



Public Investment Policy and Structural Reforms for Increased Productivity and Growth

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Aaron Institute for Economic Policy

In the name of Aaron Dovrat z"l

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, by designing a strategy based on measurable targets which can be subjected to international comparison, and proposing detailed plans for economic policies which are based on the most current international knowledge. We focus primarily on reforms towards economic growth which would stem 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 in relation to leading countries in the developed world, and this is also the case with labor productivity. Through its economic studies, the Aaron Institute presents targets, 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 which would address the full range of economic and social issues facing the Israeli economy, particularly among families below the median of the income distribution, who comprise significant parts of the Arab and Haredi (ultra-Orthodox) populations, where 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 on socioeconomic research which offers practical tools to achieve these goals.

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Public Investment Policy and Structural Reforms for Increased Productivity and Growth

The impressive recovery of the Israeli economy from the COVID-19 crisis, and the return to the employment rates which prevailed prior to the crisis, allows the government to return its focus to reforms which are crucially needed for the Israeli economy, in order to promote sustained growth and poverty reduction. Our analysis shows that prior to the crisis, according to 2019 data, a change for the better was evident in the economy, as indicated by the reduction of the gap in GDP per capita between Israel and the benchmark countries, along with reduction of the gap in labor productivity (that is, GDP per hour worked). This positive shift has been identified only recently due to a change in the measurement of GDP growth which was applied by the Israel Central Bureau of Statistics (CBS) in 2021,¹ indicating an additional real growth of the GDP by 0.5% in 2021 and the preceding years. Our analysis is based on an international comparison of 2019 data, since 2020 was a year of economic crisis due to the COVID-19 outbreak, and the data for 2021 is incomplete. We believe the positive change in 2019 will continue in the data for 2021 and 2022.

In order to turn this positive change in the economy into an ongoing trend, and to enjoy the full growth potential of the Israeli economy, attention should be directed once again to promoting the reforms which are necessary to address the main growth barrier facing the Israeli economy – low labor productivity. Despite the improvement recorded in recent years, the GDP per hour worked in Israel is still 37% lower in comparison to advanced countries which resemble Israel in terms of population size and the structure of their economy, and which Israel aspires to resemble in terms of the standard of living and poverty rates (“benchmark countries”). Due to the low labor productivity, the standard of living in Israel as represented by GDP per capita is still lagging behind the standard of living in the benchmark countries, despite the positive change, as the GDP per capita in Israel is USD 38,600, compared to USD 51,300 in the benchmark countries (OECD 2019 data, in 2015 prices, PPP).² The benchmark countries are Austria, Denmark, Finland, Sweden, and The Netherlands.

¹ The updated series of national accounts were published by the CBS at the end of August 2021.

² The average GDP per capita between 2016 and 2020 was USD 37,000, compared to USD 51,000 in the benchmark countries (constant 2015 dollars, PPP).

