
A Blueprint for Improving the Employment Outlook in Israel

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Executive Summary

The employment market in Israel is currently going through one of its most difficult periods ever. Some of the problems stem from problematic internal public policies that have continued for years, some are the result of global processes that western economies are going through, and some are no doubt due to the current security situation. The combined result is very low labor force participation rates and particularly high unemployment rates – both of which translate into poverty and inequality in gross incomes that are already among the highest in the western world, and are continuing to rise steadily year after year, decade after decade. Following three decades of continuous increases in unemployment rates came four years of war with the Palestinians and a particularly deep recession. There are indications that the current recession is ending in 2004 and that the country is returning to its “normal” trajectories. The problem is that these long-run trajectories are not sustainable in the long run.

The current situation is not etched in stone. Instead of allowing globalization to exacerbate the socio-economic situation, the state of Israel can channel the openness in directions that contribute toward a raising of the entire population’s standard of living, including that of the weaker segments of society, and toward a sharp reduction in unemployment. Policymakers wrongly use the “capitalism” label to justify socio-economic policies that are strongly biased in favor of employers, private interests, and narrow ideologies.

This report focuses on the key issues that affect the labor market in Israel. The goal is to outline the dimensions of the problems, explain their root causes, and recommend short- and long-term policies needed for improving the situation. The report distinguishes between labor supply policies intended to enlarge and upgrade Israel’s labor force and labor demand policies designed to increase the number of available jobs.

Recommendations

A growing economy requires more and more educated and skilled workers, and this means that the relative demand for uneducated workers is steadily decreasing over time. This reduced demand is reflected in unemployment rates that are negatively related to education levels. As the chance of finding work diminishes, the motivation to look for a

job also ebbs, a fact that is then reflected in high rates of non-participation in the labor force. **The state of Israel's primary objective in the socio-economic realm must be to concentrate on two areas simultaneously: increasing the level of knowledge and skills in the general population, particularly among the disadvantaged; while substantially improving the work environment, i.e., the physical infrastructure and production technologies.**

In light of the fact that the focus in this report is on a comprehensive, systemic, approach for addressing Israel's pressing labor problems, the recommendations presented should be accepted in their entirety. Partial adoption of these recommendations is liable to aggravate matters rather than improve them. At the same time, it is important to stress that policies should not be applied retroactively since people cannot go back and re-plan their lives.

Recommendations related to Labor Supply (Job Search)

1. Work incentives and reduction of the tax burden

a. Family income from all sources should be combined, the tax base enlarged, and the tax burden reduced

The tax base should be enlarged to include income from capital gains, income earned abroad, etc. – with application of the tax brackets on income in its entirety. This would require the filing of an annual income tax return that would include all household income, as is customary in other western countries.

While the tax base would be enlarged, there would be a concomitant decrease in the tax burden that would be facilitated by a reduction in government spending, which is among the highest in the world – even when defense expenditures are excluded from the comparison. These measures are necessary for lowering income tax, broadening the tax brackets, and reducing indirect taxes.

The tax burden on the middle class is excessive. From every additional shekel earned by someone in the sixth income decile, the government takes two-thirds and leaves the employee with one-third. This tax burden has a negative impact on living standards, on the motivation to work, and – in some cases – even on the desire to remain in Israel for those whose skills provide them with alternative options.

Indirect taxation, such as VAT, is also a greater onus in Israel than in most western countries. This is a regressive tax whose biggest impact is on the poor who spend all of their income on consumption. If the state of Israel would lower its non-security-related public spending to western levels, it could lower its annual tax burden by an average NIS 7,000 per family. It is all a question of national priorities.

b. All sources of aid and subsidies must be combined, with transparent criteria

All sources of welfare and non-welfare aid and subsidies to families, businesses, organizations and individuals from all government agencies – Social Security, the Housing Ministry, the Interior Ministry, the Ministry of Religion, etc. – should be brought under one roof. Just as all the tax collection systems should be combined in

order to streamline the process, so too should government aid programs. The provision of aid will then be carried out according to clear, transparent criteria that are uniform for all sectors and groups in Israeli society.

c. Work disincentives must be replaced with incentives to work

A significant part of government assistance (for those able to work and not physically impaired) must be given as an incentive to work. An example of this is the Earned Income Tax Credit (EITC), instituted by the United States federal government, which grants a negative income tax of 40% on one's income up to a specified amount – thereby providing a financial incentive that increases (up to a maximum amount) the more the individual works. When income reaches the predetermined maximum amount, the amount paid to the worker by the government becomes constant, even if the worker's income rises further, and then the credit gradually decreases (with additional increases in income) until it disappears entirely.

