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Macroeconomic Policy Outline for Recovering the Economy

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Policy Paper 2020.08 / October 2020

This is a short summary, for the full paper (in Hebrew) see
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Aaron Institute for Economic Policy

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Macroeconomic Policy Outline for Recovering the Economy

Since March 2020, the COVID-19 pandemic has plunged the Israeli economy into the most severe crisis in its history, concurrently with a worldwide recession. Due to the failure to adequately prepare the healthcare system, the poor management of the pandemic's containment and the economic response, and the enactment of a second lockdown, and given the current and projected morbidity rates and the economic policy which has been implemented, the Aaron Institute predicts a decline of about 10% in Israel's GDP per capita by the end of the year, among the sharpest in OECD countries. At the same time, the Israeli economy experiences high unemployment rates and low employment levels, pushing the job market back to where it had been some ten years ago.

The current policies regarding employment and national budget management **contradict basic economic principles and exhibit some critical failures:** the safety nets provided until June 2021 do not stipulate incentives for employment, job training and retraining; the government has not introduced any economic plan supporting growth and demands, while such a plan is most acutely needed; the inability (or lack of will) to devise a national budget plan fosters instability and uncertainty; and the introduction of aid "packages" and one-off "bonuses" only serves to increase mistrust in policy management. These failures have resulted in ongoing unemployment, which is bound to drive a large part of the younger population, especially those of underprivileged backgrounds, away from the employment market in the longer term, even after the health crisis is resolved. As a result, the Israeli economy is projected to undergo a period of significant decline in GDP per capita, impaired economic growth, and increased poverty and inequality.

To tackle this health and economic crisis, the government must implement immediately a public health policy of "smart distancing", i.e. selective lockdowns informed by testing, tracking and tracing (TTT), which would make it possible to contain the disease while minimizing economic damage. At the same time, and assuming containment of morbidity rates would be achieved during October-November, the government must announce an economic plan presenting a vision of growth and poverty reduction, outlining policy objectives and focusing on increasing employment availability as well as quality, in order to return by the end of 2022 to the pre-crisis employment rates of January 2020. A central feature of such a plan is creating demand for workers in various industries, while reducing barriers and uncertainties facing the business sector. The multi-year budget framework

required for such a plan should be approved urgently and enacted promptly, with full budget allocation for 2021.

The policy we recommend consists of substantial expansion of employment policies and of employment- and growth-enhancing projects, which cannot be commenced and nurtured without government involvement. The cost of capital raising for the government is at an all-time low, thus Israel has both the capacity and the need to carry out an aggressive, long-term policy aiming to boost its economy and to increase employment and productivity. Our recommendation is to increase public investment by about 2% of the GDP every year during 2021-2022, amounting to around NIS 29 billion of additional public investment annually. In the optimistic scenario, this investment will raise growth rate during 2021-2022 by an additional one percent while improving employment rates – assuming an employment-enhancing policy is enacted. We estimate that the additional expenditure towards enhanced employment and productivity, guided by clearly defined objectives, will not trigger a rise in interest rates, even if the debt-to-GDP ratio reaches around 85% with a forecast for closing the excessive structural deficit from 2023 onwards.

The proposed economic policy should include the following elements:

1. Setting employment rate objectives for the 25-64 age group, focusing on returning by the end of 2022 to the employment rate recorded at the end of 2019 – 78 percent – as well as short- and medium-term goals for some particular population groups, mainly in the Israeli-Arab and Haredi (ultra-Orthodox) sectors.
2. Making fundamental changes in the furlough mechanism and accompanying safety nets which will encourage businesses to furlough fewer employees and to recruit workers when demands increase, while at the same time incentivizing employees to work regardless of the market situation. These measures may include restricting the option to furlough employees according to the extent of economic damage sustained, replacing the current rigid fulrough scheme with a flexible part-time alternative, stipulating an employability test as a condition for eligibility, and supporting the self-employed to the same extent as salaried employees.
3. Establishing a Ministry of Labor which would focus on execution of employment-related policies, through coordination between the various agencies which handle employment and training programs, such as exists in most developed countries.
4. Developing large-scale employment schemes which provide vocational diagnosis and career counselling, as well as guidance to further education and training, support through the process of proactive job search, and workplace assignment.

