

# The Miracle of „Silicon Wadi“: How Specific is the Israeli Economic Model?<sup>1</sup>

■ RADU CRISTIAN MUȘETESCU

[Academy of Economic Studies, Bucharest]

## Abstract

*The paper argues that the economic performance of the Israeli economy makes this country a case study with tremendous academic and public policy relevance. Israel could be seen as a classic model of the implementation of the Western receipt for the rule of law, respect for private property and, since the 70s, promotion of the free trade with the rest of the world and support for domestic markets.*

Senor and Singer argued that „if there is one story that has been largely missed despite extensive media coverage of Israel, it is that key economic metrics demonstrate that Israel represents the greatest concentration of innovation and entrepreneurship in the world today”<sup>2</sup>. Some accounts place Israel in front of the most acclaimed technological and financial cluster of the Californian Silicon Valley in the United States of America. According to OECD, „the Israeli economy is enjoying its 13th consecutive year of growth, demonstrating remarkable resilience. Increases in output, averaging nearly 4% annually since 2003, have exceeded those of most other OECD countries”<sup>3</sup>.

When public opinion as well as academia take into consideration the case of Israel, the political conflict with the Palestinians as well the implications for regional and international relations

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2 Dan Senor, Saul Singer, *Start-Up Nation. The Story of Israel's Economic Miracle* (New York: Twelve, 2009)

3 OECD Economic Surveys, Israel (January 2016), <https://www.oecd.org/eco/surveys/Israel-Overview-OECD-Economic-Survey-2016.pdf>

## Keywords

Israeli; economic freedom; private property; investments

are the top issues. However, there is apparently a background story that is maybe more important, from an academic but also public policy perspective, and that is the impressive economic performance of the Israeli economy. Its technology leadership in the world but also financial innovativeness are massively underrated.

### **Why Israel is not a case study?**

There may be several considerations in explaining why the analysis of the Israel economy is somehow neglected in the academic literature dealing with development. It most probably has to do with a culture of political correctness in the Western academia that deliberately avoid praising Israel as a model of economy and society.

The independence of Israel is a result of an anti-colonial struggle as much as in other parts of the world. But the implant of a „*Western*“ receipt, which fundamentally generated the economic success in the Jewish state, cannot be easily accepted as a receipt for post-colonial development in much of the rest of the world. This is, however, a not so easy to swallow receipt for the elites in the post-colonial states in Asia and Africa, where the liberation from the imperial metropolis has been unfortunately put in the same package with an anti-capitalist agenda. The instinctive moves of these elites have been to control as much as possible their economies and societies, usually to extract personal rents and to eliminate opposition.

It can be argued that Israel could be seen as a classic model of the implementation of the Western receipt for the rule of law, respect for private property and, since the 70s, promotion of the free trade with the rest of the world and support for domestic markets. They are just elements of what could be termed the economic system in Israel. From a political perspective, Israel is a mature and blossoming democracy and this is, again, in sharp contrast with the neighboring region.

The abrupt difference between Israel and the majority of the Arab economies surrounding it may suggest a difference in quality of governance. Ignorance by academia, to say the least, of such a reality may be the result of the outright boycott. The „*Boycott, Divest and Sanctions*“ movement has a significant academic component met in the Western-European and American universities, not to speak about the universities in the less-democratic countries.

Such reasons, if true, are morally wrong and unacceptable from an academic perspective. Facts and figures tell the entire world a story that should not be missed in any country that aspires to become a prosperous, sound and resilient economy and society. The challenge is to explore whether the economic success of this country is specific or can be transferred to other countries. A highly specific experience means that the ability to transfer it somewhere else is minimal while non-specificity would suggest a currency model, possibly to be adopted by other countries attracted by the same results.

### **Facts and figures that speak for themselves:**

With a population of less than 9 million inhabitants, Israel Gross Domestic Product topped 300 billion USD in 2015. This is very close to the size of the economy of the Arab Republic of Egypt of 330 billion USD but with a population of almost 100 million.

Starting from 2010, Israel is a member of the Organization for Economic Cooperation and Development, the club of 35 developed countries with a mature and stable economic governance. The only countries outside the historical North

are, besides Israel, Chile, Korea, Mexico and Turkey. In fact, Israel already graduated in the league of high income countries in 1986.

