

A Blueprint for Improving the Employment Outlook in Israel

Dan Ben-David

Department of Public
Policy, Tel Aviv
University, and the
Center for Economic
Policy Research (CEPR),
London

Avner Ahituv

Department of
Economics
University of Haifa

Noah Lewin-Epstein

Department of Sociology
and Anthropology
Tel Aviv University

Haya Stier

Department of Labor
Studies and Department
of Sociology and
Anthropology
Tel Aviv University

Abstract

Israel's labor market is going through one of its most difficult periods ever. Some of its problems trace to years of misguided policies; some originate in processes being experienced by other Western economies; and some from the current security situation. The results are low labor-force participation rates, high unemployment rates and low productivity – manifested in relatively low economic growth and in rates of poverty and gross-income inequality that rank among the highest in the West, and rising continuously. Some three decades of steadily rising unemployment rates were followed by four years of war with the Palestinians and a particularly severe recession. There are indications of an end to this recession in 2004 and a return to the country's "normal" trajectories.

The problem is that these very stable, long-term – multi-decade – trajectories are unsustainable in the long run. Although their steadiness over such an extended period may give the appearance that they are etched in stone, Israel's long-run social and economic trajectories should not be regarded either as facts of life nor as divine destiny.

In a country that faces considerable external dangers, the fact that the ability to provide adequate defense is founded on socioeconomic strength should be self-evident. Instead of allowing globalization to worsen its socioeconomic situation, Israel can channel its effects in directions that will raise its population's standard of living, including that of its weakest groups, and lower its unemployment rate perceptibly.

This paper focuses on the main issues affecting the Israeli labor market. Its goals are to describe the magnitudes of the problem, explain their origin, and recommend a systemic short- and long-term policy for the revitalization of Israel's labor market and the elevation of its economy and society to healthy, sustainable paths. It is written in as non-technical a language as possible so as to be accessible to policy-makers and readers that are not professional economists.

correspondence:

Dan Ben-David
Department of Public Policy
Tel-Aviv University
Ramat-Aviv 69978, Israel

Tel: 972 3 640-9912
Fax: 972 3 640-7382
email: danib@post.tau.ac.il

<http://spirit.tau.ac.il/public/bendavid>

I. Introduction

Israel's labor market is going through one of its most difficult periods ever. Some of its problems trace to years of misguided policies; some originate in processes being experienced by other Western economies; and some from the current security situation. The results are low labor-force participation rates, high unemployment rates and low productivity – manifested in relatively low economic growth and in rates of poverty and gross-income inequality that rank among the highest in the West, and rising continuously. Some three decades of steadily rising unemployment rates were followed by four years of war with the Palestinians and a particularly severe recession. There are indications of an end to this recession in 2004 and a return to the country's "normal" trajectories. The problem is that these very stable, long-term – multi-decade – trajectories are unsustainable in the long run.

The main watershed year for the Israeli economy was 1973. In a sharp turnaround from which the country never managed to recover, the economy transformed from one of the fastest growing in the West to one of the slowest growing. Until the seventies, Israel had been steadily narrowing the gap vis-à-vis the leading countries; the American standard of living was 2.7 times higher than Israel's in 1950 and "only" 1.6 times higher in 1972. Since 1973, Israel has been retreating in relative terms and its standard of living actually fell in 2001–2003. The income ratio between the United States in Israel returned to the early-1960s level of 2.2 in 2003 and the direction of the trend in income disparities is toward the 1950s. The rate of unemployment climbed from 2.6 percent in 1973 to 10.6 percent at the end of 2003.

When more people are not working, poverty rates tend to grow. In the late 1970s, about one-fourth of Israeli households lived under the poverty line in terms of gross income, (i.e., before the intervention of the tax and welfare systems). Today, this is the plight of more than one-third of households. Israel's current levels of poverty and inequality are among the highest in the West. Furthermore, they have been rising steadily for three consecutive decades.

How did we arrive at this state of affairs? How do we turn things around? This paper will attempt to deal with the main issues that affect the Israeli labor market. Its goals are to describe the magnitudes of the problem, explain their origin, and recommend a systemic short- and long-term policy that will tackle them. For lack of space, the original study was abridged so that its main points could be included here. The full study may be obtained from the authors.

The paper distinguishes between policies aimed at increasing and upgrading labor supply and policies targeted at increasing the number of jobs available, i.e. labor demand. To focus more closely on main issues that pertain to the population that large, the paper addresses neither all the problems associated with Israel's labor market nor all population groups that have special characteristics. We believe that focusing on and dealing with the main issues will provide a considerable contribution toward improving the social and economic trajectories upon which Israel is situated. It is these considerations that dictated the focal points of reference in this study.

The academic team came from two relevant disciplines in the socioeconomic realm: two economists (Dan Ben-David, who chaired the team, and Avner Ahituv) and two sociologists (Noah Lewin-Epstein and Haya Stier). Dan Ben-David is a macroeconomist specializing in economic growth and international trade. Avner Ahituv specializes in labor economics. Noah Lewin-Epstein researches in the fields of labor, labor markets, and social stratification and mobility. Haya Stier does research on the family, labor and labor markets, and gender sociology.

The next section of the paper describes the main problems in the Israeli labor market, traces their origins, and explains the conceptual change needed for bringing about substantive change in Israel's employment and earning levels.

Section III presents recommendations for the requisite policy to improve the state of employment in the short term. Section IV focuses on recommendations for long-term change in the domestic labor market. The last section sums up the study.

II. Main Problems in the Labor Market

The process of economic growth is central in any discussion of job creation. A recessionary economy is one that discharges more workers than it absorbs. In a growing economy, the opposite occurs. Thus, even before focusing on the specific characteristics of the Israeli economy, there is a need to understand the primary sources of economic growth.

The Israeli economy needs to increase its steady state, or sustainable, growth rate – that is, to move to the steepest possible growth trajectory, reflecting high growth rates over a period of many years. While a temporary increase in output due to nonrecurring policies may be construed by the public as the outcome of growth-creating measures, such growth dissipates swiftly.

Hence, there is a need to correct a basic public misunderstanding about what leads to faster growth. An increase in government expenditure to stimulate domestic demand may ultimately increase output, but along most paths that the money is currently channeled, the outcome will be short-lived. Furthermore, the implications of financing the increase in public expenditure have precisely the opposite effect: dampening private sector consumption and investment.

The distinction between steps meant to stimulate aggregate demand (i.e., total private and public demand) and those designed to bolster supply is critical in the growth context. Policies targeted at stimulating demand tend to have a limited impact, and if this were not enough, they are sometimes accompanied by problematic results of their own in the form of higher prices (inflation), higher interest rates, and the crowding out of private consumption and investment.

The main route to permanently increasing growth in per-capita output – the main indicator of a country's standard of living – is by taking action on the supply side. The engine of growth, termed “technological progress,” is based on productivity improvements that flow from the upgrading of physical and human capital and greater efficiency in the use of these factor inputs. This implies that the growth process is one in which traditional areas of business activity that yield low incomes are replaced with new areas that facilitate a higher standard of living. In other words, one of the main characteristics of a growth process in any country is structural economic change. Problems arise and are magnified when the labor force lacks the tools (human capital infrastructure) or the conditions (physical capital infrastructure) to make the transition.

Table 1 presents an underlying picture of Israel's economy and labor force in comparison with several other countries. As indicated in the table, a much smaller proportion of the working-age population in Israel participates in the labor force.¹ Those who are employed tend to work

¹ Definitions: members of the working-age population who are willing to work regarded as “participating” in the labor force. The rate of non-participation is the percent of the working-age population that is not looking for work. Labor force participants who find work are termed “employed”; those who do not manage to find work are called

more hours. However, the output per hour of the Israeli worker (labor productivity) is quite low, relatively speaking.

When few people participate in the labor force and the labor productivity of the employed is low, the combined result is less GDP per capita than in other countries. If a greater share of the population worked, and if labor productivity were higher, each worker could work fewer hours and the standard of living of the entire population could be higher.

A growing economy needs more and more educated and skilled workers, meaning that its relative demand for poorly educated and unskilled labor declines steadily over time. The decrease in relative demand is reflected in unemployment rates that rise in inverse proportion to the level of education (Figure 1). The scantier the prospects of finding work, the less willing people are to look for work. Israel's non-participation data reflect this phenomenon. In 2000, for example, 68.9 percent of the working-age population that had five to eight years of schooling did not participate in the labor force. Of the remaining 31.1 percent who sought work, 13.1 percent did not find it and were unemployed.

An increase in the level of education has two important positive implications. Better educated people are able to contribute more to their jobs, making higher wages possible. Furthermore, since the chances of finding work rise in tandem with education, more people will seek employment and more will find it. There are exceptions, of course – poorly educated people who have jobs and amass wealth – but at the national level, where policy is determined, it is important to bear in mind that these are the exceptions rather than the rule

The relationship between

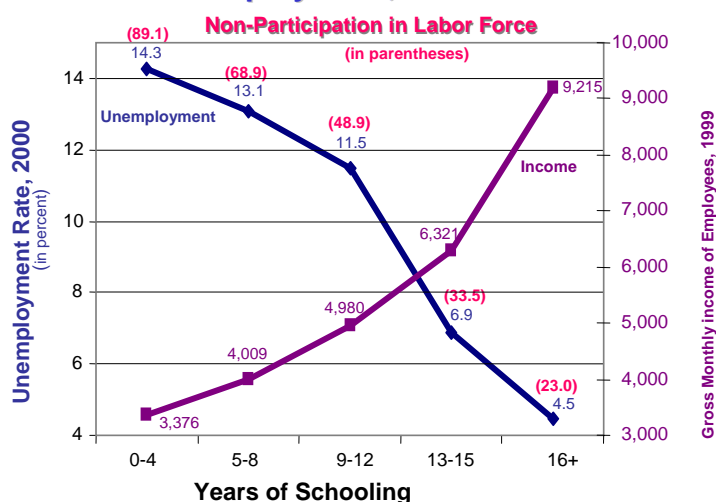
Table 1
International Comparison of Labor Force, 1997
Israel = 100

	GDP per capita	GDP per employed person	GDP per hour	Hours worked	Labor participation rate
Israel	100.0	100.0	100.0	100.0	100.0
Average	120.0	95.1	109.4	88.2	113.5
Australia	126.3	98.4	103.7	94.9	111.6
Iceland	140.9	94.3	100.8	93.6	132.6
U.K.	116.6	90.1	102.3	88.1	112.3
U.S.	168.2	121.5	121.5	100.0	120.4
Germany	126.1	101.2	126.4	80.1	103.0
Mexico	43.7	40.1	41.3	97.1	108.9
Norway	152.0	106.3	149.3	71.2	130.6
Spain	91.4	97.3	105.7	92.0	90.1
Finland	116.8	95.7	106.7	89.7	119.0
France	120.4	110.0	130.6	84.3	97.6
Sweden	117.5	91.4	115.7	79.0	122.6

Source: Dan Ben-David (2003), Economic Quarterly
Data from ILO, World Bank and Israel Central Bureau of Statistics