5. Substantially expanding participation volumes in job training programs, particularly those that provide general human capital and occupations which are in demand under current market conditions, and implementing a broad reform in the vocational training system as outlined by the Employment 2030 Committee, including collaboration with employers in the design of study and internship programs.
6. Substantial expansion of public investment in infrastructures, particularly transport infrastructures.
7. Support for the business sector through drastically reducing bureaucracy, expanding the volume of state-guaranteed loans available, and increasing the low execution volumes of fixed-costs subsidy grants.
8. Investing in reforms according to priorities stemming from the root causes of the productivity gap between Israel and the benchmark countries, meaning above all investment in physical and digital infrastructures which complement human capital through economic integration of impoverished population groups, mainly in the Israeli-Arab and Haredi sectors.

1. Summary and Conclusions

Since March 2020, the COVID-19 pandemic has plunged the Israeli economy into the worst crisis in its history, alongside a worldwide recession. The *Financial Times* declared Israel "the first significant country to re-enter an economically crippling closure, after failing to curb a second wave of the coronavirus," quoting warnings by health officials that "the health system would be overloaded within weeks if the lockdown is not imposed" (*Financial Times,* September 13, 2020). **Due to the failure to address the public health issue and the ensuing renewed lockdown, Israeli economy is expected to suffer <u>another</u> blow amounting to around 2-3 percent of the GDP. Given the current and projected morbidity rates, and the failed economic policy implemented, the Aaron Institute predicts a decline of about 10% in Israel's GDP per capita by the end of the year, which is among the highest in OECD countries.**[1] At the same time, the Israeli economy experiences high unemployment rates and low employment levels pushing the job market back to where it had been some ten years ago, and that constitutes the most pressing problem facing households, particularly those in the more impoverished strata of society.[2]

It is important to note that the current policy in regard to employment and budget management contradicts the economic principles which guided policymaking during 2003-2016. Contrary to international convention and past precedents, the safety nets provided to unemployed, furloughed, and self-employed individuals, effective until June 2021, do not include incentives for employment, training, and retraining. There is no projected timeline for achieving economic certainty and stability, and the government **does not have a plan to support growth and demands when such a plan is of the utmost necessity.** The government's inability to devise and approve a budget for 2020 immediately upon its appointment, to be followed by a budget plan for 2021 with integrated growth-enhancing plans for the next few years, gives rise to even more instability. The introduction of relief "packages" and one-off "bonuses" only serves to increase mistrust in policymakers whereas a policy tool which has been developed by the professional authorities over a long time and gathered wide support,

[1] The forecast issued by the US Federal Reserve on September 16, 2020, estimates that the United States' GDP will decline by 3.7% in 2020, and unemployment rate will reach 7.6%. The forecast for G20 countries published by the OECD on September 16, 2020, predicts a 7.9% GDP decline in Europe. When conducting an international comparison, it should be noted that the population growth rate in Israel is higher by about 1-1.5 percentage points compared to most developed countries, thus a similar decline in GDP means a larger decline in GDP per capita for Israel.

[2] As of July 2020, the effective employment rate for the 25-64 age group is around 72%, and unemployment rate at this age group is around 11%. While the data from August is slightly better, the Aaron Institute estimates that the situation will be aggravated due to the increase in morbidity and the enactment of full lockdown.

such as a new job training system, is either not implemented or undergoes major alterations by the government or Knesset to an extent which obstructs its effective implementation. These shortcomings augment the effects of the pandemic and of the restrictions on economic activity, and increase the likelihood of prolonged unemployment which may cause a large swath of the younger population, particularly those with underprivileged backgrounds, to drop out of the job market in the longer term, even after the health crisis is resolved. As a result, the Israeli economy is projected to undergo a period of significant decline in GDP per capita, impaired economic growth, and increased poverty and inequality.

