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: Taub Center warns: Economy at a crossroads

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• By ANNA AHRONHEIM

The economy is entering 2026 at a "highly sensitive point," according to the Taub Center's "State of the Nation Report 2025," which analyzed the macroeconomic fallout of two years of war alongside long-standing structural weaknesses.

Released on Monday, the report warned that sharply rising defense expenditures combined with already elevated debt levels could come at the expense of essential civilian services. This could also harm public investment unless the country returns to a path of rapid economic growth, it said.

The authors of the report, Prof. Benjamin Bental and Dr. Labib Shami, highlighted that while the easing of regional tensions offers an opportunity for recovery, Israel faces a delicate balancing act of sustaining heightened security needs without undermining long-term economic capacity.

Taub Center president Prof. Avi Weiss, who edited the report, said that it highlighted the "substantial socioeconomic challenges" Israel faces after two years of conflict and underscored the need for evidence-based policymaking.

According to the report, "the increase in defense spending and debt accentuates the dependence of civilian spending on the economy's growth rate."

The government expanded the 2023 budget by NIS 23 billion (approximately 1% of GDP) and the 2024 budget by an additional NIS 107b. (more than 5% of GDP) to finance the war in Gaza. In 2025, the Knesset approved a defense budget of NIS 136b., which was later increased by NIS 31b. following the conflict with Iran.

As a result, the country's deficit ceiling rose to 5.2% of GDP, although substantial tax revenues are expected to reduce the actual 2025 deficit to approximately 4.5%. The debt-to-GDP ratio has increased by 10 percentage points since 2024 and is projected to stabilize at 70%-71%, assuming no renewed fighting. The increased debt burden alone adds roughly NIS 8b. in annual interest costs.

Without accelerated economic growth, rising defense needs may crowd out civilian spending, creating a "vicious cycle" of slower growth and reduced fiscal capacity, the report said.

A MAN carries bread at Jerusalem's Mahane Yehuda market earlier this week.
(Marc Israel Sellem/The Jerusalem Post)

Despite the turmoil, unemployment has remained low at around 3% since 2022. However, productivity gaps between Israel and comparable European economies remain substantial.

Between 2015 and 2023, Israel narrowed the value-added per-worker gap from 20% to 12%, with notable improvements in services and information and communication technology, in which the productivity gap closed entirely by 2020. Yet productivity "per hour worked" remains 30% below that of peer countries, largely because Israelis work about 25% more hours per year.

Capital per worker in Israel is roughly half that of comparable European economies. According to the report, raising capital intensity to European levels would eliminate the GDP-per-worker gap and close about half the GDP-per-hour-worked gap.

Further, Israel's consumer prices were 13% higher than those in comparable European countries in 2023. Healthcare costs were 40% higher, and housing, Israel's largest household expenditure, was 20% more expensive. Communications services were the only major category that was cheaper, by about 22%, whereas costs related to recreation and culture, as well as clothing, were similar to those in comparable countries.

Some factors, such as low competition in services, high operating costs, import barriers, and "limited economies of scale," keep Israel's price levels elevated. Exchange rate fluctuations have also played a major role: After years of shekel appreciation, Israel became more than 40% more expensive than the Eurozone at its peak. By 2023, the gap had narrowed to approximately 30%, and the gap with the US had closed.

The hi-tech sector continues to anchor Israel's economy, accounting for 20% of GDP, 60% of exports, and 40% of economic growth since 2018. Hi-tech wages are nearly triple those in the rest of the economy.

Exports of hi-tech services surged from $15b. in 2013 to $55b. in 2024, raising their share of total exports from 21% to 44%.

Bental said that Israel can meet its long-term security challenges without sacrificing civilian services if growth rebounds.

"Defense expenditures, which have risen dramatically due to war, will remain high and impose a heavy economic burden on the economy," he said.

Nevertheless, there is room for optimism. "If the best scenario materializes, the economy will be able to meet the security challenge without harming the civilian services provided by the government," Bental noted.

"But to ensure growth, the government must pursue growth-supportive policies, and in particular, it has to invest in developing the country's physical infrastructure and in human capital in Arab and haredi (ultra-Orthodox) society in order to raise productivity in the economy," he said.