Figure 1

Relationship between Schooling, Unemployment, and Income



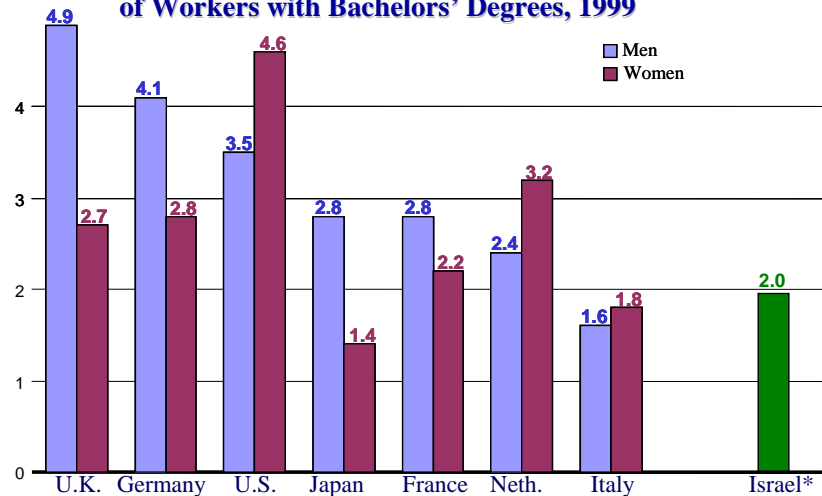
Source: Dan Ben-David (2003), Economic Quarterly
Data from Israel Central Bureau of Statistics

“unemployed.” Thus, people who are not employed are not necessarily “unemployed.” They may not be looking for work at all, in which case they are “non-participants” in the labor force.

education and labor is not unique to Israel. In the leading Western countries, the unemployment rates of those who have an academic education and those who lack a high-school diploma are substantially different (Figure 2). In the Netherlands, for example, the ratios of these two unemployment rates – that of workers who lack a high-school diploma to that of workers who hold bachelor's degrees – is 2.4 among men and 3.2 among women, whereas in the United States the ratios are 3.5 and 4.5, respectively. In Israel, the unemployment rate in 1999 among people with 0–12 years of education (this may include those who passed the matriculation exams, who have lower unemployment rates) was twice as high as the unemployment rate among those with 16+ years of education.

Figure 2

Ratio of Unemployment Rate of Workers Lacking High-School Diploma to Unemployment Rate of Workers with Bachelors' Degrees, 1999



Source: Dan Ben-David, Tel-Aviv University
Data from Israel Central Bureau of Statistics and BLS

* In the case of Israel, this is the ratio of the unemployment rates of persons with 0-12 years of schooling to that of persons with 16+ years of

The importance of these ratios should be clear. They provide more than a snapshot of the present moment. A society that aspires to a high standard of living must realize that only a well-educated labor force can cope with new technologies and rapid changes in the labor market that are essential for accomplishing this. In such an economy, the well-educated have much better prospects of finding work than the poorly educated.

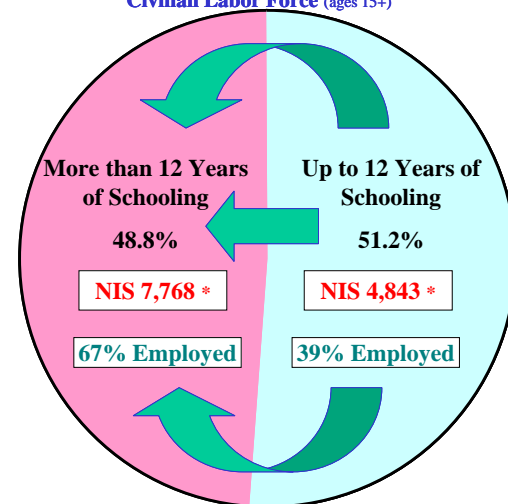
About half of Israel's population (51 percent) has twelve or fewer years of education (Figure 3). The income of this population is only 75 percent of that of the other half of the population. Their prospects of employment are only 39 percent, as against 67 percent among the population that has post-primary education (not necessarily an academic degree). These are non-trivial differences.

A serious policy targeted at providing “root” treatment of poverty, inequality, and also growth should aim at substantially reducing the share of population that is poorly educated. How will such a policy contribute to lowering the levels of poverty and inequality?

- Those who upgrade their education will benefit directly, as their incomes rise together with their chances of finding work.

Figure 3

Distribution of Education, 2000
Civilian Labor Force (ages 15+)



* Gross monthly income of employees

Source: Dan Ben-David, Tel-Aviv University
Data from Israel Central Bureau of Statistics

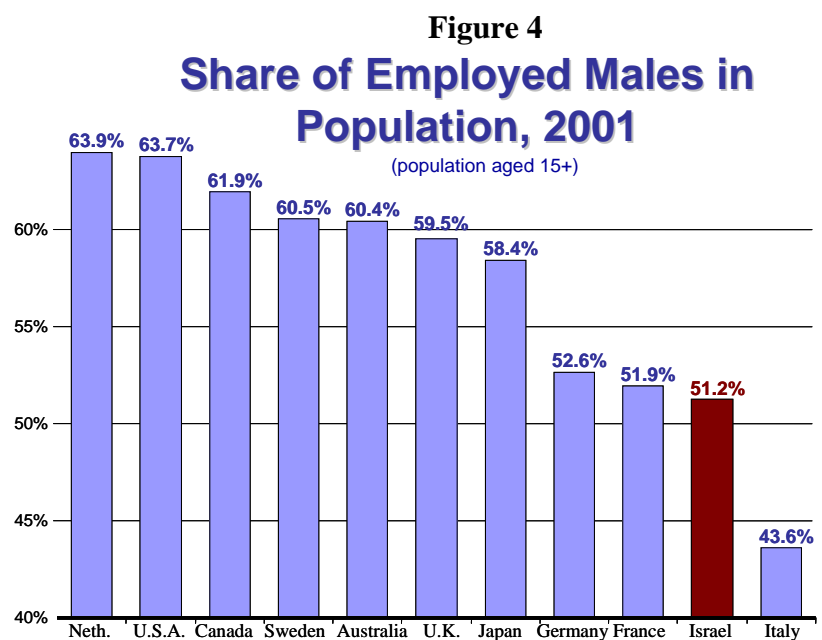
- b. Those who do not upgrade their education will also be better off because they will have fewer poorly educated people to compete with. Hence their job prospects will improve and there will be a positive effect on their wages. Of course, such outcomes are possible only if Israel stops importing thousands of poorly educated foreign workers and substantially increases their cost of employment (Israel's hundreds of thousands of foreign workers are employed at below-minimum wages and do not receive social benefits mandated to Israeli workers, hence their hiring depresses the wages of unskilled Israeli workers and reduces the Israelis' likelihood of finding work.)
- c. Moving a sizeable number of people from the 0–12 education cohort to the post-secondary education group would increase the supply of well-educated workers and moderate wage increases among members of this group.

In other words, the policy would act at both extremes of the income scale, helping to boost income at the bottom of the scale and to moderate increases at the top. As for economic growth, overall improvement of the population's education level would make the economy much better able to absorb, apply, and develop more advanced and efficient production methods – the main key to higher sustainable growth.

Since unemployment and non-participation rates are both negatively correlated with the level of education, it is also possible to focus on the reverse side of the picture, the employed. When many people are unemployed and many others are not seeking work, the employment rate will be low, as Figure 4 shows. Comparative data on various Western countries, gathered by the U.S. Bureau of Labor Statistics, coupled with data on Israel from the Israel Central Bureau of Statistics – with Israel's population adjusted to the Western standard, i.e., the civilian population and not the total population – show that Israel has one of the lowest employment rates in the sample (which includes, but is not limited to, all the G7 countries other than Italy).

The American employment rate is 4.4 percent higher than Israel's. All four main English-speaking countries and several other leading countries have significantly higher employment rates than Israel's. Hence, a common claim made in Israel – that the globalization process necessitates high rates of unemployment and non-participation – is not borne out by the facts.

Figure 5 shows the steady downward trend in the employment rate of Israeli men since 1973. In the United States, which started out with a higher employment rate in 1973, experienced a decline during the years following the Yom Kippur War and the subsequent global recession prompted by the Arab oil embargo. Since the early 1980s, however, American employment rates has been rather steady at around 71.5 percent while Israeli employment



Source: Dan Ben-David, Tel-Aviv University
Data from Israel Central Bureau of Statistics and BLS

rates have been falling continuously.

A. Labor Force Participation

Israel's rates of non-participation in the labor force are among the highest in the West. As shown in Figure 6, the non-participation rate of Israeli men is 20 percent higher than the OECD average and 38 percent higher than the American level. A simple comparison of Arab men with Jewish men would appear to indicate similarity between the groups. The average, however, masks a totally different participation picture. The participation rate of Arab men declines more rapidly – relative to that of Jewish men – during the course of their lives, due to primarily to the physically demanding nature of their work.

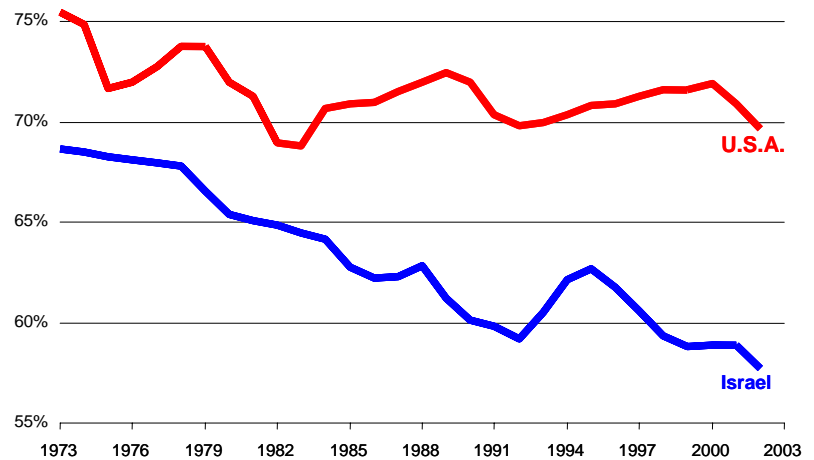
One group of men that stands out in particular for its low participation rate is the ultra-Orthodox. According to Central Bureau of Statistics estimates, 80 percent of the ultra-Orthodox men do not participate in the labor force. This is not to say, however, that the problem of men's non-participation begins and ends with the ultra-Orthodox. The rate of non-participation of other Jewish men is also much higher than the Western norm. In the main working-age cohort, 25–64, non-participation is lower in all groups. However, differences between Israel and the other countries remain quite high.

Among women (Figure 7), the main exceptions are Arab women, who have a non-participation rate of 78 percent. Non-participation rates of Jewish women resembles the OECD average.

