

18

Caesarea Economic Policy Planning Forum

.....

June 2010



Caesarea
Economic Policy
Planning Forum

Academic Director of the Forum

.....

David Brodet

The Employment of Arabs in Israel

Research Team

Team Leader

Dr. Yosef Jabareen, Faculty of Architecture and Town Planning, The Technion – Israel Institute of Technology

Team Members

- **Yaser Awad**, Director of Fair Representation and Employment Equity Project, Sikkuy; Sakhnin College
- **Prof. Daniel Czamanski**, Associate Dean for Research, Faculty of Architecture and Town Planning, The Technion – Israel Institute of Technology
- **Dr. Ramzi Halabi**, University of Tel Aviv; Gordon College
- **Shuruk Ismail**, Program Director of the Arab Community Program, Yad Hanadiv
- **Nitsa (Kaliner) Kasir**, Head of the Labor Market and Welfare Policy, Research Department, Bank of Israel
- **Helmi Kittani**, CEO, The Center for Jewish-Arab Economic Development
- **Sami Saadi**, CPA, Founder of Tzofen
- **Architect Amin Sahly**, City Engineer of Tamra
- **Attorney Irit Tamir**, CEO, Kav-Mashve
- **Imad Telhami**, Entrepreneur and Owner, Babcom Centers

Research Assistant

Ofer Dror, The Israel Democracy Institute; Department of Economics, The Hebrew University in Jerusalem; ERCCG

Summary

The participation of the 1.5 million Arabs in Israel in the workforce is an extremely complex and significant challenge for Israel and its economy. The Arab employment rate in Israel, which is lower than that of the rest of the population in the country, is one of the lowest in the world. The situation of the Arabs as individuals and as members of a national minority is problematic and can have far-reaching implications for the relations between the Arab minority and the State and its institutions. The situation is also particularly difficult from the perspective of distributive justice and economic growth in Israel. The OECD countries have also confronted Israel with the important challenge of employing Arabs and closing the gaps between Arabs and Jews in Israel. This summary presents the main obstacles to the employment of Arabs and their economic development, as well as principal recommendations for amending the situation.

Main Obstacles to the Employment of Arabs

1. **There are two economies in Israel: one is the well-developed, modern, Jewish economy, which continues to advance, and the other is the lagging, undeveloped Arab economy, which has suffered from institutional discrimination for several decades.** The most serious results of this situation are a high level of poverty among the Arabs; large economic gaps between Arabs and Jews; the alienation of the Arabs from the State and its institutions; and an adverse impact on Israel's economy and GDP.
2. In a hypothetical situation of economic equality between Arab and Jewish men in the areas of employment and income, the earnings of employed Arab men would be NIS 37 billion, instead of the current NIS 27 billion. This constitutes an increase of NIS 10 billion, or 36%. In addition, in a hypothetical situation of economic equality between Arab and Jewish women, the income of Arab women would be NIS 28 billion, rather than NIS 7 billion. This constitutes a NIS 21 billion, or 300%, gain. In other words, **the lost potential to Israel's economy as a result of the failure to utilize the potential of the Arab male and female labor force amounts to NIS 31 billion a year** (based on 2006 data).
3. **Today there are 13,500 Arab university graduates who are unemployed.** According to the social survey undertaken in 2008 by the Central Bureau of Statistics (CBS), 9,000 of the 10,000 female Arab university graduates who are unemployed have lost hope of finding employment. There are also 3,500 male Arab university graduates who are unemployed. **In five years – if the government continues the trend of non-intervention in the employment of Arabs – the number of unemployed Arab graduates is expected to reach 30,000.**
4. **The vast, ever increasing economic gaps between Jews and Arabs in Israel, which exceed those in the OECD countries, are manifested in the following spheres, *inter alia*:**
 - a. **Employment rate:** 42% for Arabs in contrast to 59% for Jews
 - b. **Per capita income:** In 2007, while the average gross monthly wage in the Arab sector was NIS 5,419, it was NIS 8,056 among Jews. Similarly, the hourly wage of Arab males is 30% lower than that of Jewish men with the same level of education. There is a 23% difference between the wages of Arab and Jewish women.
 - c. **Poverty level:** Approximately 50% of Arab families live below the poverty line (after transfer payments and taxes) compared with about 15% of Jewish families.
 - d. **Occupation and industry:** Only 1% of the employees in the high-tech industry are Arab.
 - e. **Unemployment rate**

