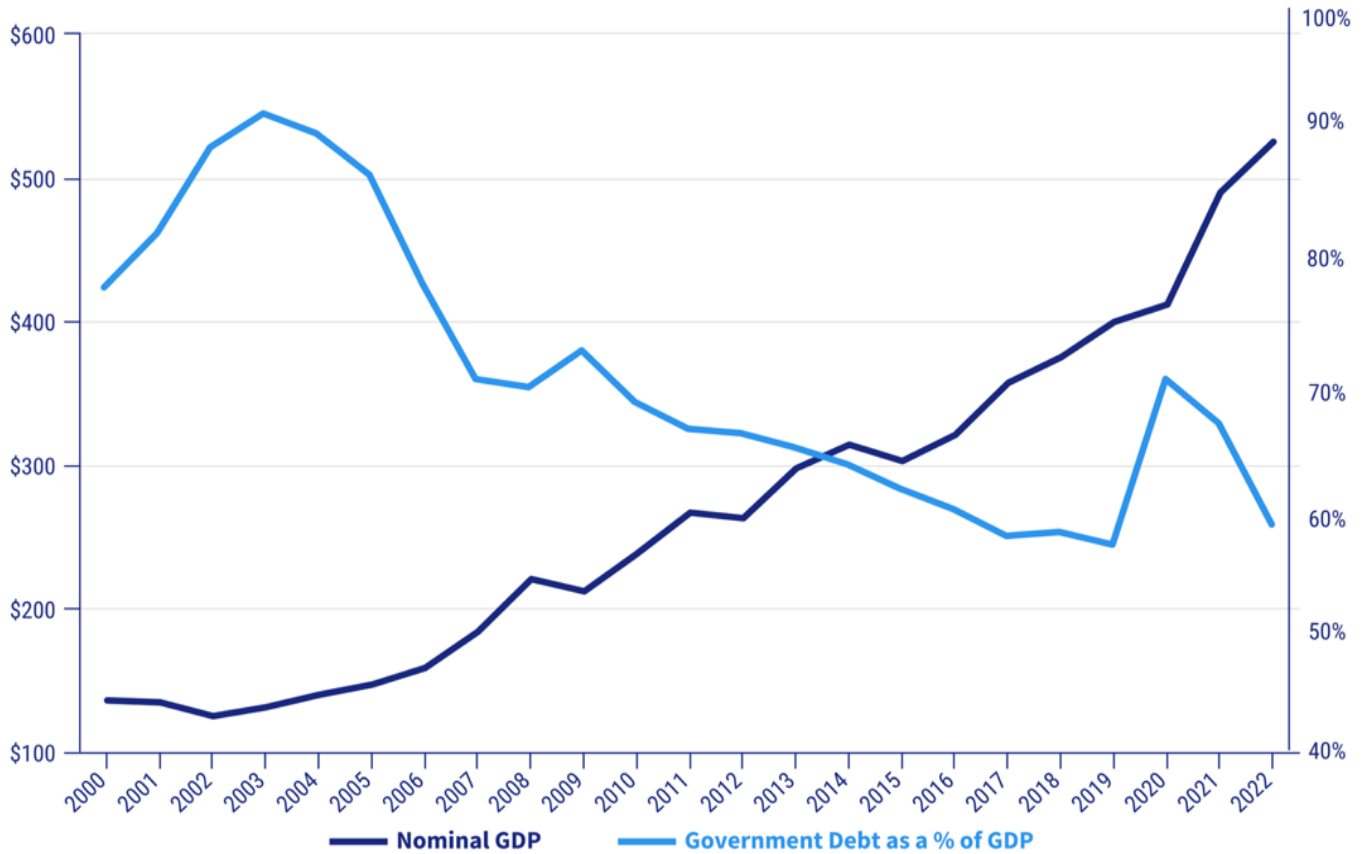
Islamic jihadists such as Hamas, Hezbollah, Iran, and Iran's other proxies understand they cannot win a war against Israel in the near-term. Their long-term strategic goals are to make life dangerous and unbearable for Israelis, raise doubts that Israel is a permanent safe haven for Jews, destabilize the Israeli economy, and ultimately force millions of Jews to leave the country. Israeli security and prosperity are in and of themselves victories over its enemies.

While neighboring countries such as Syria, Lebanon, Iraq, and Yemen collapsed into civil war, revolution, and state failure in recent years, Israel maintained 4% average annual economic growth. Due to rapid economic growth and fiscal discipline, Israel was one of the very few countries in the world to reduce its government debt burden during and after the Global Financial Crisis in 2008. The Israeli debt-to-GDP ratio is currently 60% (see [Chart 3](#)) compared to 94% in the United States. Although not advisable, a 100% debt ratio similar to the U.S. would provide Israel with more than \$200 billion of untapped borrowing capacity if necessary.

