TAUB CENTER
for Social Policy Studies in Israel

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## From the Director

The Taub Center's Board of Directors has undergone a number of changes recently. After seeing the Center through five years of significant change and growth, Caryn Wolf Wechsler's term as Board Chair has come to an end. As Executive Director of the Taub Center for just over half of this period, I could not have asked for a more supportive partner – and friend – than Caryn. She provided the leadership, commitment and devotion that helped bring together the Center's veteran Board members with the new Board members who have joined in recent years.

The new Chair is Greg Rosshandler, sponsor of this Bulletin and a major supporter of the Taub Center. Greg, who hails from Australia, represents a new direction that the Board is taking by recruiting membership from outside the United States. Greg is very passionate in his support for Israel and for the Taub Center and we are extremely fortunate that he has agreed to lend his unique strengths, visions and positive, forthright approach to help guide the Center as it moves to the next level.

As part of the new direction that the Taub Center Board is taking, I would like to welcome two new Israeli Board members: Benny Landa and Ofra Strauss. They, together with Dov Lautman who joined the Board last year, reflect the Center's efforts to involve prominent and influential Israelis in supporting our work and bringing it before the country's leading policy makers. We look forward to working closely with them to increase the strength of the Board and to grow support for the Center from within Israel.

Dan Ben-David
*Executive Director*

## In this issue

# Living on borrowed time?

*Israel's economy is currently performing well in comparison with other Western countries, but the long term outlook is less promising.*

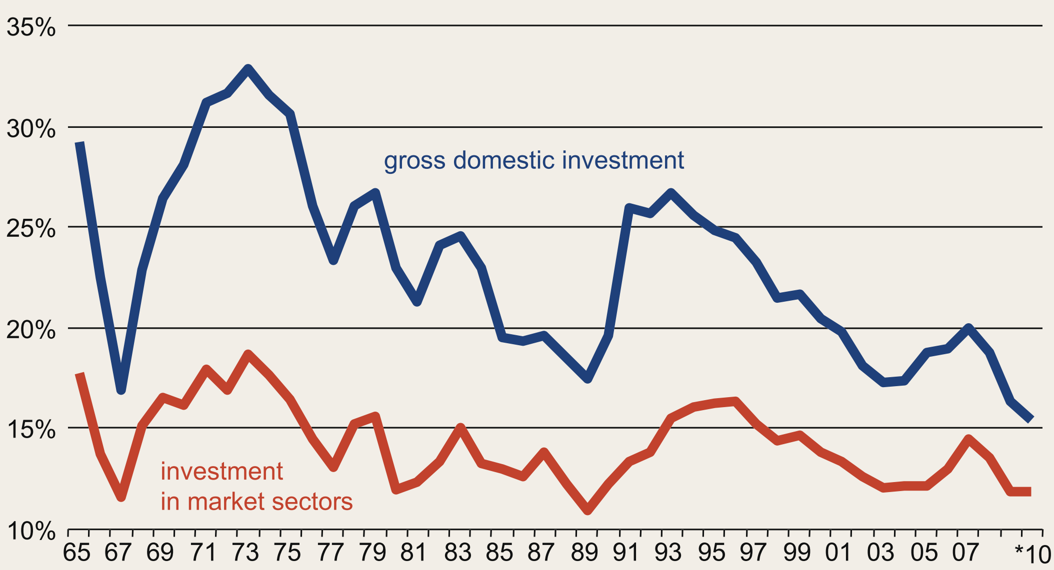
Israel's macro economic performance in recent years has been enviable: above-average growth, below-average unemployment, a trade surplus, moderate inflation, and a shrinking public sector debt as a fraction of output. As Professor Eran Yashiv, Chair of the Taub Center's Economic Policy Program shows in the new *State of the Nation Report 2010*, Israel weathered the 2007 to 2009 financial crisis better than most developed economies, with a downturn that was both smaller and shorter than that of the US and most of Western Europe.

While the current economic picture compares favorably to what other Western countries are experiencing, there is also reason for concern. In contrast to the current economic indicators, Yashiv shows that indicators foreshadowing future economic performance paint a more worrisome picture. Israel's economic future requires investment in physical capital such as equipment, buildings, and public infrastructures, and it requires cultivating human capital including general work skills and habits as well as a high degree of training and specialization in the lines of work demanded by a highly specialized 21st century global economy. Though both kinds of investment are critical for its future, Israel has been lagging.

