

A blue-tinted background image showing several hands in business attire writing on documents and using a pen, suggesting a collaborative work environment.

An Economic Strategy for Israel: Vision, Strengths, and Threats

Yated Foundation and Aaron Institute



Special Policy Paper / 2025



Aaron Institute for Economic Policy

Dedicated to the memory of Aaron Dovrat

The vision of the Aaron Institute for Economic Policy in the Tiomkin School of Economics is to support sustainable economic growth and social resilience, along with poverty reduction. To achieve these goals, the institution strives to design a strategy based on measurable goals, which can be subjected to international comparison, and propose detailed plans for economic policies based on the most updated international knowledge. We focus primarily on reforms towards economic growth stemming from increasing employment and raising the GDP per hour worked (labor productivity) in Israel.

The key measure of sustainable economic growth – GDP per capita – is still low in Israel compared to leading developed countries, and so is labor productivity. Through its economic studies, the Aaron Institute presents goals, innovative policy tools, and reforms to promote growth, high-quality employment, and labor productivity.

The Institute's mission is to help shaping the socioeconomic policy in Israel through the development of long-term plans that address the full range of economic and social issues facing the Israeli economy. Our main focus is families with less than median income, who comprise significant parts of the Arab and Haredi (ultra-Orthodox) populations. In these groups specifically, increasing employment and productivity would greatly contribute to achieving the goals of growth, social resilience, and poverty reduction. In addition, our studies aim to influence the professional discourse, and to stimulate discussion based on reliable information and socioeconomic research that offers practical tools to achieve these goals.

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1. 1. An Economic Vision for the State of Israel

A strong economy is a key component of Israel's national resilience – socially and politically, as well as with regard to national security. Therefore, the plan below sets an overarching objective: the Israeli economy will be among the top ten economies in the world in terms of GDP per capita, and will enjoy inclusive, sustainable and ongoing growth alongside low poverty rates, within 15 years. The program was formulated in parallel with the work of the Mind Israel team and provided the team with economic support for its policy recommendations regarding force buildup and the required budget.

In order to realize this overarching objective, our plan aims to achieve the following goals:

Economic Resilience and Security

- The economic power of Israel will facilitate effective strengthening of its national security, in a scope that would not hamper the economy's potential for growth, while developing the necessary technological advantages in the face of the various security threats.
- The Israeli economy will be managed with budgetary responsibility informed by a long-term view, aligned with the building of national, social and military resilience – including energy redundancy and nutrition security.
- The Israeli economy will be sturdy and well-prepared to weather political and security crises, geopolitical shifts, and macroeconomic changes in both domestic and global business cycles.

Economic Welfare and Equal Opportunity

- A strong, growing economy will bring about socioeconomic welfare, as well as personal safety and economic security with a positive outlook, alongside equal rights and opportunities for all the country's residents. This will turn Israel into an attractive, supportive epicenter for Jews around the world.
- Israel will dedicate attention and special efforts towards the advancement of households at the bottom quarter of income earners, through dissemination of the skills necessary for human capital which would be capable of high-quality employment and sharing the burden of military service.
- Through maximum economic utilization of the diverse human resources within society, reflecting a value-based ethos of fairness, equality, and cohesion – Israel will enjoy high socioeconomic mobility and low poverty rates.
- The Israeli economy will benefit from a strong, sustainable partnership among all the various population groups comprising Israeli society, whereas human diversity and social cohesion constitute a strength.

Growth Through Innovation and Competitiveness

- Israel will have a modern economy, characterized by utmost openness to the global economy, and based on technological advantages and cutting-edge scientific research.
- Establishing Israel's position as a favored key player in the global economy will be a significant element of the Israeli foreign policy.

Infrastructure and Long-Term Growth

- In order to realize this vision, and based on an underlying principled ethos, the Israeli economy will enjoy an efficient public sector, promoting public infrastructures and services which would be efficient and accessible to all strata of society.
- The socioeconomic policy will promote a proportionate cost of living, relying on a competitive business sector, as well as adequate supply of housing and transport infrastructures in line with actual birth rates and other characteristics of the Israeli population.

2. Strengths of the Israeli Economy

The state of Israel possesses several substantial strengths. In recent years, it has exhibited a significant growth in GDP per capita,¹ and a remarkable ability to recover from global crises (the financial crisis of 2008 and the COVID-19 crisis of 2020) as well as localized national security crises. A number of anchors have provided the foundations and engines for the growth of the economy:²

1. A responsible budgetary policy, maintaining low and decreasing debt-to-GDP ratio during times of normalcy.
2. Positive trade balance and balance of payments, including substantial currency reserves.
3. A central bank whose independence is established by law, and a monetary policy compatible with the Israeli government's inflation target (1%-3%) and the targets set by the Bank of Israel – supporting economic growth and full employment, while maintaining and supporting financial stability.
4. Maintaining a stable financial system while promoting its efficiency and its integration in the global system.
5. A liberal, democratic political system which protects proprietary rights and prevents corruption and crime through the independence of the judiciary and the police.
6. A large, innovative high-tech industry which acts as a growth engine and comprises workers with high labor productivity.
7. Natural gas fields which provide a significant positive economic impact, by offering energetic independence along with proportionate environmental protection.³
8. A labor market characterized by high employment rates and low unemployment.
9. A healthcare system which is efficient and accessible to all the population.

¹ Between 2006 and 2022, Israel's GDP per capita had grown at an average annual rate of around 2%. This trend has slowed down in the wake of the political crisis which started in 2022, and the outbreak of war on October 7, 2023.

² The order of items in this list does not signify their relative importance.

³ Failure to protect the environment may result in costs which will offset the positive economic impact of gas production. Furthermore, Israel is accountable to international standards, due (among other things) to environmental restrictions imposed on imported goods by its trade partners.

3. Weaknesses, Threats, and Challenges in the Israeli Economy

The Israeli economy is facing significant threats, both external and internal:

3.1. External Threats

A. Military-Security Threats on Multiple Fronts

Following the attack on October 7, 2023, and since Iran and its proxies have joined the armed conflicts waged against Israel, it appears that barring a major transformation of current conditions, military-security threats handled simultaneously on several fronts will pose a challenge in economic terms as well.

- **Threat to fiscal robustness** – the costs of the Iron Swords War, along with the need to increase defense expenditure in the coming years, pose a real threat to Israel's fiscal robustness and to its standing in international financial markets. A significant increase in the structural deficit, credit rating downgrade and an increase in the debt-to-GDP ratio are the first manifestations of the potential damage to the growth of the national economy and to the quality of life in Israel.
- **Diminished legitimacy and political standing** – the effects of the war, and of the perceived legitimacy of the military actions taken by Israel, may keep undermining the support it receives. This may lead to political isolation, which will also have economic implications (divestment by financial and real investors, and weakening of trade partnerships), including relations with liberal democracies.

B. Trends in the Global High-Tech Sector

- **Cyclical weakening in the global high-tech industry** – caused by the global rise in interest rates, which has led to a diminished “risk appetite” and thus reduced investments.
- **The competitive positioning of the Israeli high-tech industry** – in recent years, many countries (such as the UK, Germany, France, India, and China) have managed to bridge gaps and to create an ecosystem and substantial capacities for innovation. The security situation in Israel, alongside the internal crises (see below) and the expensive cost structure, increase the risks involved in investing in Israel and threaten its competitive standing.
- **A slowdown in the current innovation cycle alongside the dominance of tech giants and challenging business models** – the slowdown manifests in exhausting the innovation surrounding mobile and cloud technologies in the context of consumerist applications. The next innovation cycle, which is based on AI and includes incorporation of scientific advancements, is still in its infancy and requires huge investments and various technological capabilities. The uniqueness of the Israeli labor force, comprised mostly of veterans of military technological units, may turn out to be less relevant. The relative weakness of scientific research in Israel is another threat to the ability of the high-tech industry to remain competitive.

