Postwar Economic Strategy

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Celebrating 15 Years of Israeli Membership in the OECD

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In the name of Aaron Dovrat z"l

Aaron Institute's Macroeconomic Strategy

Vision: Support sustainable economic growth and social resilience, along with poverty reduction

The strategy is based on **comparing** Israel to leading countries - "**Benchmark Countries**" – with higher GDP per capita and lower poverty rates

Benchmark countries:	Sweden Netherlands Finland Denmark Austria	Israel
GDP per Capita*	$63.9K	$45.8K
Poverty rate**	7.6%	16.9%

Identify measurable targets to increase GDP per capita and reduce poverty

* 2023 OECD data, 2020 prices, adjusted for purchasing power parity (PPP)
** Poverty rate after taxes and transfers, 2021, Denmark 2020

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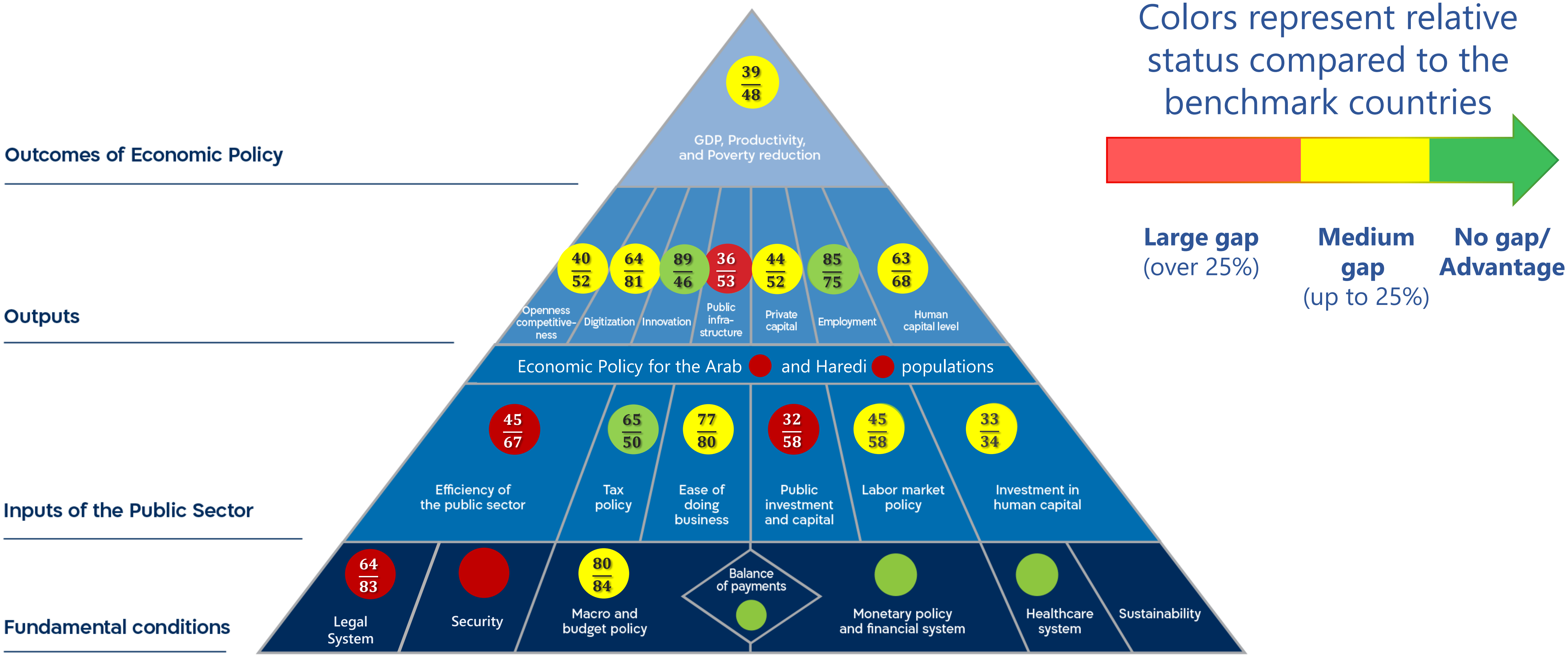
Pyramid for Identifying Barriers to Growth and Poverty Reduction



* The values represent the ratio of the distance to the frontier between Israel and benchmark countries in international indicators.