Private savings provide the main source for investment spending, but in recent years savings have declined from 24 percent of GDP to about 18 percent. Not surprisingly, investment is declining; as shown in the first figure. Though levels of gross domestic

**Investments, 1965-2010**

as percent of GDP




* 2010 estimate.

Source: Taub Center for Social Policy Studies in Israel.
Data: Israel's Central Bureau of Statistics.

investment in Israel have tended to fluctuate between 20 and 30 percent, they fell to an all-time low of just over 15 percent in 2010 – which is lower than the 20-24 percent of output that is common in comparably well-developed countries.

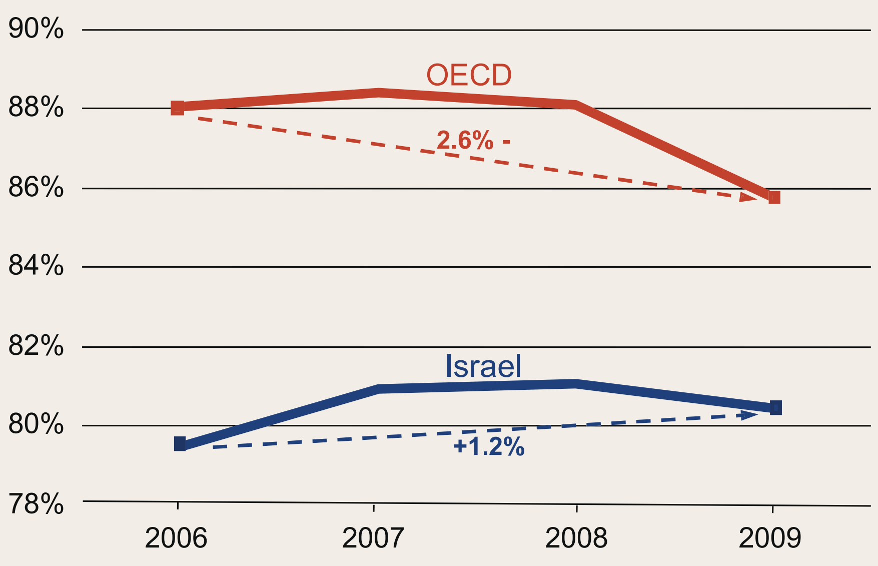
Alongside the shortfall of private investment, Israel is also experiencing a shortfall of public investment. The capital stock of the government sector has been growing recently at just over one percent, below that of any OECD country, where the average is over three percent.

Finally, Israel lags in investment in human capital. Large numbers of Israelis, particularly Israeli men, do not participate at all in the work force. The second figure shows that even after a 1.2 percent increase in labor force participation among prime working age Israeli men, and a 2.6 percent decrease in the comparable figure for men in the OECD, Israel's employment rate is still five percentage points below the OECD average.

Among those who are in the work force, a very large number are in low-skilled, low-paying dead-end jobs. Yashiv refers to a "dual job market:" one sector of the labor force has job security, which also translates into on-the-job training and skill development; another sector has low skills, low pay, low levels of employment stability, and, concomitantly, a low degree of skill development alongside their already low level of skills. Five to six percent of Israeli employees are employed by manpower companies (outsourcing or temporary

**Employment rate, 2006-2009**

Prime working age men (35-54)




Source: Taub Center for Social Policy Studies in Israel.
Data: OECD.

agencies) where even if the worker happens to work for the same nominal employer for a long period of time, he or she is, in fact, changing jobs all the time as locations and tasks are changed by the contractor.

Yashiv suggests a linkage between the lags in physical and human capital investments. The lack of skilled labor leads to a perpetuation of outdated production technologies that favor low-skilled, low-paid workers over more modern, capital intensive approaches that require more investment and more skilled workers with higher productivity. In other words, the labor force deficiencies reinforce those of the production sector and vice versa. This economic problem is creating an acute social problem of economic stratification between two Israels: one that is benefiting from modernization and globalization, and one that is being left behind.