C. A Slowdown in Europe, Eastern Asia and the Middle East

On the one hand, a global downturn – some of which is cyclical, and some stemming from geopolitical tensions (Russia-Ukraine, USA-China, Middle East, Radical Islam); on the other hand, bursts of inflation and rising interest rates worldwide – challenging growth, particularly in Europe. At the time of writing, the US economy exhibits ongoing growth despite its tight interest rate policy, reflecting the relatively slow curbing of inflation. However, the high debt-to-GDP ratio of the US is a cause for concern regarding its fiscal stability (Eichenbaum, 2021).

3.2. Internal Threats

A. Emigration of High-Quality Human Capital

Frequent wars, a lack of sense of safety, the slump in the high-tech sector due to decreasing investments and the shift to AI technology, internal polarization, political instability, declining standard of living and high cost of living – these are all among the main reasons which may encourage emigration from Israel. A large-scale emigration of high-quality human capital poses a significant threat to Israel's economy and its stability.

B. Weakening Judicial System

The cluster of bills which the government sought to enact on the eve of the war has not been shelved. These bills mainly aim to remove various restrictions on the executive branch, by limiting the powers and authority of the judicial system and the attorney general office. The attempts to push this legislation in 2023 created great short-term uncertainty across the economy, as reflected in the financial markets, along with concerns that the quality of state institutions may be undermined, thus hindering long-term growth potential. We will note that in the short term, weakening the judiciary may harm Israel's political standing and its perception as a liberal democracy, and reignite an internal crisis which would exacerbate the existing polarization.

C. Political Instability

Ongoing political weakness impairs decision-making ability, in both the immediate and the long term. Political and economic leadership which would lead a path of contraction and fiscal responsibility, while aiming for political and security stability, is of the utmost necessity at this time. The current crises pose a threat to Israel's social cohesion, and its ability to retain high-quality, productive human resources.

D. Lack of Integration by Haredi Men in Education, the IDF, and Employment

High fertility rates among the Haredi population will increase its share of the population, so that its share of all households is projected to rise from 10% to 18% within 20 years.⁴ The Haredi leadership's efforts to avoid sharing the burden of military service and participating in employment, as well as its opposition to the acquisition of relevant education and skills, constitute a real threat to Israel's economy, its social resilience, and the personal safety of its population.

E. Gaps in Human Capital Quality and Income Gaps Affecting Arab Society

Israel's Arab society, which represents 21% of the population, is characterized by gaps in employment rate and quality, as well as high crime rates. These characteristics impair growth, personal safety, and social cohesion.

F. Housing and Transportation Crisis

Between 2008 and 2023, Israel's housing price index has risen by 205%, and rent has increased by around 62% on average, compared to a 32% increase in the consumer price index. This trend stems from limited availability, manifested in a consistently low increase in the supply of housing units, relative to the increase in the number of households. Insufficient transportation infrastructures in Israel, leading among other things to long, exhausting travel times (travel time during peak hours has increased by 47%, compared to a 30% increase in the benchmark countries),⁵ also contribute to the marked increase in housing prices, which mostly affects the weaker strata of society and exacerbates inequality.

⁴ In Haredi society, the bulk of the employment problem relates to men, hence the number of men of working age is represented by households.

⁵ 2022/2023 TomTom Index. See below for more on the benchmark countries.

G. Shifts in the Labor Market and in Human Capital Development

- **Training quality of the population who does not pursue academic education** – in recent years, the Israeli economy has benefited from a significant increase in the rate of labor market participation, and in 2023 employment rates were similar to those of the benchmark countries (79% in Israel, 82% in the benchmark countries). However, labor productivity (GDP per hour worked), whose increase has been the primary cause of the rise in GDP per capita over the last few years, is still low in comparison to the benchmark countries. Therefore, achieving high growth rates depends on improving labor productivity. Around one quarter of the gap is due to human capital quality, particularly among population groups who do not pursue academic education.
- **The AI Revolution** – The artificial intelligence revolution is expected to bring about far-reaching shifts and upheavals in the labor market. Large-scale automatization of “white collar” occupations may lead to a rapid, dramatic decrease in the demand for many professions, such as customer service and support, accounting, software development, and graphic design. This is a considerable threat to many professions, particularly at the bottom half of the income distribution. Effective handling of major changes such as these requires high-level basic skills, personal flexibility and learning ability, as well as an efficient, powerful vocational training system and a flexible labor market.

4. An Economic Strategy for Israel

4.1. Strategic Principles

These are the three main principles for a comprehensive economic strategy for the Israeli economy, which would support the objective of sustainable growth accompanied by poverty reduction:

- I. The strategy is backed by professional economic analysis, which delves into the trends of the national economy’s growth, and identifies its strengths and weaknesses in comparison to advanced countries. This comparison facilitates a thorough understanding of the root problems and **focusing on the necessary areas of action.**

- II. **The goals of the economic strategy are clearly defined, and progress towards their realization can be measured over time.** Setting ambitious, measurable goals which can be monitored over time, accompanied by a work plan designed to achieve them, is the common work process applied in public policymaking in every advanced country.
- III. To promote economic growth in Israel, it is necessary to examine its economy in comparison to leading countries in Western Europe and North America. Therefore, **the reference index for Israel that was chosen by Aaron Institute is a group of benchmark countries which includes Austria, Denmark, Finland, Sweden, and The Netherlands. These countries are on a similar scale to Israel in terms of population,⁶ and resemble it in the nature of their growth which relies on human capital,⁷ yet they are characterized by levels of GDP per capita and labor productivity which exceed the OECD average, and their poverty rates are lower compared to Israel.⁸** We wish to emphasize that this reference index is different than the one commonly used in economic analyses, which is the OECD average. We believe the latter is not an appropriate target to aspire to, and does not provide **a useful reference point for identifying Israel's weaknesses** because, as an average value, it is also affected by relatively poor countries or those whose characteristics, such as population size and physical assets, are vastly different to those of Israel.

4.2. Strategic Objectives – Sustainable Growth and Poverty Reduction

As stated in the vision statement, the strategic objective for the Israeli economy is twofold: raising GDP per capita and reducing poverty rates, so that their levels will closely match the average of the benchmark countries within 15 years or so. GDP per

⁶ This is not to say that the population composition is similar. Israel's population is more heterogenous, and contains a large poor population characterized by high fertility rates.

⁷ Also, their wealth is not founded on natural resources, as in the case of Norway. We consider expanding the group of benchmark countries to include Belgium and Switzerland.