In place of child allowances, which are given regardless of the parent's working status, it is possible to provide tax relief for those who care for dependents. This creates a positive incentive to work since it reduces – in accordance with the size of the family – the income base upon which the tax is due, as is customary in the U.S. with its system of standard deductions and exemptions. The larger the family, the lower the taxable income, with equal reductions for each additional dependent. As noted above, changes in these laws should not be imposed retroactively on those who have already set the size of their families and could be pushed into poverty by the new framework.

2. An integrated system of programs in basic education, professional training, and job placement

The new system must institute several programs that complement each other, each with its own target audience and goals. The first recommendation is to enhance the opportunity to expand basic knowledge; the second concerns frameworks for professional skills training; and the third seeks to link upgraded knowledge and skills with improved prospects for job placement.

a. The “Second Chance” Program

The aim of the supplementary basic education program for adults is to upgrade the general human capital of interested adults who dropped out of the school system as children or to new immigrants who did not acquire a high school education in their countries of origin. This program will give them the means to improve their earning capacity. Since the focus of this program is to enable workers to upgrade their basic level of education, we recommend that this program be given within a state framework. The purpose of these studies is to provide the equivalent of a high school education, and therefore entry should not be conditional upon employment status.

b. Vocational Training

Involving employers in professional training programs contributes to an improvement in employment prospects. Colleges should be encouraged to establish technological

training centers in cooperation with employers and benefiting from government support. Participation of the business sector in such initiatives is particularly useful. These centers should provide modular training courses for technicians and practical engineers, in-service training, and job re-training. The training of technicians, practical engineers, and other trades will include an internship with private businesses.

c. Job Placement

The system of job placement in Israel must be undergo a substantial overhaul that includes privatization. The government must enter into contractual relations – including oversight and supervision, with the option of withholding payments and even imposing fines when conditions are not met – with private companies for specified periods of time and with a system of performance bonuses. Every Job Center must be regional, specializing in the needs of the local population and employers, in order to provide personal service to the extent possible.

The function of the Job Centers will be to locate, offer, and recommend various options to all those who apply: courses to complete and upgrade one's education, vocational training, and/or immediate job search. The Center must maintain contact with the job seeker throughout the entire process that begins with job location and continues for a specified period thereafter. The applicant can benefit from the professional expertise and experience of the Job Center in matching individual skills and preferences to existing options in the vicinity.

3. A long school day and enrichment programs for children and youth

The state must provide (a) free education in practice during a longer school day for all Israeli children; and (b) subsidized enrichment programs for children and youth during after-school hours. This will have both a positive static impact (i.e., on the standard of living), and a positive dynamic impact (i.e., on the rate of economic growth that reflects the pace of improvement in living standards). These are the yardsticks by which one should measure the relative costs of these programs – namely, increased future production and tax revenues resulting from a larger work force and higher-quality human capital in tomorrow's work force.

4. Amendment to the Severance Compensation Law

The Severance Compensation Law is a progressive social law that entitles a dismissed employee to severance pay in the amount of one month's salary for each year of employment. A retiring employee receives severance pay as if he or she were dismissed. Under the current system however, workers who resign from work lose their right to severance pay, even if they give notice sufficiently in advance. For someone working in the civil service, a large institution, or holding a management position, the likelihood of receiving severance pay is high regardless of who instigates the worker's departure. The main victims are low-salaried workers. This asymmetry between the flexibility for the employer and "inflexibility" for the employee leads to a situation that is neither efficient

nor fair: Employees are unable to fully benefit from their skills and abilities, while employers have yet another tool that can be wielded against employee wage demands.

The law must be amended to obligate employers to deposit severance pay into a savings account on an ongoing basis, so that it will stand at the disposal of the employee when the job comes to an end, for whatever reason. In this way, every employee will be able to receive what he or she deserves under any circumstances, whether due to retirement, resignation, firing, or the employer suddenly “disappearing”.

5. Upgrading human and transportation infrastructures – a core long-run solution

There is an urgent need to simultaneously upgrade two primary infrastructures – education and transportation – that complement one other. When a good education will be available in regions that are today considered “in the periphery,” and these regions are linked to large urban centers by rails and roads, this country will undergo a transformation of a magnitude that is only imaginable at present. Today’s “periphery” will become tomorrow’s suburb, because almost the entire population of Israel will live within no more than a half-hour train ride from one of the large urban centers.