- f. **Local development levels**
 - g. **Employment opportunities**
 - h. **Financial assistance options**
 - i. **Lack of local employment and of industrial zones:** Our findings indicate that **only 2.4% of all industrial zones in Israel are located in Arab settlements**. In Nazareth Elite (Upper Nazareth), for example, which has a population of 42,000 inhabitants, there are five industrial zones. The area of the Tziporit Zone alone, approximately 6,000 dunams, is larger than all the developed industrial zones in all the Arab settlements in Israel combined. By contrast, the industrial zones in Nazareth, the largest Arab town in Israel, which has about 66,000 inhabitants, account for only 150 dunams.
5. **The participation rate of Arab women in the labor force in Israel is one of the lowest in the world**, currently standing at 21% as compared to 57% among Jewish women. This rate, which is lower than the average in the Arab world and is far below the average in the OECD countries, has many and varied ramifications, including greater poverty; the underutilization of the market's economic potential; wider gaps between Jews and Arabs; the slow development of an Arab middle class; the increased alienation from the State and its institutions; and the impairment of the status of women in general.
6. **Arab men and women have a strong desire to work.** In 2008, the employment rate of Arab men was 62.4%, while that of Jewish men was 61.5%. **A study undertaken by Yosef Jabareen found that 43% of unemployed Arab women are prepared to accept employment immediately** if given the opportunity. The conclusion is that if the rate of those willing to work is combined with the actual employment rate of Arab women (about 21%), the employment rate will be similar to that of Jewish women.
7. **Arab human capital is progressing with time, but there are still gaps between it and its Jewish counterpart.** For example, there has been a marked improvement among Arabs in the area of education: Between 1961 and 2007, the average number of years of schooling rose from 1.2 to 11.3, which signifies a more than nine fold increase. However, there are still gaps between Arabs and Jews in the area of education, especially in terms of government investment. Note that the increase in education level has not found significant and appropriate expression in the sphere of employment, which is unprecedented in the world economy, according to the OECD report.

Employment in the Ultra-Orthodox Sector

Research Team

Team Leader

Prof. Yossi Tamir, Director, TEVET Employment Initiative, JDC Israel; Professor, Department of Social Work, The Hebrew University in Jerusalem

Team Members

- **Bezalel Cohen**, Program Manager, Haredi (ultra-Orthodox) Program, TEVET Employment Initiative, JDC Israel
- **Dr. Neri Horowitz**, President, Agora Policy
- **Hagay Levin**, Senior Researcher, National Economic Council

Research Assistant

Roni Hacohen, Research Assistant, National Economic Council

Summary

In 2003, in response to the emerging threat to its economic stability, the government decided to slash the National Insurance, welfare, and education budgets. The ultra-Orthodox sector dubbed these decisions “the Netanyahu Edicts.” This constituted a milestone in the growing institutional recognition of the sociological effects of the ultra-Orthodox community on Israel’s economy, welfare policy, and labor market. The transformation of the issue of the ultra-Orthodox employment rate from an annoying question of equality to a macroeconomic subject is encapsulated in the title of the article by Berman and Klinov (1997), “Jewish Father Stops Going to Work.” For the first time, the ultra-Orthodox’s lack of participation in the workforce was presented in this article in macroeconomic terms, with widespread effects on the labor market and GDP. The modest booklet had a great influence on the economic media, the Ministry of Finance, and the policy makers.

In the ultra-Orthodox household – under the increasing pressure of a high birthrate, a decline in financial support of the younger generation by the older generation, increasing poverty, and the beginnings of new consumption patterns – the participation of the men in the labor force has been a central issue for some time now. The solution of a single, female breadwinner (in the framework of employment for ultra-Orthodox women) in the education system and in other areas of the labor market is no longer sufficient. Religious leaders are increasingly permitting ultra-Orthodox men to enter the workforce on a selective basis. The State of Israel and the Ministry of Finance have designated the employment of the ultra-Orthodox as one of the main targets of its labor policy.

In this document, we begin by using up-to-date data to present the macroeconomic problem that derives from the patterns of employment in the ultra-Orthodox sector. Policy-makers realized over a decade ago that this problem threatens the welfare of the ultra-Orthodox population, as well as the strength and prosperity of the Israeli economy in the future. We then briefly analyze the obstacles to employment in the ultra-Orthodox sector and outline the attempts undertaken in recent years to encourage employment in this sector. Finally, we point out the main dilemmas confronting policy planners today as in the past, and propose initial measures for action, with a preference for the following three:

Area	Proposal
Organizational Framework	Appoint a special body within the Ministry of Industry, Trade, and Labor and allocate a special budget to encourage employment of the ultra-Orthodox.
Demand for Ultra-Orthodox Employees	Mobilize major employers to hire qualified ultra-Orthodox workers.
Human Capital Deficiencies	Encourage all age groups to study mathematics, English, and subjects that will contribute to enhancing their qualifications for employment.