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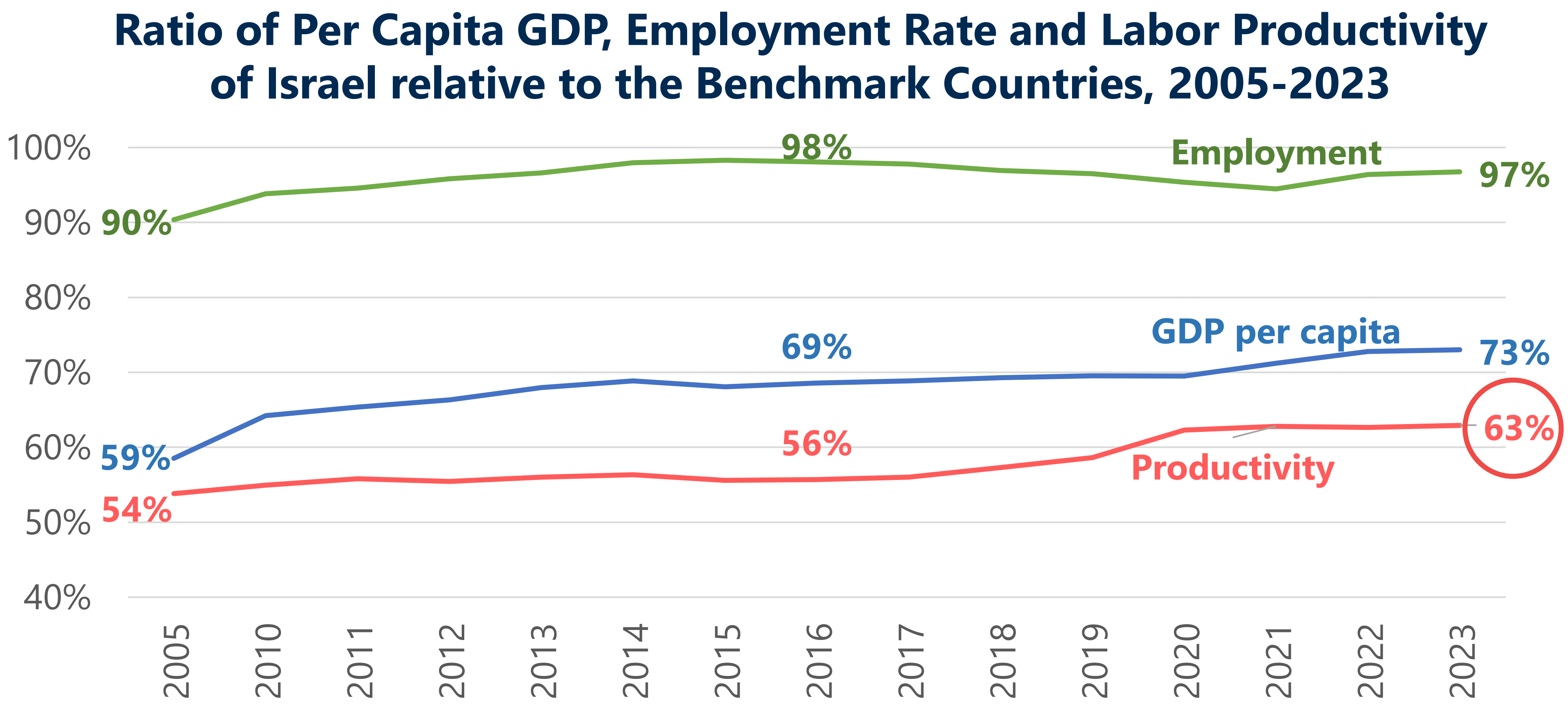
Israel's Per Capita GDP Is 27% Lower Than That of the Benchmark Countries (at 2020 PPP prices)

The cost of living accounts for ~14% of the PC GDP gap



Most of the gap stems from the difference in output per hour (productivity)

Source: Aaron Institute analysis to OECD data. 2020 prices PPP.

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Decomposition of the Productivity Gap Between Israel and Benchmark Countries

Human capital**		Private capital per hour		Public ICT capital per capita		Public capital per capita		TFP		GDP per hour gap
6.4$	+	5.4$	+	0.3$	+	7.5$	+	4.6$	=	24.2$
27%	+	**22%**	+	**1%**	+	**31%**	+	**19%**	=	100%
88%		54%		81%		34%				Stock - % of benchmark countries

Growth barriers stem from a deficiency in public capital, private capital, and human capital

Source: Aaron Institute analysis based on OECD and IMF data. Average gap 2017-2021

* Hall, Robert E. and Charles I. Jones. "Why do Some Countries Produce So Much More Output per Worker than Others?" The Quarterly Journal of Economics 114, no. 1 (February 1999): 83–116. https://academic.oup.com/qje/ article/114/1/83/1921741

** Based on the OECD PIAAC survey.

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Economic Resilience in Addressing the Security Challenge*

Projections for 2025 and 2026-2035

* Increase in defense expenditures of 1% of GDP for 2026-2035

2025 War Scenario and Its Impact on the Economy
A Starting Point for 2026-2035 Policy*

- **Reference Scenario – Ongoing conflict**
- **North: Agreement with Lebanon**
  - **Near-normal economic activity resumes by the end of 2025**
  - **IDF presence and ongoing tensions in southern Lebanon**
- **Gaza: War with Low and High intensity**
  - **Military control** at least until the end of 2025
- **Judea and Samaria: Escalation of the security situation**
- **Iran: Ongoing uncertainty**

* The scenario was developed in consultation with security experts: Gabi Ashkenazi, Amos Yadlin, Giora Eiland, and Amos Gilad.