So, while competent management of monetary and fiscal policy has been keeping the Israeli economy in relatively good macro economic shape, compared to other OECD countries, Israel faces some major long run problems in the labor market and with regards to physical capital. These problems reduce the potential for economic growth and for standards of living that characterize developed economies, a process that may leave Israel farther and farther behind. In addition, these problems tend to aggravate inequality, which in turn reduces social welfare, engenders friction, and further perpetuates the long-term problems of the economy. The current system of government in Israel does not generate optimism for the possibility of adopting policy steps that will effectively deal with the dysfunctional aspects of Israel's labor market. ■

## Too many cooks spoil the tax broth

*Recent reform of tax administration leaves a planning vacuum.*

The tax system has a pivotal role in the functioning of any economy. The first job of a well-designed tax system is to provide revenue for the services provided by the government effectively and fairly. Taxes also have a powerful influence on citizens' behavior – for example, encouraging work or idleness, thrift, or irresponsible spending. They can redistribute income more fairly and also affect the macro-economy. Collecting more taxes in boom times and leaving more money in citizens' hands in downturns helps to stabilize the economy. It follows that the proper functioning of the entire economy depends on a stable and well-designed system of taxes.

Yarom Ariav, the recent Director General of the Israeli Finance Ministry, concludes that the country's current structure of tax administration constitutes a troubling obstacle to maintaining a consistent and stable tax system. In the Taub Center's new *State of the Nation Report 2010*, Ariav points to a recent series of problematic policy reversals reflecting Israel's inability to implement such a tax regime: While direct taxes have been reduced, indirect taxes have been increased; the value added tax rate is constantly being changed; the gasoline tax was raised and almost immediately the increase was cancelled; a plan to end the VAT exemption on fruits and vegetables was suddenly revoked; there have been frequent changes in the taxation of real estate with no real policy in evidence; tax exemptions for foreign investors were followed by an announced intention to reverse the exemption; and so on.

Ariav explains that the problem originates with the ill-advised merger of two quite distinct taxation functions: policy and collection. Before 2004, there were two distinct collection bodies in the Ministry of Finance: the Income Tax Department and the Duties and VAT Department. Above these collection departments was an administrative unit, the State Income Administration. While the subordinate bodies implemented the tax policies, the supervising administrative unit devoted itself to strategic considerations such as the design and harmonization of tax policies. In 2004, the two departments were merged into the Tax Authority.

There may have been a certain rationale for merging the two collection departments, but practically speaking this has not yielded any meaningful savings thus far. At the same time, the merger was perceived as making the State Income Administration superfluous. While the Income Administration ceased being the locus for organized strategic thinking about tax policy, no other body within the Finance Ministry filled the strategic policy making void that was created. The result is that now there are a plethora of different officials within the ministry working in virtual isolation from one another -- and often at cross purposes -- to craft Israel's taxation policy. The Tax Authority is charged with collecting taxes, not designing them; the Budget Department is focused on overseeing expenditure, not income; and so on.

Ariav calls for the immediate restoration of the former status and function of the State Income Administration, stating that both logic and history make this the right office for examining and coordinating tax policy from a system-wide perspective, thus providing Israel with a tax regime that will promote growth, stability and fairness. ■

# Fiscal discipline alongside distorted allocations culminating in a summer of growing unrest

*Israel's unusual success in controlling spending has been accompanied by distorted national priorities favoring politically powerful special interest groups. In this summer of 2011, public resentment has spilled over into increasing unrest in the form of sit-ins, boycotts and strikes.*

In the early 1980's, Israel's government was one of the most profligate in the developed world, with public expenditure exceeding 70 percent of national income. The aftermath of the peace treaty with Egypt and the stabilization plan of the mid-1980s led to rapid improvement, but in 1990 Israel's spending as a share of income reached 55 percent, a share that was higher than in 22 of 23 developed OECD countries (only Sweden spent more). By the year 2000, Israel's public expenditures fell to 51.5 percent of GDP, still greater than in all but four of the 23 countries. But as the Taub Center's Executive Director, Professor Dan Ben-David, shows in the *State of the Nation Report 2010,* Israel had emerged by 2010 as one of the OECD's thriftiest governments, with a 45 percent spending to GDP ratio that was lower than that of 16 of the 23 OECD countries.

The primary, and best-known, source of the spending decline has been reductions in defense expenditures as a fraction of GDP, from 12.6 percent in 1990 to 6.9 percent of GDP in 2009. Another four percentage points have been saved by the reduced interest payments on the smaller national debt. It seems, though, that there is little awareness of Israel's noteworthy record in controlling civilian expenditures (that is, public spending minus defense expenditures and interest payments).