The Employment of Foreign Workers

Research Team

Team Leader

Prof. Zvi Eckstein, Deputy Governor, Bank of Israel

Team Members

- **Sharon Gambashu**, Deputy Director, Budget Department, Ministry of Finance
- **Matan Gilat**, Assistant to the Deputy Governor, Bank of Israel
- **Yehuda (Yud'ka) Segev**, CEO, Israeli Manufacturer's Association
- **Keren Turner**, Internal Coordinator, Budget Department, Ministry of Finance
- **Avshalom (Abu) Vilan**, CEO, Israeli Agriculture Association
- **Prof. Eran Yashiv**, Tel Aviv University; Bank of Israel

Research Assistant

Or Nuriel, The Israel Democracy Institute; Bank of Israel

Summary

This document presents the socio-economic effects of employing temporary foreign workers on employment, wages, and poverty among residents. The document also describes the present situation in Israel as regards the employment of foreigners, comparing it with the situation in selected developed countries. It concludes with recommendations and points for consideration regarding policy in areas that have not yet been fully addressed.

Wages and the standards of living in developing countries are significantly lower than those in developed countries; consequently, the latter attract the inhabitants of the former in search of work, even if only temporary. The minimum wage in the developed countries is far higher than the accepted wage in many industries (construction, agriculture, and nursing care) in the migrants' countries of origin. The large supply of these workers in their home countries makes it possible to choose workers whose skills surpass those of unskilled local workers.

Increasing the supply of low-skilled workers, whose reservation wage is particularly low, creates immediate pressure to lower the wages of workers with similar skills, as well as those of workers whose skills are even lower. The greater ability of the migrants coupled with their lack of access to welfare services compels local workers across the board and in similar industries to work for low wages, which in turn leads many of the local workers to leave the labor market entirely. As a result, both the poverty and the inequality of income of local workers are heightened.

For a long time, Israel's labor market has been characterized by low employment rates among unskilled workers and by low wages for those with a low level of education. As a result of these and other factors, such as the mass employment of foreign workers, levels of poverty and income inequality in Israel are higher than in all the OECD countries.

The employment of Palestinians in Israel began immediately following the Six Day War (1967). In the wake of security incidents during the first half of the 1990s, they began to be replaced by foreign workers. Some 77,000 legal foreign workers (i.e., with permits) and as many as 125,000 illegal foreign workers (without permits) are currently employed in Israel, and many more would like to work in Israel. The number of permits issued to Palestinian workers within the 1967 borders (the "Green Line") is estimated at 28,600, and according to the Central Bureau of Statistics (CBS), another 25,000 illegal Palestinian workers are employed. The employment of legal foreign workers is particularly widespread in agriculture, construction, and nursing care.

The extent of the employment of foreign workers in Israel's labor market is high by international standards. International comparisons are problematic, due to the fact that the way foreign workers are defined varies greatly. However, when the field is narrowed to temporary foreign workers only, their rate in Israel is twice the acceptable rates in the western world, and even higher still if the comparison is restricted solely to unskilled workers (see the report of the Eckstein Committee, 2008). The extensive employment of foreign workers does not support Israel's comparative advantage – knowhow and innovation. It leads to cheap, labor-intensive production in which labor productivity is low, as well as to the continued existence of occupations and industries that otherwise could not survive in Israel's economy. Since the principal victims of the employment of foreigners are low-skilled workers, and the principal beneficiaries are employers and skilled workers who belong to the better-off strata, the employment of non-Israelis widens the income distribution gaps in Israel.

The extensive employment of foreigners also has long-term social implications. This process raises social, moral, and legal issues in the sphere of migration, which affect the formulation of policy toward foreign workers. This has special significance in a country where immigration by persons who are not Jewish, or who are not close relatives of a local resident, is not permitted by law.