The usual suspect argument met in popular opinion or in academia is that such performance is related to the massive foreign aid provided by the United States of America and, at one point in the past, by Germany. Not digging too much into the argument about the merits of foreign aid, similar cases of important financial transfers have not generated even close results. This is the case of countries like Egypt, not to speak of the cases like Afghanistan or Iraq. The US foreign assistance to Israel goes primarily to the military sector and usually this would have meant that such a financial transfer should have crowded out the private sector.

According to Dr. Adam Reuter, CEO of Financial Immunities Consulting and the Chairman of Reuter-Maydan Investment House, „*Israel is the world's top exporter of drones; the world's co-leader (along with the US) in the development, manufacturing and launching of small and medium size satellites; the sixth largest exporter of military systems; the 2nd largest cyber exporter*“<sup>4</sup>.

Since 1972 with the listing of Elscint, over 160 Israeli ventures have been listed on NASDAQ, more than any other country outside of the U.S. according to Dan Isenberg ([www.economist.com](http://www.economist.com)). In fact, there are six more Israeli companies on the NASDAQ than from all of Europe combined. According to the research firm IVC, more than 770 Israeli ventures were acquired in just 10 years (2003 – 2012) for more than 40 billion USD by mainly American companies. This is a massive figure for a state with a population the size of Virginia or New Jersey in the United States or Honduras in Latin America. Israel, a country from the Middle East, is truly in the same category of peers like Switzerland or Austria.

There is approximately one start-up for every 1, 800 Israelis and such a density of new ventures suggest a manifest freedom to incorporate and to implement new ideas and ventures. Israel does not reward the initiation of a business per se (such as European aid schemes sometimes do) and does not reward particular tax or other incentives for individuals to start-up a new venture. Such a policy framework would suggest that the density is, in fact, even more pronounced than in other countries such as the European ones.

According to the website [www.startupranking.com](http://www.startupranking.com), Israel is surpassed only by USA (one start-up per 14, 500 inhabitants) and Switzerland (one start-up per 36.600 inhabitants) according to the number of start-ups per population<sup>5</sup> at its level of 40.500 inhabitants per start-ups. In Turkey, the figure is one start-up per around 390.000 inhabitants, in Egypt is for more than 237.000 inhabitants while in Romania is around 156.000 inhabitants.

## Opinions about present-day Israel business environment

Dan Senor and Saul Singer, in their acclaimed book „*Start-Up Nation. The Story of Israel Economic Miracle*“, cites several business-persons in what regards their qualitative assessment of the Israeli business environment<sup>6</sup>. For example, Google CEO, Eric Schimdt, considered that „*USA is the number one place in the world for entrepreneurs but after the US, Israel is the best*“. Microsoft former

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4 Hillel Fendel, „Through War and Peace, Israel's Economy Continues to Soar“ (August 31st, 2014), <http://www.israelnationalnews.com/News/News.aspx/184595>

5 The website is a platform for advertisement of start-ups. Registration is voluntary and paid for. While this is not an attempt to statistically measure the phenomenon, it is however an image of how active this sector is.

6 Senor, Singer, *Start-Up Nation*

CEO, Steve Ballmer affirmed that „*Microsoft is an Israeli company as much as an American company*“.

Paul Smith, senior vice-president of Philips Medical, had the opinion that „*in two days in Israel, I saw more opportunities than in a year in the rest of the world*“ while Gary Shainberg, VP for technology and innovation at British Telecom, „*there are more new innovative ideas, as opposed to recycled ideas – or old ideas repackaged in a new box – coming out of Israel than there are out of Silicon Valley now*“.