In view of Israel's very low participation rates, as reflected in Figures 6 and 7, the relevant question is how these could rates be brought up to the norms of developed countries. Labor participation rates in the OECD countries are 9.6 percent higher than Israel's. If Israel's participation rates were brought up to the OECD average, it would be the equivalent of adding about a quarter of a million workers. Even if the labor productivity of these added workers

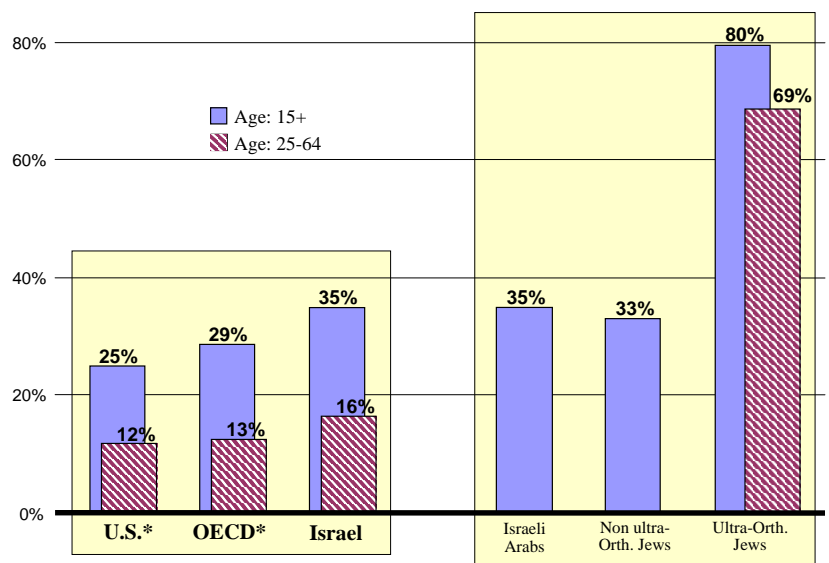
Figure 5
Share of Employed Males in Population

Men aged 15+, 1973-2002



Source: Dan Ben-David, Tel-Aviv University
Data from Israel Central Bureau of Statistics and BLS

Figure 6
Share of Male Non-Participation in Labor Force, 1998



Source: Dan Ben-David (2003), Economics Quarterly
Data from Israel Central Bureau of Statistics and ILO

were 25 percent lower than that of the current labor force – or even if only 67 percent of the new participants in the labor force actually found work – the growth of the labor force would be reflected in a NIS 22 billion increase in GDP (in 2000 prices) each year.² If Israel's participation rates were raised by 20.4 percent, to the American level, it would amount to an increase of more than half a million workers and an extra NIS 47 billion in annual output. These GDP increases, of course, would occur only if the heightened willingness to work is accompanied by large-scale job creation.

How can hundreds of thousands of additional jobseekers join an economy that already has 280,000 unemployed who are looking for work and not finding it? At the Israel Business Conference in December 2002, prime minister Ariel Sharon, stated that the problem lies not in a shortage of jobs but in the fact that Israelis just don't want to work. He has repeated this on several occasions since then, and many ministers in his cabinet have expressed themselves similarly.

Obviously, there will always be people who do not want to work and will avoid work in any way possible. This, however, is a far cry from labeling hundreds of thousands of people as shirkers. As is shown in the section of this study dealing with the value of labor, Israelis appear to be as willing to work as anyone else.

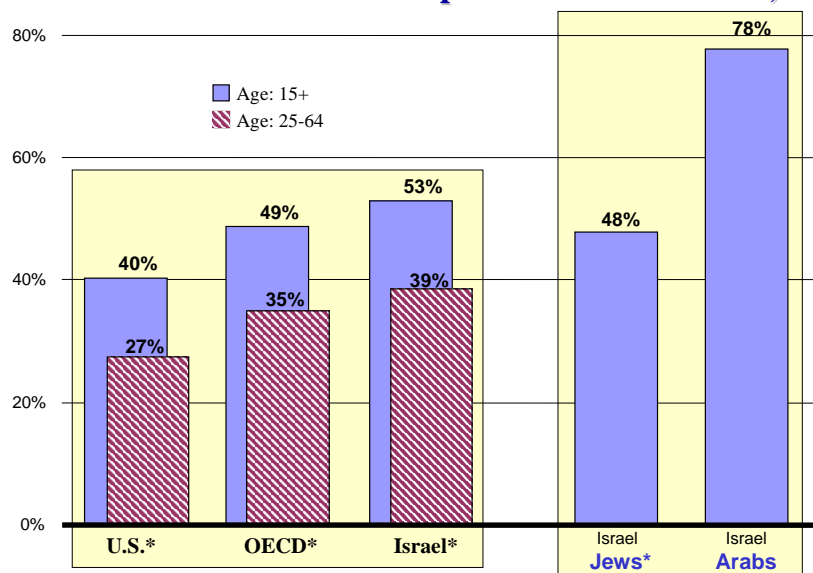
Any serious "root" treatment of the employment problem necessitates that the government internalize the fact that Israel does not have 525,000 "shirkers" (280,000 unemployed plus 245,000 others who would participate in the labor force if Israel matched the OECD's participation rates) or 800,000 "shirkers" (if the country were to add another 520,000 jobseekers to the unemployed, as it would if the American participation rates were equaled here).

B. The Tax Burden and the Middle Class

Israel needs not only to integrate non-job-seeking citizens into the labor force but also to increase the work incentives for those already participating. At first glance, Israel's average tax burden is not exceptionally high. About one-third of the industrialized countries have heavier burdens than Israel's. The problem in Israel revolves around how the burden is distributed.

The tax burden on some segments of Israel's population is one of the highest in the world. Income tax rises steeply with income. In 2004, taxpayers in just the sixth income decile

Figure 7
Share of Female Non-Participation in Labor Force, 1998



Source: Dan Ben-David (2003), *Economics Quarterly*
Data from Israel Central Bureau of Statistics and ILO

² For a more detailed exposition, see Dan Ben-David, "The Israeli Labor Force from an International Perspective," *Economics Quarterly*, March 2003 (Hebrew), pp. 73–90.

already reached the 43 percent marginal rate³ – plus more than 11 percent in National Insurance contributions (paid by employer and employee) as well as additional levies.

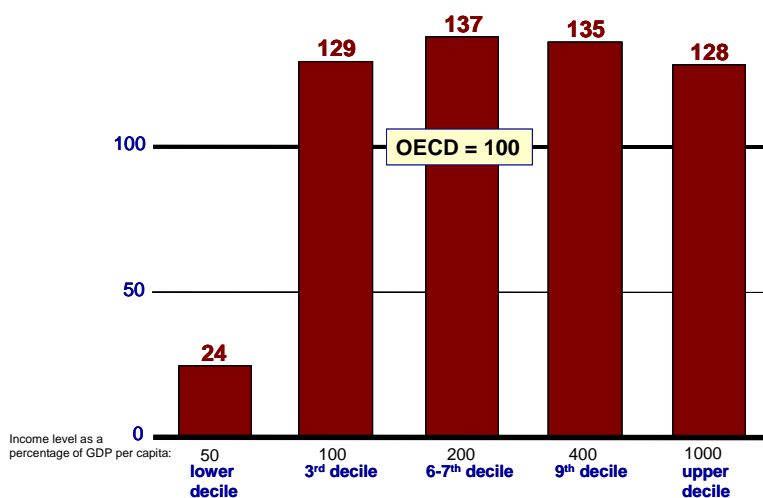
Adi Brender of the Bank of Israel compared the marginal tax at various income levels in Israel with the marginal rates at corresponding income levels (relative to per-capita GDP) in the OECD countries. Figure 8 adjusts his findings to Israel's income deciles. In general, the marginal income tax rate in Israel is 30 percent higher than that in the OECD countries in every income decile except the lowest one. The disparity is greatest in the middle class, at 37 percent, and narrows toward the two extremes, at 20 percent in the third decile and 29 percent in the highest decile.

The higher the marginal tax rate, the weaker the incentive to work more. To illustrate how heavy the tax burden on the middle class is, say that a married worker with two children, in the sixth decile, considers taking on additional work that will increase his monthly gross wage by NIS 100. What will be the resultant increases in the employer's costs and in the employee's disposable income?

The list of payments that buffers between wage cost and disposable wage is lengthy. Among the taxes paid is the health tax. While this is formally a tax in Israel, it is not obvious that it should be regarded as a tax for all income levels. If this tax did not exist, households would pay some level of healthcare premiums in any case. Therefore, at low income levels there is no reason to treat the health tax as a tax. The health tax rises commensurate with income at a fixed rate of 4.8 percent in order to subsidize healthcare services for those who pay little, if anything, for them. Assuming that sixth-decile households already pay for about as much for health insurance as they would in any event, i.e., even if there were no health tax, all extra healthcare charges are treated here like a full-fledged tax.

The calculation of the net wage does not account for indirect taxes. However, the average propensity to consume at this income level, according to the Central Bureau of Statistics, is roughly 100 percent of net income. In other words, at this level of income, the entire wage increase will be spent on consumption. Hence, the 17 percent value added tax (VAT) should be deducted from the disposable income. In fact, the 17 percent VAT underestimates all of the indirect taxes because it excludes various other taxes such as purchase taxes, customs duties,

Figure 8
Marginal Tax Rates, Israel vs. the OECD Countries, 2003
by income deciles*



Source: Adi Brender (2003) Bank of Israel

* Gross household income deciles

³ The Central Bureau of Statistics divides households headed by employees by monthly gross financial income. In 2001, monthly income in the sixth decile fell into the NIS 10,664–NIS 12,203 range. A married spouse (sole breadwinner) with two children and a monthly gross income of NIS 11,100 was in the sixth decile and paid the 43 percent marginal tax rate (according to calculations at http://www.hilan.co.il/Moked_Yeda_Lesachar/hishuv.asp) on each additional NIS received.

excise taxes, and government fees.

As Table 2 shows, a worker's decision to work more and increase his gross wage by NIS 100 is reflected in an NIS 105.90 increase in employer's cost and boosts his disposable wage by only NIS 38.70 – what remains after NIS 67.20 is paid out in taxes. In other words, if a worker in a middle income decile decides to work more in order to improve his standard of living, the government of Israel will receive nearly twice as much as he would.

This is a non-insignificant burden. Lowering it would increase the desire to work, especially among members of the middle class. It would also enhance the feasibility of hiring more workers. For example, if the employer's cost were "only" twice the disposable wage that the worker would receive, the employer could pay less, the worker could earn more, and both sides would have a greater incentive to increase employment.

Just as the total tax burden does not reflect the distribution of the burden in the case of direct taxes such as income tax, an international comparison of VAT rates does not provide a full picture either. The latest report of the State Revenues Administration at the Ministry of Finance, for example, compares VAT rates in thirty Western countries.⁴ Half of these countries have higher VAT rates than Israel's (which was 18 percent at the time the report was published). However, the countries' VAT rates vary considerably and not all rates are administered on all goods.

To obtain a more accurate picture of the indirect-tax burden in Israel as against other countries, is useful to examine the share of indirect tax revenues relative to GDP. Israel imposes a wide variety of fees and other taxes – from levies on fuel up to an annual charge for the mere possession of a television set. The result, shown in Figure 9, is that the share of government revenues derived from taxes on goods and services (VAT and other) to GDP is 29 percent higher in Israel than the European Union average. Only one country out of the thirty examined by the State Revenues Administration had a higher burden of indirect taxes. When Israel is compared with the United States, its indirect tax burden is 2.42 times higher, i.e., 142 percent more than the burden on the American citizen.

Taxes on goods and services are regressive taxes whose negative impact is stronger at lower income levels because the poor set aside a larger proportion of their income for consumption than do the rich. At the lowest income levels, VAT and the other taxes on goods and services actually amount to an income tax on the poor. The full array of indirect taxes dampens private consumption and investment and, by so doing, constitutes a heavy millstone around the neck of domestic economic

Table 2
Additional Employee and Employer Taxes
for additional NIS 100 in gross income

(for married male with 2 children and NIS 11,000 gross monthly income)

	Additional employee taxes	Additional employer cost
income tax	43.0	
social security	5.6	5.9
health tax	4.8	
VAT on consumption	7.9 (not including purchasing taxes, customs, etc.)	
total taxes/costs	61.3	5.9
disposable income / employer cost	38.7	105.9

Ratio of employer cost to employee net income $2.7 = \frac{105.9}{38.7}$

Actual marginal tax rate for worker in 6th income decile: 63%

Source: Dan Ben-David, Tel-Aviv University

⁴ Ministry of Finance, State Revenues Administration, *Annual Report 2002–2003*, No. 52, November 2003 (Hebrew).

activity, with everything that this implies for job creation.