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Chart 3

**Israel Nominal GDP vs Government Debt as a Percent of GDP
2000-2022**



Source: IMF

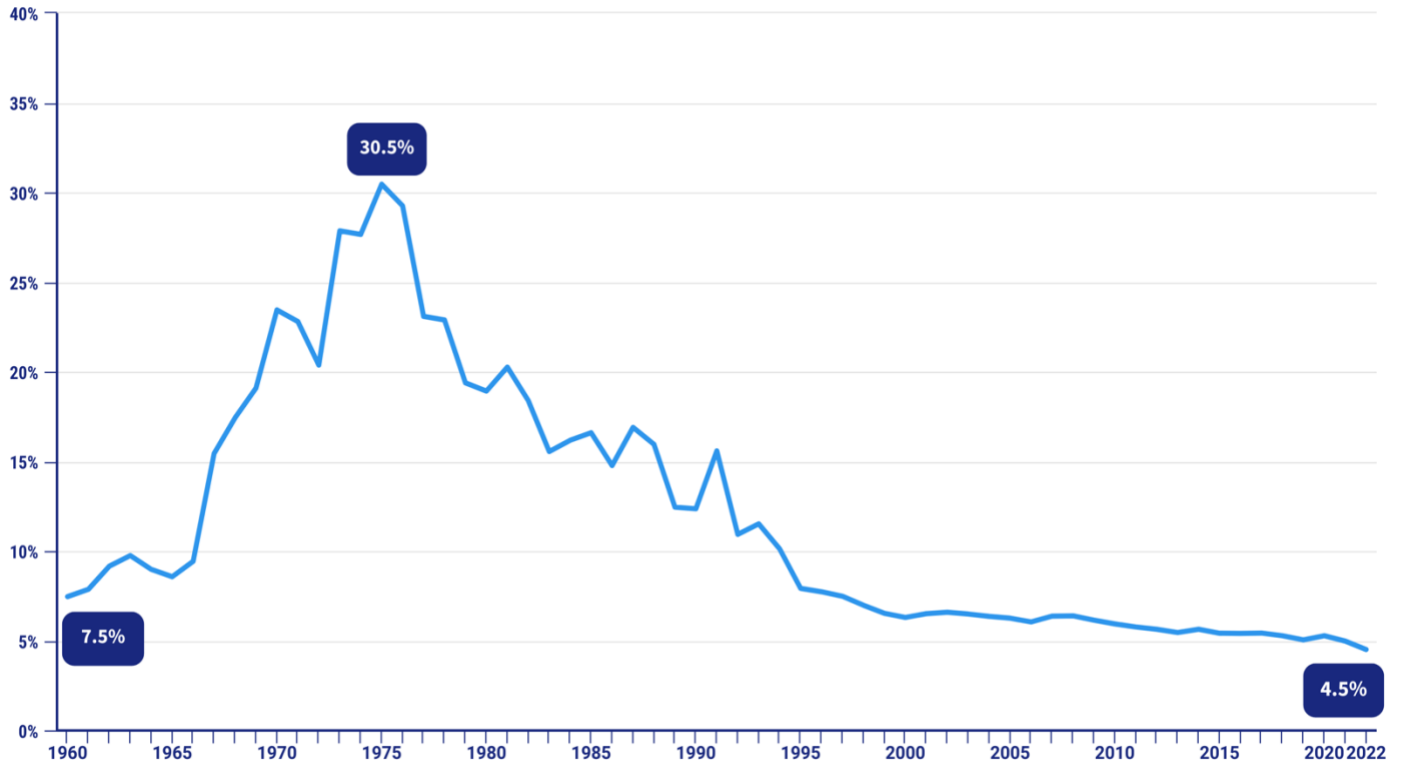
c. Hindsight is 20/20: Defense Spending Lagged the Economy

In the aftermath of the 1973 Yom Kippur War, Israeli economic growth stagnated, exacerbated by global recession, inflation, and mounting military expenditures. Defense spending exceeded 30% of GDP but fell rapidly following the 1979 peace treaty with Egypt. In the 1980s and 1990s Israel shifted from socialism to capitalism, igniting the economic boom that continues until today.

Remarkable economic growth and peace treaties with Egypt and Jordan reduced Israel's defense burden from onerous to manageable over the past 50 years. When the Oslo Accords were signed in 1993, Israeli defense spending still comprised 11% of GDP. For comparison, U.S. military expenditures were 4.6% of GDP in 1993 and they are about 3.5% now. As you can see in [Chart 4](#), Israel's defense burden shrank substantially and continuously over the past 50 years.

Chart 4

**Israel Military Expenditure as a Percent of GDP
1960-2022**



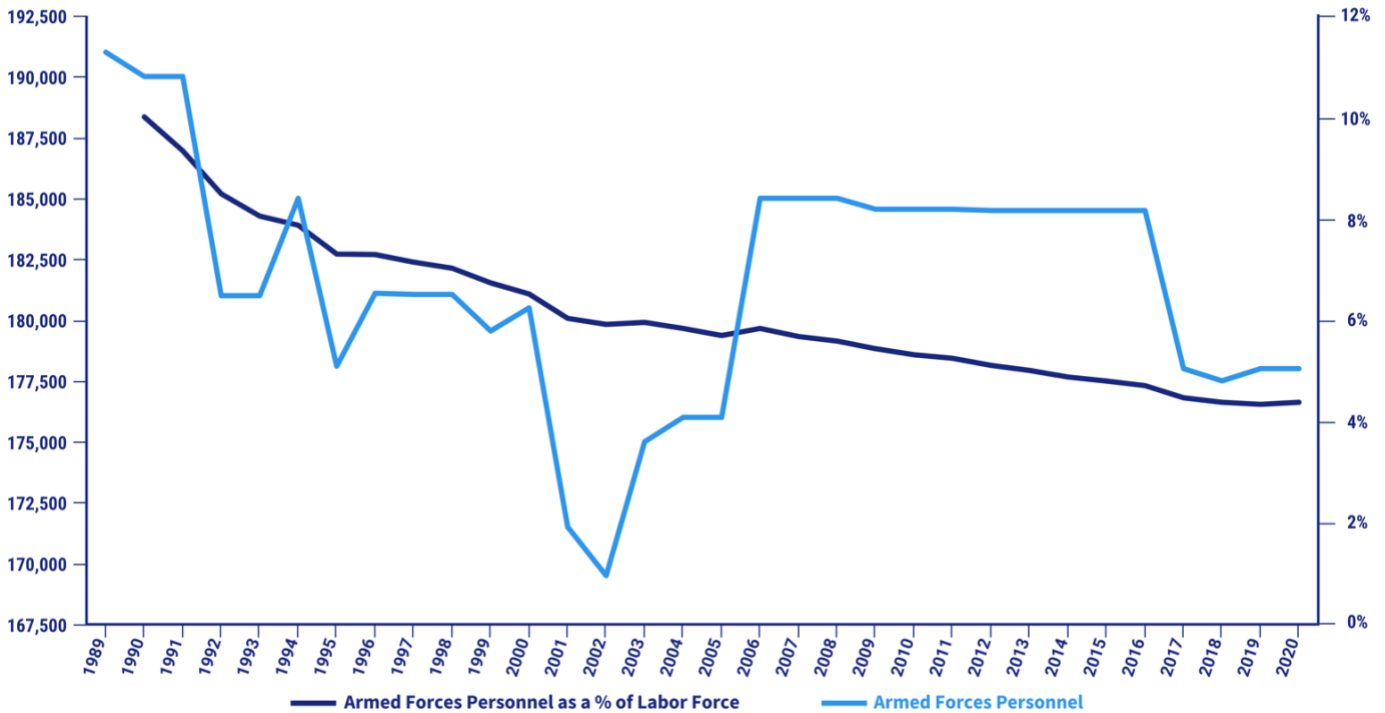
Source: World Bank WDI - World Development Indicators

Unfortunately, economic growth does not tell the entire story. Since the 2008 Global Financial Crisis, Israeli defense spending grew by just 1.2% per year when adjusted for inflation. As mentioned above, Israel's real economic growth averaged 4% during these years. Israel shrank the size of its active-duty armed forces by 7,000 troops since 2008. Although this number might seem negligible, it is striking when placed into a broader demographic context (see [Chart 5](#)).