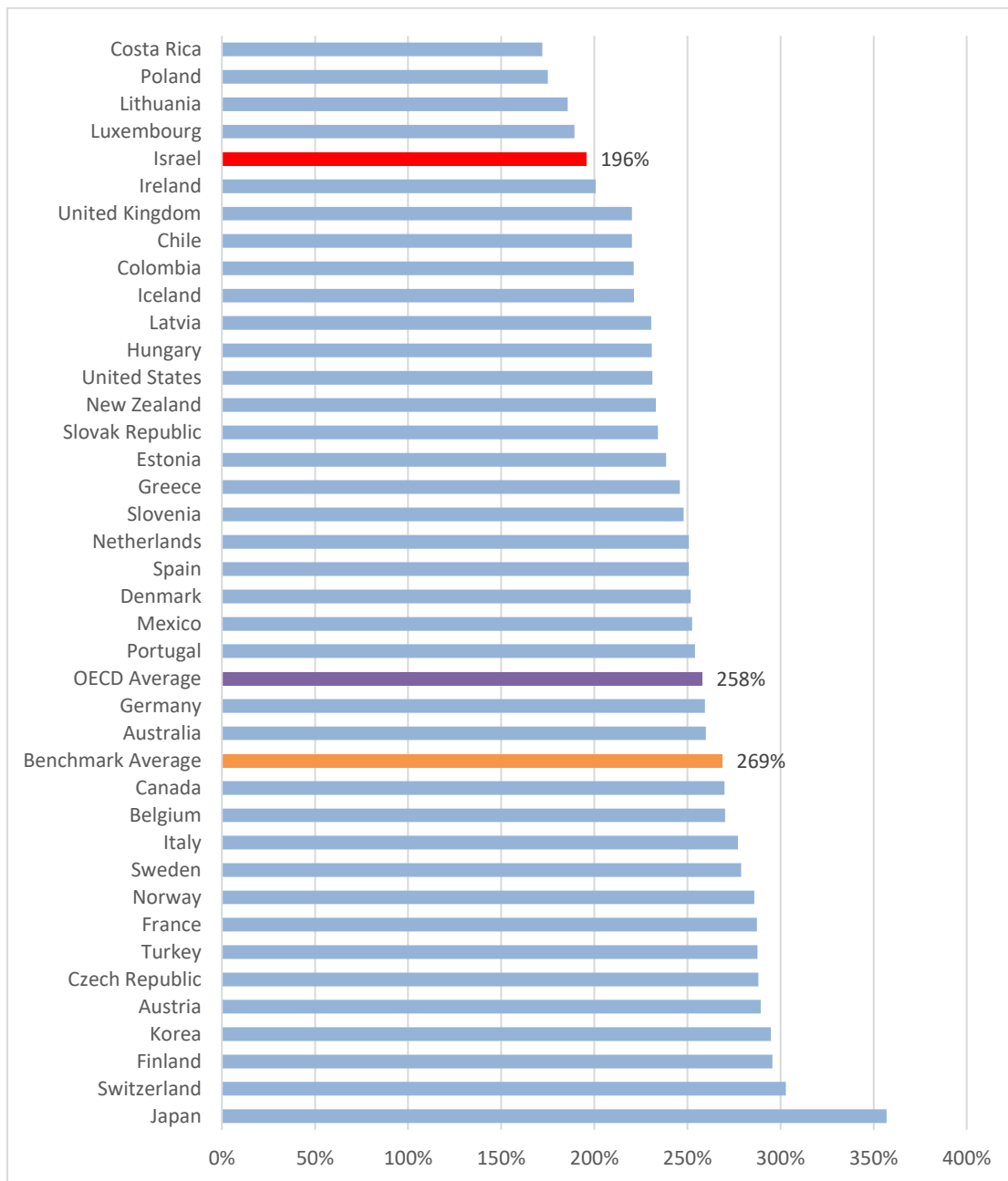
The GDP growth in the Israeli economy during the decade which preceded the COVID-19 crisis (3.8% per year) was derived for the most part from the rise in employment rates (65%) and a more moderate rise in labor productivity (35%). Employment rates cannot keep growing at a similar rate in the future, due to the expected saturation in the employment rates of the non-Haredi Jewish population.

The GDP per hour worked in Israel (labor productivity) is USD 43.2, compared to USD 68.4 per hour worked in the benchmark countries in 2019³ – a gap of USD 25.2 per hour worked. These data indicate that despite the increase in labor productivity in Israel, and the reduction of this gap – which stood at USD 26-27 per hour worked between 2015 and 2018 – the current gap is still large. Considering the significant increase in the employment rate in Israel over time, only reduction of the labor productivity gap would enable Israel to match the standard of living of advanced countries.

The strategy of the Aaron Institute entails that setting priorities for the government requires analyzing the macroeconomic causes of this gap. Using a macroeconomic model, we analyze the productivity gap and identify the share of each factor of production in this gap. This analysis allows focusing the discussion and designing suitable government policies. Our analysis reveals that the main cause of the labor productivity gap between Israel and the benchmark countries is a severe shortage of investments in the Israeli economy – both public and private. According to data from the International Monetary Fund (IMF), the aggregate capital in Israel represents 196 percent of the GDP, compared to 269 percent in the benchmark countries (Figure 1). An additional cause of the productivity gap is the low proficiency level of individuals below the workforce median, who do not pursue academic education.

³ The GDP per hour worked in Israel between 2016 and 2020 was USD 42, compared to USD 68 in the benchmark countries – a gap of USD 26 per hour worked (constant 2015 dollars, PPP).

Figure 1: Aggregate Capital in GDP Percentages in OECD Countries



The benchmark countries are Austria, Denmark, Finland, Sweden, and The Netherlands.

Source: authors' calculations based on IMF data.