The higher the tax burden – direct or indirect – the stronger the incentive to avoid or evade taxes, resulting in an even heavier burden on those who are unwilling (or unable) to conceal economic activity.

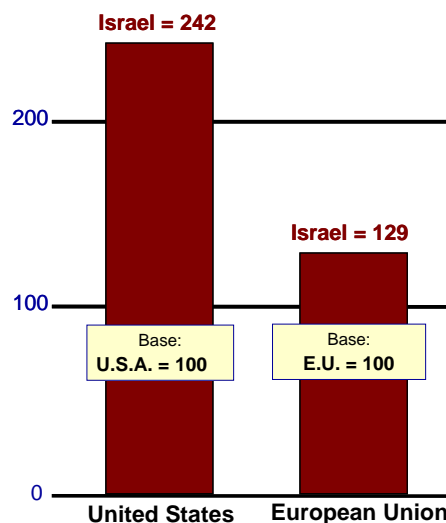
When part of the population is saddled with a relatively heavy tax burden, and when that burden is not apportioned progressively among people at different income levels, or equally among those of similar income, the country needs to enact policies that minimize the distortions. This, however, is not enough. Israel should lower its tax levels so that workers may retain a larger share of their work income – and this requires cutting government spending.

Since Israel was established, annual tax collection has never sufficed to cover government expenditures, which in recent years have been among the highest – relative to GDP – in the Western world: 54.0 percent as opposed to an OECD average of 40.8 percent in 2003 (Figure 10). It is true that Israel spends much more on defense than do the OECD countries, but even Israel's non-defense – i.e. civilian – government expenditures were higher by 6.6 percent of GDP. In other words, Israel's annual non-defense spending was NIS 33 billion greater than the OECD average.

The cumulative result of the government deficits is a large public debt that Israel has to pay back with interest. In 2003, interest payments alone accounted for 5.8 percent of Israel's GDP as against 2.0 percent in the OECD countries. This is equivalent to the country's entire public health expenditure and much more than the amount spent on primary and secondary education in Israel.

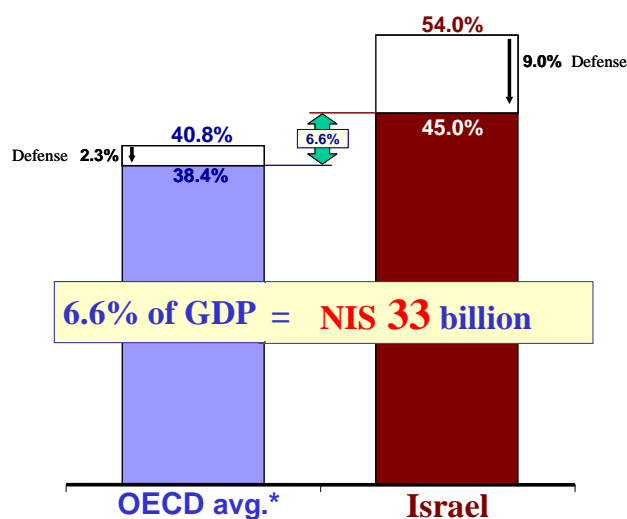
Had the non-defense government expenditures been spent on infrastructure development or in the building of a social-welfare system that delivered exceptional support for those unable to work, one might claim some justification for the extra expenditure and the additional burden it puts on the taxpayer. However, the sub-par state of Israel's infrastructure and the sub-standard living conditions of many of its sick and elderly give no evidence of proliferate expenditures for these purposes.

Figure 9
Indirect Taxes as Share of GDP, 1999
(Taxes on goods, services, real estate, etc.)



Source: Dan Ben-David, Tel-Aviv University
Data from Ministry of Finance.

Figure 10
Total Government Expenditure, 2003
as a percentage of GDP



* 26 countries for which OECD reports data on interest payments.

Source: Dan Ben-David, Tel-Aviv University
Data from Israel's CBS, Bank of Israel, OECD and CIA.

In order to avoid any misunderstanding, this paper focuses on the state's role in providing tools and conditions for more employment. However, there is a need to draw a distinction between those who can work and those who cannot due to age, illness, or other factors. Israel is duty-bound to meet the medical and caregiving needs of this population group and to administer a welfare system that will allow these people to maintain dignified lives at a reasonable standard of living. The reduction of taxes is not intended to harm those who cannot work. As Figure 10 shows, Israel's civilian budget has enough slack – in comparison with the Western countries' budgets – that cutbacks can be made in less important areas without having to deal a blow to those who cannot help themselves.

The problem in Israel is not in a broad unwillingness to work but in the existing conditions for expanding employment. The parameter that affects labor-force participation rates in Israel and abroad is the extent of the difference between what one may earn by working and what one may obtain without working. In Israel, the de facto distance between the two is smaller than the formal one.

On the one hand, many Israelis receive financial aid through a multitude of government channels – not all explicitly under the formal aid umbrella with its uniform and relatively transparent conditions for provision of assistance. On the other hand, there is inadequate enforcement of the minimum wage and other labor laws specifying minimal working conditions. This result is a de facto narrowing of the gap between income from labor and income received while not working – with everything that this implies regarding the labor-force participation rate. Additionally, insufficient law enforcement acts as an incentive for employers to refrain from hiring low-skilled Israelis when they can employ – under illegal work conditions – similarly skilled foreign workers at half the price. Inadequate human and physical capital infrastructures, supplemented by the heavy tax burden, make it even harder to find work and inhibit hiring.

Clearly, it is not possible to speak about employment changes at magnitudes of hundreds of thousands of people in the short term. Therefore, it is very important to begin laying the necessary foundations that will facilitate long term changes. The severe implications of Israel's current trajectories necessitates putting a high priority on implementing these adjustments sooner rather than later.

C. Labor as a Value

Labor means more than doing something productive. It has social and emotional aspects and is central in most individuals' identity as their primary activity in modern society. Labor is a focal point of endeavor that gives people a sense of achievement and of value in the eye's of others. Losing a job threatens one's self-esteem, sense of belonging, and the possibility of contributing to others. For many, joblessness is related to a sense of social isolation.

In recent years, voices from various quarters in Israel have impugned the work motivation of entire population groups. This approach infers that many people prefer not to work and would rather live on the public dole. The reduction of transfer payments has also been justified in part by the need to whet people's ostensibly deficient motivation to go out and work.

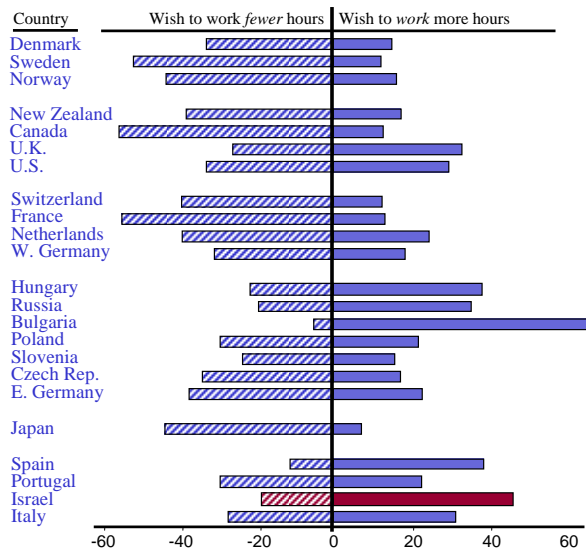
How accurate are these assumptions about the Israeli worker? In a 1997 study, members of adult populations in more than twenty countries were asked whether they were interested in devoting more time or less time to work than they were devoting at the time of the interview. The data in Figures 11 and 12 depicts the separate responses of men and women in twenty-three

countries (Stier and Lewin-Epstein, 2003).⁵ As Figure 11 shows, a large proportion of Israeli men (nearly 50 percent of respondents) said they were interested in devoting more time to work; only a minority (fewer than 20 percent) preferred to work less. Only Bulgaria surpassed Israel in the percentage of persons interested in devoting more time to work.

Among women, too, the assumption that Israelis prefer to work as little as possible appears to be groundless (Figure 12). More than 40 percent of Israeli women said that they would prefer to devote more time to work; only about half that proportion expressed a preference for working less (the remainder preferred to leave the situation as it was at the time of the interview.) The percentage of women, like men, who would rather devote more time to work was high in Israel relative to other countries. Bulgaria and Spain had higher rates; Italy's rate was similar to Israel's. In Scandinavia, Western Europe, and even parts of Eastern Europe, the proportion of women who preferred to work more was smaller.

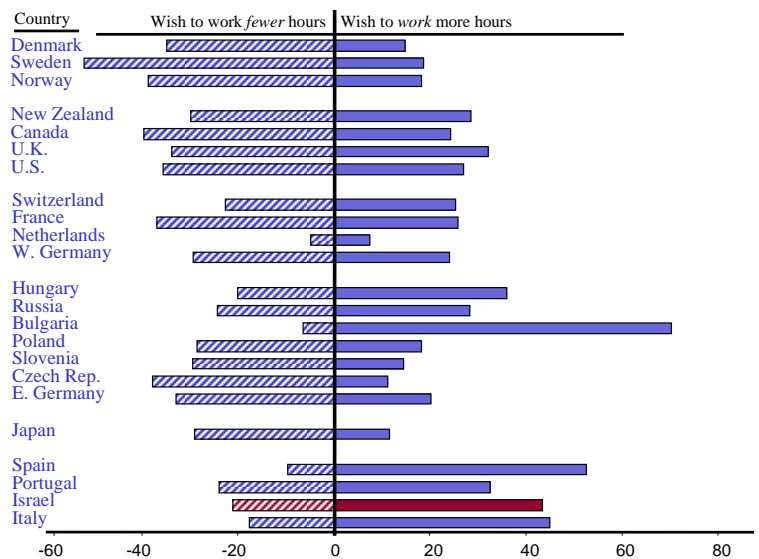
Data from other sources, gathered in different contexts, also indicate that, as a rule, Israelis want to work. In a 1998 study (Habib, Morgenstein, and Zipkin, 1998), the preferences of welfare clients among immigrants from the former Soviet Union were examined directly.⁶ The study found that a large majority of immigrants preferred to work instead of accepting income-maintenance benefits.

Figure 11
Male Preferences for Working Hours, 1997
Ages: 18-65



Stier and Lewin-Epstein (2003) "Time to Work: A Comparative Analysis of Preferences for Working Hours"

Figure 12
Female Preferences for Working Hours, 1997
Ages: 18-65



Stier and Lewin-Epstein (2003) "Time to Work: A Comparative Analysis of Preferences for Working Hours"

⁵ Stier and Lewin-Epstein (2003), "Time to Work: A Comparative Analysis of Preference for Working Hours," *Work and Occupations*, pp. 302-326.

⁶ Habib, J.; B. Morgenstein, and A. Zipkin (1998), "Job versus Income Support: Integrating Soviet Immigrants into the Israeli Labor Market," *Research Report 71*, National Insurance Institute.

A more recent study focusing on recipients of income supplements (Morgenstein et al., 2003) found that most of the unemployed had actively sought work and expressed the wish to work.⁷ However, the duration of disengagement from the labor market had an adverse effect on this willingness; people who had been out of the job market for more than five years expressed little motivation for returning.

In summation, there is no support for the sentiment that Israelis relate to work differently than do the populations in other countries. Their willingness to work does not fall short of that of other peoples – and the findings of the sample indicate the proportion of working-age population who want to work is actually higher in Israel than in most other countries.

