TAUB CENTER
for Social Policy Studies in Israel

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From the Director

The Taub Center's standing as one of Israel's leading research institutes was bolstered over the past year with the addition of some of the world's most renowned scholars to its 15 member International Advisory Council. Four Nobel Laureates – Gary S. Becker, Aaron Ciechanover, James J. Heckman and Daniel Kahneman – joined a fifth Nobel Laureate, Lawrence Klein, already on the Taub Center's Council. Also joining the Council were Israel's most highly cited academic economist, Elhanan Helpman, from Harvard University, and Adam Gamoran from the University of Wisconsin, one of America's leaders in education research, who was also recently appointed by President Obama to serve as a member of the National Board for Education Sciences.

We are very proud and happy to welcome these six new members to the Taub Center's International Advisory Council.

Dan Ben-David
Executive Director
Taub Center for Social Policy Studies in Israel

Education, Employment and Long-Term Trends

The process of economic growth greatly increases the demand for educated and skilled workers. This has a substantial and increasingly negative impact on the incomes and the employment chances of the less educated.

The State of Israel faces several severe problems in the socio-economic realm: high levels of poverty and income inequality, and economic growth rates that are low – in relative terms – compared to leading developed nations. These problems are connected in many areas and in particular in the area of education.

Economic growth is accompanied by a steady and continuous process of structural change. As a result, the demand for educated and skilled workers increases while the relative demand for unskilled labor declines. As long as comprehensive measures to reduce the supply of uneducated and unskilled labor are

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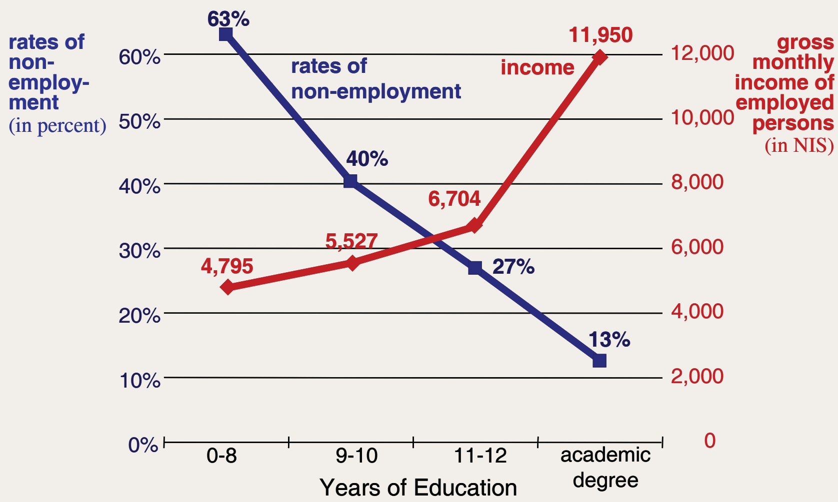
not implemented, these workers will find it difficult to find employment and their wages will suffer. This will in turn have severe consequences for poverty and inequality.

Figure 1 (from the Taub Center's *State of the Nation Report: Society, Economy and Policy 2009*) shows the relationship between education, employment and income for 2008 among individuals between the ages of 25 and 54. The higher the level of education, the lower the rate of non-employment and the higher the income.

Fig. 1 **Relationship between Education, Employment and Income, 2008** | ages 25-54



Source: Dan Ben-David, Economic Quarterly, 2003 (updated).
Data: Israel's Central Bureau of Statistics, OECD.

This relationship has been becoming much more pronounced over time, as is evident from Figure 2. The graph shows the average rate of non-employment within low-education groups among prime-working age men aged 35-54 from 1970 through 2008. Four decades ago, the percentage point differences in non-employment rates among the various education levels were very small compared to today. Non-employment was less than 10 percent for all groups.

Since then, non-employment rates among men with only 1-4 years of schooling have exhibited a five-fold increase, reaching approximately 50 percent today. There was also a significant increase in non-employment among men with 5-8 years of study, although their rates of non-employment still remained below those with 1-4 years of study. The increase in non-employment becomes more moderate as the level of education increases. The lowest rates of non-employment are among those with 16+ years of study (generally people with an academic degree). In contrast with the other education groups, average rates of non-employment in the 16+ group have not increased since the mid-1990s.