Large disparities in real estate prices will be the catalyst for educated families to move out of the big cities to locales where they can expand and improve their living accommodations without having to give up on good education for their children or unduly extending their commuting time to work. Social integration will be a natural outcome. One byproduct will be that businesses, not only families, will prefer to move to the suburbs, since their employees are already living there and the costs of travel and shipping will be significantly reduced.

The following are separate recommendations for each field:

a. Education

- The level of education in the core subjects must be substantially improved. Even the scholastic achievements of Israel’s top students are below those of the top students in western countries.
- Educational gaps in Israel are the largest in the West. The level of education in core subjects must be identical throughout the school system and in every town and neighborhood of Israel. Students from socio-economic backgrounds linked to low achievements must be given additional resources and assistance that can enable them to fully realize their innate abilities and potential.
- Streamlining and transparency in the educational system is essential. The reason for low achievement is not inadequate funding. A number of factors contribute to the decline, including teaching quality, inadequate curricula, inefficient and wasteful management, and the lack of flexibility and transparency in all parts of the system.

When the children of today become the employees of tomorrow, they will be changing jobs at a pace that their parents would not recognize. Therefore, the state

must prepare them with a “toolbox” of resources that will suit the needs of the future economy. The greater the pool children who benefit from improved education, the greater the number of those who will be able to subsequently access and benefit from academic institutions, and this will serve both the children and the state of Israel.

b. Transportation infrastructure

Israel’s transportation infrastructure does not meet the minimum requirements of a modern economy and society. The current substandard links between workforce in the “periphery” and jobs in urban centers contribute to a growing socio-economic cleavage that throttles mobility between the two. Instead of transforming the periphery into a suburb, huge amounts of money were invested in building unsuccessful factories or artificially propping up existing businesses in a game of industrial musical chairs throughout the country.

Currently:

- The level of congestion on Israeli roads is among the highest in the world.
- This level was reached even though Israel has only half the number of vehicles per capita of other industrialized countries. As standards of living in Israel approach leading western levels, the fleet of vehicles on the roads can be expected to double.
- Overcrowding on Israel’s roads increased at a pace in which congestion doubled during a span of just 15 years.

And yet in the 1990s, Israel invested in its transportation infrastructure only about half what western countries invested, as a percentage of the national product. In light of the existing and anticipated future congestion on Israeli roads, the implications for future income inequality and economic growth of not making the necessary transportation investments should be patently clear. The current fashion of using private financing for large public projects is not cost-free since these are funds that would have otherwise been available for business sector investments. In other words, there is no alternative but to use public funds to finance major parts of the transportation infrastructure that is needed for Israel. Since there is sufficient money in the national budget, the issue of funding is simply one of determining national priorities that coincide with the nation’s real needs.

Recommendations related to the Demand for Workers (Job Creation)

Increasing the number of employed workers in the economy is not just a matter of increased motivation or enhanced work skills. The number of available jobs must also sharply increase. An analysis of this subject can be divided into two parts: immediate implementation of policies aimed at causing improvement in the short run, and immediate implementation of policies whose positive impact will increase over time.

1. Demand for workers – the short run

a. The first goal: halting the decline and stabilizing the economy

Three domestic factors (i.e., beyond external factors such as stock market declines and recessions in the West or the war with the Palestinians) that have caused a bad situation to turn into a dangerous one from an economic perspective:

- **Policies that lack credibility:** Until 2003, economic policies in the fiscal and monetary realms significantly – and unnecessarily – undermined confidence in Israel's government and, as a result, increased uncertainty. This seriously impaired economic activity, labor relations, and ultimately, economic growth.
- **Lack of political horizon:** The existence of a political horizon provides a sense of hope, of light at the end of the tunnel – and this increases consumption as fears of an upcoming rainy day dissipate, while investment grows as people prepare for arrival of a new era. A lack of horizon has precisely the opposite effect.
- **Lack of security fence where most of the economic activity takes place:** Construction of a security fence along the shortest, straightest, cheapest, and most defensible line could have prevented most terrorist attacks within pre-1967 Israel, where most of the economic activity takes place. Non-construction of the fence led to an annual loss of 3% in GDP per capita (according to Eckstein, Tsiddon, Dar, and Tillman). Completion of the northern third of the fence contributed to a non-negligible drop in the number of terrorist attacks. It is important to complete construction of the fence as soon as possible.