III. Recommendations for Improvement of Employment in the Short-Run

The following recommendations are ranked in the order of their effect on the labor force. The first recommendations can be effective in both the near and the distant future. The later recommendations are those whose effectiveness will be primarily in the long run. A main challenge for the next few years is to deal with healthy, working-age people who are either unemployed or non-participants in the labor force.

A. Work incentives and reduction of the tax burden

The focus here is on enhancing the willingness to work of those who do not participate in the labor force and those who participate in a way that does not realize their full labor potential. Greater efficiency in the tax and welfare systems will add a new dimension to the concept of universality in Israel. Tax rates should be set in accordance with total income irrespective of its sources. The same total-income principle should determine the extent of assistance. Only those in need of assistance should receive it and, in the relevant cases, the aid should be given in a way that will act as an incentive to work.

In a country in which most Israelis could have lived within half an hour's travel distance of a main population center, had there been an adequate transport infrastructure in place, there is no reason to grant aid to anyone – individuals, households, or businesses – on the basis of place of location. Instead, the money should be invested in developing essential physical and human infrastructures that enable the extremely large disparities in real-estate prices to act as a stimulus for dispersing the population and bring about social integration.

This part of the paper is based on three principles:

1. Merging all household income from all sources, broadening the tax base, and lowering the tax burden.

The tax base should be broadened to include capital gains, income from abroad, and so on – and a common tax schedule should be applied to the total income instead of the current practice of applying different tax rates to different incomes irrespective of the household's

⁷ Morgenstein et al. (2003), *The State of Employment of Income-Maintenance Recipients: Resources, Barriers, and Need of Assistance in Jobseeking*, *Research Report*, National Insurance Institute and Brookdale Institute (Hebrew).

total income. The only exception in this regard should be in setting capital-gains taxes at rates that are similar to those abroad (i.e., lower rates on capital gains than on other sources of income) in order to encourage domestic investment and prevent capital flight.

This requires transition to a compulsory filing of annual tax returns that report all household income from all sources. Such a transition would not require the income tax authorities to expand their staff by very much, but they would have to change their modus operandi considerably. Not every taxpayer must be audited, but anyone who is suspected of tax evasion or whose name comes up in a sample, and is caught evading taxes, must be punished to the full extent permitted by law. This is not only fair to those who pay all of their required taxes, it would also serve as a deterrent for others while increasing revenues from tax collection.

Broadening the tax base and lowering the total tax burden are necessary measures in making it possible to lower income-tax rates, spread out the tax brackets, and reduce the value added tax. Tax rates rise rapidly in Israel and they are already very high at medium income ranges. This negatively affects living standards, it inhibits the willingness to work – and, in some cases, it dampens the desire to remain in Israel for those who have the option to work and live abroad. When this is added to the fact that the population needing assistance is growing much more rapidly than the population financing the aid, the result is an unsustainable trajectory for a country with an open economy and open borders for its citizens. Emigration of the country's most skilled and best-educated will only hasten this process.

2. Merging of all sources of aid and subsidies and making them transparent.

All aid and subsidies currently emanating from all sources – such as Social Security, the Ministry of Construction and Housing, the Ministry of the Interior, etc. – to all households, businesses, and all others, should be merged. Just as all tax-collection systems should be merged in order to make the process more efficient, the same should be done in regard to aid. Only one government agency should assist individuals and households and it should do so on the basis of need only – under clear, transparent, and uniform criteria for all sectors and population groups. Those who cannot work due to illness, disability, etc., as well the elderly, should receive aid at levels that will allow them to live in dignity.⁸

Financial aid due to family circumstances (e.g., single-parent households) and state of employment (e.g., the unemployed) should be offered for limited periods of time and in amounts that will not encourage permanent dependency on the assistance. This aid should be accompanied by the integration of other systems listed below. Such support would enable those undergoing a difficult transitional phase in their lives to receive a period of time in which they could reorganize and find the most suitable employment alternative. The better the match – of skills and the willingness to work on the one hand, with available workplaces on the other hand – the greater the gain to the economy. On the other hand, it should be clear, that it is not feasible to allow the job search period to remain open-ended, and this manifests itself as an incentive for the person receiving aid to compromise with the employment possibilities available.

Necessary, though insufficient, conditions for providing subsidies to businesses, is the existence of market failures in the field and/or a social rate of return on investments that

⁸ To prevent the emergence of a non-incentive for today's young people to save for old age, compulsory participation in a savings plan/plans by all who earn over a minimum level should be seriously considered.

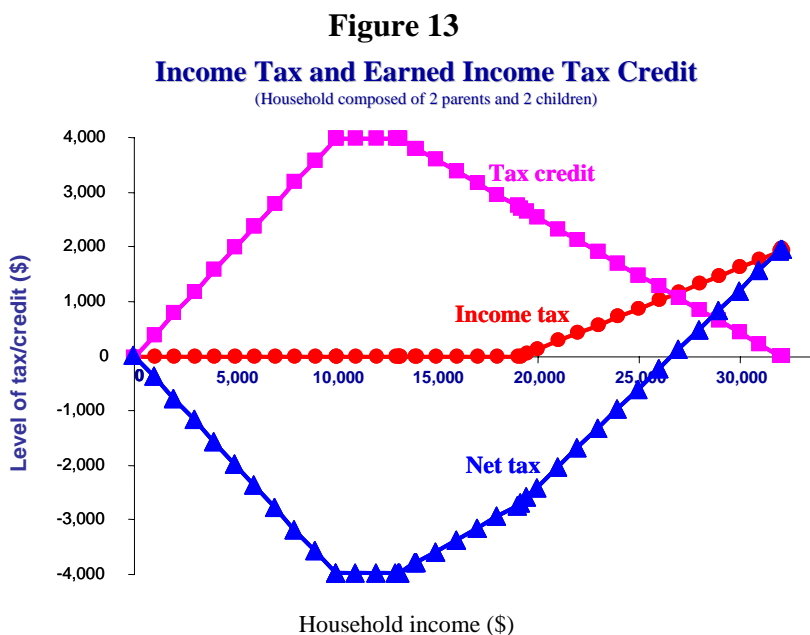
exceeds the private rate of return. The government should avoid subsidization that will distort business considerations toward inefficiency and long-term dependency. The primary focus of assistance to the business sector should be at the general level and not that of the individual firm – provision of a solid structural and business infrastructure supported by efficient, rapid, and inexpensive public services.

3. Replacing non-work incentives with work incentives.

A large share of the aid for the able-bodied should be given in the form of work incentives. In this regard, two of the most salient and successful programs in the United States are “Wisconsin Works” (or what is referred to in Israel as the “Wisconsin Plan”) and the Federal Earned Income Tax Credit (EITC).

- The objective of the Wisconsin Plan, enacted in 1996, is to replace allowances and grants with time-limited subsidies conditioned on employment (expanded discussion of this appears in section C below).
- The EITC program is essentially a negative income tax of 40% which means that the aid increases with household income (Figure 13). In the case of a household with two or more children, the credit (in 2001) this aid peaks at \$4,000 on an annual income of \$10,000 (an amount that reflects American standards of living and is not meant as a target for adoption in an Israeli version of the program). The maximum credit of \$4,000 is given up to an income of \$13,175, after which it declines as incomes rise, until it disappears entirely at an annual income of \$32,000. For a family with two children, the Federal income-tax minimum threshold is \$19,500 (and in most cases, there are additional state and local taxes). At these income levels, however, the tax owed is still smaller than the tax credit and the household continues to receive negative Federal income tax.

It is important that the subsidies be provided to the worker rather than to the employer (as is the case in Israel). One problem with grants to employers who hire new workers is that these end when the workers cease to be “new.” Then the incentive to hire becomes an incentive to fire the existing employee and replace him/her with someone new. In the EITC method, the benefit accrues to the worker, for whom it is an incentive to persevere and succeed at work in order to earn raises that will increase the credit. Practically speaking, employers share



Source: Dan Ben-David, Tel-Aviv University
Data from Internal Revenue Service

this type of grant with workers because it allows them to employ workers at a lower cost than what the workers actually receive.

Israel's child allowances are an example of financial assistance that is a non-work incentive. If the goal is to provide aid in care-giving for children to all families regardless of their incomes, it is possible to do so by reducing taxable income as family size increases – as is done in the United States by means of standard deductions and exemptions. For any given level of income, the larger the household, the lower its taxable income (equal reductions for each additional child).

Since the objective of this paper is to detail a systemic policy approach and the limited space facilitates discussion of little beyond the primary policy goals, it is not possible to expand on the transitional details involved in moving from current regimes to recommended ones. Nevertheless, it is important to stress a point that holds in additional contexts as well but does not receive sufficient emphasis in Israel's public discourse: the transition phase must be carried out with the maximum sensitivity that is possible to fund and budget. This is important not only because it is more humane, it is also appropriate in terms of facilitating the implementation of new programs and limiting resistance to relevant arguments.

Child allowances are a classical example of the issue of switching from an old aid regime to a new one. Households that determined their size on the basis that earlier levels of aid would be continued should not be harmed during the transition. Such households cannot turn the clock back and re-plan their lives and size accordingly. On the other hand, those who choose to expand further after the new regime goes into effect should be subject to the new criteria for provision of aid.

The implementation of financial incentives that encourage work, instead of incentives for non-work – as is common in Israel today – is a central component of any attempt to return workers to, or to integrate them into, the labor market. On the other hand, it should be clear that, in lieu of adequate contemporary skills training tailored to a competitive and open market, coupled with additional complementary steps, changes in the incentive structure will have a limited effect.

B. Significant reduction in the number of foreign workers

After the first outbreak of Palestinian violence, the number of Palestinians employed in Israel fell significantly. During the first half of the 1990s, the dwindling number of Palestinians working in Israel was replaced by an increasing number of foreign workers (Figure 14) at a rate that kept the overall share of non-Israeli workers relatively constant. In the latter half of the 1990s, Palestinians were once again hired in rising numbers – until the outbreak of the second outbreak of violence in the early 2000s – while Israel continued to import growing numbers of foreign workers. At one point, one out of every eight workers in Israel was not Israeli, a share higher than in all European countries except Switzerland.

While the Israeli economy is experiencing an increased demand for educated and skilled workers, the flooding of the labor market with unskilled foreign workers has been crowding out unskilled Israelis from the labor cycle and depressing their wages.

Foreign workers are attractive mainly due to their low cost, which, according to the Finance Ministry, is 40–50 percent below the cost of hiring an Israeli. As the Finance Ministry notes, the primary reason for their low cost is due to the fact that Israeli employers

do not provide foreign workers with all the rights entitled to them by law: e.g. minimum wage, social benefits, and so on.

The government handling of the foreign workers issue is highly problematical. While one hand attempts to find and round up all illegal workers, the other hand continues to issue thousands of new permits each year to new workers – with minimal attempt at enforcing existing labor laws on Israeli employers.

The most effective way of reducing the demand for foreign workers is to make it much more expensive to employ them. Enforcement all labor laws, including the minimum wage, is only the beginning. A tax rate in the double-digits on wages should be imposed on the employers of foreign workers in order to effectively eliminate their cost-effectiveness. The immigration police should pursue lawbreaking Israeli employers and not only illegal aliens. As demand for foreign workers declines, more and more of them will be inclined to leave voluntarily.