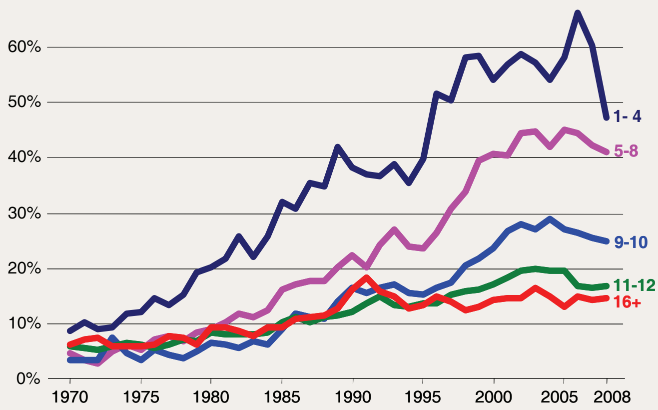
A nation seeking to reduce rates of poverty and inequality at their source must increase the level of education among its population. A person whose education is upgraded will have better prospects of finding employment and of obtaining a higher income – and reduced chances of living in poverty. As more and more individuals upgrade their education, there will be less competition for jobs among those who remain less educated, and they too will find that their prospects of garning employment and raising their incomes have improved. As in other countries, the economic growth process and the increasing demand for educated workers guarantees a positive return to education even when the educated population in the economy grows.

While complementary stimulatory measures – such as a negative income tax for low-income workers and a tax on employment of foreign workers – can make a non-negligible contribution toward improving employment and wages among Israelis, only comprehensive policies dealing with the problem sources, including upgrading levels of education and skills in Israel, can bring about substantial changes in Israel's long-term trends of poverty, inequality and economic growth.

Fig. 2

Non-employment rates by years of education

as share of 35-54 year-old male population, 1970-2008



Source: Dan Ben-David, Taub Center and Tel-Aviv University.
Data: Israel's Central Bureau of Statistics.

Public Expenditures: A look at Israel's National Priorities

Contrary to conventional wisdom, the underlying reason for Israel's high rates of poverty and inequality and low rates of economic growth over the past several decades is not due to insufficient government budgets but to the underlying national priorities that determined how those budgets were allocated and spent.

Why are Israel's rates of poverty and disparity so high and what caused them to rise over the past several decades? How did it happen that, despite population groups within Israel that innovate at the frontiers of human knowledge, the country's steady state rates of productivity and economic growth consistently lag behind those of the G7 countries leading the Western world? Has Israel's defense budget been so large that civilian public expenditures were simply insufficient for coping over the years with the country's primary social and economic problems in the realms of education, employment, health and welfare? The chapter on public expenditures in the Taub Center's recent *State of the Nation: Society, Economy and Policy 2009* report focuses on these questions. Some of the highlights from this chapter are brought forth here.

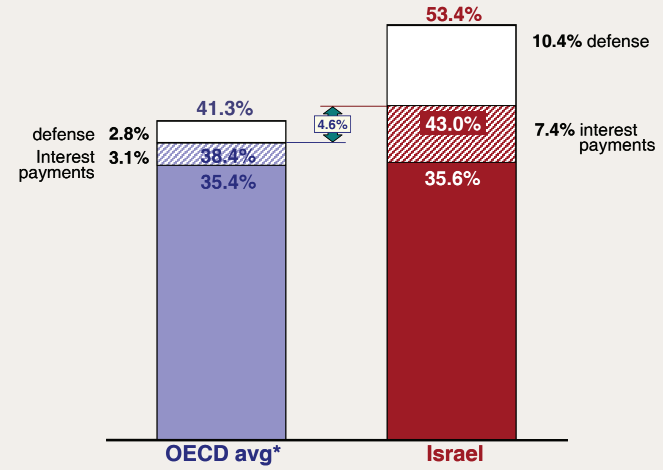
In seven of the eleven years between the 1973 Yom Kippur War and the peak inflation rate of 445 percent in 1984, Israel's public expenditure exceeded 70 percent of the country's Gross Domestic Product (GDP). After implementation of the Economic Stabilization Program, the country's public expenditure fell to an average of 53.4 percent during the two decades spanning the years 1985-2004, which is still relatively high compared to other Western countries. The prevailing conventional wisdom in Israel has been that although total expenditures are higher in Israel, the civilian portion of public expenditures is lower than the Western average because of the much higher defense expenditures in Israel.