⁸ The poverty line is set at half the median income per equivalized individual. Poverty rate is the relative share of individuals, out of the total population, living below the poverty line.

capita level is a common metric for the standard of living, since it represents the scope of available sources in the national economy which provide the population with goods and services, both private and public. As of 2023, the GDP per capita level in Israel is \$42,272 (in 2015 prices, PPP), which is 19% lower than the average figure in the benchmark countries (\$52,499, Figure 1). Closing this gap will place Israel among the top ten strongest economies in the world, in terms of GDP per capita.⁹

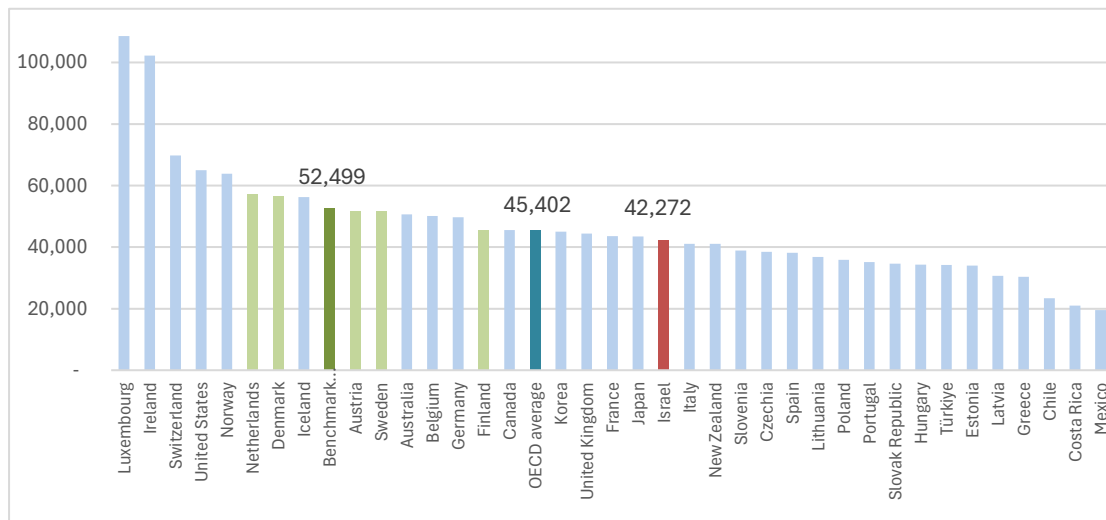
Our analysis reveals that achieving this goal within 15 years is possible. It will require a professional economic policy which would implement employment support reforms, particularly among population groups characterized by low employment rates; improve labor productivity through investments in human capital and public capital; and reduce the cost of living by encouraging competitiveness and increasing housing supply – as will be described in the following sections of this economic plan. This policy will facilitate a 4% growth in Israel's GDP, on a long-term annual average (an average annual growth of around 2% in GDP per capita). A similar growth trajectory had characterized the Israeli economy from 2005 to 2022, and it reflects the economy's growth potential. During that period, the overall GDP of the benchmark countries grew at an average rate of 1.5% per year (and the GDP per capita grew at an average rate of 0.9% per year), hence continuation of these trends is projected to enable closing the gap by 2039.¹⁰ A lower growth rate of the GDP per capita, 1.5% for example,¹¹ will obviously result in a slower process of closing the gap, so that in 2039 it will stand at 11.5%.

⁹ Luxemburg and Ireland are not included in the comparison of GDP per capita, since their GDP is exceptionally high. Luxemburg is a tiny country, and Ireland's GDP is high, among other reasons, due to its recording of the profits of multinational corporations from real activity conducted elsewhere ("stateless income"). When these two countries are excluded, the GDP per capita of the benchmark countries ranks among the top ten.

¹⁰ In fact, our analysis shows that the gap in GDP per capita (in terms of PPP) will be down to 4% in 2039. We assume that closing this gap, due in part to a reduction in the gap in productivity per hour worked, will be reflected in an increase in the economy's purchasing power (PPP), thus the price differential between Israel and the benchmark countries will decrease, and the GDP per capita in terms of PPP will increase. This assumption stems from the rise in productivity as a component of the economy's growth.

¹¹ A conservative estimate, which serves as the basis for the analysis in the next chapter.

Figure 1. GDP per capita in Israel, the benchmark countries, and the OECD, 2023



Fixed 2015 dollars, PPP.

Source: authors' tabulations of OECD data.

We note that the measurement of the standard of living in international comparison is conducted in terms of PPP, reflecting local purchasing power. The shift from measuring GDP per capita in USD terms to its measurement in terms of purchasing power is in itself indicative of the high price levels in Israel. In USD terms, Israel's GDP per capita in 2023 was 55,249 (12th place in the ranking of OECD countries, Table 1), whereas in PPP terms the GDP per capita drops to 52,000 (20th place).¹²

The World Bank provides a forecast of projected PPP exchange rates (Implied PPP conversion rate),¹³ which suggests that it predicts a further increase in price levels in Israel, and further erosion of purchasing power. If this forecast becomes reality, Israel will struggle to close the gap in GDP per capita, highlighting the pressing need to deal with the cost of living pervading the economy. Reforms which will boost labor productivity, along with targeted measures addressing the cost of living, will improve the purchasing power of Israelis and contribute to an increase in GDP per capita in terms of PPP, and to the closing of the GDP-per-capita gap between Israel and the

¹² We tend to record GDP in terms of fixed PPP dollars, but for this illustration we used current PPP dollars, as the World Bank does not provide the data in terms of fixed dollars.

¹³ National currency per current international dollar.

benchmark countries. To illustrate, a 10% reduction in the relative cost of living in Israel would raise the GDP per capita by 12% (dollars, 2015 prices, PPP).¹⁴

Table 1. Ranking of GDP per capita, in USD and PPP, OECD countries, 2023

Country	rank USD	rank PPP	Country	rank USD	rank PPP
Luxembourg	1	1	Belgium	16	11
Norway	2	3	Germany	17	13
Ireland	3	2	New Zealand	18	21
Switzerland	4	4	United Kingdom	19	18
Iceland	5	8	France	20	16
United States	6	5	Italy	21	19
Denmark	7	7	Japan	22	25
Australia	8	14	Spain	23	24
Netherlands	9	6	Estonia	24	26
Benchmark	10	9	Slovenia	25	22
Canada	11	17	Lithuania	26	23
Israel	12	20	Portugal	27	27
Sweden	13	12	Latvia	28	29
Austria	14	10	Slovak Republic	29	28
Finland	15	15	Greece	30	30

Source: World Bank

In the context of economic growth, we remind that Israel has high fertility rates: between 2018 and 2023, Israel's population grew at an average rate of 1.9% per year – around 3.6 times higher than that of the benchmark countries (Table 2). Hence, for the GDP per capita to keep rising, the real growth of the GDP must continue at a rate which exceeds the population growth rate.

Table 2. Population and GDP growth, Israel and benchmark countries, 2018-2023

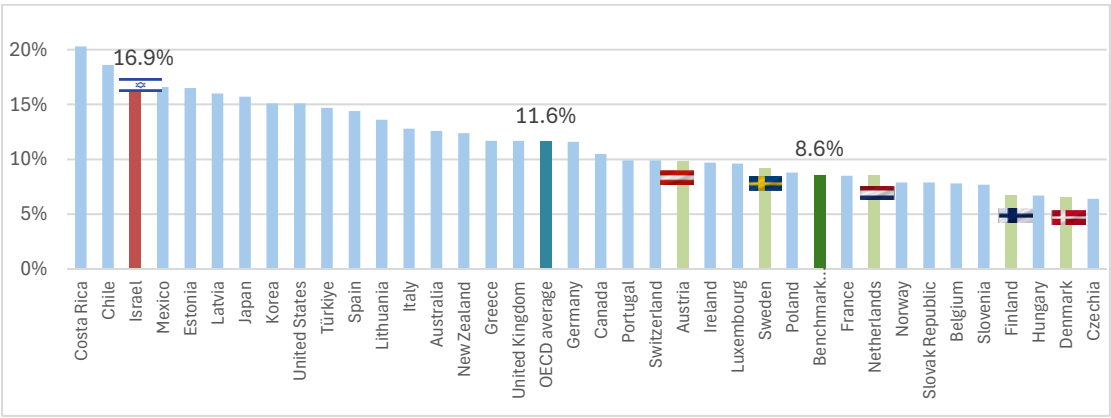
	Israel	Benchmark Countries
GDP	4.0%	1.5%
Population	2.1%	0.6%
GDP per Capita	2.0%	0.9%

Source: authors' tabulations of OECD data

¹⁴ Israel's high price levels, compared to the benchmark countries, are all the more pronounced when considering that the average GDP per capita in these countries is 19% higher than that of Israel (2023 data).