The stock of public capital per capita in Israel is lower by 65% compared to the benchmark countries, and its share in the productivity gap is around 31%, amounting to around USD 7.7 per hour worked (Table 1; this figure refers to the cumulative sum of both types of public capital). In order to highlight the various investment channels required, the mechanisms of their contribution to economic growth, and their interrelations with other factors of production in the economy, we conducted an assessment which facilitates detailed, viable policy recommendations. The analysis of the contribution of public capital to the productivity gap was conducted while differentiating between two components: public capital, which consists primarily of transportation infrastructures (75%), and ICT (Information and Communications Technology) public capital. **The importance of public capital to the growth of economic productivity is great, since it is a complementary factor of production to all other factors of production in the economy – it contributes to the productivity of private capital, to the productivity of human capital, and also to the productivity of the existing public capital, as also shown by the economic literature.**⁴

Table 1: Components of the Labor Productivity Gap between Israel and the Benchmark Countries

Gap per Hour Worked	25.2\$	100%
Public Capital per Capita	\$7.4	29%
Public ICT Capital per Capita	\$0.3	1%
Private Capital	\$5.3	21%
Human Capital	\$6.4	25%
Total Factor Productivity (TFP)	\$5.8	23%

ICT capital is digital infrastructures. The benchmark countries are Austria, Denmark, Finland, Sweden, and The Netherlands.

Source: authors' calculations based on IMF and OECD data.

⁴ Ramey, V. A. (2020), "The Macroeconomic Consequences of Infrastructure Investment", National Bureau of Economic Research No. c14366.

Considering the current low stock of public capital per capita, sensible and efficient investments should provide the Israeli economy with high marginal return on investments in public capital. According to the Ministry of Finance, the main barrier to increasing investments in transportation infrastructures is a lack of a detailed plan for implementation. Therefore, the Aaron Institute is preparing a detailed plan for the implementation of infrastructure investments, at a volume which will reduce the gaps between Israel and the benchmark countries by 2040. This plan comprises projects which are economically worthwhile for the economy, particularly with regard to transportation infrastructures, and examines the impact of investments on the labor productivity and overall productivity across the economy, with a reference to regional components. The main features of this plan are presented in this paper. We would like to stress that the economic literature shows that investment in transportation infrastructure has profound effects on the GDP, which are not captured in standard cost-benefit analyses. One of the primary mechanisms used to account for these effects ties infrastructure investments to agglomeration effects. According to these models, an efficient transportation system contributes to the agglomeration of businesses in business hubs, and thus facilitates the utilization of economies of scale, leading to an increase in productivity and GDP. The aforementioned effects are manifested through various economic mechanisms, including the sharing of workers and skills, knowledge flow, utilizing economies of scale in manufacturing, exploiting the benefits of diversity, risk distribution, and so forth. An OECD study on the return on agglomeration found that in all the countries studied, the GDP per worker was significantly higher in agglomerated cities, compared to less agglomerated cities in the same country.⁵

This paper also presents the required volume of investments and the recommended investment path toward closing the gap in public ICT capital per capita, which stands today at a level which is 19% lower than the level of public ICT capital in the benchmark countries.⁶ The volume of annual investment necessary to reduce this gap – 0.34 percent of the GDP – is much lower than the required investment in public physical capital, with a significant potential impact on the efficiency of the public sector which is relatively large in Israel, on the advancement of the business sector, and on the labor productivity across the economy.

⁵ OECD (2017), “What Makes Cities More Productive? Agglomeration Economics and the Role of Urban Governance: Evidence from 5 OECD Countries”, OECD Productivity papers no. 06.

⁶ For further reading on the relation between digitalization of the economy and economic growth, see Axelrad, H., Sumkin, S. and Haver, S. (2022), “Promoting and Developing Digital Transformation in Israel toward 2030”, Aaron Institute for Economic Policy.

The contribution of the **business sector capital stock** in Israel to the GDP gap is 21%, amounting to USD 5.3 per hour worked. Despite the growth of the capital stock per hour worked in the Israeli business sector, it is still 46% lower than the capital stock per hour worked in the benchmark countries. Out of the existing capital stock, our model allows extracting the marginal cost of capital, which is higher by 23% in Israel compared to the benchmark countries. This cost stems from the business environment in Israel, particularly the excessive regulation and administrative burden which increase the cost of business activity and constitute a tax on ongoing activity. We wish to emphasize the opportunity facing the government to encourage investment in the business sector, stimulate competition, and reduce the cost of living in Israel through **the establishment of the Regulation Authority (ROB). We believe that effective work by the Regulation Authority toward regulatory optimization and reduction of the bureaucratic cost requires well-defined targets and a fundamental change in the concept of regulation in Israel, and is key to increasing investments in the business sector, and consequently streamlining business activity and increasing labor productivity. Regulatory optimization will reduce barriers to entry, stimulate competition, and reduce the cost of living.** The success of the Regulation Authority is not granted, but depends on the quality of the Authority's management, its standing among government offices, and its ability to make an effective use of the powers and tools vested in it by law. Most of all, the success of this Authority hinges on a joint governmental effort by all government offices and regulators, based on an understanding that cooperating with the Authority toward reducing the cost of bureaucracy is not merely a bureaucratic duty on their part, but an essential need of the Israeli economy to encourage the business sector and the scope of investment across the economy as a whole, stimulate competition, and reduce the cost of living. The Authority which is about to be established should draw support from the Prime Minister Office, and employ all its powers, including the publication of annual reports, to inform the government as well as the general public on the progress and the barriers along the way toward high-quality regulation in accordance with international standards, and the reduction of the cost of living.

