

Introduction – Prof. Eugene Kandell, Conference Chair

Two Economies – One Society

Initial thoughts to stimulate a discussion

Dear Eli Hurvitz Conference Participant.

As Yohanan Plesner wrote to you, The Eli Horowitz Conference this year is embarking on a three-year project that will focus on long-term strategic issues of relevance to the government and the country. This process will establish a continuity of research and discussion, engage a wider set of experts, facilitate more productive interactions with the government, and showcase the intermediate results - in annual conferences that will undoubtedly spark lively debates.

We chose a unifying theme for the launch of the three-year project, **Two Economies-One Society**. The goal of this document is to shed light on this initiative's defining features, and outline the topics that will be discussed within this theme.

In general, every economy can be divided into two components: the **innovative**, which pushes the envelope of best technologies and practices worldwide, and **everything else**. While this is not a customary partition in national statistics or academic papers, I would argue that, with regards to Israel, such a categorization is not only appropriate, it is necessary. Indeed, to not to look at the Israeli economy through such a lens is to miss very important trends. As such, I maintain that Israel has two, very weakly-connected economies, which I call (for the lack of better terms) the **Innovative Economy**, and the **In-Need-of-More-Innovation Economy**.

Allow me to demonstrate why this partition is indeed reasonable in the case of Israel, and may in the future also be applicable to the rest of the world.

First, I'll begin with the **Innovative Economy**. In a variety of ways, the nature of this economy is quite cosmopolitan: its markets, main competitors, financing and reference points are all based abroad.¹ It has very high productivity and generates large amounts of wealth, attracting equally large amounts of investments. Moreover, the Innovative Economy is relatively lightly regulated, and is sometimes exempt from certain regulations. Moreover, its firms and workers are highly mobile, and, in general, members of the Innovative Economy are comfortable in cosmopolitan environments.

As result, many foreign firms and governments are willing to pay significant amounts to attract these companies and their employees. However, even without this inducement, many Israeli firms and their investors choose to move significant parts of their operations overseas, so as to be closer to key markets and sources of financing. While some of the firms do get direct government support, the firms and workers in this economy are of the mindset that they are not dependent on government largesse, and don't feel that the government is either their partner or savior. The Innovative Economy is characterized by very high salaries, due to its high productivity, and in the last two decades has been the primary source of vast wealth accumulation by a significant number of people in Israel.

There is near consensus in the government and the public discourse that Israel must become a very competitive place for this value-generating, yet mobile economy. Thus, it is regulated and taxed much more lightly than the rest of the economy. The Innovative Economy is also a source of great pride for Israelis, and a topic of great interest around the world, which makes our work at SNC - to promote Israeli innovation – that much easier.

In Israel, this economy is larger than in any other country in terms of employment rate and percentage of GDP. As a result, its macro effect on the overall economy is much higher than in any other country. Not surprisingly, when National Accounting world-wide was modified to better measure the impact of innovation on GDP, Israel's GDP rose the most. This highly diverse economy has evolved into a self-sustaining ecosystem, with many supporting institutions and norms. In the foreseeable future, Israel's Innovative Economy could become the most consistent driver of economic growth, making its share of the overall economy even bigger. At

1 This does not mean that the definition Innovative Economy is equivalent to Tradable Goods and Services. The vast majority of its products are indeed tradable (when they are successful), but definitely not all tradables are innovative.

the same time, such an outcome is not at all assured, as Israel faces strong competition from abroad, and the Innovation Economy thus needs to grow, to maintain the interest of investors and customers, as well as provide enough of an incentive for firms to stay in Israel.

The **In-Need-of-More-Innovation Economy** (For the sake of brevity, I will also use the term the **Main Economy**) is completely different. The former has a very low aggregate rate of productivity – almost 50% lower than the Innovative Economy, according to a rough estimate. Its productivity is much lower by industry comparison with other developed countries (services, construction, logistics, etc.). Much of its markets are in Israel, though it does export. The Main Economy is very local in its mindset, heavily regulated, and more heavily taxed. It depends on the government not only in terms of regulation, but also as a state of mind: if something goes wrong its managers and employees frequently blame the government and expect it to bail them out. The government, on the other hand, feels that this economy is its captive client (even when it is not), and treats it heavy-handedly. This economy pays high salaries only to members of strong unions, or to employees in monopolistic industries, while the public foots the bill. For the rest, wages are low - in accordance with productivity.