The second component of the strategic objective is reducing poverty rates in Israel, with the aim of closely matching the average of the benchmark countries in around 15 years. Figure 2 presents the average poverty rates in OECD countries in 2020, after transfer payment and taxes.¹⁵ It can be seen that the poverty rate in Israel is 16.9%, compared to an average of 8.6% among the benchmark countries. This gap is partly explained by the choice of certain population groups, such as Haredi men, not to participate in the labor market.

Figure 2. Poverty rate after transfer payments and taxes, 2020 or most recent data year



Source: authors’ tabulations of OECD data

In Israel, as in the rest of the world, gaps in income from work – stemming from employment rate gaps as well as the growing gaps in income per hour worked – are a primary source of poverty and of disposable income inequality among households. We stress that we support poverty reduction through work, and oppose transfer payments (allowances) which discourage seeking employment. We further note that we focus on poverty reduction and avoid using the term “inequality”, since in our view the appropriate objective is securing a reasonable standard of living, relative to that of the benchmark countries, across the entire Israeli population. Focusing on income disparities may lead to a policy which aims to reduce disparities by undercutting the top deciles, thereby reducing inequality without a significant improvement in the

¹⁵ The most current data available, as of August 2024.

standard of living. On the other hand, the poverty rate – which is also a relative rather than absolute metric, determined by the number of people whose income is less than half the median income – provides an accurate representation of the desired outcome. In general, the objectives of raising the standard of living and reducing poverty rates enjoy an overwhelming support from Israeli citizens, and thus can constitute an accepted government objective for many years to come.

4.3. A Methodological Framework for Identifying the Economy's Weaknesses

4.3.1. Growth Trends in the Economy

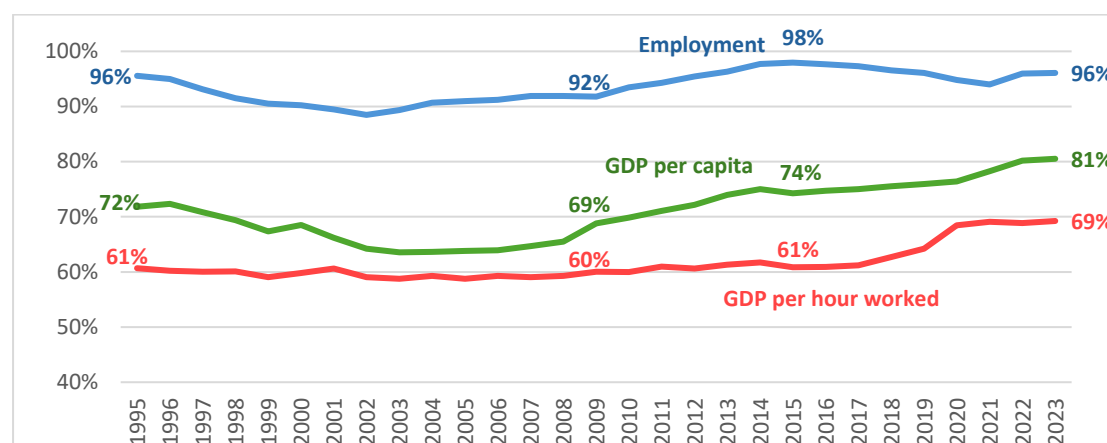
In order to undertake an effective policy towards the strategic objective, it is necessary to analyze the sources of the GDP-per-capita gap. Analysis over time reveals that the standard-of-living gap between Israel and the benchmark countries, measured by means of GDP-per-capita gaps, has been decreasing but is far from being closed (Figure 3). The narrowing of the gap has been caused by two growth engines: the growth in employment rates and the growth in labor productivity, measured by GDP per hour worked.¹⁶ Since the end of the Second Intifada in 2003, Israel has exhibited a continuous increase in employment rates. This trend, stemming from a deliberate government policy, had been the main growth engine of the national economy between 2003 and 2016. During that period, the number of employees grew at an average annual rate of 3%, compared to 0.6% in the benchmark countries, and the employment rate ratio between Israel and the benchmark countries rose from 89% to 98% (Figure 3). This increase, which is significantly higher than Israel's population growth rate (1.9%), was caused by the natural growth of the workforce and by the entry of additional population groups into the labor market. During those years, Israel's GDP grew at an average annual rate of 4.1% (compared to 1.5% in the benchmark countries), whereby 70% of this growth stemmed from the increase in employment (Figure 4).¹⁷ The rate of increase in labor productivity during those years was lower, albeit still higher than in

¹⁶ Growth components – employment and labor productivity – can be expressed in terms of workers or hours worked. We prefer to express the growth in employment in terms of workers, in order to facilitate an easy comparison with the natural population growth.

¹⁷ For further details on this calculation, see the Appendix.

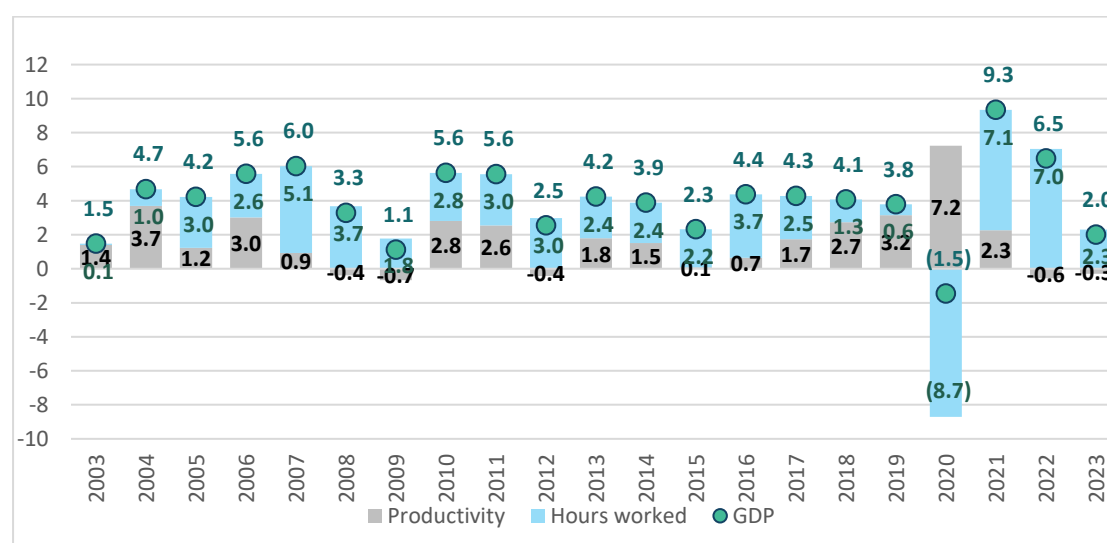
the benchmark countries (1.3% and 1.0%, respectively). Consequently, the labor productivity ratio between Israel and the benchmark countries showed a modest improvement during this period, rising by only 2 percentage points (Figure 3).