The government must announce and enact promptly an economic plan presenting a vision of growth and poverty reduction, with a focus on increasing the rates of high-quality employment. The Aaron Institute proposes a targeted objective for this vision in terms of employment rate – 78 percent of the 25-64 age group, meaning a return to pre-crisis employment rates. For this to happen, the government should set short- and medium-term goals for some particular population groups, devise a targeted plan towards increasing high-quality employment until the end of 2022 at least, and ratify as a matter of urgency the multi-year budget framework required for the implementation of this plan. **A key feature of such a plan which is essential to the attainment of the abovementioned objectives is the creation of demand for workers in various industries, while reducing barriers and uncertainties facing the business sector.**

The COVID-19 crisis found Israel in an exceptionally good macroeconomic situation, despite some failures in the ongoing budget during 2017-2019. Israeli economy went through over a decade of rising employment, as well as a moderate decrease in poverty rates over the last few years and continuous growth rate of 3.5% per year, and reached a debt-to-GDP ratio of 61% and a 10-year interest rate of 0.70%.[3] On the other hand, the state has been run for over 18 months without a budget to support growth-enhancing reforms, and the structural budget deficit has reached at least 3.5% of GDP as a result of transfer payments lacking any economic value.

[3] In fiscal terms, Israel is one of the strongest among developed countries. The 10-year government bond rate, which had reached 12% during the Second Intifada, has since decreased steadily and is currently similar to the US Treasury bond rate. The market insurance premium for government bonds (CDS) has been 60-70 basis points for several years now, its lowest rate ever, which is comparable to countries such as Poland and the Czech Republic. Debt-to-GDP ratio has been on a steady decline since the early 2000s, and by the end of 2019 reached a level of 61% with government spending stabilized at around 40%, a result of ongoing responsible management between 2003 and 2016.

Considering these circumstances, the government could have devised, as early as late May or the beginning of June – when morbidity had decreased and the current government was appointed – a public health policy designed to contain the pandemic, accompanied by clear, reliable and transparent economic policies which would have allowed the Israeli economy to deal with the crisis much more effectively than some other countries. Outlines for such policies were presented by Bank of Israel as well as other advisory bodies, both within and without the government,[4] **but they were not implemented and instead were replaced with a policy which was undecisive, ineffective and non-transparent.** The policy which has been required, then as well as now, is meant to get the economy back on track in order to mitigate the damage to the GDP, while managing the health risks. This calls for immediate implementation of a policy of **"smart distancing" – selective, targeted lockdowns informed by accurate data obtained through large-scale, rapid testing as well as tracing and tracking (TTT strategy).** Both the economic research and the accumulated experience from Taiwan, South Korea, Singapore and China – which combined smart distancing with an option for temporary full distancing – show that a policy of smart distancing is preferable, and manages to achieve a decrease in morbidity and mortality rates while softening the blow to the economy. The onset of the second wave in Israel demonstrates the utter failure of the Israeli authorities to introduce TTT strategy, and the ensuing health and economic costs. Simultaneously, and assuming containment of morbidity rates would be achieved during October-November, the government must introduce, as stated above, **an economic plan focusing on increasing the availability of high-quality employment and improving productivity as an engine for growth and poverty reduction.** This paper describes the economic policy that the government should adopt for the next few years and especially 2021, and includes recommendations on three levels: key principles of fiscal policy; recommended

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[4] Eckstein, Even, Hadad, Lifschitz, and Sumkin (March 2020), "COVID-19 Crisis: Recommendations for Economic Policies", Aaron Institute and the Institute for National Security Studies (INSS); Eckstein and Lifschitz (April 2020), "Economic Policy Principles for Lockdown Emergence", Aaron Institute for Economic Policy; Bental and Eckstein (April 2020), "COVID-19 Through the Eyes of An Economist", Aaron Institute and Taub Center for Social Policy Studies in Israel; Eckstein, Larom, and Lifschitz (May 2020), "Employment Policy Response to COVID-19 Crisis", Aaron Institute for Economic Policy; Bental, Eckstein, and Sumkin (July 2020), "What Can the World Teach Us About Economic Policy Response to COVID-19 Pandemic? Lessons from the First Wave", Aaron Institute and Taub Center for Social Policy Studies in Israel; Bank of Israel (May 2020) "Statement by Bank of Israel Governor in a Government Meeting Discussing Approval for Budget Expansion"; Bank of Israel (July 2020) "Statement by Bank of Israel Governor in a Government Meeting About Provision of One-off Grant for All Israeli Citizens"; Bank of Israel (September 2020), "Statement by the Governor in a Government Meeting on September 9, 2020"; Team of Experts Commissioned by the National Security Council (NSC; April 2020), "Securing Containment and Preparing for Lockdown Emergence" ; Advisory Committee to the NSC (July 2020), "Principles for Managing the Economic Aspect of the Second Wave of COVID-19 Crisis".

policy during the crisis highlighting employment and support for businesses; and reforms and projects which enhance employment and productivity. It is important to note that the said reforms have been needed for some time now, and the current crisis provides further indication of their importance and necessity.