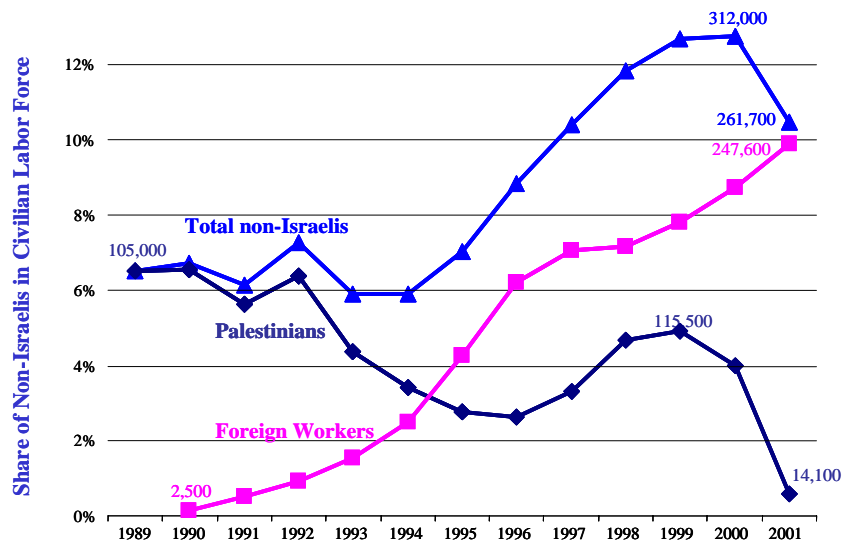
Once foreign workers are no longer cost-effective, local employers will have no choice but to employ Israelis. It should be clear, however, that the departure of the hundreds of thousands of foreigners will not be an employment panacea for all 280,000 unemployed Israelis. The higher the cost of labor becomes, the more employers will have to abandon Third World production techniques and adopt more advanced ones. Thus, Israeli workers will be in greater demand but will be used more efficiently. In the construction industry, for example, instead of a large number of workers climbing floors with buckets in their hands, one crane operator will suffice. Since his/her output will surpass that of any bucket-hauler, it will be possible to pay him/her more. However, the number of crane operators needed will not equal the number of foreign workers with buckets.

If the employment of foreign workers is reduced significantly, demand for domestic workers and the wages for unskilled workers will experience a relative increase.

C. An integrated system of supplemental adult education, vocational training, and job placement

The purpose of the vocational training system is to integrate working age adults having difficulty finding a steady job and to upgrade their skills so that they can make a decent living. Rather than continuing with the existing framework, we propose an integrated network that will complement the current employment policies. Although one should not expect the integration of the vocational training, welfare, and placement systems to lead to drastic

Figure 14
Non-Israeli Workers, 1989-2001*



Source: Dan Ben-David (2003) Economic Quarterly

Data from Israel Central Bureau of Statistics and Bank of Israel

* includes legal and illegal workers

changes in the short run, the experience in Israel and Western countries⁹ indicates that such integration can make a contribution in the medium term (two or three years after the program goes into effect).

In each year between 1999 and 2001, 39,300 to 41,600 Israelis attended vocational training courses for the unemployed and for recipients of government income supplements that were run by the Ministry of Labor and Welfare. Most of the students (between 80 and 90 percent) were receiving unemployment compensation and a minority (about 5,000 each year) received income supplements. During these years, the direct cost of running the courses was NIS 200 million per year while income supplements and unemployment compensation payments during the participants' studies came to NIS 600 million. Several months prior to the writing of this report, unemployment compensation payments to students were lowered to 70 percent of total eligibility; therefore, the share of income supplement is expected to grow. According to current forecasts, only 15,000 persons will attend these courses in 2003, meaning that the direct cost will be much smaller than planned.

Historically, almost all vocational training courses in Israel have been run directly by the Ministry of Labor and Welfare. In 2003, inspection of the courses was transferred to the Ministry of Industry, Trade, and Labor. There is an intention, not yet realized, to outsource the actual implementation of the courses to external scholastic institutions. The courses are to be offered in four national districts and are sorted into training for those who have academic education (20 percent of all vocational training students) and courses for the rest of the population. In both cases, only Israel citizens who have completed their formal studies may enroll. The courses provide training in a variety of fields such as caregiving, auto mechanics, bookkeeping, and computers, and they last from several months to more than a year. Applicants are referred to courses at the government employment offices and must pass written exams, oral exams, and interviews before they can begin their studies. At the end of the courses, they have to pass tests in the acquired trade.

Since the early 1960s, developed countries have been providing government-funded vocational training programs for working people. In Europe and the United States, as in Israel, the declared purpose of the courses is to increase the earning potential of people with low human capital (though not necessarily little ability). As the vocational training systems grew, professionals and policymakers began to ask themselves whether the goals that had been set were being attained. They also started to gather data about course graduates and to estimate the return on their studies in various ways. Since the early 1990s, in view of the experience acquired, the modus operandi of the vocational training centers has undergone major changes (extensively in the U.S., less so in Europe).

To the extent possible, research has estimated the training courses' influence on two variables: graduates' chances of finding work, and their wages some time after the completion of studies. Most studies identify a small positive effect (usually not statistically significant) on both the employment and the earning level of the participants. Since university education delivers a return of about 5 percent per year, many scholars believe that one should not expect vocational training to provide a return of more than 2 percent. It is also interesting that,

⁹ For an interesting survey of reforms in the U.S. and the U.K., see Nightingale, Pindus, Kramer, and Nickelson (2002), "Work and Welfare Reform in NYC during the Giuliani Administration, Urban Institute, USA, and Saranna Fordyce (2003), "Unemployment Dealt With? Next Stop, the Economically Inactive," Department for Work and Pensions, U.K.

according to almost all studies, women attain a much higher return than men. In Israel, the return for immigrants surpasses that of non-immigrants.

Researchers distinguish between two types of courses: voluntary and compulsory. In the U.S., for example, there are compulsory courses for prisoners, dropouts at the junior-high level (of an age when working is still prohibited), and single-parent mothers who have been receiving government subsidies for several years. Voluntary courses are for high-school dropouts, the unemployed, and, in certain cases, workers who wish to retrain. For the most part, the return on compulsory courses is lower. In Israel, vocational training falls into the compulsory category because they provide an income for participants whose eligibility for unemployment compensation has run out. Thus, some participants enroll in vocational training due to the financial return that they receive as they study and not necessarily due to a wish to improve their personal human capital. Recently, several changes have been introduced in this regard; their effect should be examined in the future.

As things stand today, the existing set of vocational training courses has not performed as expected and is in need of a thorough reform. For this purpose, lessons should be drawn from the experience in Israel and the extensive experience acquired in Western countries during the past forty years. The new system should be composed of several circles, each addressing a different target population and different goals, but all being complementary. The first recommendation pertains to offering the possibility of upgrading basic knowledge. The second recommendation concerns the upgrading of vocational skills. The third recommendation deals with the system that connects the upgrading of knowledge and skills with job placement.

1. “Second Chance” program

The supplemental education system called “Second Chance” should be separated from the vocational training and placement systems. The function of the former is to provide general human capital for interested adults who did not complete their formal secondary education as children and for recent immigrants who did not acquire secondary education in their countries of origin. The provision of supplemental basic education would enable these people to take the first steps in improving their earnings capability. Due to the fact that the supplemental studies are largely general in nature, we recommend that they be provided publicly. Since the goal in these studies is to equip students with a basic high-school education, studies should not be conditioned on the student’s state of employment. On the basis of recent experience in the U.S., these studies may be undertaken on a part-time basis, e.g., twice a week.

Israel began pilot training programs of this kind about three years ago. The participants managed to cover two years of high-school material within slightly more than half a year. The supplemental basic-education track is important because it opens doors to better vocational training and employment in the future.

As with too many other government projects of this type, standards for quality control of Israel’s existing supplemental education programs have yet to be determined and conclusions have yet to be drawn. These conclusions about the activity in Israel, once they are brought together, should be combined with experience accumulated abroad – and the program should be expanded considerably so that those interested in improving their education to the twelfth-grade level will be able to do so. There may be good reason to outsource the scholastic activity to private firms, but only if strict quality control standards

are applied. The curriculum should be national and modular, i.e., participants should be able to exit and enter at several junctures along the way and receive a diploma at the end of each phase after passing a national test. The “second-chance” program should be the first phase in the construction of a skill-acquisition track. Farther down the track, the participant can choose between relevant options that may include vocational training or, in the event of scholastic success, academic studies.

The enhancement of Israeli workers’ basic knowledge is very important not only for the workers but also for society at large. Thus, the studies should be subsidized – directly, and also by means of long-term loans at subsidized interest and easy payback terms. This would make it possible to give everyone who wishes a second chance to get back aboard the study ladder.

2. Vocational training

(The following are points taken from Ben-Shahar team’s report that was presented before the Barak cabinet, as detailed in Helpman and Shavit, 2000)¹⁰

- i. Employers’ involvement in vocational training contributes to the success of training in two respects:
 - higher employment rates;
 - higher-quality employment.
- ii. Colleges should be encouraged to establish technological-training centers in conjunction with employers and with government encouragement. It is especially important for the business sector to take part in this initiative.
- iii. The centers should offer three kinds of programs: modular training for technicians, supplementary training, and vocational retraining.
- iv. Training of technicians and skilled professionals in other fields should include internship with businesses.

3. Job-placement system

Israel’s job-placement system should be overhauled and privatized. The government should contract with private entities – including performance bonuses, regulation and inspection of performance, with the possibility of withholding payment and even imposing penalties if the terms are not met. Each job center should be based within a district, while each district should have job centers that specialize in fields that reflect the characteristics of local residents and employers in order to personalize the services as much as possible.

The centers’ function should be to identify, list, and recommend various alternatives to each applicant – supplemental education, vocational training, and/or an immediate search for work. The center should keep track of the applicant at all stages of the course of action that he/she chooses until a job is found and also for a predetermined period afterwards. Applicants should be able to benefit from the center’s professional knowledge

¹⁰ Elhanan Helpman and Yossi Shavit, “The Royal Road to the Market,” *Ha’aretz*, June 13, 2000. The article focuses on part of a broad range of socioeconomic themes and recommendations presented to the government by a team headed by Haim Ben-Shahar in May 2000. (Members of the team: Dan Ben-David, Haim Ben-Shahar, Elhanan Helpman, Manuel Trachtenberg, Efraim Sadka, Dani Tsiddon, Yossi Shavit, and Haya Stier). Part of the team’s work was summarized in a series of article in *Ha’aretz*; it appears in full in Dan Ben-David, ed. (2000), “National Socioeconomic Priorities” (Hebrew).

and accumulated experience in accordance with their qualifications and preferences for available opportunities.

Listed below are several practical points that may be integrated into the redesign of the job centers. The points are culled from the experience of corresponding projects in Britain and the United States. Presumably, lessons learned after the program is implemented should lead to changes in and adjustments of various aspects of the program.

i. Structure of the job centers:

- Each job center should have defined goals and standards that conform to a national benchmark that will be established. Its goals should be clear and ranked according to their importance and the likelihood of their success. This itemization should be included in the bids for the establishment of the center.
- Each center should interact closely with the local supplemental education and vocational training centers (as set forth in Recommendations 1 and 2). This interaction may establish milestones toward a worker's successful placement.
- Employers in the district should be encouraged to take part in drawing up a profile of their requirements from potential workers, to participate in job fairs, and to undertake employment of workers from the district.
- Important local organizations (university, community centers, youth movements, kibbutzim, affluent neighborhoods) should be utilized for support and volunteering at the centers.
- Special centers should be established for unique groups (e.g., the ultra-Orthodox in Jerusalem, persons with disabilities), with emphasis on providing each group with specific solutions.
- Assistance in methods of job-search and job-attainment should be emphasized; this includes writing a curriculum vitae, mastery of job-interview behavior, and understanding what is required of a beginning worker.
- The centers should accompany and support the unemployed during the transition period, until they find permanent jobs.

ii. Establishment of a national center for the coordinating the following functions:

- The national center should have a system for real-time reporting and delivery of data, making it possible at any point in time to determine the number of applicants and their placement possibilities. Analysis and rapid publication of non-confidential data on the internet will improve transparency and allow outside researchers to examine the functioning of the structure and propose alternatives.
- A system for the evaluation of training quality should be established, and its results utilized in a continuous evolution of the system. Here too, the results and conclusions should be published fully and promptly.
- Creation of a system to audit the private centers - with a mandate to impose sanctions, if necessary – to ensure that the operators are providing the services stipulated in their contracts.