Figure 3: Ratios of GDP per capita, productivity and employment rate* between Israel and the benchmark countries, 1995-2023



* Employment rate for ages 25-64.¹⁸ Source: authors' tabulations of OECD data

Figure 4: GDP growth in Israel, segmented into contribution components of productivity per hour worked vs. hours worked*, 2003-2023



* Negative values represent a negative impact on growth. In 2020, if employment had not changed, productivity would have led to a 7.2% growth; and if productivity had not changed, the decline in employment would have led to a drop of 8.7% in GDP (negative growth), thus the GDP decreased by 1.5% in total. Source: authors' tabulations of OECD data

¹⁸ Employment rate targets refer to ages 25-64, rather than younger individuals, since ages 20-24 represent the most critical time frame for acquiring skills, education, and professional qualifications.

In 2017, the trend of growth components had reversed. Since then, the GDP growth rate has remained around 4.0% per year, but the contribution of the labor productivity component has increased to 60% of the overall growth. During these years, labor productivity in Israel has grown at an average annual rate of 2.4%, compared to 0.3% in the benchmark countries, and the number of employees in Israel has grown at an average annual rate of 2.1%, compared to 0.9% in the benchmark countries.¹⁹ This improvement in the economy's labor productivity was mainly facilitated by the growth of the high-tech sector.²⁰ Between 2017 and 2023, the employee growth rate in this sector was 6.7% per year on average, so that by the end of 2023 its share of the overall employment (in terms of hours worked and number of employees) reached 10%, and its share of the GDP was 20.1%. The growth in the number of employees has not reduced productivity levels, due to the onboarding of highly skilled workers with high labor productivity, which is as high as the sector average.²¹ Between 2017 and 2021, labor productivity improved in other sectors, such as financial services (an average annual growth of 4.7%, due to an increase in human capital quality and investments in ICT) and wholesale and retail trade (4.4%). These trends contribute to an increase in the labor productivity of the economy as a whole.

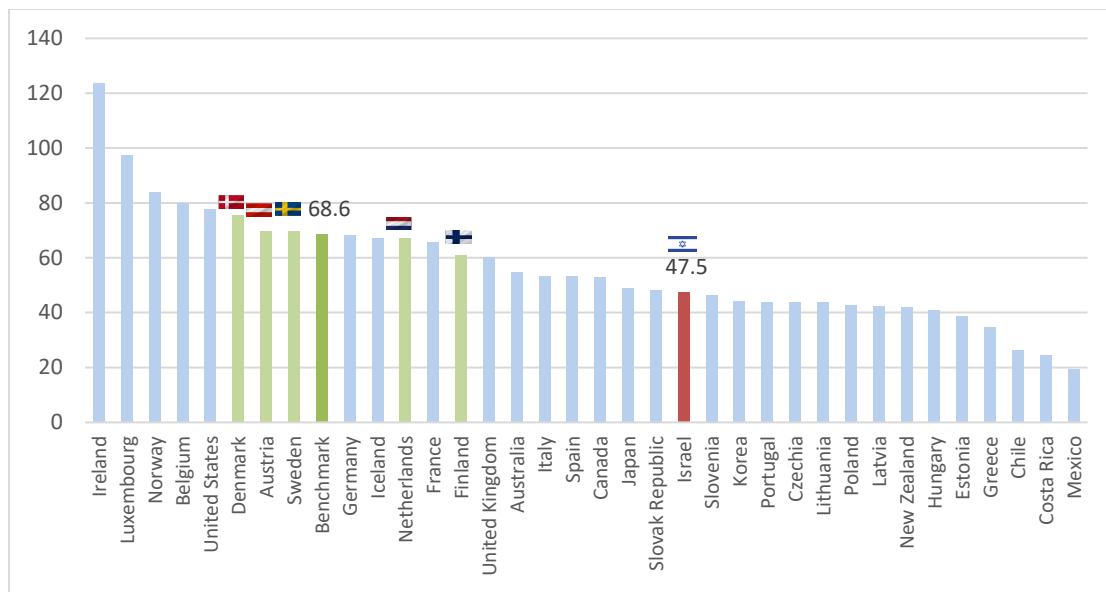
The increase in the labor productivity growth rate has led to a narrowing of the productivity gap between Israel and the benchmark countries (Figure 3). However, the level of GDP per hour worked, which in 2023 stood at \$47.5 (2015 prices, PPP), has remained lower than the average of the benchmark countries, which was \$68.6 – a gap of \$21.1 per hour worked, compared to \$26.1 at the end of 2016 (Figure 5).

¹⁹ A change in growth composition was evident in the benchmark countries as well, where the growth rate of labor productivity has decreased while the growth rate of employee numbers has increased.

²⁰ The high-tech sector comprises the following industries: manufacture of pharmaceuticals, including homeopathic medicine (Division 21); manufacture of computer, electronic and optical products (26); manufacture of aircraft, spacecraft, and related equipment (30); telecommunication services (61); computer programming, consultancy and related activities (62); data processing, hosting and related activities, web portals (63); research and experimental development on natural sciences and engineering (72).

²¹ In 2023, annual GDP per worker in the Israeli high-tech sectors was NIS 650,000, which is 2.15 times higher than the rest of the economy (NIS 302,000 on average).

Figure 5: GDP per hour worked in dollars*, OECD countries, 2023



* 2015 prices, PPP. Source: authors' tabulations of OECD data

Examination of growth trends in Israel highlights several key points for strategy formulation:

- The significant increase in employment rates since 2003, across all economic sectors, is a result of a **government policy to support employment**,²² which has resulted in employment rates currently exceeding the OECD average and nearly matching the average of the benchmark countries. A key outcome of the increase in employment is an increase in both income from work and the available (net) income of all households (Lifshitz and Larom, 2024).
- **It is necessary to maintain the policy which focuses on incentivizing the labor market**, as the primary engine for both GDP growth and poverty reduction, in particular among Haredi men and Arab men and women. If previously untapped population groups are not integrated, employment rates cannot keep growing at a similar rate in the future, due to the expected saturation of the employment rates of non-Haredi Jews.

²² Such as reducing child benefits (2003), cutting down unemployment benefits and reducing disincentives to work (2003-2010), expanding vocational training programs for unskilled workers (2010-2023), and negative income tax (expanded in 2012).

- The increase in employment rates, which introduces to the employment sphere inexperienced people, including some whose employable skills are lower than average, is one reason for the slow growth of labor productivity in Israel between 2003 and 2016. Particularly as those workers mostly joined the service sectors, which are characterized by lower productivity. Therefore, it is necessary to **take measures to increase productivity, particularly among workers in these sectors, to ensure their wage level is appropriate and continue the positive trend of increasing employment rate** and of improving household welfare, in particular those at the bottom half of the income distribution.
- Given that employment rates in Israel are already close to those of the benchmark countries (a gap of 4 percentage points), **narrowing the labor productivity gap** (currently at 31%) **is the only way for Israel to reach a standard of living matching that of advanced countries.** An analytic framework for identifying the sources of the labor productivity gap is presented in Section 4.4, forming an additional professional premise for formulating the economic strategy.