Israel's government has been contending intensively with the economic and social repercussions of employing non-Israelis since the beginning of the decade. This has included altering the number of permits, employment methods, taxation, and levies; establishing a migration police force (2003); and setting up a Migration and Population Authority (2009). However, policy in the area of the employment and residence of foreign workers has failed to:

1. Prevent the adverse effect on the wages and employment of residents with skills similar to those of the temporary legal foreign workers;
2. Implement adequate employment and residence arrangements for persons holding temporary work permits;
3. Prevent the entry and employment of illegal foreign workers.

There are currently several committees that deal with various aspects of the issue of foreign workers: the matter of the children of these workers is dealt with by an inter-ministerial committee, headed by Yossi Edelstein of the Migration Authority; an inter-ministerial committee, headed by the Ministry of Finance, deals with arranging the employment of foreign workers in the nursing care industry; the Eckstein Committee deals with Palestinian workers; a ministerial committee headed by the Minister of Justice deals with the various aspects of Israel's Migration Law.

In May 2009, an agreement was signed by the government and the farmers based on the conclusions and recommendations of the Eckstein Committee (2008) regarding foreign workers in agriculture, and sub-committees were set up to deal with this matter. The document sets out recommendations and ideas with the aim of formulating an ideological basis and providing possible solutions to the problems addressed by each sub-committee.

The state of affairs concerning the employment of foreigners, by industry:

- **Construction:** In recent years, the number of permits for foreign workers in construction has contracted substantially. In accordance with the government's decision, this number will fall to zero in 2012 (the current number of permits is 8,000, and in July 2010, it will drop to 5,000). As of 2009, 25,000 permits have been issued to Palestinians, and in the framework of the committee set up to examine the employment of Palestinians, the extent of employment of non-Israelis in the industry will also be reviewed. It appears that there is extensive employment of illegal workers in this industry.
- **Agriculture:** On 12 May 2009, an agreement was signed by the government and the farmers to reduce the number of permits for foreign workers from the current number of 26,000 to 18,500 per year by 2015, and to concurrently subsidize mechanization and agricultural technology, as well as partially subsidize the wages of Israeli workers in the industry. According to the agreement, a pilot scheme is currently being launched to employ seasonal foreign workers. There does not seem to be extensive employment of persons without permits in agriculture.
- **Nursing care:** According to official figures, as of February 2010, there are over 44,000 foreign workers in this field, and the number of persons eligible for permits is even higher – over 100,000 by the end of 2008. The system of employment does not impose any upper limit on the quantity; this is determined according to the number of individuals who are entitled to nursing care. Nursing care workers are subject to many restrictions, such as the ban on establishing a family or having children. This matter is currently being addressed by an inter-ministerial team, which aims to settle it in accordance with what is accepted in other developed countries. While there are illegal foreign workers in this industry, albeit to a limited extent, many workers shift to illegal domestic work, such as housekeeping, child care, etc.

- **Catering and hospitality services, manufacturing, business services, etc.:** Only a small number of permits are issued in this area. There appears to be extensive employment of illegal workers in the hotel, restaurant, and cleaning services industries, particularly through manpower agencies.
- **Illegal non-Israeli workers (without permits):** There are currently 150,000 illegal foreign workers in Israel, of whom 25,000 are Palestinians. In addition, there are 24,000 persons who have infiltrated into Israel from Africa through the border with Egypt. The vast majority of these are in Israel as asylum seekers or persons who have entered the country illegally – but only a small fraction of them received refugee status, as almost all are migrant workers. They are employed primarily in the services and hotel industries. In January 2010, the government decided to increase fines and intensify legal action against employers of illegal foreign workers or employers who do not respect the terms of the work permits. Instructions were also issued to the Migration and Population Authority and the Tax Authority to coordinate data in order to prevent tax credits from being received while employing illegal workers.

Against this backdrop, we have formulated recommendations in areas that require reform or reassessment. Since some of them are already being dealt with by the government and by various committees, we have decided to divide our recommendations according to the issues being addressed by the committees.

The Third Sector and its Relationship to the Public and Business Sectors

Research Team

Team Leader

Dr. Nissan Limor, The Hebrew University of Jerusalem

Team Members

- **Raanan Dinur**, former Director General, Prime Minister's Office
- **Prof. Benjamin Gidron**, Ben Gurion University of the Negev
- **Prof. Tamar Hermann**, Senior Fellow, The Israel Democracy Institute; The Open University
- **Prof. Yossi Katan**, Tel Aviv University
- **Rachel Liel**, Executive Director, New Israel Fund
- **Udi Praver**, Head of the Policy Planning Division, Prime Minister's Office
- **Boaz Sofer**, Senior Vice-President of Planning and Economics, Tax Authority
- **Dr. Yaron Sokolov**, Executive Director, The Israeli Civic Leadership Association; Head of the B.A. Program, The Center for Academic Studies, Or Yehuda
- **Ahuva Yanai**, CEO of Matan, Your Way to Give (Registered Nonprofit)
- **Zvi Ziv**, Chairman of Ma'alah, Business for Social Responsibility (Registered Nonprofit)
- **Noam Zussmann**, Research Department, Bank of Israel