Chart 5

**Israel Armed Forces Personnel vs Israel Armed Forces Personnel as a Percent of Labor Force
1989-2020**



Source: World Bank WDI - World Development Indicators

Between 1993 and 2023 Israel’s populace grew by 2.1% per year, by far the fastest population growth in the developed world. In 1993 there were 5.2 million Israelis with 2.3 million of them in the labor force. Today there are 9.7 million Israelis with 4.8 million in the labor force. If Israel conscripted a similar proportion of the labor force today as it did in 1993, the IDF standing army would be more than double in size.

Although Israel has 540,000 troops mobilized for this war, it probably will not need to permanently double the size of its regular forces. With 20/20 hindsight following the October 7th massacre, however, Israel’s reduction in force and stingy defense budgets seem short-sighted. The good news is that Israel can afford to pay for this expensive conflict as well as permanently enlarged defense budgets. Accomplishing both, while also boosting living standards for the average Israeli, however, will require robust economic growth to continue.

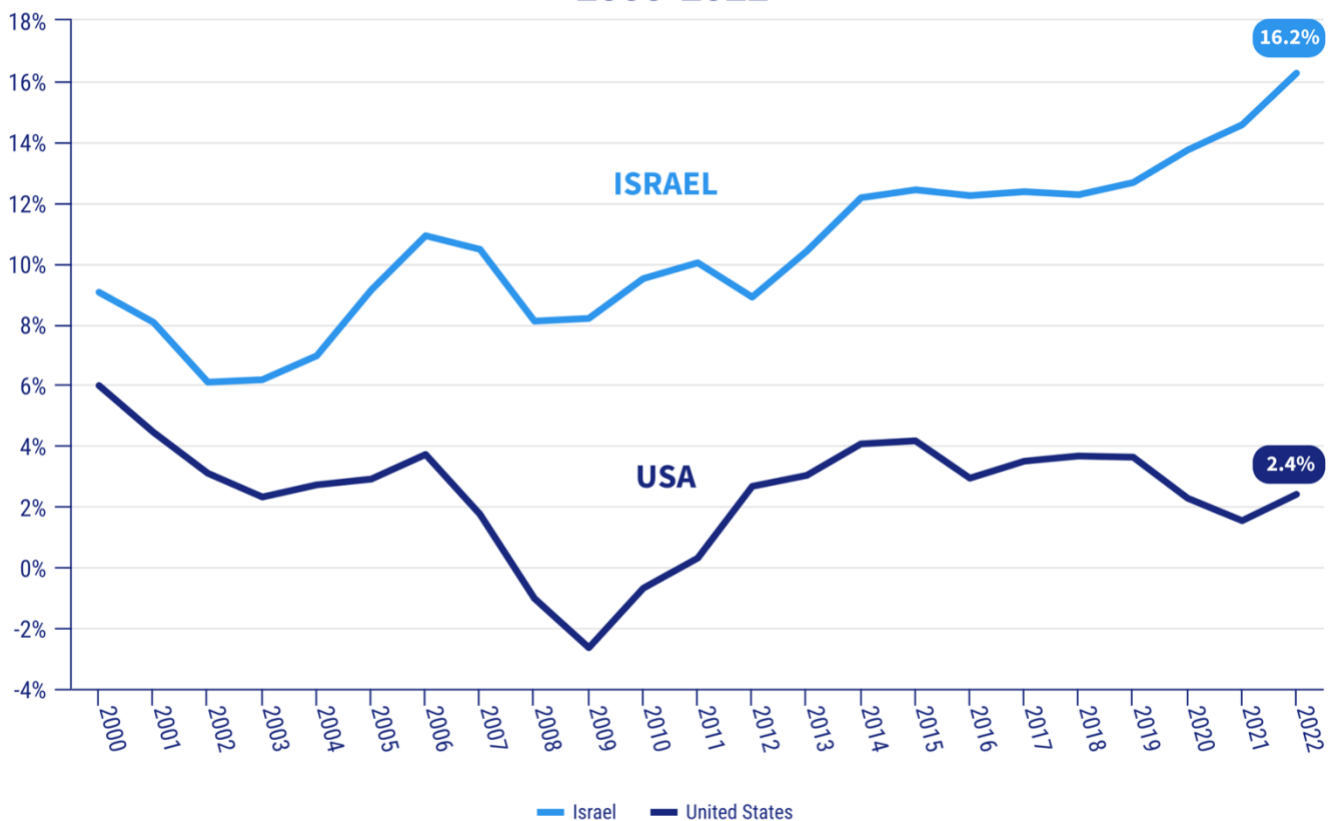
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IV. WEALTH AND CAPITAL IN ISRAELI SOCIETY

Israeli households are amassing wealth at a rapid clip due to their high savings rate. As you can see in [Chart 6](#), net saving as a percentage of GDP stands at 16.2% in Israel vs. 2.4% in the United States, and the gap is widening. Most of this capital resides in private pension funds. The Israeli savings system is based on tax-advantaged defined contribution plans similar to American 401(k) accounts, but with government mandated contribution requirements by employees and employers.

Chart 6

**Israel and USA Savings Rate
2000-2022**



Source: OECD (2023), Saving rate (indicator). doi: 10.1787/ff2e64d4-en

Of course, the highest and best use of this capital is infrastructure and private sector investment, but it is also available for Israel's defense expenditures if required. Although the savings rate skewed somewhat higher after Covid, during the more normal pre-pandemic years Israeli society saved about 12% of GDP. Even if the economy suffers a recession similar in depth to the Second Intifada, Israelis should still comfortably save \$3 billion to \$4 billion each month.

Unlike prior wars in 1948, 1967, 1973, and in Lebanon, Israel's financial firepower exceeds its needs.