Macroeconomic budgeting principles. The most significant market failure is the uncertainty about the functioning of the economy during the COVID-19 outbreak. Fiscal and monetary policies alike must convey stability and willingness to address uncertainty through the creation of a clear budget framework, which would provide the government with executive capacities and at the same time express its obligation to the private sector for substantial advancement of multiple large-scale projects as soon as possible. The policy we recommend consists of **significant expansion of employment policies and of projects which enhance inclusive growth, in which the government plays a pivotal role. The cost of capital raising for the government is at an all-time low,** thus Israel has both the capacity and the need to carry out an aggressive, long-term policy aiming to boost its economy through increased employment and productivity, to reduce the gaps between Israel and leading countries.[5] Our recommendation is to increase public investment by about 2% of the GDP per year during 2021-2022, amounting to around NIS 29 billion of additional annual investment. These measures necessitate attainment of budget certainty as soon as possible, to allow quick and effective implementation of the proposed plans which would affect demands across the economy. In case interest rates begin to rise, deficit expansion should be halted. It is important to note that we do not recommend indiscriminate expansion of government spending, definitely not as a goal in of itself or as a means to boost demands; the increased government spending we propose should be directed entirely at investments which enhance growth, productivity, and employment.

In the optimistic scenario, this investment will raise growth rate during 2021-2022 by an additional one percent while improving employment rates – assuming an employment-enhancing policy is enacted – so that employment rate will rise back to around 78% by the end of 2022. In this case, deficit-to-GDP ratio will reach around 83% at the end of 2022. We assert that the deficit-to-GDP ratio will start decreasing again from 2023 onwards, under best circumstances, as a result of the increased growth induced by the rise in productivity once the economy reaps the benefits of these investments. We estimate that **additional expenditure**

[5] Benchmark countries: a group of developed countries resembling Israel in their population size as well as their reliance on human capital and international trade, which includes Austria, Denmark, Ireland, Finland, The Netherlands, and Sweden.

towards enhanced employment and productivity, guided by clearly defined objectives, will not trigger a rise in interest rates, even if the debt-to-GDP ratio reaches around 85% with a forecast for closing the excessive structural deficit from 2023 onwards. However, we recommend that if the 10-year interest rates or CDS gaps rise above 1.5%, deficit expansion should be halted by increasing VAT, cancelling tax exemptions, or cutting expenditure.

Economic policy should focus on the following issues:

1. **Employment goals – government policy should target increasing employment rates, and set goals for employment rates of the 25-64 age group.** Introduction of qunatitative goals by the government, particularly employment goals, has proven itself as an effective tool for enactment of active policies and assessment of alternative schemes. The employment policy response to the current crisis must be accompanied by measurable, quantitive goals for the short term, to provide focus for the government's efforts to get as many workers as possible back into employment through training schemes and job creation. **The main goal we propose is to return by the end of 2022 to the employment rate recorded at the end of 2019, which was 78 percent (in the 25-64 age group).** This aggregate goal should be split into subgoals according to population sector, gender, and age. In addition, intermediate goals should be set: 74 percent at the end of 2020 and 76 percent at the end of 2021.
2. **Providing a safety net while maintaining an incentive to go to work –** as long as the pandemic reduces the demand for workers, long-term safety nets should be provided to furloughed employees and workers who experience underemployment due to market conditions, as well as the unemployed and self-employed, similar to the provisions already introduced until June 2021 **but with some major revisions. We would like to stress that the furlough mechanism requires a fundamental reform, to allow only businesses impacted by the crisis to place employees on furlough, while taking special care to retain incentives to return to work once the situation improves.** Therefore, the safety nets should be modified in ways which encourage businesses to minimize the use of furlough and to recruit workers when demands increase, and at the same time give employees an incentive to work regardless of market situation.[6] The proposed policy should include the following elements:

[6] The Employee Retention Scheme announced recently at a cost of around NIS one billion which offers NIS 5,000 compensation for each employee not placed on furlough, according to criteria covering the damage sustained by the business and a minimum number of employees, is a minor step towards increasing labor market flexibility and encouraging sustained employer-employee relationships. However, it is significantly inferior to the plan proposed in this paper.