Our analysis further indicates that **the gap in human capital quality**, as reflected in workforce proficiencies, accounts for 25% of the productivity gap, which amount to a difference of \$6.4 per hour worked. This paper outlines the Institute's recommendations in regard to the population group which does not receive academic education, in particular the importance of implementing the recommendations of the Employment 2030 Committee, which focus primarily on increasing employment rate and quality, with an emphasis on workers below the median income and those hailing from the Arab and Haredi societies.

The results of our analysis emphasize that the stock of investments in the Israeli economy and the quality of human capital account for 77% of the gap in GDP per hour worked between Israel and the benchmark countries. These factors, whose impact is most pronounced in the traditional manufacturing, construction, commerce, and services sectors, are consistent with the many findings which show that the productivity problem is mainly concentrated in non-tradable sectors, and in tradable sectors which primarily target the domestic market. These results are also consistent with previous recommendations made by the Aaron Institute (Employment 2030 Committee, and The Committee for Economic Advancement of the Commerce and Services Sectors), to invest primarily in increasing the productivity of the weaker workers in the Israeli economy, most of whom are employed in these sectors, which are characterized by low productivity and wages. **Therefore, adopting the reforms and policy measures proposed in this paper to address the existing gaps in investments and human capital quality in the Israeli economy, in addition to its expected contribution to economic growth, would also improve the poverty situation, since the main bulk of the growth in productivity and wages will benefit workers below the median income.**

Special emphasis is given in this paper to the high-tech sector, where labor productivity and wages are higher in comparison to other sectors. The years 2017-2021 were marked by a significant increase in the rate of workers employed in the high-tech sector among the 25-64 age group (6.7% per year),⁷ so that at the end of 2021 they represented 11.9% of all employees across the economy (12.3% of all salaried workers). Our analysis shows that this increase has been supported by the entry of young age cohorts into the high-tech sector, and the transition of highly skilled, educated workers from other sectors to the high-tech sector.⁸ The higher salaries in the high-tech sector, and the trends of transition of skilled workers to this sector, contribute to the advancement of the other sectors (most notably the banking sector), which, in order to retain skilled workers who have adequate skills for high-tech occupations, will be forced to adjust their wage levels and streamline their operations, thereby contributing to an increase in labor productivity. This advancement in other sectors is also likely to occur due to the need to attract workers in non-high-tech occupations (economists, lawyers, etc.) who will wish to enter the high-tech sector due to its high wage levels – a process which will contribute to the pressures for wage increases and streamlining in other sectors.

The high levels of productivity and wages in the high-tech sector also contribute to the development of skills and education in the long term, since younger age groups in elementary schools are already being directed to suitable education. This trend will lead to an increase in the share of academic graduates with STEM-related qualifications and a “high-tech degree”,⁹ who would be able to integrate into highly productive roles in the labor market.

⁷ The annual increase rate in the number of employees in Israel is less than 0.5%.

⁸ For further data, see Hashai, N., Sumkin, S. and Nir, R. (2022), “What Are the Necessary Skills for High-Tech Worker”, Aaron Institute for Economic Policy and Trump Foundation.

⁹ STEM: Science, Technology, Engineering, and Mathematics. A “high-tech degree” is defined as an academic degree in one of the following subjects: computer science, mathematics & computer science, management information systems, electrical engineering, electronics engineering, computer engineering & computer science, computer & electrical engineering, communication systems engineering, and data systems engineering.