In the short-run the government may borrow this cash to fund the war, but larger defense budgets are unlikely to require onerous taxation over the long-run. Unlike prior wars in 1948, 1967, 1973, and in Lebanon, Israel's financial firepower exceeds its needs. On top of this, American government assistance and donations from world Jewry will help alleviate fiscal pressures in the near-term.

a. Recession and Recovery

In addition to the direct costs for military mobilization, the war is taking a broader economic toll. Israel mobilized 360,000 reservists which comprise 7.5% of the labor force. Another 200,000 people were evacuated from communities near the Gaza Strip and along the Northern border with Lebanon. This group removes about 100,000 people from the labor force. Although not included in Israeli labor force statistics, another 180,000 Palestinians and other foreigners are no longer working in Israel amounting to an additional 3.6% of total employment. Added together, about 13% of the Israeli work force is dislocated by the current war.

In the early months of the Covid pandemic, when the Israeli government adopted draconian closure policies, the unemployment rate approached 22%. Current dislocations, plus the impact of a broader recession on the economy, will likely reach 15% to 17% of the labor force this time around. As a result, the pandemic experience serves as a fitting analogy for the economic costs of the current war. Direct costs to support the Israeli economy could approach a similar \$30 billion, or perhaps as much as \$50 billion depending on the scale and duration of the conflict.

b. Israel's Growth Engines Remain Intact

Israel's long-term economic growth is powered by four engines: technological innovation, rapid population growth, increased labor force participation, and improved productivity. Despite handwringing in recent months during the judicial reform debate, Israel's technological prowess remains intact. Rising percentages of [Orthodox Jews are working](#), which is a trend that could accelerate if yeshivah subsidies are constrained by increased defense expenditures. Contrary to popular misconception, population growth is rapid for every sector of Israeli society [including non-Orthodox Jews](#).

Of the four engines, technological innovation is the most discussed, particularly venture capital backed startups. Productivity improvement, however, is the most important albeit least appreciated by the broader public. Defined as the total economic output per hour worked, productivity is the key driver pushing living standards higher for the average Israeli. Productivity improves as Israeli companies achieve larger economies of scale and upgrade

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quality and efficiency in response to intensified business competition. [Ongoing productivity growth](#) is best understood in the context of Israeli economic history.

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V. A BRIEF HISTORY OF THE ISRAELI ECONOMY

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

a. Israel's Founding Economic Institutions

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

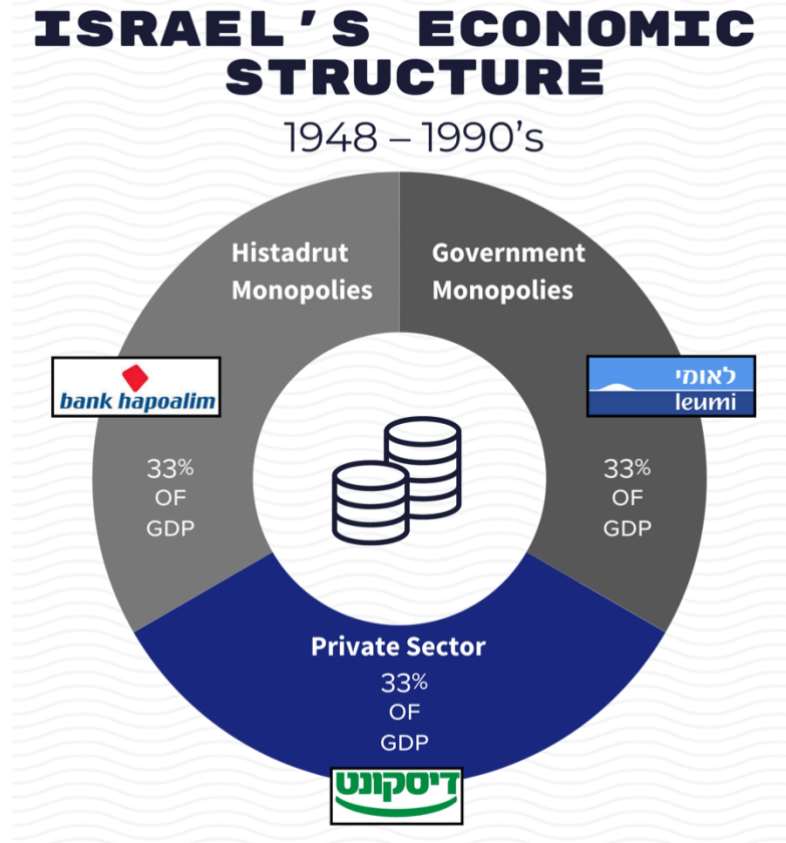
The history of labor unionism in the Yishuv was unique. In other countries, entrepreneurial capitalists created business enterprises, and their employees organized unions to demand improved pay and working conditions after the fact. In the 1920s, during the early years of the British Mandate in Palestine,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

Histadrut businesses generally became monopolies in their fields. Despite this highly monopolized economic structure, most Histadrut enterprises were remarkably efficient. They served a very small but rapidly growing population. These two characteristics – small scale

and rapid growth – kept the Histadrut’s monopoly powers in check, since the Yishuv could not support large scale competition during the 1930s and 1940s.

Following independence in 1948, the newly formed government established state-owned enterprises as a complement to the Histadrut’s business activities. Together, the government and the Histadrut controlled about two thirds of Israeli economic activity (see [Chart 7](#)). The private sector remained small and interconnected with the government but nonetheless dynamic, given Israel’s rapidly expanding population and economy.

Chart 7



b. Stagnation and Crisis

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

Life became very difficult for the average Israeli in the early 1980s. Per capita income for Israel's 4.2 million people was a meager \$6,000 per year. Government expenditures and debt exceeded 60% and 260% of GDP respectively, similar to Greece during the Euro debt crisis. Despite a costly military burden compounded by the 1982 Lebanon war, only 20% of government expenditures were allocated for defense. The remainder supported generous subsidies and social insurance programs. The Israeli government subsidized certain food products, insolvent public sector companies, and the kibbutzim. The banks collapsed in 1983, prompting an expensive government bailout and takeover.

c. The Economic Stabilization Plan

The economic crisis and the Lebanon war pushed the two leading Israeli political parties into a national unity coalition government. In July 1985 the Israeli government implemented a successful "Economic Stabilization Plan," which reduced the inflation rate, cut government spending, and restructured public sector companies. Although difficult to discern at the time, the Economic Stabilization Plan inaugurated Israel's arduous journey from economic distress to eventual success.

In the 1990s Israel shifted from a socialist to a market economy, and economic growth accelerated in response. To further cement its new capitalist foundation, Israel gave its central bank – The Bank of Israel – more independence to maintain its disinflationary policies. As a result, the inflation rate dropped in Israel from 20% per annum in the late 1980s to almost zero (prior to the recent Covid inflationary spike), allowing interest rates to fall as well.