Figure 3 compares Israel's public spending to that of the OECD countries. The average Israeli expenditure of 53.4 percent of GDP over the years 1985-2004 was indeed higher than the OECD's 41.3 percent of GDP during that same time period. Also, Israel's average defense spending, 10.4 percent, was substantially higher than the OECD's 2.8 percent. However, after subtracting defense spending from overall expenditures in both

Fig. 3

Total Public Expenditure, 1985-2004

as a percentage of GDP



* 23 countries for whom OECD reports data on interest payments.

Source: Taub Center for Social Policy Studies in Israel.
Data: Israel's CBS, Bank of Israel, OECD.

Israel and the OECD, Israel's civilian expenditure (43.0 percent of GDP) was still 4.6 GDP percentage points higher than the OECD's (38.4 percent of GDP).

To illustrate how much Israel's civilian expenditure exceeded the OECD's over these two decades, it is possible to estimate the cumulative value of Israel's surplus civilian expenditure compared to that of the OECD by multiplying Israel's output by the difference between civilian expenditure in Israel and in the OECD during each of the years. When tallied up, Israel's surplus civilian expenditure relative to the OECD average for the 1985-2004 period equaled NIS 363.9 billion in 2008 prices. This amount is half of Israel's entire 2008 GDP of NIS 725.1 billion. In other words, Israel's long-run trends of low growth and high poverty and income inequality relative to the OECD in recent decades did not result from lower civilian expenditures than the OECD, but from different priorities in the utilization of the civilian budgets.

The high level of public expenditures, which were not completely funded by taxes and other revenues, resulted in annual budget deficits. The financing of these deficits has meant that Israel had to borrow and subsequently return not only the principal on the loans, but has also had to pay the interest on them. Interest payments represent a "fine" of sorts that is placed on Israel's inability or reluctance to live within its means. Debt is justified when the loan is used for building infrastructure that would also benefit the next generation – which makes it reasonable to expect that the next generation should also participate in paying for it.

But when it comes to infrastructure projects over this period, Israel lagged far behind the OECD countries. For instance, in the area of transportation infrastructure, traffic congestion in Israel reached three times the OECD average, though the country only had half the number of vehicles per capita as the OECD (Ben-David, 2003a). The act of borrowing to pay for expenditures that do not pertain to infrastructure investments means rolling over to the next generation bills for expenditures that the future generation will not benefit from.

The fact that Israel's annual interest payments as a share of GDP are more than twice the OECD average is a serious enough problem. When this is combined with the fact that Israel's physical infrastructure has been seriously neglected over these two decades, the problem becomes even more acute. Israel's interest payments reached NIS 33.3 billion in 2008 (Figure 4), more than the Education Ministry's overall budget that year, which reached NIS 28.6 billion. In fact, interest payments – the "fine" Israel paid in 2008 for its inability to live within its financial means – were more than double the budget of all the elementary and secondary education in Israel and nearly double the Health Ministry's entire budget. This is one practical implication of rolling the debt over to the next generation.

However, even after subtracting from public expenditure not only the defense spending but also interest payments, Israel's civilian public expenditure over the two decades (35.6 percent of GDP) was almost identical to that of the OECD (35.4 percent of GDP). This relative equality in civilian spending between Israel and the OECD seriously undermines the prevailing

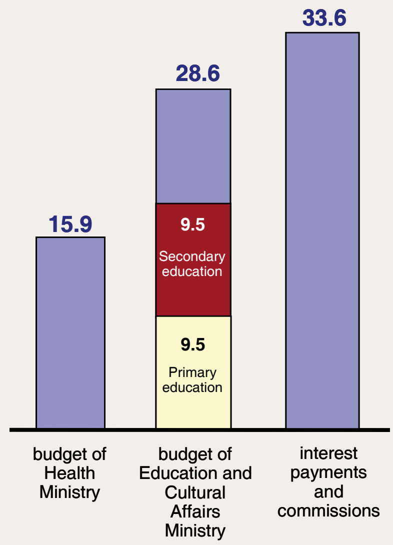
conventional wisdom that Israel's civilian expenditure was too low to allow an in-depth treatment that might have alleviated the country's high (in comparison to the OECD) rates of poverty and income inequality and relatively low rates of economic growth.
It is interesting to compare Israel's public expenditure not only to other countries but also to other time periods in its own history. Figure 5 presents a comparison of recent years with the past, while continuing to exclude defense spending and interest payments. In the 1960s, during the years preceding the Six Day War and in the shadow of existential national security threats, Israel absorbed massive waves of immigration, built roads, towns, schools and research universities – projects that we know today as key infrastructures for generating economic growth.