The greatest challenge facing this trend is the alignment of the school system and the higher education system toward imparting suitable skills for an advanced labor market, a move which should include admission of greater numbers of first-year students into “high-tech degree” courses; a shift to English-language tuition, at least in some courses, to instill fluency in spoken English which would be useful in occupations which require this proficiency; and similarly, adapting and updating study programs to address the required skills for the labor market.¹⁰

The high productivity in the high-tech sector has triggered an economic discussion on the question of whether the strategy in Israel should focus on efforts to expand the high-tech sector as much as possible. Thus, for example, there have been calls to set an ambitious target of increasing the relative share of high-tech employees to 15% of all employees across the economy. We believe this is not the correct target.¹¹ As previously stated, the high productivity of the high-tech sector contributes to the advancement of the other sectors, and at the same time increases the supply of workers with appropriate skills for integration in high-tech occupations, extending to other sectors as well. **Therefore, the correct goal would be to raise the population’s educational attainment and quality, as well as skill levels, in a manner which would facilitate integration into high-tech occupations in the high-tech sector as well as other sectors, and thus enhance labor productivity and innovation across the economy as a whole.** We oppose the setting of any “sectoral” goals, and support an objective which would provide the entire population with the education and skills which enable them to integrate into high-productivity, high-wage occupations, in any sector they choose.

In light of this analysis, the policy recommendations proposed by the Aaron Institute are as follows:

¹⁰ Adding courses in data science and coding literacy, and tracks of study which focus on product management and business intelligence.

¹¹ The Israeli high-tech sector is already very large in international comparison, and it is not clear how much further it could be expanded, partly because of the restraining factor of the currency exchange rate, since the products of this sector are almost entirely export-oriented.

A Policy for Reducing the Public Capital Gap

The large gaps in public capital necessitate a plan for investments in transportation infrastructures, particularly public transport infrastructures, so that by 2040 Israel will significantly reduce the gaps in transportation infrastructures vis-à-vis the benchmark countries. We call for adoption of a multi-year plan of investments in transportation infrastructures, according to the primary investment needs, namely: extended development of mass transit systems in the metropolitan areas; increasing the capacity of heavy rail transit in the crowded lines; upgrading the road infrastructure to support public transport; and improving the connectivity between the various means of transport.

Formulating a multi-year plan for infrastructure development should be accompanied by an advancement of planning and execution processes, in order to establish a long-term government commitment. Such a commitment will provide private actors with certainty in regard to the adaptation of urban development, including employment hubs, residential and leisure complexes, and development of transportation access. This element is critical for the efficiency of investments in the economy, and also for the volume of private investments in all areas, particularly in the areas of services and commerce. We propose setting quantitative targets for the quality of transportation access, and designing the investment plan in accordance with the achievement of these targets. The qualitative overarching targets of the investment plan are:

- Shortening travel times during peak hours by 35% to 50%.
- Increasing the number of passengers who reach metropolitan centers within 45 minutes, from 45% to 72%.
- Increasing the use of public transport in metropolitan areas, from 10% to 40%.¹²

¹² Our proposed plan includes an increase in the use of high-quality public transport which includes a metro system adapted for rail transit (both heavy and light), and a designated system of buses and roads to be used exclusively for toll trips and public transport. These investments should lead to an increase in the share of public transport trips in metropolitan areas, from 10% to 40%.

The government's professional staff should mobilize around this cause, arrange a sufficient inventory of investment plans for core infrastructures, and ensure that barriers are removed and national infrastructure projects are carried out as rapidly and efficiently as possible. Transportation infrastructures constitute a central part of core infrastructures. According to estimates made by Aaron Institute, informed by consultation with transportation planners, reducing the public capital gap requires preparation of investment plans at a volume of NIS 800-900 billion. This figure is in line with the recommendation to increase investments by around 2% per year, starting at the 2023 state budget. Therefore, we support the proposal to enact a National Infrastructures Law, whereby extensive projects will be subject to the authority of a consolidated public system, vested with the power to coordinate and settle disagreements between regulators in a prompt manner, thereby preventing delays in the completion of projects which are inherently prolonged. A further recommendation is to establish a national infrastructures fund, which will facilitate conserving budgets in years when the deficit is low and there is no planning inventory for immediate execution of sizeable projects. In addition, a cabinet should be assembled, headed by a senior minister, which would be tasked with promoting the implementation of the recommendation to advance long-term plans and investments, and to adapt them to the advancement of residential and commercial construction.