In the „*Ease of Doing Business*“ Report, published by the World Bank in 2017, Israel ranks 52<sup>nd</sup>, after countries like United Arab Emirate (rank 26<sup>th</sup>) but in front of Bahrain (rank 63<sup>rd</sup>), Oman (66<sup>th</sup>), Morocco (68<sup>th</sup>), Turkey (rank 69<sup>th</sup>), Qatar (rank 83<sup>rd</sup>), Saudi Arabia (rank 94<sup>th</sup>) or Egypt (rank 122<sup>nd</sup>). Israel has an impressive performance in what regards strength of legal rights (rank 4<sup>th</sup> in the world), protecting the rights minority investors (rank 9<sup>th</sup> in the world) with an outstanding position in extent of ownership and control (rank 4<sup>th</sup> in the world). The worst quality in the dimension of the business environment deals with taxation (rank 96<sup>th</sup> in the world), registering property (rank 126<sup>th</sup>), dealing with construction permits and getting electricity (ranks 71<sup>st</sup> in the world). Moreover, a certain inefficiency in the law enforcement (time to enforce contracts in the justice system) makes a negative impact on the enforcing contracts dimension (rank 89<sup>th</sup>).

A certain duality of the Israeli economic system can be perceived as the new and innovative economy operates together with a more traditional and industrial one where local business groups are accused of attempting to capture rents through the policy and institutional framework<sup>7</sup>.

### **Israeli economy in the international rankings**

Israel is a small country with an area of 20, 770 square kilometers. From an economic perspective, it is almost cut from all their neighbors and its only relevant business connection is through air and sea. In a certain sense, Israel was condemned not to become a regional hub for manufacturing or logistics and to focus on research and development or high net value goods (like, for example, diamonds).

According to Global Innovation Index 2017 Report published by INSEAD and Cornell University, Israel is in the top 20 most innovative economies in the world (rank 17<sup>th</sup>) and it is the fifth non-Western world, after Singapore, Korea, Japan and Hong Kong. The closest economies in the Middle East in the ranking is the United Arab Emirates, on the 35<sup>th</sup> place, and Qatar, on the 49<sup>th</sup>. Israel is the only economy in the region which goes in top 10 according to certain pillars of the index (business sophistication and knowledge and technology output). On the other hand, Romania ranks 42<sup>nd</sup> place (practically the last position in Eastern Europe).

According to the Global Competitiveness Report on 2016-2017, published by the World Economic Forum, Israel ranks 24<sup>th</sup>, after United Arab Emirates (16<sup>th</sup>) and Qatar (18<sup>th</sup>). Saudi Arabia (29<sup>th</sup>) and Kuwait (38<sup>th</sup>) come closer even if we may perceive that the energy wealth of these Arab states has played a key role in their rankings as it has allowed them to sponsor the quality of their business environment. Israel is the first in the Global Competitiveness ranking among the oil-importing countries, far away from the next ones (Jordan on 63<sup>rd</sup> and Morocco on 70<sup>th</sup>). We can only imagine how recent gas discoveries in the Israeli waters (Leviathan and Tamar gas fields) may impact at their turn the position of Israel in the close future. Romania ranks 62<sup>nd</sup>, after Vietnam and Colombia and before Jordan and Botswana.

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<sup>7</sup> Jonathan Nitzan, Shimshon Bichler, *The Global Political Economy of Israel* (London: Pluto Press, 2002)

Maybe the most important aspect of the Global Competitiveness Report is that World Economic Forum places Israel in the 2<sup>nd</sup> place in the pillar of innovation, the first place being held by Switzerland.

According to the Index of Economic Freedom published by the American Heritage Foundation, Romania and Israel had in 2017 the same score (69.7) and are closely positioned (Israel on 36, Romania on 39). However, there are significant differences among the components of the score. Israel is outperforming at protection of Property Rights, Judicial Effectiveness and Financial Freedom while Romania at Tax Burden, Government Spending and Fiscal Health. Take it simply, war imposes on Israel a public budget burden that down-ranks it to the level of Romania, a country with no security issues at the present. Without such a burden, Israel would have most probably been in the top 10 countries in the world according to economic freedom.

### Capital and development

While education and culture are perceived by some observers as definitional for the success of Israeli innovation economy, it must be stressed that another component is also critical in this respect. Access to capital in a pro-market, competitive way, is critical for transforming ideas innovation into technology, technology into capital goods and capital goods into consumer goods. As opposed to the European economies where the vast majority of the capital invested into research and development is usually allocated through state channels, in Israel, like in the United States of America, a true culture of investing into innovation and betting fortunes on technologies that make the final consumer better (and the companies profitable) is paramount.