- The option to furlough staff should be **contingent on the extent of the damage** to the employer's economic activity (in terms of turnover), relative to a pre-crisis reference point, just as the compensation to businesses is determined according to the extent of damage sustained.
- Businesses which has not reached a certain minimum threshold of damage for two months **will not be allowed to place or keep employees on furlough**, and will be required to take them back to work or terminate employment, in which case these workers will be placed on unemployment status.
- The rigid furlough mechanism currently in place should be replaced with **an option for part-time employment**, either for the same employer or a different one, along with providing proportional compensation for the terminated part to workers who had been employed full time previously. The extent of compensation for a full- or part-time job will be capped according to the maximum amount of unemployment benefits, and overall income will be significantly lower than that of a full-time job.
- Employers who place employees on furlough will be required to submit a full report covering total work hours of all employees, monthly wages, and the extent of reduction in turnover. That report will be submitted at the end of every month and compensation will be paid out 15 days after reporting. A processing mechanism for such reports should be put in place immediately, along with an **enforcement apparatus** co-directed by Social Security and the Tax Authority.
- **The amount of unemployment benefits provided to furloughed or unemployed individuals should be reviewed after six months** according to age, family status, and overall unemployment rates.
- **Eligibility for unemployment and guaranteed minimum income benefits should be contingent on in-person reporting at employment centers** as well as an employability test, effective immediately as it had been pre-crisis. Continued eligibility for furloughed or unemployed individuals after the initial six months will require participation in an employment scheme.
- **The self-employed should be supported to the same extent as employees,** entailing an increase in the support for younger self-employed individuals

whose eligibility is currently low, while at the same time ensuring that a self-employed individual who lost their entire income would be eligible to the same amount of support as an employee with an equivalent salary who had been fired, but not exceeding thereof. In addition, a cap should be set for self-employed workers who had lost part of their income, in increments according to the extent of their losses, in order to remove the incentive to reduce activity. Thus, the extent of support should be contingent on income loss, assessed according to four incremental brackets as is the norm in most countries. Self-employed individuals who sustain ongoing loss of income should receive support in closing their business or transitioning to a salaried status.

- **Action should be taken to reduce the numbers of foreign workers** in the construction, agriculture, and nursing care sectors, since their employment leads to a reduction in the wages of Israeli workers, thereby diminishing their incentive to work.

3. **A Ministry of Labor** – an essential precondition for effective enactment of employment policy is coordination between the various organizations which deal with employment, job training programs and the unemployed population, as well as those which collect or maintain data on these topics. In this context, the Aaron Institute recommends that the government **establish a Ministry of Labor, such as exists in all developed countries**. The CEO committee appointed following a recommendation by the Aaron Institute is a temporary solution, which should lead over the coming year to the establishment of a separate, dedicated Ministry of Labor, mandated to focus on the implementation of a comprehensive employment policy, and to realize government objectives based on the recommendations of the Employment 2030 Committee. The report issued by this committee constitutes a comprehensive work plan for that proposed Ministry of Labor, designed to foster high-quality employment over the course of the next decade.

4. **Employment schemes** – as stated above, **eligibility for unemployment benefits should be contingent on an employability test, effective immediately** as per the pre-crisis situation: an obligation to report in-person at employment centers (possibly using digital means), availability to start working, and proactive job search. In the medium term, all unemployed and furloughed workers should be obligated to take

part in an employment scheme which provides vocational diagnosis and career counselling, as well as guidance to further education and training, support through proactive job search, and workplace assignment. These schemes could be outsourced, using a voucher system, to job training and placement agencies in the private sector which would be picked according to well-defined criteria and subject to government oversight.