Israel is one of very few countries in the world where the debt to GDP ratio is lower today than prior to the financial crisis in 2008.

Not always consistent or without acrimony, successive governments (both Labor and Likud) kept deficits and debt relatively under control. Over time, Israeli government debt declined from 260% of GDP in 1984 to 60% at present (see [Chart 3](#)). Since the early 2000s the Israeli government consistently reduced its debt burden, modestly reduced personal and corporate tax rates, and boosted infrastructure investment. Israel is one of very few countries in the world where the debt to GDP ratio is lower today than prior to the financial crisis in 2008.

d. Israel Charges Toward Less Monopolistic, More Competitive Economy

Privatization of public sector companies began in the 1990s and accelerated in the 2000s. Privatization removed the state from a dominant position in economic life, but in many cases merely transferred monopolies from state to private ownership.

In response, the government embarked on a profound restructuring of the Israeli economy, reminiscent of Teddy Roosevelt's early 20th century trust-busting in the United States. In 2005,

the Knesset passed “The Law for Encouragement of Competition and Reduction of Conflicts of Interest in the Israeli Capital Markets,” acting on the recommendations of the Bachar Committee (named for its chairman, the late Dr. Yosef Bachar, Director General of the Ministry of Finance). The Bachar reforms empowered the previously enfeebled capital markets, while insurance companies, asset managers, and investment banks gained traction as viable competitors to the monopolistic banks.

In December 2013, the Israeli government passed the “Law for the Promotion of Competition and Reduction of Concentration.” This law mandated separate ownership of financial and nonfinancial companies, akin to laws enacted in the U.S. in the early 20th century. Between 2013 and 2019, the Israeli government forced large business pyramids controlled by monopolistic tycoons to divest and unwind. Since this sweeping piece of legislation, the Israeli government enacted numerous laws to intensify competition in a variety of sectors including financial services, cellular telecommunications, [broadband access](#), electricity production, [construction](#), and international trade.

The job is far from finished, but economic reforms in Israel are gradually reducing competitive barriers. In fact, the impairment to Israeli agriculture by this war forced the Israeli government to ease certain protectionist policies on food imports. Increased competition motivates management to invest in productivity-enhancing technologies and processes. Of necessity, Israel will likely accelerate pro-competition economic reforms already under consideration to maintain robust economic growth after the war.

VI. VIOLENCE IS ENDEMIC TO PALESTINIAN SOCIETY, INHIBITING ECONOMIC DEVELOPMENT

Like many Israelis, we are also sympathetic to the Palestinian plight. A peaceful and prosperous Palestinian society is most certainly in Israel’s interest. Unfortunately, Palestinians and their sympathizers typically blame Israel for their economic and social ills. The story, however, is much more complicated. As long as Palestinian society encourages or even tolerates violence against Israel, Israelis, and Jews, they will forever live with Israeli security controls. Palestinian violence is also an unacceptable response to Israeli settlements, even if they or their sympathizers consider those settlements to be illegitimate. Most Israelis recognize that Jews and Palestinians have legitimate sovereign claims to part of the land, but Israeli “occupation” is the consequence of Palestinian violence rather than its cause. Israel’s security measures inhibit Palestinian economic development in a variety of ways, but they are not the primary impediment.

Palestinian economic performance is hindered by poor governance, a clan-based political structure, excessive dependence on international aid, and terrorist groups either passively supported by or beyond the control of the Palestinian Authority. The Gaza Strip is completely dependent on outside financial support, most of which is channeled by the Hamas

**A peaceful and prosperous
Palestinian society is most
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regime into terrorist activity. The overwhelming majority of Israelis fervently hope that the Palestinians will one day accept Israel as a majority Jewish state, even if only begrudgingly. Although this may never happen, a cessation of Palestinian violence toward Israel would be sufficient to remove most security controls.

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Population figures vary significantly for the West Bank and Gaza, but the CIA World Factbook estimates there are approximately 3.2 million Palestinians living in the West Bank and 2.1 million in the Gaza Strip. Average annual population growth is roughly 1.6% and 1.9% respectively. According to the World Bank, annual Gross Domestic Product (GDP) in the West Bank is \$12 billion (\$3,600 per capita), and \$3 billion in the Gaza Strip (\$1,600 per capita; see [Chart 2](#)).

Palestinian economic potential can best be assessed by way of comparison with Jordan and Israel's Arab citizens. Many among the Jordanian and Israeli Arab population identify as Palestinian with similar social, religious, and cultural structures. Yet their economic circumstances diverge widely. The government of Jordan no longer tolerates anti-Israel terrorism emanating from its territory; therefore, they do not encounter Israeli security measures. Nonetheless, Jordanian GDP per capita is only \$4,200.

While the average Jordanian income is 16% higher than in the West Bank and more than double that in Gaza, Jordan is much more reliant on domestic production rather than foreign remittances and aid. Without foreign aid, incomes for Palestinians in the West Bank would be lower, at least initially. Jordanian governance is more effective than the Palestinian Authority, but Jordan also lacks a robust rule of law.

a. Arab Israeli Incomes are Significantly Higher

Economic life is on a vastly different trajectory for Israel's 1.7 million Arab citizens. Their standard of living is rising rapidly, even though their annual average household income of \$37,000 still lags Jewish households by 34%. Israeli Arabs have interacted with Israeli state institutions such as the police and the courts for several generations. As is the case for Palestinians and Jordanians, clan vendetta and honor-based violence are still significant problems in Israeli Arab communities, but the State of Israel is recognized as the legitimate law.

Unlike the Palestinians in the West Bank and Gaza, most Israeli Arabs work or engage in business rather than rely on external financial aid. Although discrimination is certainly a problem in Israeli society, Israeli Arab entrepreneurs and businesspeople nonetheless benefit from Israel's modern financial and legal institutions in their economic affairs. These advantages are reflected in their very high standard of living compared to Palestinians living in Jordan, the West Bank, or Gaza.

b. The Palestinian Authority Does Not Exercise a Monopoly Over Legitimate Police Powers

Until Mahmoud Abbas became President of the Palestinian Authority in 2005, the leading Palestinian political factions in the West Bank pursued military organization and terrorism against Israel rather than building institutions required for economic prosperity such as courts, banks, capital markets, factories, or corporations. Even today the Palestinian Authority does not exercise a monopoly over legitimate military, police, or judicial powers in the West Bank, and maintains an ambivalent relationship with armed terrorist groups attacking Israel. Probably the least understood aspect of Palestinian society by Westerners – particularly their most ardent supporters – is the tension between family-based clans, called “hamulas” in Arabic, and attempts by the Palestinian Authority to build state institutions.