An almost neglected factor in the same Global Competitiveness Report on 2016-2017 is that venture capital availability in Israel is second to only Qatar in the world, while USA is on the 4<sup>th</sup> place. In fact, the take-over of Israeli start-ups by American companies or their listing on NASDAQ is a natural consequence of the massive involvement of the U.S. venture capital funds into the technology sector in Israel.

Israel is a powerhouse in the case of Venture Capital. According to the Ernst & Young, there have been 13.1 billion USD invested as venture capital in Israel during the 2006 – 2013 period, well after USA (254.6 billion), European Union (55.4 billion) and China (33.05 billion) but well above other countries. This is a 2% share of the world invested venture capital. According to Heritage Foundation, *„Israel has the world’s highest concentration of high-technology start-ups per capita”*<sup>8</sup>.

Israel adopted at one moment an approach in commercial policy which stressed involvement in free trade agreements. It started with the European Economic Communities (1964 and 1975) and culminated with the 1985 Free Trade Agreement with the United States of America. According to Sauer (2012), *„since 1985, several sectors of the economy have been successfully liberalized, helping Israel to become a world leader”*<sup>9</sup>.

So the core economic argument in the case of economic performance of Israel consists in its core focus on the protection of private property and the promotion of free exchange relatively soon, well before the globalization decade of the 90s.

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8 Institute for Economic Freedom, Heritage Foundation, „Index of Economic Freedom 2017”, <http://www.heritage.org/index/country/israel>

9 Bycorinne Sauer, „Israel’s Economic Miracle: Where do we go now?”, Jerusalem Post, April 25, 2012, <http://www.jpost.com/Features/In-Thespotlight/Israels-economic-miracle-Where-do-we-go-now>

## Other explanations advanced in order to explain the Israeli economic performance

We may advance the paradox that a state which has a massive defense budget but still retains the market economy approach has to divest from redistribution programs in order to avoid suffocating the economy. Such a constraints may limit the welfare programs that so much distorts the economy. Israel does not impress by allocation of public resources towards education or research among the OECD countries.

The constant and massive security challenge for the state of Israel made the society the pioneer in employing military and defense technology, which at its turn, generated an abrupt learning curve that supplied knowledge that could be patented. The French weapons embargo of 1967 pressed Israel even more towards the United State of America and the openness of the American economic system.

### Israel as a frontier society

Israel has proven that it is a resilient society as it succeeded in insuring economic performance even in times of war and internal security challenges<sup>10</sup>. From this respect, it is a glimpse of the future society all over the world. Maybe one of the most relevant concepts that could be advanced is the one of the „*frontier society*“ (a term long ago used in the case of USA, for which Israel is some kind of Wild East). Such a term implies a bad publicity in popular but also academic press but which, according to some accounts, generated the culture of contemporary America. Individualism, respect for property rights, resilience towards violence, self-reliance but also exploration, entrepreneurship are among the traits promoted by such a society<sup>11</sup>.

In fact, numerous accounts point to the cultural dimension of the Israeli society as being defining for its economic performance and ability to innovate. The so-called „*chutzpah*“ attitude has been encouraged by „*a healthy cynicism for authority is encouraged*“<sup>12</sup>. It is argued that a culture that challenges authority and does not accept failure is critical to innovation.

### Conclusions

Israel is a case study with tremendous academic and public policy relevance. The core argument of this paper is that the Israeli economic system combines an unique set of private property protection, freedom in the participation of the global economy and a tremendous access to the capital available for investments in new ventures. The receipt for such a success is not unique and may be replicated anywhere where observance of individual and collective property rights are welcome.

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10 Fendel, *Through War and Peace*

11 Dan Illouz, „Zionism and Capitalism: The Quest for Freedom“ (November 31st, 2013), <http://www.jpost.com/Opinion/Columnists/Zionism-and-capitalism-The-quest-for-freedom-332545>

12 Omar Tellez, „Chutzpah Lessons from the Israeli Startup Scene“ (2015) <https://techcrunch.com/2015/03/22/chutzpah-lessons-from-the-israeli-startup-scene/>

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