4.3.2. The Sustainable Growth and Poverty Reduction Pyramid – A Fundamental Comparison of the Economy's Components

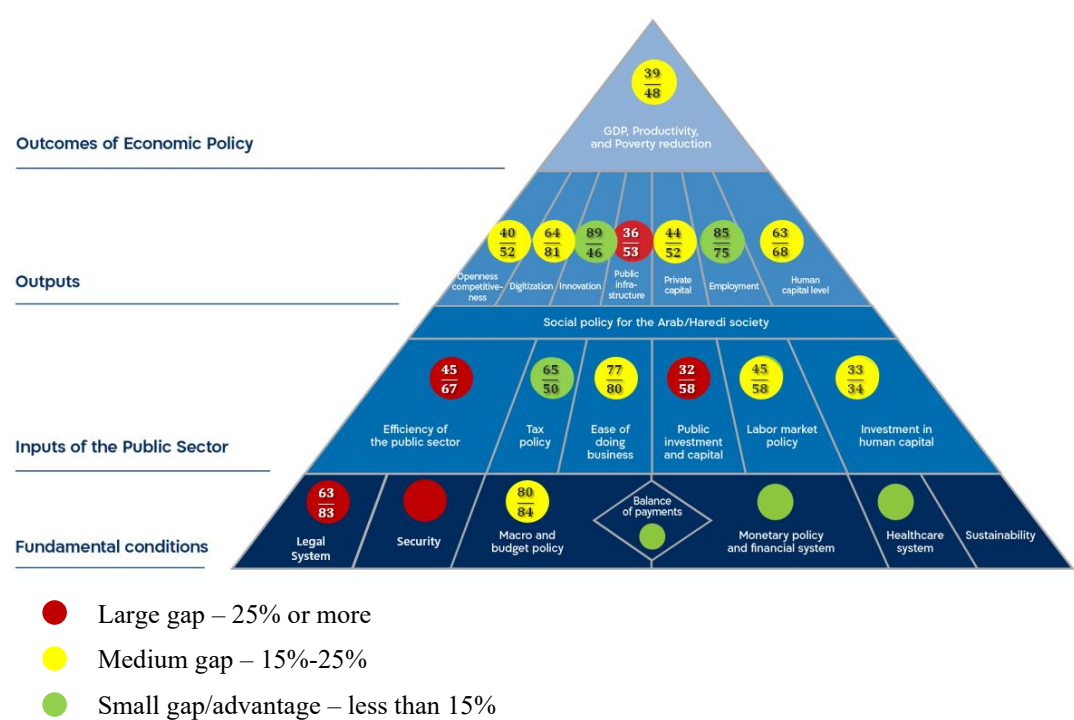
Aaron Institute developed a model providing visual representation of the conceptual framework for economic strategy planning: The Sustainable Growth and Poverty Reduction Pyramid.²³ The pyramid represents all components within the Israeli economy and society, in a tiered structure (Figure 6). Each tier supports the success of the tier above it, and is in turn supported by the activity in the tier below it. The top of the pyramid represents the objective of the economic policy: reducing the gaps in GDP per capita and in poverty rates between Israel and the benchmark countries. The second tier contains metrics indicating the success of the Israeli economy in various areas

²³ The model's methodology is based on a framework for assessing competitiveness performance, designed by The National Competitiveness Council in Ireland (the initial model was presented in 2003, and expanded in 2016), which was adapted to the characteristics of the Israeli economy and expanded to incorporate key policy areas related to it. For further details, see National Competitiveness Council (2016), *Ireland's Competitiveness Scorecard 2016*.

directly required to achieve this objective, such as employment and factors of production which support high labor productivity. The next tier represents input components that need to be provided by the government for this purpose. And the bottom tier, the base of the pyramid, represents the essential preconditions for economic activity within the national economy (Menahem-Carmi and Kalisher, 2024).

This depiction facilitates examination of the relative condition of the Israeli economy compared to the benchmark countries, whose accomplishments in terms of sustainable growth and poverty reduction have been proven in recent decades. Examination of each component reveals the economy’s strengths and weaknesses, making it possible to concentrate research efforts and the necessary government policies towards advancing the strategic objective, while continuously measuring progress.

Figure 6: The Sustainable Growth and Poverty Reduction Pyramid, Israel vs. benchmark countries, by gap size



Source: authors’ tabulations of IMF, OECD, GCI and EIU data from 2023 or most recent data year

To ascertain the relative condition of the Israeli economy in comparison to the benchmark countries, we calculate a score for each component of the pyramid. The

score is calculated by weighing various metrics which represent an international comparison of different aspects of each component, based on the Distance to Frontier (DTF) method, which was developed by the World Bank to compare the results of metrics which are measured by different units. The DTF value of a country represents its relative gap from the country with the highest performance.²⁴ This form of ranking makes it possible to weigh metrics and indices with different units of measurement and determine the relative position of each country according to its results. This ratio reveals the gap between Israel and the benchmark countries within each component. **Scores highlighted in red represent the components in which Israel's situation is particularly bad**, meaning there is a gap of at least 25% between Israel's distance from the best-performing country and the average distance of the benchmark countries. Yellow scores represent the components in which this gap is between 15% and 25%, while green scores represent components where Israel's relative position is better, or the gap from the benchmark countries is negligible.²⁵

As stated above, analysis of 2023 data indicates an improvement in the GDP-per-capita gap between Israel and the benchmark countries, which at the time stood at 19%.²⁶ This gap stems primarily from the gap in productivity per hour worked, which is 31% lower in Israel.²⁷ The **Outcomes** tier points to the main causes of the productivity gap, primarily the **low level of public infrastructures**, and in particular the poor quality of public transportation and mass transit infrastructures. In addition, the Israeli economy is lagging substantially behind the benchmark countries in the **levels of openness and**

²⁴ By ranking the results along a uniform scale of 0-100, where the country with the best result is graded a 100 and the country with the worst result is graded a 0, while all other countries are graded according to their relative distance from the best-performing country. Mathematically, the value of country X in a specific metric will be the difference between its score and the score of the worst-performing country, divided by the difference between the scores of the best-performing and worst-performing countries, multiplied by a 100 ($DTF = \frac{X_i - X_{min}}{X_{max} - X_{min}} \cdot 100$). E.g., if a given metric attaches a score of 250 to the best-performing country and a score of 50 to the worst-performing country, while the score of the inspected country is 100, then the DTF value of the inspected country is: $\frac{100 - 50}{250 - 50} \cdot 100 = 25$.

²⁵ For a breakdown of the metrics used for each component of the pyramid, see: Menahem-Carmi, Kalisher, and Megiddo (unpublished manuscript), "The Growth and Poverty Reduction Pyramid – Methodology and 2024 Update", Aaron Institute for Economic Policy.

²⁶ GDP per capita in 2023: Israel – \$42,272, benchmark countries' average – \$52,499 (2015 prices, PPP). This figure reflects a reduction of 6 percentage points, down from 25% in 2017.

²⁷ GDP per hour worked in 2023: Israel – \$47.5 per hour worked, benchmark countries' average – \$68.8 per hour worked (2015 prices, PPP).

competitiveness, both in terms of barriers to the entry of foreign firms and in terms of the costs of labor, making it difficult to introduce new technologies and to increase the variety of available products, thus contributing to the cost of living. **Digitalization** is another area in need of improvement, particularly with regard to communication with public authorities and to the scope of digital technology use by businesses and households.