Hamulas are extended family groupings organized for joint protection and economic well-being. Hamula clans can be assembled into armed militias. Armed clans operate according to principles of tribal vendetta justice. Most hamulas are reticent to surrender self-protection to the Palestinian Authority, which would leave them vulnerable if other clans do not follow suit. Lacking fundamental legal institutions required by a market economy, the significant aid flowing into the Palestinian Authority reinforces the hamula structure. Powerful hamulas

The tension between clan or tribal social organization and state institutions is... a pervasive phenomenon inhibiting economic development around the world... Unfortunately, terrorist groups seeking to expand or garner greater influence within Palestinian society can gain prestige by attacking Israel... For as long as these social and political dynamics persist, the Palestinians will be consigned to economic mediocrity.

compete politically to capture and redistribute cash and other privileges to their clan and its allies. For a more complete summary see Glenn E. Robinson “[Palestinian Tribes, Clans, and Notable Families: Strategic Insights.](#)”

Ideologically based factions that cross familial lines, such as Fatah, approach politics within the Palestinian Authority in much the same way. Rather than establishing independent institutions, governance is essentially the division of available resources by powerful, often militarized, groups. Despite gripes to the

contrary, this system hinders the establishment of functional Palestinian state-like institutions more than outside interference by Israel.

The tension between clan or tribal social organization and state institutions is not unique to Palestinian society. It is a pervasive phenomenon inhibiting economic development around the world. Private militias are also a pervasive problem in many countries. Unfortunately, terrorist groups seeking to expand or garner greater influence within Palestinian society can gain prestige by attacking Israel. Internal political competition can often threaten or delegitimize parties seeking greater accommodation with Israel. For as long as these social and political

dynamics persist, the Palestinians will be consigned to economic mediocrity.

c. How Did We Get Here? Palestinian Economic History

In June of 1967, the combined militaries of Egypt, Jordan and Syria mobilized against Israel. After six days of intense warfare, Israel once again repelled Arab enemies bent on its annihilation. Not only did Israel win the war, but it captured the West Bank from Jordan, the Gaza Strip and the Sinai Desert from Egypt and the Golan Heights from Syria. The Arab countries suffered a humiliating defeat and Israel retained strategically important territory that improved its defensive position.

The 600,000 Arabs in the West Bank and 350,000 in the Gaza Strip lived in a pre-industrial economy. The 1967 Census figures showed that 35% of the population were farmers or fishermen and another 25% worked as craftsmen, artisans, or construction laborers. Unemployment was quite high, particularly in Gaza (www.levyinstitute.org, [The 1967 Census](#)). While Jordan allowed the PLO (Palestine Liberation Organization) to launch terrorist raids from the West Bank prior to the war, it also incorporated many West Bank residents into the Jordanian economy (the West Bank accounted for half of the Kingdom's population at the time). Egypt, on the other hand, sponsored terrorist Fedayeen raids from the Gaza Strip and let Gaza residents languish in poverty.

Israel did not develop the Palestinian economy in the early years, hoping to trade most of the newly acquired territory for a lasting peace. The Arab League, however, adopted the Khartoum Resolution which articulated their three famous No's: 1) No peace with Israel. 2) No recognition of Israel; and 3) No negotiations with Israel. Egypt backed up its hostile intent by shelling Israeli positions in the Sinai Desert during the 1969-1970 War of Attrition and by launching a devastating joint surprise attack with Syria against Israel on Yom Kippur in 1973.

Following Israel's victory in the Yom Kippur War, Israel and Egypt finally signed a peace treaty in 1979. Egyptian President Anwar Sadat tried to bring the Palestinians to the negotiating table, but their leaders in the PLO refused. Jordan would not join the peace process unless the Palestinians also joined. As a result, Israel returned the Sinai Desert to the Egyptians, but the West Bank and Gaza Strip remained under Israeli control. The PLO preferred to perpetuate armed conflict rather than liberate Palestinian territory peacefully.

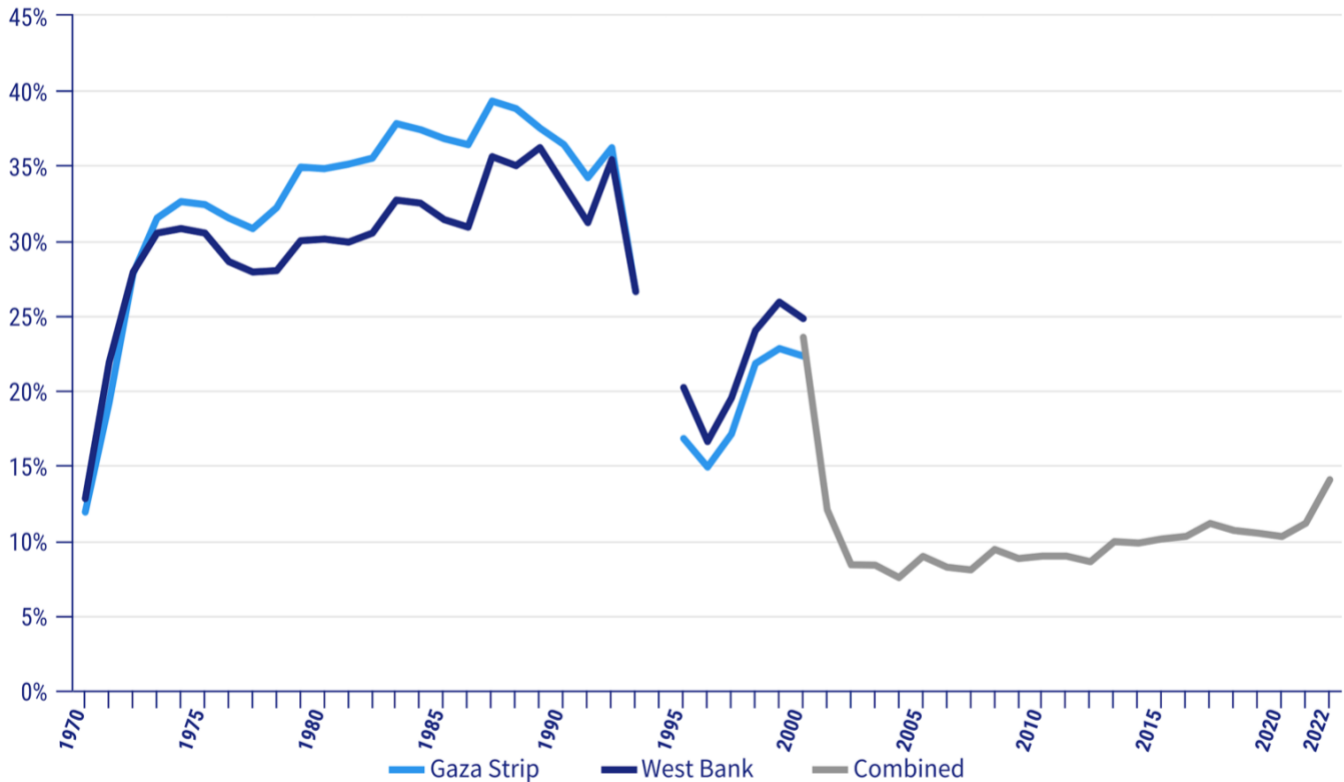
Israel pursued ad hoc economic policies toward the Palestinian territories. On the one hand, every Israeli government encouraged Jewish settlement in areas critical to Israel's security, and later in other areas important to the religious settler movement. Meanwhile, Israel never developed a coherent economic strategy for the Palestinian population other than allowing them to work inside Israel. Palestinian laborers worked in construction, restaurants, and other unskilled or moderately skilled jobs.