During this period, Israel was characterized by substantially higher economic growth than all other countries with similar income levels while income disparities within Israel were very low compared to most Western countries. The infrastructure investments in the 1960s were made when Israel's civilian expenditures (excluding defense and interest expenses) were 20.6 percent of GDP, slightly more than half the country's average public expenditures over the years 1985-2004 (also excluding defense and interest expenses).

Fig. 4

Government Budget, 2008

Selected budget items, NIS billions



Source: Taub Center for Social Policy Studies in Israel.
Data: Ministry of Finance.

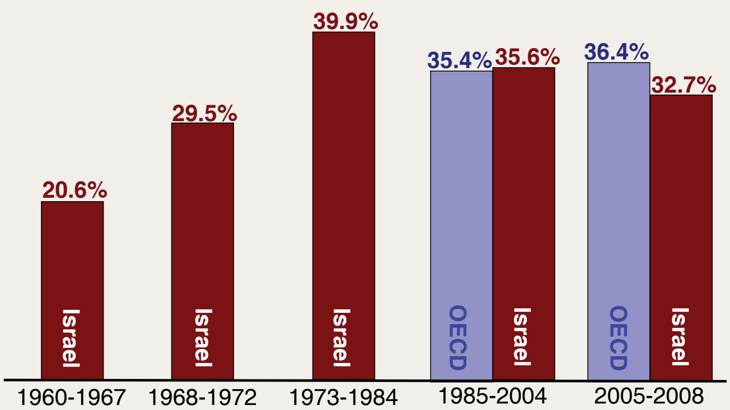
Israel's public expenditures, excluding defense spending and interest expenses, grew considerably between the Six Day War and the Yom Kippur War. The ratio of expenditures to GDP rose by almost one half, from 20.6 percent of GDP before the Six Day War to 29.5 percent of GDP in the years 1968-1972. After the Yom Kippur War in 1973 and until the record inflation year in 1984 and the Economic Stabilization Program, public expenditures (net of defense and interest payments), rose by an additional 10 percent of GDP, reaching 39.9 percent of GDP in the years 1973-1984.

The substantial increase in civilian public expenditures reflected a major change in Israel's national priorities. Although the overall total was higher than it had

Fig. 5

Total Public Expenditure, 1960-2008

excluding defense expenditures and interest payments, as a percentage of GDP



Source: Taub Center for Social Policy Studies in Israel.
Data: Israel's CBS, Bank of Israel, OECD.

been in the past, the era of large investments in basic infrastructures for the development of a modern economy came to an end, making way for new priorities that reflected much less of a national perspective and considerably more sectoral, local and/or personal considerations. Consequently, the rate of economic growth declined significantly.

In recent years, including the budget years 2009 and 2010, Israel's public expenditures, after exclusion of defense and interest expenditures, have been lower than the OECD average. This reduced level of available funds requires that the money be spent wisely. It also requires a serious examination of how the burden of its financing is distributed among Israel's population together with a substantial improvement in the enforcement of the country's tax laws.

In a world that is witnessing increased competition between countries, when Israel's rates of poverty and income inequality are high and its long run economic growth path is lower and flatter than those of leading Western countries, national priorities in budget allocation play a crucial role. The time has come for dealing with the question of whether the government budget should focus primarily on providing core treatment of central social and economic issues from a national perspective – such as building and strengthening human and physical infrastructures – or whether the focus should be on sectoral, local and/or personal interests. In a country that already has to bear a substantially heavier defense burden than is typical in the West, there is an even greater need for responsibility and caution when deciding how to spend what remains of the budget. Expenditures should be determined on the basis of national interests, with an emphasis on providing the tools and conditions that will enable as many people as possible to successfully contend in a modern economy while stressing a more selective social security network that maximizes the available assistance to those who truly need it most.

How minimum the wage, how negative the tax?

Israel's minimum wage is among the highest in the West, but lawmakers want to raise it further. On the other hand, the country's negative income tax is very low compared to the United States.