Research Assistant

Inbal Abbou, Ben Gurion University of the Negev

Summary

A. Topic

The third sector in Israel is an important and essential part of Israel's society and economy. Civil society and third sector organizations have been present in Israel since its pre-state period, and constitute the country's social infrastructure. Its activities and organization, during regular periods and at times of crisis, are a reflection of Israel's strength and resilience. Nonetheless, this sector is confronted by obstacles that prevent it from realizing its full potential. This situation affects certain processes in society that impair solidarity and widen the social gaps in Israel, harming Israel's democracy and society.

A discussion that addresses the question of the role of civil society in the context of the relations between the state and society has never taken place in Israel. What is its proper and desirable place, and how can social forces be integrated into the effort to tackle the challenges confronting society? If in the past, the claim was made that Israeli society was “a mobilized society,” in the sense of summoning the will and the faith to realize the age-old vision and establish a modern, democratic, Jewish state, today there are ever-growing demands from within society for the right to participate in the process of molding the character of the society and the state, rather than leaving this solely to the formal establishment. A cross-sectoral partnership in which the culturally diverse segments of society are represented offers an opportunity for national progress and development toward equality and social justice.

The importance of the third sector to Israel’s economy and the share of its organizations in providing social services in an era of privatization and commercialization raises a series of dilemmas regarding the responsibility of the state, corporate social responsibility, and the manner in which third sector organizations conduct themselves, all of which are affected by government policy and the attendant legal arrangements.

This document seeks to elucidate the various issues, to delineate the current state of affairs in Israel, including an international comparison, and to propose main points for discussion, as well as possible alternatives aimed at formulating public policy and developing the tools required to help third sector organizations fulfill their mission and realize their potential.

B. Main Issues

1. The place and role of civil society organizations and the third sector in the fabric of Israel
2. The factors that assist and that obstruct the full utilization of the potential of these organizations
3. Government policy and the effect of inter-sectoral cooperation to contend with the challenges of Israeli society in the decade ahead
4. Legal arrangements, regulation, and the taxation of third sector organizations and their donors
5. Ways of encouraging local households and businesses to contribute

C. Principal Recommendations

Some of the issues that the following recommendations address require a preliminary examination of the objectives, policy, and ways of achieving the aims, and a subsequent discussion by the concerned parties to identify implementation procedures that are appropriate for Israel’s society, the local situation, and the constraints. Some of the issues have yet to be adequately discussed by the public, which is a vital a point of departure for the recommendations.

1. Policy

- a. Formulate government policy in conjunction with the third sector that will give expression to the role and status of this sector.
- b. Discuss and forge a path for cooperation between the three sectors – the government, business, and society (the third sector).
- c. Establish a “round table” process to encourage debate and broaden it to encompass additional areas.
- d. Examine the regulation of third sector organizations, coordinate matters of self-regulation with them, and update the arrangements in accordance with the needs of the 21st century.
- e. Adopt government policy that encourages philanthropy and targets segments of society characterized by meager donations through incentives in the form of tax breaks and simple mechanisms to obtain them.

2. The financing of third sector organizations

- a. Encourage the creation of a philanthropic capital market and establish various paths for financing civil society organizations.
- b. Designate a specific rate of *Mifal Hapayis* (national lottery) funds to be transferred to third sector organizations via a public philanthropic fund established for this purpose.

3. The financing of third sector organizations through public funds

- a. Separate the three paths of public funding:
 - i. Payments by law or special arrangements
 - ii. Benefits/grants to third sector organizations
 - iii. Payment for services purchased by the government or the municipality
- b. Increase indirect funding (via tax benefits for donors and organizations). Direct budgeting (allocations and grants) will be decided according to government policy, which will be determined from time to time.

4. Taxation: donor benefits

- a. Expand donor tax breaks.
- b. Provide tax breaks to donors by reducing taxes for specific donations (designated matters, gifts of a certain size, etc.).