At peak, approximately 40% of the Palestinian labor force was employed in Israel (see [Chart 8](#) and [Arie Arnon, "Israeli Policy Toward the Palestinian Territories: The Economic Dimension](#)

1967-2007). Wage income from Israeli jobs transformed the West Bank and Gaza Strip into urbanized societies with smaller agricultural sectors and a growing range of service occupations. The standard of living rose, but Palestinian entrepreneurship was limited, and Jewish settlements developed most industrial enterprises inside the territories.

Chart 8

**Palestinian Workers in Israel
% of Total Workforce in West Bank and Gaza Strip
1970-2022**



Source: <https://www.palquest.org/en/highlight/33700/palestinian-labor-israel>

Israel neither encouraged nor discouraged a homegrown financial system or industrial base in the West Bank or Gaza Strip. Although there are several Palestinian banks (some of which were founded prior to 1967), they remain quite small leaving many people unbanked. To this day financial products like credit cards, mortgages, and insurance policies are utilized by very small fractions of the population.

Palestinian businesses tend to be small enterprises. World Bank data indicates that 99% of Palestinian business firms employ fewer than 20 people, and there are only a handful of larger corporations. Like other tribal societies around the world, hamulas facilitate financial relationships among trusted kin, but hinder large-scale anonymous financial institutions. The PLO, when based outside of the territories, devoted its resources to terrorism and did not advocate for alternative economic arrangements.

d. Oslo, Closures, and the Second Intifada

In 1993, Israel and the PLO reached a historic accord whereby the Palestinians were supposed to recognize Israel in exchange for autonomy within the newly established Palestinian Authority (PA). Israel ultimately withdrew from the major Palestinian population centers, and agreed to negotiate the final status of the territories within five years if security could be maintained. Instead, Israel suffered increased terrorism emanating from the territories, often from the jihadist groups Hamas and Palestinian Islamic Jihad. In response, Israel imposed numerous and sometimes extended “closures”, preventing Palestinians from reaching their jobs in Israel. Israeli employers increasingly replaced Palestinians with other foreign workers.

In July 2000, President Bill Clinton invited Yasser Arafat, President of the Palestinian Authority, and Ehud Barak, the Prime Minister of Israel to Camp David to hammer out a final peace agreement. Despite Israeli acceptance of a Palestinian state comprised of the West Bank and Gaza Strip, the Palestinians rejected the offer and demanded a “right of return” for millions of Palestinians to live inside Israel’s borders. This demand was tantamount to a denial of Israel’s right to exist as a state with a majority Jewish population, a principle Israel believed the Palestinians had accepted in the 1993 Oslo Accords. Yasser Arafat left the unsuccessful summit and unleashed a massive terror campaign known as the “Second Intifada.”

Over the next five years, more than 1,000 Israelis lost their lives in waves of Palestinian suicide bombings and other terrorist attacks. The Israeli response killed an estimated 3,000 Palestinians, but another casualty was the economic linkages between Israel and the PA. Most Palestinians working in Israel were replaced during this period (see [Chart 9](#)). Average income in the territories fell by 30% during the Intifada, while unemployment exceeded 30% in the West Bank and 40% in Gaza. The poverty rate in the West Bank rose from 13% prior to the Intifada to 40% and from 32% to 65% in the Gaza Strip (Arie Arnon).