Job centers should be compensated according to their placement success rates and the duration of their clients' employment. If the client chooses a supplemental education or a

vocational training track, the center should be compensated as a function of the client's success in completing each structured segment of the course. Basing the centers' remuneration on a key linked to applicants' success, as determined by a national-level committee of experts, will assure that the centers will make a serious effort to point applicants in the most appropriate directions.

According to the maximalist approach, the factor that ensures a serious attitude on applicants' part is the lack of an alternative. In other words, no able-bodied person should qualify for public assistance unless he/she takes part in the placement program. That person needs to choose between the supplemental education track, the vocational training track, and immediate job search. Those who choose to supplement their education must successfully complete each structured segment of the course. Anyone who fails to do so will be removed from the program.

The vocational training track should be structured in a similar fashion, with each individual offered several distinct opportunities during a defined period of time. Anyone who does not enroll a program of supplemental education or vocational training will (following the maximalist approach) have to accept any job offered after a specified search time frame has been exhausted.

The public debate should focus on the extent to which Israel should lean toward maximalism. The extent of toughness should correspond as closely as possible to the peaks and troughs of the business cycle. There is a need to balance between greater firmness at times of ample job availability and greater flexibility at times of economic contraction.

The Wisconsin plan, piloted at a time of economic upturn in the United States, seems to have brought quite a few people back into the labor market. Its successes, however, were accompanied by much criticism (as was the EITC program) in regard to issues related to job duration, the job quality, and so on. In the case of the Wisconsin plan, there was also criticism about a shifting of support for the needy from the public level to volunteer charitable associations and organizations. These phenomena are already surfacing in Israel, even though the Tamir Committee recommendations about the introduction of an Israeli version of the Wisconsin plan have not yet been implemented.

In sum, it should be borne in mind that the sole purpose of reforming the education/training/placement system is to assist and complement the rest of the proposed solutions. Its prospects of success will be slim unless significant changes in the other contexts are made. As stated above, the approach related to the enhancement of employment in Israel must be systemic.

D. Longer school days and afternoon enrichment programs for children and teens

The labor supply of many parents who would like to work away from home is limited by the need to care for children and teens during the day. Existing centers, such as Na'amat and WIZO, provide day-care only for the youngest children. However, they are expensive and they do not provide care for older children and teens.

Women are the main casualties of the existing situation. Many women stop working when they give birth and cannot always return to work quickly thereafter. This brings their career advancement to a halt and, at times, prevents their embarking on a career track altogether, to the detriment of their future working conditions and wages. An additional setback is experienced at the family level, as household income is negatively affected when one parent does not utilize his/her full earning capacity.

At the national level, the exit from the labor force reflects a non-trivial output loss. Protracted interruption of away-from-home employment, measured in years, and the transition to vocations that do not fully utilize many women's abilities is indicative of the extent to which the nation is not fully realizing the potential of its population.

Additionally, as we explain in detail below, the level of knowledge attained by Israeli children in the core subjects is quite low, with grave ramifications for the ability of the next generation to cope in the labor market. The combined significance of these facts – low labor-force participation, incomplete utilization of human capital, and a low level of children's education – is that the country's current and future standard of living is diminished by the loss of output, on the one hand, and by the diversion of product for income supplements and other forms of support, on the other hand.

Recommendation: truly free education in a long school day for all children and subsidized afternoon enrichment programs for children and teens.

A report by the E.L.A. Committee, presented in November 2003 to the Minister of Education and the Chair of the Knesset Education Committee – proposing systemic structural reform of the national education system – addresses itself to this specific issue as well.¹¹ In its proposal of a framework for change in teachers' working conditions and salaries, the report states, "Every full-time teacher should come every morning, leave every evening, and carry out all required tasks on the school premises. The number of vacation days should be consistent with the norm in other fields.

"The additional amount of time that every full-time teacher works will enable payment of higher wages, making the profession more attractive to college graduates. When teachers will work more hours per day and more days per year, the system will not need as many teachers. A transition to a situation in which fewer teachers are employed (a gradual transition, of course, and not in one go for obvious reasons) will release funds that may be transferred to teachers who work more hours.

"Once the teaching faculty spends all day and every day in school, students may receive additional teaching hours, a longer school day and a longer school year. The provision of more education will mark the first step toward raising the overall national achievement level and narrowing education disparities by making it possible to provide, at the national level, the reinforcement that affluent parents give their children privately today. Once the teacher is present in school after teaching hours as well, he or she will be more accessible to students, who today are forced to turn to private tutors when they have questions on the material.

"As soon as the schools adopt work days, work weeks, and work years that are the norm in other sectors, more parents will be able to join the labor force – making it possible to improve their families' standard of living." The Dovrat Committee made the same recommendation in its 2005 report for reform of Israel's educational system.

The E.L.A. Committee report continues: "If the country also manages to provide children who so desire with enrichment programs, including age-appropriate social, educational, and athletic activities during after-school hours – i.e., after the end of the longer school day – at a

¹¹ The members of the committee were Tamar Barak, Dan Ben-David, Herzl Bodinger (chair), Edo Ohayon, Dalia Prashker, Shabtai Shavit, Hillel Wahrman and Zvi Zameret. The E.L.A. Committee – Citizens for the Advancement of Education in Israel – operated under the auspices of the Forum for National Responsibility.

subsidized price (and even at no charge if necessary, on the basis of income tests), Israel will gain in two ways:

- “Time spent idly, watching television, etc., will be channeled to more productive and healthy leisure activities.
- “Any parent who wishes to work will have a full opportunity to do so with peace of mind.”

E. Further points

1. Credible policies, political horizon, and completion of the security fence

The main factors behind the substantial socioeconomic downturn since 1995 are not limited to stock-exchange slumps, recession in the West, and the war with the Palestinians. Three domestic factors contributed to a substantial worsening of an already bad economic predicament.

- The fiscal and monetary policies led to a significant – and unnecessary – decline in confidence in Israel’s governing system and, as a result, to heightened uncertainty that negatively affected economic activity, labor relations, and ultimately, economic growth.
- The existence of a national horizon conveys hope, a sense of light at the end of the tunnel – enhancing people’s willingness to consume without fear of a “rainy day” and to invest so as to be prepared for the new era when it comes. The absence of a horizon has exactly the opposite effect: the greater the decline in consumption and investment, the greater the contraction of aggregate demand for goods and services and, concurrently, of demand for labor.
- The failure to build a security fence along the route that is shortest, most direct, least expensive, and most defensible by Israel’s military – a project that may have prevented most of the terror attacks within the Green Line, where most of Israel’s economic activity takes place – led to a 3-4 percent annual decline in per-capita GDP (according to Eckstein, Tsiddon, Dar, and Tilman). That is, Israel experienced a total loss of NIS 42 billion–NIS 57 billion in 2001–2003, with all that this implies in terms of the lost jobs (not to mention the most important loss of all, that of lives). The cost of building the security fence, including all its crossings, had the shortest route been followed, would have totaled NIS 3-4 billion according to then National Security Advisor Major-General (res.) Uzi Dayan.

2. Special treatment for special population groups

Two sectors stand out in particular for their non-participation in the labor force are ultra-Orthodox men and Arab women. The example of Bangalore, India, is a useful indicator of how a poorly skilled population may be integrated into the labor force, as Helpman and Trachtenberg (2000) note as part of the work of the Ben-Shahar team.¹² The need for electronic typists, switchboard operators, and similar vocations – who need not be

¹² Elhanan Helpman and Manuel Trachtenberg, “A 61 Percent Question,” *Ha’aretz*, June 16, 2000. The remarks appear in the team’s summarizing work, Dan Ben-David (ed.), “National Socioeconomic Priorities,” 2000.

physically present in factories or head offices – facilitates training and employment of many workers in villages, development towns, and ultra-Orthodox neighborhoods.

3. Law enforcement

The extent to which laws are neither kept nor enforced has led to a distrust of government institutions and to considerable distortions in economic efficiency, income distribution and in shouldering the public debt. Some of the main issues in this regard:

- A substantial amount of business activity and employment goes unreported. This is reflected in extensive tax evasion that heightens the burden on those who abide the law. It also allows individuals to receive welfare benefits – thus exacerbating the tax burden even more – for a fabricated appearance of poverty,.
- A business culture of non-compliance with agreements – ranging from individuals and businesses that write bad checks to the government which reneges on its contractual commitments in compensating contractors and vendors.
- Disregard by employers of labor laws such as minimum wage and social benefits. Enforcement would have various short- and long-term effects. The greater the enforcement of the minimum wage, the larger the gap between what one can earn by working and the aid that is received when not working. The larger this gap, the greater the incentive to work.

On the other hand, in the short run, an increase in the employment costs of those who currently break the law and pay sub-minimum wages may result in a loss of jobs. The combination of more jobseekers and fewer jobs may be translated into a short-term increase in the unemployment rate.

However, beyond the fact that employed persons should be assured at least the minimum conditions that they are guaranteed by law, there are long-term implications as well. Just as increasing the cost to hiring foreign workers will require technological changes and a more efficient use of Israeli workers, so will the business sector internalize the fact that the country has become serious about enforcing its laws and will revert to more efficient production methods that make better use of the labor force – which, by then, should be more skilled than it is today. This will be reflected in higher wages and a better standard of living. To the effect that this heightened productivity increases the competitive ability of Israeli firms, the end result may even be an increase in the number of workers employed.

- In an economy that is finding it increasingly difficult to reconcile between a firm's need for flexibility in production and rigid labor laws that considerably limit this flexibility, there is a growing movement toward bypassing existing hiring laws by relying on companies that provide employment services. As a result, a worker often finds himself working in one firm while formally employed by a separate firm hired by a still different firm that is itself hired by an additional firm – and so on down a purposefully murky chain. When such workers are not paid in accordance with their employment contracts (or with the law), the companies conveniently pass the responsibility from one to the other. These workers, most of whom are unskilled, poorly educated and badly paid, cannot cope in the judicial system against the companies' batteries of lawyers. The end result is that a legal black hole is created in which the workers' basic rights disappear.

As long as employers, labor unions and the government are unable to find common ground for resolving the legitimate needs of employers and workers, there is an urgent need for determining (by law) that the recipient of services is held legally responsible for ensuring that workers providing the services receive all of the wages and benefits entitled to them by law. Once this accountability is formalized legally, the result would be an explicit address for losses incurred by workers. Serious enforcement of the law would have short- and long-term implications for the labor market that would resemble those described in the discussion on enforcement of the minimum wage.

A country that allows its laws to be held in widespread and systematic contempt undermines the foundations of a democratic society and endangers its future.