In light of the very volatile events (wars, hyperinflation, massive immigration, political assassination, etc.) that Israel has experienced over the past several decades, the relative stability of its civilian public spending – compared to what took place in the West over the same period – might come as a surprise (top panel of the figure). The share of civilian expenditures to GDP in Israel was the same in 2005 as it was in 1990. In contrast, civilian expenditures (as a share of GDP) in the OECD countries exhibited some major fluctuations. These ranged from increases of 37, 23 and 21 percent in Portugal, Japan and Belgium to spending cuts of 21, 20 and 14 percent in Norway, New Zealand and the Netherlands, respectively.

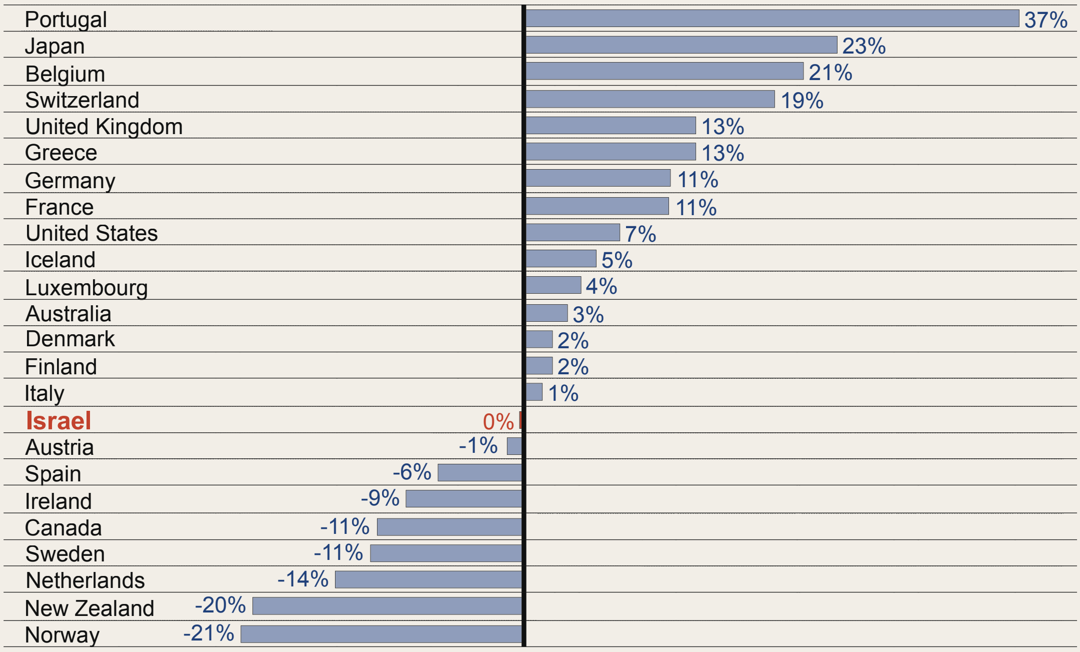
The past five years have been characterized by a major global recession that affected many countries quite severely. Subsequently, civilian public expenditure rose in all but one of the 23 OECD countries, with an average increase of 12 percent between 2005 and 2010 (bottom panel of the figure). Having experienced its major recession at the beginning of the last decade rather than at its end like most other countries, Israel reduced its civilian expenditures by six percent, standing out – together with Switzerland – as the only countries that cut their spending share in 2005-2010. As a result, Israel's civilian public expenditures in 2010 were below those in 21 of the 23 OECD countries.

With such low amounts of public funds available for civilian needs, Israel needs to make very judicious use of its resources. There is relatively less available from the overall pot in Israel for special interests and sectoral demands. In a region that is undergoing considerable unrest since the beginning of 2011 – and in light of its history of experiencing several critical events each decade – Israel needs to preserve the precious few degrees of freedom that it has available in its budget and spend them wisely.