Israel already has some of the highest rates of non-employment in the western world. Its high rates of poverty and inequality have led to demands that the country's minimum wage be substantially increased from its current NIS 3,850 to NIS 4,600 per month. What might be the consequences of raising the minimum wage and are there alternatives that might be more effective?

In a country that is already not a strict enforcer of the current minimum wage, one might ask why there is a demand for a higher minimum wage rather than first and foremost a demand for more rigorous enforcement of the current minimum. In addition, higher wages might lead firms to want to employ less workers as a result of the higher hiring costs – thereby potentially leading to higher wages for those who are working, but to higher rates of unemployment among those wishing to work but unable to find jobs. This notion relating higher minimum wages with higher unemployment rates may make intuitive sense, but it has been very difficult to definitively prove or disprove empirically.

However, it is nonetheless possible to focus on the relative size of the current and proposed minimum wages and compare them with a number of other barometers. For example, how do Israel's current and proposed minimum wages compare to other countries? An accurate comparison must take into account not only the minimum wages but also the standards of living in different countries. One measure of the standard of living is a country's median wage.

The ratio of the minimum wage to the median wage in 23 OECD countries is depicted in Figure 6. In the United States, the minimum wage equals 34 percent of the median wage. In the Netherlands, this ratio rises to 43 percent, while the OECD average ratio is 46 percent. Israel's current minimum wage is 58 percent of the country's median wage – with only two OECD countries, New Zealand and France, with higher ratios of minimum to median wages (59 and 63 percent, respectively). Should Israel decide to raise its minimum wage to the proposed level to NIS 4,600, then the ratio of its minimum wage to its median wage will be the highest in the western world.

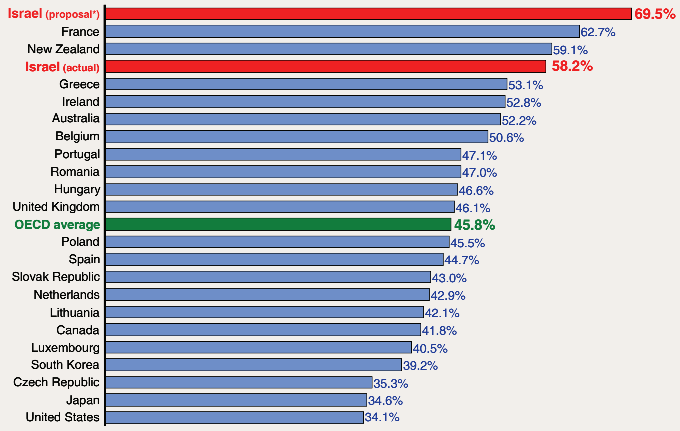
From a domestic perspective, is the minimum wage sufficient for raising a family above the poverty line? Figure 7 looks at the percent difference between a two-parent family's income and the poverty line – assuming that both parents work and receive no more than the minimum wage plus a child allowance from the government for each child.

In families with no children, the existing minimum wage (still in force since 2008) yields the family an income that is over twice as high as the poverty line income (120 percent higher). Families with three children receiving child allowances have incomes over 20 percent higher than the poverty line. Only at seven children does the sum of two minimum wages for each parent plus child allowances yield an income roughly equaling the poverty line. The proposed minimum wage hike increases the differences between family incomes and the poverty line for families of all sizes.

Fig. 6

Minimum Wage

as a percent of median wage, 2008



* proposal for minimum wage of NIS 4,600

Source: Dan Ben-David, Taub Center and Tel-Aviv University
Data: Israel's Central Bureau of Statistics, Social Security Institute and OECD.

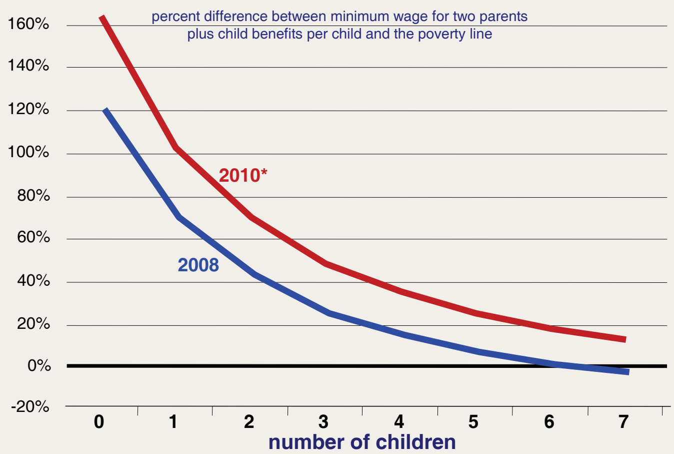
The real question revolves not just on whether or not the minimum wage should be increased, but on whether this is even the best way to approach the issue of low incomes. One major alternative that has been implemented with relative success in the United States is the negative income tax – or, as it is called in the U.S., the Earned Income Tax Credit, EITC (though not the focus here, it should be noted that such a negative income tax program should be supplemented by a parallel program of upgrading education and providing professional training).