Aaron Institute's Macro Model: Supply Based

- **Output is equal to employment times labor productivity**
- **Economy is divided into 3 sectors:**

High-tech sector | Business sector – excluding high-tech **| Public sector**

  - **Estimated labor productivity (GDP per worker)** by sector based on present and past data

- **Additional assumptions**
  - Unit elasticity of state tax revenues with respect to GDP
  - Civilian government expenditures – following the budget numerator
  - Government defense expenditures – based on the Aaron Institute's forecast/data

The model's forecast deviates downwards from national accounting, as in CBS data public sector productivity increases with higher defense spending (war expenses)

Reference Scenario: Employment Projections

Estimation of reserve duty and temporary absentees from the workplace* (thousands): Low and High Scenarios

	Actual data		Projection			
	Q4 2023	Q4 2024	Q1 2025	Q2 2025	Q3 2025	Q4 2025
Reservists	220	90	70	60-100	50-100	50-70
Temporarily absent from work**	310	40	30	30-50	20-50	20-30

* Based on the Labor Force Survey data from the CBS and estimates for the population exposed to conflict in the North.

** Excluding temporarily absent workers due to reserve duty.

The macroeconomic forecast was built based on the data in the table, according to sectoral division and labor productivity in the sectors.

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Economic Outcomes for 2024 and Aaron Institute's Forecast for 2025

Based on the reference scenario (3/2025)

2025 Budget

No growth-enhancing reforms

Budgetary adjustments of 1.5%-2% of GDP

	[1]2024	2025	
		Reference	Severe
Employment growth	1.1%	1.8%]2[	[2]1.0%
Productivity growth	-0.2%	1.0%	0.0%
Marginal interest rate[3]	4.75%	4.5%	5.0%
GDP growth	**0.9%**	[4]**2.8%**	[4]**1.0%**
Defense expenditures to GDP ratio	8.6%	[5]6.9%	[5]8.0%
Civilian expenditures to GDP ratio	34.7%	33.7%	33.7%
Deficit to GDP ratio[5]	9.4%	[6]5.2%	[6]6.6%
Debt to GDP ratio	**67.8%**	**68.8%**	**71.4%**

[1] Sources: Employment: CBS, Labor Force Survey Monthly, January 2024; Productivity, Output, Deficit: CBS, National Accounts Presentation 2024; Debt-to-GDP Ratio: Accountant General, first estimate of the debt-to-GDP ratio for 2024. [2] Based on temporarily absent workers. [3] The interest that the Israeli government must pay on new debt and the rollover of some existing debt annually. [4] Based on a macroeconomic model of employment and productivity. [5] Based on data from the Ministry of Finance and adjustments to the Aaron Institute model. [6] Based on the 2025 budget.

2026-2035: 1% of GDP Increase in Defense Budget
Requires 2% of GDP decrease in non-defense expenditures and 3.5% growth to guarantee Debt-to-GDP Convergence

2035 forecast, based on economic policy scenarios, budgetary adjustments, and war scenarios

Economic Policy 2026-2035		Reference scenario		Severe scenario	
	budgetary adjustments 2026 onwards	1%	2%	1%	2%
Growth-enhancing	GDP Growth (annual average)	**3.5%**	**3.5%**	**3.5%**	**3.5%**
	Deficit in 2035 (out of GDP)	3.5%	2.2%	4.3%	2.9%
	Debt-to-GDP Ratio in 2035	**70.3% Stabilizes**	**60.0% Converges**	**77.3% Diverges**	**66.6% Converges**
Non-growth-enhancing	GDP Growth (annual average)	**2.5%**	**2.5%**	**2.5%**	**2.5%**
	Deficit in 2035 (out of GDP)	3.6%	2.2%	4.4%	3.0%
	Debt-to-GDP Ratio in 2035	**75.6% Diverges**	**64.8% Converges**	**83.1% Diverges**	**71.9% Stabilizes**

Source: Aaron Institute

Non-growth-enhancing policy implies GDP growth rate of 2.5%. Most likely would not enable keeping resilient economy with required defense budget.

Economic Risks for Israel from 2025 Onwards.

- **Security-political-economic instability**
- **Social instability and the renewal of the judicial reform**
- **High debt-to-GDP ratio on a non-declining trajectory – resulting from large deficits and low growth due to transfers to non-productive activities and non-growth-related reforms**
- **Risk of negative impact on the high-tech sector: slowdown in foreign investments and boycotts**

Increased risk of emigration of young adults with high human capital (Brain Drain)

Employees of the high-tech sector are twice as likely to be called up to reserve duty compared to other sectors

The Resilience of the Israeli Economy Relies on Employment and Productivity

- **A growth-supporting policy is required, focusing on:**
  - **Sustaining the high-tech** sector as a platform for economic growth
  - **Human capital improvement** through post secondary education
  - **Investments in infrastructure** (transportation, housing, and digitization)
  - **Reducing barriers to investments** in the non-high-tech business sector
  - **Reducing the cost of living** by removing competition and import barriers
  - Improving public sector efficiency

  - **Much to do following the OECD recommendations!**