The causes for the gaps in the Outcomes tier stem from two main areas of **Public Sector Inputs**. The first is **low investment and insufficient public capital stock**.²⁸ Due to the high birth rates in Israel, the public capital stock per capita is around a third of the benchmark countries' average (according to data published by the International Monetary Fund – IMF).²⁹ The second area is **inefficient public sector**, reflected in the inflated size and structure of the Israeli government. These factors result in high direct operating costs as well as indirect costs, due to the complexity of decision-making processes, the creation of friction points and intra-governmental bureaucracy, and the reduced efficiency of government operations. At the same time, Israel is falling behind in adopting the use of data as a strategic asset for budget building and for the advancement of knowledge-based policies, as well as in the digitalization of the public sector.

At the **Basic Conditions** tier, two major challenges bearing on the Israeli economy are the quality of the judicial system and the national security level. A functioning **judicial system** which protects proprietary rights is an essential precondition for the sound operation of the national economy, indicating the stability of trade relationships with overseas partners. According to the 2023 Democracy Index published by the EIU,³⁰ Israel is defined as a “flawed democracy” with weaknesses in the areas of governance, culture, and political engagement.³¹ As for the **national security level**, events in 2023 and 2024 have further underscored the tight relationship between national security and

²⁸ Public capital stock is the aggregate value of public investments.

²⁹ Public capital per capita in 2019 (most recent data available): Israel – \$12,112, benchmark countries' average – \$35,221 (2017 prices, PPP).

³⁰ Economist Intelligence Unit.

³¹ Israel is ranked 23rd out of all OECD countries, a drop of three places compared to 2021. The benchmark countries are defined as “full democracies” and in 2023 were all ranked in the top ten, except for Austria which was ranked 16th.

the sense of security among the public and investors on one hand, and economic activity on the other hand. Previously, despite sporadic security escalations, the sense of security was largely maintained among the majority of the public as well as investors. However, the war which broke out on October 7, 2023, being longer and more severe than any past escalation, has led to increased uncertainty and concerns among foreign investors.³² The war has completely altered the **macroeconomic framework**. Low growth in 2023 and 2024, along with war spending – particularly on national security, reconstruction, and civilian expenses – have increased deficits and the debt-to-GDP ratio during these years. Government measures in the current period, particularly with regard to state budgets for the coming years, will have great impact on Israel's fiscal environment, on the markets' trust in the national economy, and on its future growth.³³

4.4. An Analytic Framework for Examining the Sources of the Labor Productivity Gaps

Through the framework of the pyramid model, is it possible to identify the main areas in which there are gaps between Israel and the benchmark countries. However, this framework does not provide information about the **size** of the effect of each gap on the outcome variables. Therefore, in order to help the government set priorities, we also conduct a macroeconomic analysis assessing the **relative share** of the factors of production in the gap in productivity per hour worked between Israel and the benchmark countries. The factors of production in the economy are: employment quantity and quality (H); business capital in terms of machinery and equipment (K); and public capital (G), which comprises infrastructure capital – mainly transportation and energy infrastructures and other public structures – as well as digital (ICT) infrastructures. The remainder (A) represents the production efficiency of the factors of production within the economy, and is explained by management, innovation and the

³² As can also be seen in the capital market risk premiums and in the CDS prices referencing the Israeli government's debt, which after reaching a historic low of around 40 basis points (bp) in 2023, jumped sharply in the wake of the war and reached a peak of 175 bp. In the last quarter of 2024, CDS prices have begun to decrease, reaching 130 bp as of February 2025.

³³ In 2023, Israel's GDP grew by only 2% (1% lower than the growth forecast at the eve of the war). Aaron Institute's growth forecast for 2024 is a negative growth of 0.5% (Eckstein, Menahem-Carmi, Sumkin, and Kalisher, December 2024).

economy's competitiveness.³⁴ Table 3 summarizes the results of the macroeconomic analysis for the factors which affect, according to the model, the gap in GDP per hour worked between Israel and the benchmark countries in the years 2017-2021, which stood at \$24 (in 2015 prices, PPP).³⁵ The empirical analysis reinforces the findings of the Growth Pyramid: **Israel is lagging behind in all the economy's factors of production, as well as in overall productivity.**³⁶

Table 3: Contribution of the factors of production to the productivity gap between Israel and the benchmark countries

Productivity Gap from Benchmark Countries		Overall Productivity (A)		Public Capital per Capita ($\frac{G_c}{N}$)		Public ICT Capital per Capita ($\frac{G_n}{N}$)		Private Capital (K)		Human Capital (H)
\$24.2	=	\$4.6	+	\$7.5	+	\$0.3	+	\$5.4	+	\$6.4
100%	=	19%	+	31%	+	1%	+	22%	+	27%
Stock in % of Benchmark Countries				34%		81%		54%		88%

Source: authors' tabulations of IMF and OECD data

The analysis above indicates that the productivity gap between Israel and the benchmark countries can be divided into three main factors which are affected by government policy, and when combined their low levels account for 81% of the gap: public capital, human capital, and private capital. The remainder of the gap (19%) is explained by overall productivity, i.e., production efficiency.

³⁴ According to the Solow Model.

³⁵ Due to the delay in the publication of recent IMF data, analysis for more recent years has not been conducted yet.

³⁶ For the economic methodology employed, see the Appendix below.

5. Pinpointing the Required Areas of Action and the Change Levers for Achieving the Strategic Objective

The economic plan presented in this project seeks to address the weaknesses and the challenges of the Israeli economy, while preserving its strengths and relative advantages. The analyses above highlighted the need to address the gaps in the factors of production. Here is a description of the gaps, as indicated by the macroeconomic analysis, alongside the necessary levers of change which are expanded upon in the following chapters:

Public Capital: the level of public capital per capita in Israel, in particular transportation infrastructures (around 75%), stands at around a third of the benchmark countries' average. The gap in public capital stock per capita accounts for 31% of the productivity gap, amounting to \$7.5 per hour worked (2015 prices, PPP). The gaps in public capital stock per capita are manifested, among other things, in the lack of sufficient means of transportation for mass transit and low public transport use.³⁷ Considering Israel's high birth rates, substantial investment in public infrastructures is necessary to maintain at least a steady level of public capital per capita. A continuing decline in public capital per capita will hamper local and business activity, and impede the access of individuals to employment and commercial hubs. Therefore, **we recommend a long-term strategic plan for combined investment in housing and transportation**, through measures such as: increasing stock in high-demand areas, and high-density construction around public transportation stations; marketing land in areas with preexisting infrastructures; and strengthening and integrating urban densification with an emphasis on urban renewal. Our plan includes setting quantitative targets and defining stepping stones for progression, schedules and budgets; creating supporting statutory infrastructure; and preliminary transport planning to reduce barriers and streamline project processes.

³⁷ Eckstein, Bental, and Sumkin (2022), "[Debt-Financed Investment for Growth](#)", Aaron Institute for Economic Policy.

Another type of public capital is ICT (Information and Communication Technologies).³⁸ **The stock of ICT capital per capita** in Israel is around 20% lower than that of the benchmark countries, contributing 1% of the productivity gap which amounts to 0.3 dollar per hour worked (2015 prices, PPP). The investment required to close the ICT capital gap in the public administration sector is on a significantly lower scale than investment in core infrastructures. Nevertheless, it has the potential to greatly affect government efficiency and the advancement of the business sector (due to the need of some businesses to update their technology in order to match the new government interfaces), while also indirectly affecting the efficiency of government services and the economic feasibility of private investment and economic activity in Israel. Therefore, **we recommend investing in a digital transformation of the public sector.**

Human Capital: the gap in the quality of human capital between Israel and the benchmark countries stands at 12%, accounting for 27% of the productivity gap which amount to \$6.4 per hour worked (2015 prices, PPP). The skill levels of graduates of the Israeli school system are lower than those of their counterparts in the benchmark countries, a fact which leads to lower labor productivity overall. Even though this gap is relatively small, compared to other factors of production, its impact is significant. The analysis above presented the contribution of the increase in employment rates to the growth of the national economy and to poverty reduction, highlighting the need for a policy which would encourage employment (employment rates) while also raising its quality (labor productivity). This economic plan deals extensively with these engines of change, namely encouraging employment and improving skills, while also looking at targeted economic integration of Arab and Haredi populations, in a manner adapted to their specific needs.