4. Improving the Elasticity of Labor Supply by Establishing Symmetry in the Severance-Pay Law

“The Severance-Pay Law is a progressive social law that awards a dismissed worker severance pay at the level of one month’s wage per year of work. It includes an important component of assurance of savings. A worker who retires receives severance pay from his or her employer as if he or she had been fired. However, those who quit their jobs, even after giving suitable notice, forfeit their entitlement to severance pay” (Ariel Rubinstein, 2003).¹³

Though not required by law, employees in the public sector, in large corporations, and/or holders of senior positions in private firms stand a good chance of receiving their severance pay regardless of who initiated the separation. The main victims are low-wage workers. These workers are additionally handicapped by the fact that employers are not required to make severance-pay provisions for workers who are employed for less than one year. This gives employers of unskilled workers an incentive to fire and replace them before they complete a year of work. Thus, instead of protecting the worker, the law is abused to harm them.

Rubinstein adds, “The result of the asymmetry between the employer’s mobility and the worker’s immobility is both inefficient and unfair: employees are not able to fully realize their potential while employers are given an additional weapon against wage demands of deserving workers.

“If the employer intends to pay his worker severance pay at the point of retirement, the cost of earlier termination is not the severance pay but only the need to pay it sooner. This is a relatively minuscule loss compared with the loss faced by a worker who quits, since this worker forfeits all of his/her severance pay. The economic rationale of binding a worker to his/her job, if any, is based on the employer’s investment in the worker. However, the difference between workers who are immobilized by the Severance-Pay Law and those who are not is determined in accordance with the employee’s relative weakness or strength rather than by an intrinsic ‘economic value’ of the immobilization.”

When a worker in whom an employer has invested is offered a better job elsewhere, nothing illegitimate has occurred. The opposite is the case: the employee’s improved productivity justifies larger compensation for his/her work. A free labor market with labor mobility allows workers to test their work value and the former employer can choose to pay the market price if he/she wishes to retain the employee. This, however, does not rule

¹³ Ariel Rubinstein, “A Free Market for Those Who Quit,” *Ha’aretz*, March 10, 2003.

out the possibility of an agreement between employer and employee before commencement of training in order to ensure that the relationship between them will last for a specified period after the training, thereby allowing the employer to recoup his/her investment in having trained the worker.

“The severance-pay law is important and full of good intentions. All it needs is an amendment requiring employers to make regular deposits of severance pay to a savings fund that workers may access when their relationship with the employer is terminated, for whatever reason. Thus, all employees may receive what they are owed as easily as some of us already do, whether they have reached retirement age, whether their employer has “disappeared,” whether they were discharged, or whether they quit of their own volition.”

IV. Recommendations for Long-Term Improvement in Israel’s Employment Outlook

The key to job creation (labor demand) is productivity. In this context, the extent of an economy’s openness to international trade is very important. An open economy increases the need to improve efficiency in order to compete, it enables utilization of economies of scale – that is, provides access to markets of nearly unlimited size – for Israeli firms that manage to cut costs and develop new and innovative products and production processes.

Labor productivity in Israel is low by Western standards. This makes it difficult for Israeli businesses to compete with foreign ones and it dampens demand for Israeli workers. Upgrading human capital and physical capital infrastructures will increase the productivity of Israeli companies and make them more competitive. This upgrade in the infrastructures will also contribute to a reduction in poverty and inequality.

The argument that a root treatment of poverty, inequality, and growth in Israel requires significant and parallel improvements in two complementary infrastructures – education and transport – was first published by Ben-David (1999).¹⁴ Both infrastructures must be improved concurrently, otherwise the outcomes may be problematical. For example, if a town in the “periphery” provides an excellent education, a brain drain may occur as local graduates search for work. By the same token, if railroads and highways to distant localities are built but education is neglected, well-educated people who examine alternative places to live will never choose these as places in which to live and bring up their children.

However, if good education is offered in areas that are considered “peripheral” today, and if these areas are connected with the large population centers by fast rail and highway, the country will be transformed. In a country that is as small as Israel, almost the entire population is within a thirty-minute train ride from one of the large population centers – would such trains exist – transforming today’s “periphery” into tomorrow’s “suburb.”

Differences in real-estate prices will be the catalyst in this process, acting as an incentive for well-educated households to expand and improve their places of residence outside the major cities without forgoing a quality education for their children and without significantly lengthening their commute to work. Subsequent social integration will occur by itself. As a by-

¹⁴ Dan Ben-David, *Inequality in Israel: Several Facts and Several Ideas for Narrowing of Social Gaps in Israel*, published in *Ha’aretz* under “How to Narrow Gaps,” December 17, 1999.

product, not only will households prefer to live in the suburbs; many businesses will make the same move, since a large proportion of their workers will have already done so earlier. This will reduce commuting and transportation costs even more.

A. Education

In view of the steadily rising demand for skilled workers, and in light of the depths to which its educational system has fallen, Israel needs to substantially overhaul and reform the primary and secondary education that its children receive.

1. The level of education in core subjects must be improved.

- In 1963–1964, Israeli thirteen-year-olds were ranked above all the Western countries who participate in the international mathematics achievement tests.
- In the years 1995-1999, Israeli eighth-graders received the lowest scores among all industrialized countries that took part in the international mathematics and science tests (thirty-ninth place among fifty-three countries overall).
- Additional tests, the results of which were published in 2003, point to similar failures in additional subjects such as reading comprehension.

2. The level of education in core subjects must be equal in all education systems and in all localities and neighborhoods.

- The gap in scores between strong and weak eighth-graders was wider in Israel than in forty-nine of the fifty-three countries that took part in the international math and science exams in the second half of the 1990s.
- The wider the disparities in basic education, the greater the inequality in opportunities for those entering the job market, thus contributing to further increases in gross income inequality.
- Among the highest-achieving eighth-graders (i.e., the upper fifth percentile of those tested) in the second half of the 1990s, the outstanding Israeli pupils were ranked under their counterparts in all industrialized countries and placed thirty-fifth among the fifty-three countries. The weak Israeli students were weak by international standards, ranking forty-sixth among the weakest pupils (i.e., the lower fifth percentile) of the participating countries.
- When parents have the awareness and the wherewithal to pay privately for what the public system fails to deliver, their children will be able to cope successfully in a modern labor market. However, the inability of all children to receive private assistance in core subjects is not only indicative of future income inequality, but also that the production potential of Israel's population will not be fulfilled – and this will be reflected in slower economic growth for the economy as a whole. Thus, there is a need to redistribute the public resources in order to overcome socioeconomic hurdles in the home and in the neighborhood.

3. The Israeli education system is not suffering from a money shortage.

Educational expenditures per pupil – adjusted for living standards – in Israel's secondary education system are 21 percent higher than the average in the thirty-nine countries for which there are comparable data. At the primary school level, expenditures per pupil are 28 percent above the other countries' average. The poor performance originates not from

inadequate investment but from a wide array of factors that include teacher quality, inadequate curricula, inept and wasteful management, and a lack of flexibility and transparency in all segments of the education system that has only amplified and increased the rate of decline.

When today's children become tomorrow's workers, they will have to change jobs at a frequency that their parents have not known. Therefore, the country needs to equip them with a "toolbox" that will meet future labor market needs. As the number of children who receive the improved education rises, an expanding circle of youngsters will be able to continue along the academic track after completing high school, a path that will benefit both them and the country as a whole.

The structural reforms in Israel's education system, proposed by the independent E.L.A. commission (2003) and the government-appointed Dovrat commission (2005), focus on precisely these issues and both reached similar conclusions. The objective of the two commissions: to create conditions that will facilitate a significant improvement in educational achievements and a substantial narrowing of the education gaps.

B. Transport infrastructure

The bottlenecks in Israel's transportation system seriously hinders the free flow of production inputs and products. The severe road congestion and the lack of serious rail alternatives leads to an increase in production costs and acts as a major impediment to economic growth.

The better the transportation infrastructure becomes, the lower the production costs – increasing the competitiveness of Israeli firms against their foreign counterparts. As a result, these firms will be able to increase their sales, an outcome that will facilitate an increase in labor demand.

Israel's transportation infrastructure does not meet the needs of its economy and society. Three indicators on the current state of the transportation infrastructure:

- The level of congestion on Israel's roads is one of the highest in the world.
- This level was attained even though Israel has only half the number of motor vehicles per capita as the industrialized countries' average. As Israel's income level converges toward these countries, the national motor fleet can be expected to double in size.
- The rate of increase in road congestion in Israel is such that the congestion level doubled in only fifteen years.

In spite of this, the share of Israeli GDP invested in transportation infrastructure during the 1990s was about half the Western average. In view of the existing and expected congestion, the implications of such underinvestment for future income inequality and economic growth in Israel are fairly obvious.

It is not possible to provide the bulk of Israel's additional transportation needs through private sector financing alone – as is the de facto case today – without drying up sources of finance for investments that the private sector itself must perform. In other words, there is no choice but to use public funds to pay for much of the transportation infrastructure that Israel needs. The government's tax collection is sufficiently high, and its civilian budget – that is, its budget net of defense expenditure – is also large by Western standards, so the funding issue is simply a matter of national priorities.

Recently, there has been an increased emphasis on significantly upgrading the country's rail infrastructure. The budgets that have been pledged to this infrastructure in the years to come are an important step in the right direction.

C. Research and development

It is difficult to overstate the importance of research and development. R&D is one of the main sources of a country's business creativity, allowing its firms to stay one step ahead of their rivals. The closer Israeli firms are to the technological envelope, the better able they will be to sell higher quality products at lower prices than their competitors – resulting in greater sales and increased labor demand.

Research and development yields benefits to wider circles of businesses when the firms who successfully invest in R&D not only increase their demand for additional workers, but also for other inputs that are produced by other companies, who in turn will also need more workers.

V. Conclusion

Israel's long-run social and economic trajectories should not be regarded either as facts of life nor as divine destiny. It is possible to stabilize the current situation and to immeasurably improve the long-term picture. What must not be allowed to continue are the narrow, doctrinaire modes of thinking that have had a major influence on policy-making in Israel. The combination of dogmatic ideologies that are oblivious to their long-term consequences and a penchant among policy-makers for providing only superficial responses to symptoms rather than comprehensive systemic solutions to core problems is a primary source for the multi-decade socio-economic decline of Israel to unsustainable long-run trajectories. The gravity of the current situation presents Israeli society with a rare window of opportunity – perhaps one of its last ones – to come to its senses and take the necessary steps that can change the course of the country's socioeconomic path.

In a country in which the segment of population that is not receiving the skills and conditions necessary for success in a modern and competitive labor force is also growing at a faster pace than the segment of the population that is shouldering the increasingly heavy burden, it will not be possible to cut the amount of welfare assistance provided in the future due to the fear of resultant food insecurity and systemic collapse. It is not hard to imagine where these socio-economic trajectories are leading, if extensive changes in priorities and policies are not implemented in the near future. But these same demographic trends make it increasingly difficult to cut back assistance by democratic means, even if the magnitude of this assistance becomes so heavy a burden to finance that it may lead to the departure of physical and even human capital from the country – an outcome that would only speed up the pace of decline.

In a nation that faces such grave external threats, it is critical to understand that Israel's national security is crucially dependent on its social and economic strength. The extent and severity of the problems are clear – as are their ensuing implications. What must be done is also clear, and there is still time to do it. But the window of opportunity will not remain open forever. This paper proposes an economic blueprint for rehabilitating Israel's labor market and for raising its economy and society to healthy and sustainable new trajectories.

The time has come for national interests to prevail over narrow interests – in the public discourse and especially among its elected officials.