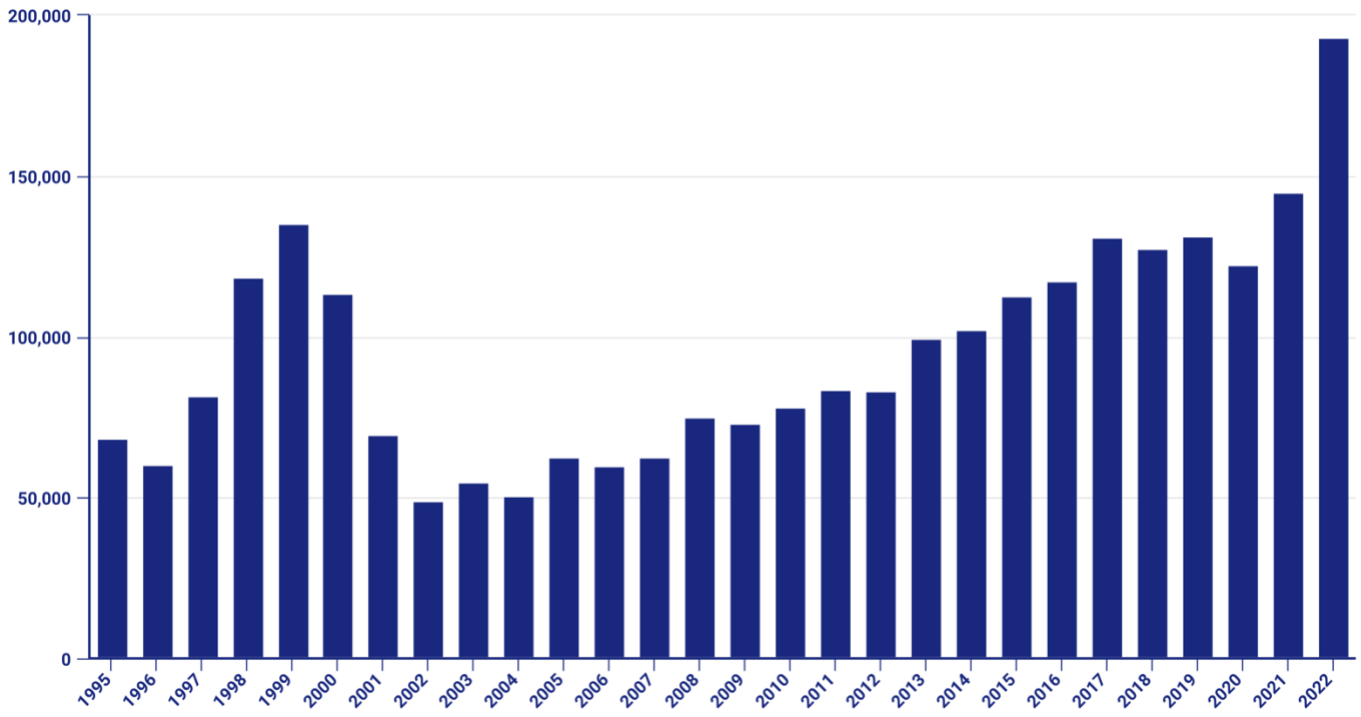


Source: Government Press Office (Israel) [CC BY-SA 3.0], via Wikimedia Commons

Israel accepted a Palestinian state comprised of the West Bank and Gaza Strip, the Palestinians rejected the offer and demanded a “right of return” for millions of Palestinians... tantamount to a denial of Israel’s right to exist as a state with a majority Jewish population, a principle Israel believed the Palestinians had accepted in the 1993 Oslo Accords.

Chart 9

**Number of Palestinian Workers in Israel
1995-2022**



Source: World Bank

e. Israeli Disengagement from Gaza

In 2005, Israel withdrew its forces from the Gaza Strip thereby handing governmental authority to the Palestinian Authority. Shortly thereafter, Hamas won a surprise majority in the 2006 elections to the Palestinian Legislative Council. A Palestinian civil war left Hamas in control of the Gaza Strip and the Palestinian Authority under Mahmoud Abbas in charge of the West Bank. Hamas rejected and continues to reject Israel's right to exist and consolidated its Gaza regime into a base for its terrorist operations. In response, Israel imposed a blockade on the Gaza Strip starting in 2007. Israel, in partnership with Egypt, prevented the importation of weapons or militarily useful materials (although Hamas became adept at smuggling operations through underground tunnels).

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Despite these hardships, the Hamas regime continued to prioritize terrorist activities against Israel over economic development in Gaza. In the 17 years since Hamas assumed control over the Gaza Strip, inflation adjusted Palestinian incomes declined significantly and the economic damage from this war will be very severe for residents of Gaza.

f. The West Bank: A Different (Sort of) Direction

Palestinians in the West Bank and the Gaza Strip have embarked upon two divergent paths regarding governance and economic policy. Hamas pursues a policy of direct violent confrontation with Israel ensuring continued poverty and periodic destruction of Palestinian lives and property. Meanwhile, the Palestinian leadership in the West Bank attempts to keep violence and terrorism on a lower boil, despite indirectly tolerating armed terrorist groups and offering support payments for families of “martyrs” killed attacking Israelis.

g. Gaza After the War

The Zionists organized their foundational political, economic, and legal institutions during the British Mandate before 1948. The Palestinians have always had the opportunity to similarly establish authoritative governing institutions, despite Israeli security controls. Israeli security controls certainly increase transaction costs and hinder some economic activities, but an end to Palestinian terrorism would eliminate most of these barriers. Once eliminated, however, the Palestinians would still encounter many of the same problems constraining economic development in Jordan.

While Israelis and Palestinians may never agree on basic principles, peaceful relations must begin with the Palestinian society at peace with itself. Most Israelis perceive a Palestinian society with functional institutions and acceptable governance to be in their interest. Palestinians do not need an agreement with Israel or an end to the Israeli security controls to build a state-like government. Similarly, Israel’s ability to facilitate these institutions is also limited, but perhaps broader cooperation with Israel’s new partners in the Arab world could facilitate more rapid improvement. As previous waves of terrorism and the current war validates, violence against Israel will only consign the Palestinians to poverty and separation from the Israeli economic engine.

h. Palestinian Prosperity is Important for Israel’s Defense

Prosperous Palestinians are very much in Israel’s strategic interest. The prosperity, however, must be generated by Palestinian entrepreneurs. Wage income from jobs in Israel is not necessarily an indicator of “dependency” if paired with a more robust business sector in the West Bank and Gaza, but excessive financial aid breeds economic and social dysfunction. Political and economic problems within Palestinian society cannot be cured immediately, perhaps not even within a single generation, but creating a much larger Palestinian

entrepreneurial class would go a long way toward laying the foundation of a more peaceful and prosperous Palestinian society. We believe this type of thinking should at least be a component of Israel's post-Hamas planning.

VII. CONCLUSION

War has come, but Israel is strong and resilient. Islamic jihadists such as Hamas, Hezbollah, and Iran want to make life dangerous for Israelis, destabilize the Israeli economy, and force millions of Jews to leave the country. Israeli prosperity is in and of itself a victory over its enemies. Israel is a rich country whose GDP per capita exceeds France, Italy, and Japan. Despite a potential war-related recession, Israel's growth engines remain intact: technological innovation, rapid population growth, increased labor force participation, and improved productivity.

With 20/20 hindsight we now know Israel underinvested in defense. The good news is that Israel can afford to pay for this expensive conflict as well as permanently enlarged defense budgets. Israeli households are amassing wealth at a rapid clip due to their high savings rate, and the government debt burden is modest. Low debt, high savings, and strong growth provide Israel significant financial firepower to fight and win this war.

War Has Come, but Israel is Strong and Resilient



Israel has significant financial firepower

Israel's economic growth is strong

Israel's savings are high

Israel's debt is low

Israel can afford to fight the war and increase defense spending over the long run

Israel has significant financial firepower to fight and win this war.

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