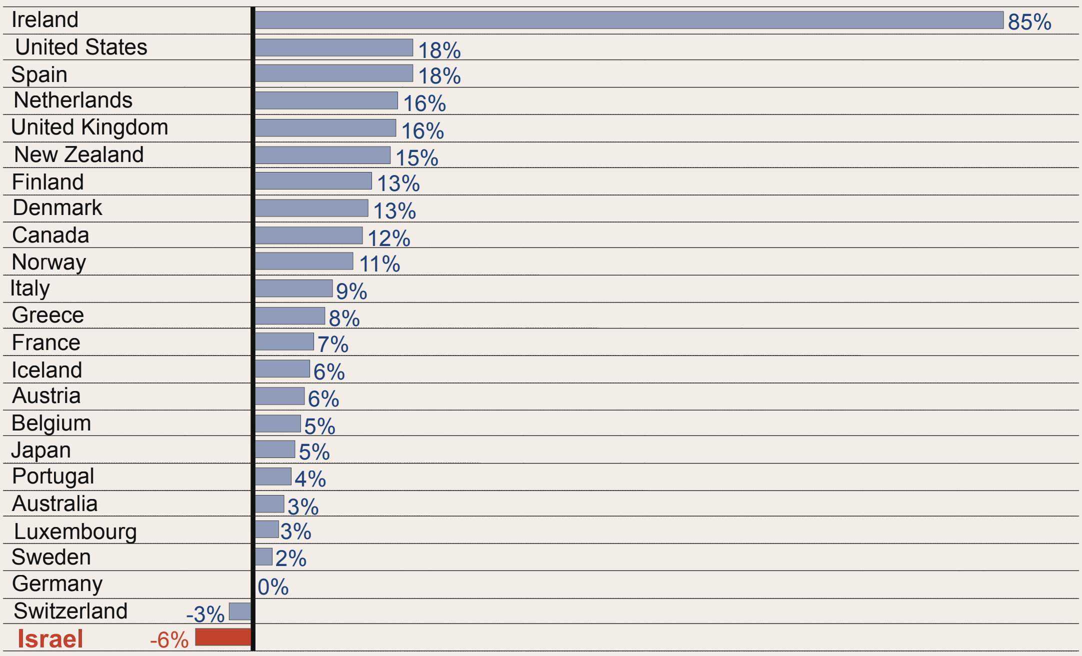
## Changes in civilian public expenditures

not including defense expenditures and interest payments, as percent of GDP

### A. 1990-2005




### B. 2005-2010*




* Subtracting defense expenditures in 2009 as estimate for 2010.

Source: Dan Ben-David, Taub Center and Tel-Aviv University.
Data: OECD, World Bank and Bank of Israel.

On the one hand, the ability to control spending in such a fluctuating environment, and to do so more rigorously than many other countries that have undergone much less traumatic periods, is a credit to the State of Israel. On the other hand, such fiscal responsibility also mandates a considerably more judicious use of the public's money. In this realm, the country's successive governments have been less than successful. This has also been the case with regard to government income, which is raised in a skewed and disproportional manner (as discussed in the companion piece in this Bulletin by Yarom Ariav).

Welfare payments per person have been increasing steadily for over four decades by multiples of the increases in the country's income per capita. This is unsustainable in the long-run. It has occurred while a very large and growing share of Israel's population has not been receiving the necessary tools and conditions for working in a modern economy. As a result, the share of families that would have lived under the poverty line today (had they not received assistance) is roughly one-third – compared to "just" one-quarter in 1979. The resulting personal inability to cope in a global workplace also translates into an increasing national difficulty to assimilate and develop new ideas. Therefore, while Israel has justifiably been referred to as the "Start-Up Nation", this attribute applies to an ever-shrinking share of Israeli society.

Instead of utilizing the limited resources at its disposal in a manner that could initiate a positive and permanent change in the country's long-run socioeconomic trajectories, government after government have let an education system – once considered by many to be one of the best internationally – to sink to the depths of the developed world, with all of the growth, poverty and subsequent welfare implications that this has.

As Ben-David points out, many individuals who could work are receiving substantial amounts of government assistance while a large number of elderly and infirm are forced to live in abject poverty. The only systemic education reform passed by the government, a half-decade ago, was abandoned. The healthcare system, still one of the best in the world, is providing increasingly unequal care as the share of public expenditures has steadily fallen since the nationwide reform in the mid-1990s.

Fiscal responsibility is not just about controlling overall spending in unique circumstances. It also requires major, and often politically difficult, decisions regarding allocation. These are called national priorities – and Israel has a considerable distance to go in this realm.

The rising wave of public protests in Israel during this summer of 2011 reflect increasing unrest with the degree of distortion in Israel's public expenditures that favor special interest groups with tremendous political clout – at the expense of the general public interest in the realms of education, health and housing. ■

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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