- c. Cancel the minimal donation required to entitle the donor to a tax benefit and raise the maximum donation required to entitle the donor to a tax benefit, especially in the case of particularly large donations.
- d. Make it possible to register a contribution that was made after the tax year (up to the end of the first quarter of the subsequent year).
- e. Accord tax breaks to corporations that demonstrate social responsibility and contribute to third sector organizations.

5. Taxation: third sector organizations

- a. For tax purposes, distinguish between third sector organizations (private, voluntary, non-profit organizations) that fall within the definition of a third sector organization and those that do not (which have been accorded that status of nonprofit (*Malcar*) in accordance with the definition under V.A.T. law).
- b. Annul the wage tax for third sector organizations, while designating those whose activities are of a business nature as businesses.
- c. Make it possible to spread capital gains tax payments over several years.
- d. Set input tax (V.A.T. paid) at 0% for donations/gifts to needy persons that are not used to generate a service or goods, and create a mechanism to ensure that this arrangement is not abused.
- e. Eliminate the distinction between a third sector organization and a corporation for profit purposes as regards surplus expenses and the taxation of dividends.
- f. Regulate the execution of profit-making activities that may not be distributed to members (including via hybrid bodies), whose aim is to finance activities for the benefit of the public within the framework of the customary tax regime vis-à-vis non-profit organizations.

6. Philanthropy

- a. Accommodate special arrangements by the law for establishing and operating Israeli philanthropic funds.
- b. Arrange a procedure to allow employees to make donations via their employers.
- c. Publicly encourage and recognize philanthropy.
- d. Prevent the state from collecting donations and competing with third sector organizations for donations. Donations from the public and from businesses should be transferred to third sector organizations.
- e. Regulate by law the collection of donations from the public, including by professional fundraisers.

7. Third sector organizations

- a. Reinforce the representative bodies of third sector organizations.
- b. Develop independent means and reduce dependence on public finances.
- c. Enhance professionalism by improving methods of management, self-auditing, transparency, and self-assessment.
- d. Foster cooperation within the third sector, and between the third sector and the government, and the third sector and the business sector.

8. Association

- a. Enable the association of non-profit organizations (in the framework of the Nonprofit Organizations Law) and companies for the public benefit (in the framework of the Companies Law) as private bodies only, and prohibit the association of local authorities, government bodies, or their branches, according to the laws governing the association of private entities.
- b. Legally define the concept of “public benefit” and provide tax breaks to entities that meet the criteria, which will be established. The tax authorities will supervise and certify an entity's fulfillment of the necessary requirements without requiring specific authorization from the Knesset Finance Committee.

9. Data and research

- a. Collect data and input them in a database that will be open to the public, including policy makers, scholars, organizations, and other interested parties.
- b. Distinguish between data regarding third sector organizations and other non-profit organizations: the government, municipalities, statutory corporations, and entities controlled or owned by a central or local authorities.

Macroeconomic Policy: Leaving the Economic Crisis Behind

Research Team

Team Leader

Prof. Nathan Sussman, Department of Economics, The Hebrew University of Jerusalem

Team Members

- **Vered Dar**, Chief Economist and Strategist, Psagot Investment House
- **Yulia Eitan**, Senior Economist, The National Economic Council, Prime Minister's Office
- **Dr. Amit Friedman**, Head of the Macro Unit, Macroeconomic and Policy Division, Research Department, Bank of Israel
- **Ruby Ginel**, Deputy Director General of Regulation & Economy, Israeli Manufacturer's Association
- **Dr. Dror Goldberg**, Department of Economics, Bar-Ilan University
- **Israella Many**, Deputy Managing Director of Economy and Tax, Chamber of Commerce
- **Yael Mevorach**, Macro Coordinator, Budget Department, Ministry of Finance
- **Rotem Rulf**, Coordinator of the Budget, Budget Department, Ministry of Finance
- **Nira Shamir**, Chief Economist, Discount Bank
- **Dr. Eldad Shidlovsky**, Head of Economics and Research Department, Ministry of Finance

Research Assistant

Nadav Ben Zeev, The Israel Democracy Institute; Department of Economics, The Hebrew University of Jerusalem

Summary and Recommendations

A few months ago, it seemed that Israel's economy had emerged relatively unscathed from one of the worst economic crises of the last hundred years. Recently, however, apprehension has grown in view of the persistence of the global slowdown in the wake of the debt crisis in Greece and several other Eurozone countries. One concern is that in order to reduce government deficits and debts, the countries of Europe will have to raise taxes and reduce public expenditure – measures that are liable to impair their economic recovery. The slowdown of demand in Europe could harm Israel's exports and retard the pace of the country's recovery. In addition, recent quarterly National Accounts data indicate that there has been some slowdown in the pace of Israel's economic recovery.