³⁸ Economic research suggests that investment in ICT has a profound impact on economic growth (see e.g., Jorgenson and Khuong, 2016). This is especially true for government investment which promotes digitalization of the public sector, thereby boosting the innovation level of the economy as a whole, as emphasized by the OECD as well. Therefore, we separate public ICT capital from the rest of the public capital.

Private Capital: The stock of private capital per hour worked in Israel is around a half of that of the benchmark countries: \$110 compared to \$204 (2017 prices, PPP), a figure which accounts for 22% of the productivity gap, amounting to \$5.4 per hour worked (2015 prices, PPP). We believe that the business environment in Israel, which is characterized by strict regulation and inefficient bureaucracy,³⁹ creates disincentives to streamlining and investment. Such an environment creates barriers to the entry of new firms, both domestic and international, thereby preventing an increase in labor productivity, exacerbating market centralization, and increasing the cost of living. Aaron Institute is looking into these issues, and a detailed plan will be published in the near future.

Alongside these targeted topics, our plan includes a macroeconomic overview of the challenges facing the national economy in the wake of the war, and of the fiscal measures necessary to stabilize it. Additionally, in order to support the streamlining of civic services and improving their quality, a dedicated chapter will present an extensive analysis of the deficiencies plaguing the funding system of municipal authorities in Israel, and recommend a comprehensive reform aiming to strengthen their economic and administrative independence.

6. Appendix – Methodology

6.1. Methodology for Calculating GDP Growth and Its Components

We will broadly define overall GDP as the product of multiplying the number of hours worked by productivity per hour worked: $Y_t = P_t \cdot L_t$, so that

$$(1) \ln Y_t = \ln P_t + \ln L_t$$

Where Y_t is the GDP of the economy in year t ; P_t is the average GDP per hour worked (overall productivity per hour worked) in year t ; and L_t is the number of hours worked in year t .

³⁹ As indicated by the low ranking of Israel in the OECD Ease of Doing Business Index – 23rd place among OECD countries, according to 2021 data.

Growth between a given year (t) and a later year ($t+j$), along with its components, is calculated according to the gap in GDP, and the gaps in hours worked and productivity per hour worked, between these years:

$$(2) \ln Y_{t+j} - \ln Y_t = \ln P_{t+j} + \ln L_{t+j} - \ln P_t - \ln L_t$$

Hence the relative share of each component in the growth of the GDP:

$$(3) \frac{\Delta \ln P}{\Delta \ln Y} + \frac{\Delta \ln L}{\Delta \ln Y} = 1$$

6.1.1. Developing the Decomposition Formula for the Productivity Gap

In order to determine government priorities, it is necessary to decompose the productivity gap according to the various factors of production, estimate the relative share of each production factor in the gap in productivity per hour worked compared to the benchmark countries, and use the results to inform suitable government policy. According to conventional economic theory, we assume that production in the economy as a whole is composed of the following factors of production: employment quantity and quality; business capital comprising machinery and equipment; public capital divided into infrastructure capital – mainly transport and energy infrastructures and other public structures – and digital (ICT) infrastructures; and a remainder (according to Robert Solow) comprised of the production efficiency of the factors of production within the economy (“overall productivity”). Based on this theory, we break down the production function above into a function with five factors of production, which is identical across countries:⁴⁰

$$Y = A \left(\frac{G_n}{N} \right)^{\beta\gamma} \left(\frac{G_c}{N} \right)^{\beta(1-\gamma)} K^\alpha (HL)^{(1-\alpha)}$$

Where the factors of production are: level of private sector capital (K), number of hours worked (L), human capital level (H), level of public capital and transportation infrastructures in particular ($\frac{G_n}{N}$), and the level of public capital in digital (ICT) infrastructures per capita in the public administration sector ($\frac{G_c}{N}$). In this framework, the

⁴⁰ For a detailed description of the factors of production and the model’s underlying assumptions, see: Eckstein and Lifschitz (2017); Eckstein, Lifschitz, Menahem-Carmi, and Kogut (2019).

measure of public capital is its per capita value, as it encompasses the entirety of public capital in the service of all citizens, particularly with regard to transport services. On top of all these variables, we add the residual, which represents the economy's overall productivity (A) (Eckstein, Menahem-Carmi, and Sumkin, 2022).

The output elasticity with respect to public capital is denoted by β , conservatively set at 0.1 (Baxter & King, 1993). The proportion of public capital allocated to digital infrastructure (ICT) is represented by γ , with a value of 0.85, in line with data from advanced economies. As for private capital, a commonly accepted convention assigns it a one-third share of output ($\alpha = 0.33$), which serves as the basis for our analysis.

The derivation of the production function yields the working equation:

$$\Delta \ln \left(\frac{Y}{L} \right) = \frac{1}{1-\alpha} \Delta \ln A + \frac{\beta\gamma}{1-\alpha} \Delta \ln \left(\frac{G_n}{N} \right) + \frac{\beta(1-\gamma)}{1-\alpha} \Delta \ln \left(\frac{G_c}{N} \right) + \frac{\alpha}{\alpha-1} \Delta \ln r + \Delta \ln H$$

Or in terms of GDP per hour worked:

$$\frac{Y}{L} = A \left(\frac{G_n}{N} \right)^{\beta\gamma} \left(\frac{G_c}{N} \right)^{\beta(1-\gamma)} \left(\frac{K}{L} \right)^{\alpha} H^{(1-\alpha)}$$

When substituting the expression for the GDP per hour worked with the expression for the optimal option in terms of capital level per worker, we get:

$$\frac{Y}{L} = (\alpha)^{\frac{\alpha}{\alpha-1}} \cdot (A)^{\frac{1}{1-\alpha}} \cdot \left(\frac{G_n}{N} \right)^{\frac{\beta\gamma}{1-\alpha}} \cdot \left(\frac{G_c}{N} \right)^{\frac{\beta(1-\gamma)}{1-\alpha}} \cdot (r)^{\frac{\alpha}{\alpha-1}} \cdot H$$

Or:

$$\ln \frac{Y}{L} = \frac{\alpha}{\alpha-1} \ln \alpha + \frac{1}{1-\alpha} \ln A + \frac{\beta\gamma}{1-\alpha} \ln \left(\frac{G_n}{N} \right) + \frac{\beta(1-\gamma)}{1-\alpha} \ln \left(\frac{G_c}{N} \right) + \frac{\alpha}{\alpha-1} \ln r + \ln H$$

We mark with Δ the gap between the benchmark countries and Israel, making it possible to break down the gap as follows:

$$\Delta \ln \left(\frac{Y}{L} \right) = \frac{1}{1-\alpha} \Delta \ln A + \frac{\beta\gamma}{1-\alpha} \Delta \ln \left(\frac{G_n}{N} \right) + \frac{\beta(1-\gamma)}{1-\alpha} \Delta \ln \left(\frac{G_c}{N} \right) + \frac{\alpha}{\alpha-1} \Delta \ln r + \Delta \ln H$$

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