In light of these recommendations, this paper also discusses the manner of funding the large volume of investments which is required to reduce the transportation infrastructures gap between Israel and the benchmark countries. **Our position is that the real interest rate environment, which is still relatively low, makes it possible to fund government investments through debt, thereby avoiding tax increases which have negative impact on the growth of the economy.** Obviously, increasing the debt does not substitute the need to optimize budgets and streamline the tax system, including the cancellation of unnecessary exemptions; these are important measures which are supported by the Aaron Institute, although not discussed in this paper. **Increasing public capital through an increase in investment at an annual rate of around 2%, with specific regard to transportation infrastructures, is expected to enhance the growth rate by nearly one percent per year, within a few years. Therefore, it is not expected to endanger the debt service derived from the temporary increase in the debt-to-GDP ratio, and the standing of Israel in the financial markets.**

A Policy for Reducing the Private Capital Gap and Encouraging the Business Sector

The biggest challenge in the process of regulatory optimization and bureaucracy reduction in Israel is resolving the stock of regulation and bureaucracy which has accumulated over the years. Many regulators naturally concentrate their efforts on new schemes and initiatives, rather than on optimizing the regulations put in place by their predecessors. Consequently, the stock of existing regulation and bureaucracy is outdated in part, and needs to be updated or cancelled. Therefore, the main task of the nascent Regulation Authority is to assess the current situation, by measurement and setting targets for regulatory optimization and administrative burden reduction. In the absence of clear metrics, it would be decidedly difficult to quantify the regulatory burden, to set concrete targets, and to monitor the achievement of targets. This is evident, among other things, from the accumulated experience of other countries which have implemented programs for reducing the administrative burden on businesses. The foundations for implementation of the burden reduction program are:

1. Publication of a regulatory prescription according to areas of activity (authorized by law);¹³
2. Systematic, professional, and monitored measurement of the cost of compliance with key bureaucratic procedures, using the SCM method;¹⁴
3. Setting metrics and targets for reduction of the stock of bureaucracy;
4. Tracking and annual publication of the regulatory prescription and of the costs of compliance with key bureaucratic procedures, similar to the measurement and publication of other economic indicators, such as inflation and employment rates.

¹³ A regulatory prescription is the inventory of bureaucratic obligations which exist in each area. This is the foundation for the actual measurement of the cost of bureaucratic compliance, and for the formulation of targets for its reduction.

¹⁴ SCM (Standard Cost Model) is the most common model for bureaucratic cost measurement, and has been adopted as a uniform methodology by the OECD and the European Union. This model is based on breaking down legislation into information obligations, and measuring the time and the cost required to fulfil each information obligation.

Policy for Reducing the Human Capital Gap

The COVID-19 pandemic and the ensuing economic crisis had set the Israeli labor market back by around ten years, as in April 2021 the effective employment rate among the 25-64 age group was 73%, similar to the rate in 2011. The brunt of the blow during the crisis was taken by workers with low skills and low income – young, Arab, and Haredi workers with secondary education or lower. However, since then the economy has recovered and regained the employment rates of 2019, at the eve of the crisis, and even exceeded those rates in most population groups (as of March 2022, the employment rate among the 25-64 age group is 79.4%). The crisis accentuated and exacerbated the two prominent employment challenges facing the Israeli economy: groups with low employment rates, mainly Haredi men, Arab women, and in recent years also Arab men; and low productivity and wages, particularly among individuals who do not pursue academic studies. The Aaron Institute has been working toward the economic advancement of Israel's Arab society, including targets and programs in the areas of employment and education, and with an emphasis on younger populations.¹⁵ Nevertheless, the continuing unemployment among some of these groups, even after the employment crisis has ended, poses a risk of long-term ejection from the labor market and an increase in poverty. Therefore, the Israeli economy urgently needs a comprehensive policy on employment and human capital:

1. A return to the path toward achieving the 2030 targets for employment rate and quality.
2. Building employment plans for a wide scale of participants (one-stop centers), which would include vocational diagnosis and guidance toward employment, education and training; matching the skills of workers to the labor market; and guidance through suitable training courses, active job seeking, and placement.
3. Implementing a comprehensive reform in the vocational training system, according to the outline proposed by the Employment 2030 Committee, with a focus on occupations which are in high demand, and expanding the number of participants in vocational training schemes to include around 40% of the age cohort.

¹⁵ For information on the Institute's activity with regard to Israel's Arab society, in the framework of The Center for Economic Policy of the Arab Society, see: <https://www.runi.ac.il/en/research-institutes/economics/aiep/arab-society-program/>.

4. Establishing an Employment Ministry which would integrate policies and enact the Employment 2030 recommendations, as exists in most developed countries, and specifically following the model which exists in Denmark, to provide integral management of all employment schemes and vocational training programs, and act as a consolidated point of contact addressing the needs of individuals who are unemployed or out of employment.