As far as macroeconomic stability is concerned, the starting point of the Israeli economy prior to the crisis was better than it had been in the past. The budget deficit and the debt/GDP ratio were on a downward track, the unemployment rate was lower than it had

been in the previous decade, and the inflation rate remained within the target range. There was a trend towards easing the tax burden, with the attendant reduction in the government's share of GDP. Israel's economy is currently at a point where government spending and the tax burden as a share of GDP are close to – and even slightly below – the OECD average. The process of reducing the tax burden and the extent of government involvement has led, *inter alia*, to the contraction of expenditures on education relative to GDP growth. The budget for higher education has been adversely affected, and the economic expansion of recent years has been accompanied by increased inequality and poverty rates. The OECD report on Israel notes that despite the tax cuts and the lower share of public expenditures in GDP, the income and productivity differentials between Israel and the leading OECD countries are still evident.

The main impact of the global crisis has been on exports. The damage has been significant and in line with the decline in world trade. However, since Israel's banking system was less exposed to mortgage-backed assets abroad, the domestic housing market was conservative and balanced, and Israel's exports were affected to a lesser extent than small open economies in Europe. The economic slowdown was also less severe than in other small, open economies that were also not exposed to mortgage-backed assets. In retrospect, government policy appears to have been neutral vis-à-vis the business cycle, the principal activity being that of the automatic stabilizers and restraint, when it came to implementing the deficit ceiling. Most of the counter-cyclical policy was implemented by the Bank of Israel, which reduced the key interest rate to its lowest level ever in line with central banks in other developed countries. The Bank of Israel also adopted an expansionary policy, purchasing government bonds and also supporting the exchange rate against the dollar by buying foreign currency, as manifested by an exceptional rise in the foreign reserves. A brief comparison of the macroeconomic policy mix during the crisis with that of several small European countries shows that Israel's fiscal policy was atypical. In countries not in the Eurozone that were able to conduct expansionary monetary policy, the policy mix was more balanced, involving the combined deployment of fiscal and monetary measures. Note, however, that as regards the debt/GDP ratio, those countries started off in a better position than Israel. The global crisis exposed once again the importance of aiming for a low debt/GDP ratio, thereby providing a greater extent of freedom in deploying counter-cyclical policy. Countries in the Eurozone were obliged to implement fiscal policy, as this was the only possibility open to them. These countries, which started from a weaker position, were in danger of rapidly descending into insolvency. In the final event, it can be said that even though Israel's fiscal policy could have been more expansionary, placing less emphasis on monetary policy, the policy implemented helped to moderate the adverse effect on the economy. However, according to an analysis of the impact of the PIGS policy in terms of fiscal stability, given the various countries' diverse structural compositions, it is not the size of the government or the share of the tax burden in GDP that explains the extent to which they were affected, but the debt/GDP ratio and the government deficit.

As previously stated, a few months ago it seemed that the policy dilemmas would be linked with the measures to be taken following the rapid emergence from the crisis. On the fiscal side, the government prepared to introduce legislation. The new expenditure rule was intended to balance the desire to cease reducing the government's share in GDP,

while recognizing that resources should be directed to education, the infrastructure, and stimulation of economic growth, on one hand, and the desire to aspire for a debt/GDP ratio of 60%, on the other. The fiscal rule was intended to join existing legislation regarding the deficit target and the easing of the tax burden. The government even presented the Knesset with a proposal for a two-year budget. The dilemma of monetary policy was connected to the policy of emerging from a low interest-rate level, while endeavoring to avoid the rapid strengthening of the NIS.

Using a dynamic macroeconomic model developed in the Bank of Israel's Research Department, the team examined the implications of the new fiscal instruments. Two scenarios were examined: rapid recovery from the crisis and slow recovery. Both scenarios indicated that it will not be possible to combine the three fiscal instruments. If the expenditure and tax reduction rule is used, it will not be possible to attain the deficit path and the reduction of the debt. Alternatively, by adhering to the deficit ceiling and the reduction of the debt, the proportion of public expenditures as a share of GDP will continue to contract, despite the recognition that it has fallen adequately. In a pessimistic scenario, which is not unlikely given recent developments, there is a possibility that expenditures will decline sharply or that the debt/GDP ratio will rise. Neither of these two possibilities is desirable and would not be welcomed by the team.

