

Executive Summary

The defense industries in Israel are essential in a number of respects. For one thing, Israel cannot always rely exclusively on external procurement sources. Domestic production is thus an integral part of research and development. It makes it possible to adapt unique weapons systems to the changing needs of the Israel Defense Forces (IDF) – systems that provide a critical edge to the IDF on the battlefield. Independent production capability is particularly important during a conflict in which the supply chain is affected, or when there are political restrictions on the use of certain types of arms. In the economic sphere, although the defense industry does not account for an especially large slice of Israel's GDP, it is one of the country's high-tech engines and a source of quality work for thousands of employees. In the political sphere, its ability to supply advanced military solutions to other countries contributes to those countries' support for Israel.

In the summer of 2018, a research team on the subject of Israel's defense industries was assembled at the Institute for National Security Studies (INSS) to focus on ways of dealing with a major change in the most recent US aid agreement: the end of the conversion of dollar aid into shekels.¹ In the discussions conducted by the team, a number of negative effects of this change on the defense industries in Israel were highlighted. The first is a drop in the revenue of companies resulting from the expected reduction in local IDF procurement. Less IDF procurement is also likely to have a negative impact on arms exports, both because the viability of production rests on economies of scale and because part of Israel's defense exports depends on the IDF's reputation and experience. Some companies in the domestic supply chain may face the risk of closure. Furthermore, some local technological knowhow may well be lost when companies close down or relocate overseas with their employees. Employment will also be negatively affected – anywhere between several thousand and 20,000 of the 80,000

jobs in the defense industries in Israel will be lost. The Ministry of Defense believes that the higher number is more accurate, while the Ministry of Finance holds that the lower number is a better reflection of the situation and also believes that most of those who lose their jobs in this field will quickly find work elsewhere. Another consequence of the change is a negative effect on employment in communities that depend on factories selling to the Ministry of Defense. In addition to all these factors, it should be acknowledged that it is easy to dismantle defense industries, but far more difficult to rebuild them if and when they are needed.

Principal Policy Recommendations

The Israeli government must prepare now for the drastic change in the conversion of aid dollars into shekels scheduled for 2025. This should include the following simultaneous efforts:

1. Prioritizing the allocation of local funding for the survival and development of special defense industries, maintaining strategically important R&D, and retaining key personnel in the field. The defense industries should be mapped and criteria set for this purpose;
2. Granting aid to local companies in order to increase exports;
3. Consideration of mergers in the industry, mainly of small companies into large ones, in order to achieve economies of scale;
4. Efficiently using aid in foreign currency that also takes the defense industries into account. Examples range from the inclusion of Israeli companies in procurement orders from American companies to closer cooperation with American companies, and moving some production and subsidiaries of Israeli companies to the United States.
5. Encouraging reciprocal procurement by American companies (although the aid agreement does not require any reciprocal procurement by these companies);
6. Extending aid for the conversion of companies, units in companies, and personnel from defense production to civilian production; and
7. Offering advice and assistance, especially for small companies in the defense industry.

In addition to the recommendations specifically referring to the state of the defense industry in Israel, the team contends that the aid agreement

constitutes a key element in the special relationship between Israel and the United States. Future changes in the agreement must therefore be gradual and include the consent of both parties to avoid giving the mistaken impression of substantial damage to this relationship. The team emphasizes that the special relationship between the two countries must be preserved, even at the cost of short-term damage to the Israeli defense industry, because in the long run, adopting the recommendations listed above is likely to prevent long-term damage. The special relationship and the American aid, which began during the Yom Kippur War, were very important when the Israeli economy was not strong, and are still important now, when Israel is one of the world's most developed countries.

Note

- 1 The US aid agreement pertaining to Israel's defense industries, signed anew in 2016, includes a clause that gradually ends Israel's option of annually converting 25 percent of the aid from dollars to shekels, which was hitherto used for the procurement of equipment from Israeli defense companies.