In the case of a family with two parents and two children, for example, the negative income tax rate in the States is 40 percent. The attractiveness of this form of assistance is that it grows with income and becomes an increasing incentive to work. An annual income of $5,000 yields an additional $2,000 from the government in the form of a negative income tax. But if the income rises

Fig. 7

Minimum wage plus children benefits

relative to poverty line



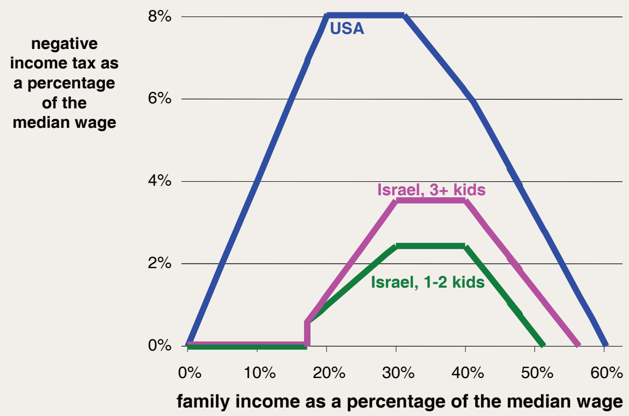
* proposal for minimum wage of NIS 4,600

Source: Dan Ben-David, Taub Center and Tel-Aviv University
Data: Israel's Social Security Institute.

Fig. 8

Negative Income Tax

In the U.S. and Israel, 2008*



* In U.S.: families with 2 parents and 2 children, net negative income tax.

Source: Dan Ben-David, Taub Center and Tel-Aviv University
Data: Internal Revenue Service, BEA, US Census, Israel's Finance Ministry, and CBS.

to $10,000, then the additional payment from the U.S, government rises to $4,000.

Figure 8 (from the Taub Center's *State of the Nation Report: Society, Economy and Policy 2009*) compares between the American and Israeli versions of the negative income tax. Both the negative income tax and the income bases are divided by the median wage to net out differences in living standards between the two countries.

The primary difference between the programs is in the degree of the incentives provided by each. The United States government gives the maximum negative tax, 8 percent of the median wage, when the family's income reaches 20 percent of the median wage. At a similar relative income level, the negative tax in Israel reaches only 1.2 percent of the median wage for families with three children or more, and even less (1 percent) for families with one to two children. In Israel the maximum amount is paid out only when income reaches 30 percent of the median wage. Not only does the negative tax begin much later in Israel, but the maximum negative tax in Israel is considerably lower: 3.5 percent of the median wage (less than one-half of the maximum negative tax in the United States) for families with 3+ children and only 2.4 percent of the median wage for families with fewer children.

The differences in approach between the two countries are substantial. The American model gives more at the beginning of the process to encourage entry into the labor market and it reaches the maximum payment much more quickly. In Israel it is possible to reach the maximum negative tax level only at much higher income levels. Even when the maximum negative income tax is reached in both countries, the Israeli model's incentive to work is considerably smaller than the American incentive.

The absence of a serious negative income tax program in Israel may be more severe than simply money spent on an effort yielding minimal outcomes. Failure could lead to a decision to cancel such an expensive program altogether rather than reimplementing it properly and yielding the desired results – with all that this entails regarding the loss of an important policy tool for encouraging employment.

Established in 1982 under the leadership and vision of Herbert M. Singer, Henry Taub, and the American Jewish Joint Distribution Committee (JDC), the Center is funded by a permanent endowment created by the Henry and Marilyn Taub Foundation, the Herbert M. and Nell Singer Foundation, Jane and John Colman, the Kolker-Saxon-Hallock Family Foundation, the Milton A. and Roslyn Z. Wolf Family Foundation, and the JDC.

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