The proposed objective is to get half of the unemployed individuals who receive unemployment benefits to attend training and employment schemes. In addition, the number of guaranteed minimal income recipients engaged in the Employment Circles program should be expanded, along with the numbers of out-of-employment Haredi and Israeli-Arab individuals involved with Mafteach and Ryan Centers, respectively. We would stress that the importance of such schemes lies in having the government subsidize the matching process, thereby reducing the cost of information for both parties, by informing workers about market demands and employers about workers' skills.

5. **Job training – participants in all the employment schemes described above will be directed to job training programs**, where the suitable training program for each individual would be selected following a process of vocational diagnosis and guidance. The list of training courses and the prioritization of voucher allocation for courses will be managed by the labor authority. Along with the expansion of training volumes to accommodate 100-200 thousand participants within two years, an overall reform in the training system should be carried out according to the **Employment 2030 Committee outline**, which would include: general human capital (Hebrew, English, and digital literacy) as part of training and in accordance with the specific skills needed by individuals; different scopes of training for specific vocations which are in high demand at the current market situation, with a return exceeding 6 percent;[7] on-the-job training opportunities incorporated into study programs; collaboration with employees from various industries in the development of training programs, including their involvement in the design of study programs and the creation of internship vacancies.

[7] Return in terms of salary, compared to the projected salary of training recipients in case they had not undergone the training course.

6. **Support for business sector –** in order to help competent businesses survive the crisis, the government must expand the support it provides through state-guaranteed loans. This policy tool alleviates the cash flow difficulty facing businesses which are expected to withstand the crisis, and is considered the most effective means of support in economic terms. Availability of state-guaranteed loans should be expanded to encompass new businesses as well, along with a fixed cost subsidy grant contingent on a minimum loss threshold of 60% and rising gradually up to 80% (trapezoid trend). The current, low execution volumes of this grant should be raised, and reviewed to ensure they do not stem from complex bureaucracy involved in obtaining the grant or excessively high threshold requirements. In addition, a mechanism should be established to address the needs of small businesses in the sectors severely affected by the crisis: the performing arts, tourism and leisure. Businesses affected by external factors should be supported, while big businesses should receive support in exchange for giving the public (i.e. the government) a share in equity.

7. **Bureaucracy and regulation** – The current time vividly demonstrates the need for reforms which would resolve the problems of over-regulation and the heavy bureaucratic burden imposed on the business sector in Israel. This issue has been discussed often over the last decade, but reforms in this area are yet to bring about any change on the ground. Improving the regulatory environment is a necessary measure for the Israeli economy, with a negligible budget cost and immediate, significant effects on entrepreneurship and investments, and notably on employment – the biggest challenge facing the economy at present. These beneficial effects would be translated, in the long run, to an improvement in market competitiveness, productivity, and growth, along with a reduction in the cost of living.

8. **Public infrastructures, particularly transport infrastructure** – Despite being a relatively new state lacking sufficient infrastructure in nearly every sector, compared to developed countries, Israel has greatly reduced public investment after the Yom Kippur War in 1973, from around 6% of GDP to around 2%. This low level of investment, which is adequate to countries with sufficiently developed infrastructures rather than a country like Israel, has actually not recovered since, and the need is evident in many sectors: transport, energy, communications, and so on. According to an analysis conducted at the Aaron Institute, the public infrastructure gap accounts for some 20-30 percent of the productivity gap between Israel and the benchmark

countries. Most of the increase in public investment should be channeled to public infrastructures, particularly the public transportation infrastructure.

9. **Projects** – in a period of deep recession, and in an economy already plagued by a severe shortage of public capital and investments, it is critically important to accelerate and invest in projects which are necessary both to increase employment in the short term and to enhance productivity in the medium and long terms, according to priorities stemming from the productivity gap between Israel and the benchmark countries.[8] These projects will enable the economy to quickly emerge from the crisis while laying the foundations for rapid, inclusive growth, which would make it possible to close the gap in the standard of living between Israel and leading countries, and even to reduce poverty. Some of these projects involve investment in physical and digital infrastructures complementing the human capital and economic integration of impoverished population groups, mainly in Haredi and Israeli-Arab societies, as elaborated in Chapter 5 of this paper.

[8] Eckstein and Lifschitz (2007), "Growth Strategy for the Economy 2017", Aaron Institute for Economic Policy.