Moreover, the firms, owners and managers operating in the Main Economy are viewed by the public with suspicion, sometimes with outright hostility. Such attitudes are fueled by media campaigns and heated political rhetoric.

This economy does not generate much interest from abroad, except in rare cases when a firm may be acquired, which is difficult due to majority holdings and strong unions. However, the Main Economy's rather problematic state also represents an opportunity, and it could become a source of economic growth – should it adopt existing best practices and technologies, and increase productivity.

Clearly, these two economies are very different in practically all aspects. So, let's explore their separate trajectories.

In the last twenty years the two economies have been developing in parallel, without much interaction, but at very different speeds. The two economies have very segregated labor forces – that rarely move across the divide. Specifically, the skilled professionals comprising the Innovative Economy are predominantly highly educated/trained males from middle-class and upper-middle-class families

originating from the four metropolitan areas and a few other strong communities. Until recently, this economy included few women and people from Israel's geographic or social periphery, and practically no Haredi and Arabs. Basically, the pool of talent for this economy comes from less than 50% of the general population.

As was mentioned earlier, the two economies diverge in terms of their wages and benefits, thus contributing to an increase in economic inequality. Should such a pattern continue for much longer the majority of the Israeli population is at risk of becoming alienated. Such a development will in time translate into political intervention, higher taxation and regulation. Given that the companies in the Innovation Economy are highly mobile, broad-based feelings of alienation are a grave danger to the Israeli economy and society.

So, the first goal we must postulate is how do we stop the divergence of the two economies, so as to maintain the cohesion of **One Society**? There are two required processes: The first is to increase the percentage of people engaged in the Innovation Economy, so as to help it expand and grow, thus maintaining its relative place in the world. There is also a need to educate the public and the decision makers about the great benefits of having a growing Innovation Economy in Israel.

The second process is to change the unfortunate title of the In-Need-of-Innovation Economy, by drastically increasing its productivity. Both are required to achieve the goal of One Society. What we definitely do not want is to slow down the Innovation Economy, as such a development may catalyze a vicious cycle leading to its demise in Israel.

But while pursuing the first goal, we must realize that the two economies have completely different needs, and must be provided with distinct solutions to flourish. Recall that the aim is to allow the Innovation Economy to stay on the cutting technological edge, grow and expand, while remaining in Israel, despite the forces that are pulling at it from overseas. Meanwhile, the goal for the Main Economy is to increase productivity by adopting best practices and technologies, while reducing regulations that hinder it, and improving labor relations.

It turns out that the actions required to achieve these goals are very different in every relevant domain: Human Capital, Financing, Regulation, and Knowledge. This fact is not always understood, and while sometimes policies address the two economies specifically, in most cases regulation and legislation are applied uniformly, making it difficult to develop effective policies for both the Innovative and Main economies.

As such, the 2017 Eli Hurwitz Conference will focus on raising the issue of Israel's two economies, by presenting some of the specific challenges in each of the aforementioned domains, and addressing them in greater detail. We intend to outline the necessary conditions needed for the process to move forward – separately for each economy and for each specific area of focus. In addition, we will set up teams after the conference's conclusion that will then embark on an exciting three-year journey.

If you would like to contribute your time and expertise to a particular domain, or the task of bringing Israel's two economies together, please let us know by sending an e-mail indicating your areas of interest to Ms. Lital Zilka litalz@idi.org.il

We hope that a wide variety of relevant stakeholders will participate in this process. We are pleased to announce that representatives from the government and related agencies, such as the Prime Minister's Office, National Economic Council, Ministry of Finance, Bank of Israel, Ministry of Education, Ministry of Economy, Ministry of Labor, Ministry of Justice, Israeli Securities Authority, Central Bureau of Statistics and others will be joined by academic researchers, Employers' Association, Histadrut, and industry representatives from the two economies at this year's conference. The idea is to have everyone focus on the strategic long-term view, while simultaneously ensuring that the topics appeal to all participants. As my previous experience shows, this is doable.

I wish you a very insightful conference and hope that you will join us in preparations for our better common future.

Sincerely,

Prof. Eugene Kandel

Conference Chair

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CEO Start-Up Nation Central