The team's fiscal policy recommendations follow:

1. **Since the three fiscal instruments are liable to clash with one another, it is necessary to pay attention to the limitations entailed in the attempt to meet the three fiscal targets.** In view of the fiscal crises in some European countries, which indicate that the process of fiscal deterioration can be very rapid, extreme caution should be exercised in order to avoid increasing the deficit beyond the track determined by law.
2. **It is necessary to review the tax-reduction trajectory.** If it transpires that the deficit trajectory is about to be disturbed, policy-makers will have to decide whether to make adjustments in the income side or the expenditure side, or in their mix. Some team members recommend making adjustments in the income side; that is, considering the discrepancy between the targets, tax reductions should be discontinued. Doing this when the growth path in the near future is uncertain will enable the government to maintain expenditures, without jeopardizing convergence to the target of the debt/GDP ratio. Since the tax burden in Israel is one of the lowest in the OECD countries, and in light of the fact that many countries are expected to increase their taxes, the team does not think that terminating tax reductions will have a grave economic effect. However, the continued reduction of taxes and sharp spending cuts, given the Brodet trajectory regarding the defense budget and debt-servicing payments, will lead to low levels of civilian expenditures, which are perceived by most of the team members as endangering future, growth given the expected adverse effect on Israel's human capital and physical infrastructure. Some team members think that if there are concerns regarding Israel's ability to meet its deficit target, it will be necessary to abandon the expenditure rule and aim at making changes in the composition of expenditures, while maintaining the tax reductions to which the government is

committed. Freezing tax reductions could have an impact on the government's credibility and on incentives in the business sector. These incentives could boost competition in this sector, especially in the context of Israel's low position on the scale of business transactions. Thus, top priority should be given to expanding the tax base, *inter alia* by canceling tax exemptions. In a situation in which revenues from measures of this kind are not practicable or adequate for attaining the deficit ceiling, the dispersal of the tax reductions over several years should be considered.

- 3. Long-term budget planning should be encouraged, although the two-year budget should be reconsidered.** Most of the team members think that the goal should be to extend the planning horizon of the national budget in strategic spheres, such as education, along the lines of the long-term plan outlined in the Brodet trajectory for the defense budget. However, in light of macroeconomic uncertainty, most of the members of the team think that a two-year budget enhances the government's flexibility and enables the democratic discussion of budgetary alternatives, since adjustments will have to be made to the budget should the growth rate differ from the expected rate. Nevertheless, if the two-year budget is approved, it will be necessary to build into it mechanisms for the second year that will provide expenditure frameworks and will indicate the income changes, which are dependent on macroeconomic performance and will become clear at the end of the first year of the two-year budget.

Monetary policy is currently in a predicament. Israel's inflation rate has overshoot the target as a result of several factors: the relatively moderate impact of the recession on Israel; the highly expansionary monetary policy; the unanticipated increase in V.A.T. and other taxes in mid-2009. In addition, there is real apprehension that Israel's low interest rates will lead to a property bubble, and certainly to a rise in the consumer price index. The policy predicament is embodied in the possible effect of an interest-rate hike – in an attempt to deal with inflation and prevent an asset bubble – on the exchange rate and exports. The dilemma could worsen if the negative scenario is realized, as global demand is expected to expand at a slower rate than anticipated. In that case, exports will be adversely affected should local currency appreciation persist concurrently.

The team calls on the Bank of Israel to make the inflation target its top policy priority. The team recognizes the complexity of the monetary predicament, but feels that in the framework of the new Bank of Israel Law, the inflation target should be the central bank's chief policy concern. The team also recognizes the importance of policy regarding the foreign currency market, and the Bank of Israel's contribution to exports. According to the team's assessment, it will not be possible to support the real exchange rate over time. Nevertheless, the team feels that it is possible and desirable to find other tools for checking local currency appreciation in the short term, especially during the initial emergence from the economic crisis. The appendix contains a proposal for supporting the exchange rate based on stimulating capital outflow from Israel, subject to the existence of surpluses on the current account of the balance of payments.

The team calls for the adoption of plans to lower the hurdles confronting businesses. In view of the existence of a restricted budgetary sphere of action, the team recommends that initiatives be introduced to reduce the bureaucratic barriers confronting Israeli businesses. International reports place Israel in a relatively low position among the developed countries in indices of business transactions. Improving the regulatory and administrative infrastructure could contribute substantially to Israel's economic growth rate at a relatively low cost.