b. The second goal: Significant reduction in the number of foreign workers

Israel reached a situation in which every eighth worker in the country is not Israeli. The share of non-Israelis in Israel's labor force is greater than in every European country except Switzerland. At a time when the Israeli economy requires more educated labor and less uneducated, unskilled workers, the government permitted unprecedented inflows of poorly educated and unskilled foreigners. The result has been to drive unskilled Israeli workers out of the labor force with concurrent downward pressure on salaries of Israeli workers with comparable skills.

Hiring foreign workers is attractive in Israel because of their low cost – some 40-50% less than the cost of employing Israelis (according to the Finance Ministry). One reason for the low cost is the fact that Israeli employers do not provide foreign workers with the benefits required by law for Israeli workers: minimum wage, social benefits, etc.

Making it significantly more expensive to hire foreign workers is the most effective way to reduce the demand for them. Applying all the labor laws to their employment, including minimum wage, is just the beginning. A double-digit tax should also be imposed to lower the incentive for employing them. The police division responsible for dealing with the illegal aspects related to the foreign workforce in Israel should pursue Israeli employers who break the country's labor laws, and not just concentrate on locating and expelling foreigners working here illegally. As demand for them

declines, the foreign workers will leave Israel on their own. A drastic reduction in the employment of foreigners will lead to an increase in demand for unskilled Israeli workers and remove much of the labor market pressure that is currently depressing their wages.

c. Other goals.

- **Temporary jobs in national infrastructure projects**

The immediate need for improved infrastructure to enable the attainment of long-term goals, and the urgency of finding jobs for hundreds of thousands of Israelis in a state of deep recession, together provide a possible – temporary – solution (it must be perfectly clear that this policy cannot apply to foreign workers). Despite the general impression that public works projects were successful during different eras and in other countries only, reality is much less clear. One should view the construction of major national projects – such as a serious transportation infrastructure, the security fence, modern sewage and drainage systems, more daycare and enrichment centers for children and youth (as noted above) – not through the lens of expensive relief projects that may not affect the consumption patterns of workers sufficiently to lift the economy out of the recession. Rather, these projects should be viewed through the lens of preparing the physical and human infrastructure that will enable future generations to fulfill their potential more fully and with greater equality of opportunity. If this also affects aggregate demand today – all the better.

- **Law enforcement**

The level of lawlessness and deeply rooted norms of non-enforcement of the law in Israel lead to a lack of confidence in the institutions of governance and to intolerable distortions in the economic system – not to mention the resultant unjust distribution of income and increased public burden. Examples include:

- A broad range of undeclared business activity. Non-disclosure leads to unpaid taxes, which increases the burden on those who do obey the law. Undeclared income also can create situations of false poverty and unjustified welfare payments, which further increase the tax burden.
- A culture of not meeting obligations, from individuals and businesses that write checks that bounce to a central and local government that does not meet its contractual obligations to vendors (on time or at all) or to its own workers.
- Minimum wage and social benefits that are viewed as general guidelines rather than as the law of the land.
- In an economy that relies more and more on manpower agencies to circumvent rigid labor laws that inhibit a legitimate need for greater flexibility in competitive production processes, problematic norms have taken hold that ultimately harm the rights – which are no less legitimate – of the workers. There is an urgent need for legislation that makes it the responsibility of the beneficiary receiving the service to ensure that the service provider receives the wages and benefits to which he or she is entitled by law.

A country that allows for widespread, systematic disdain of its laws undermines the foundations of a democratic society and imperils its own future.

- **Special treatment of select population groups**

Two sectors with particularly low participation rates in the labor force are ultra-Orthodox men and Israeli-Arab women. The model of the Bangalore region of India points to one possible way of integrating a relatively unskilled population. The need for typists for inputting data, telephone operators, etc. – who need not be physically present in the plants or head offices – allows for the training and employment of many people in villages, development towns, and ultra-Orthodox neighborhoods.

- **Educating for gender equality**

The ideology of the man as primary wage earner is still alive and well. Even when women work outside the home, they still are largely perceived to be secondary earners who do a “second shift” at home. In the long run, the situation of women will improve only through education for equality, especially regarding the care of children and the management of households. In some countries, attempts have been made to encourage men to participate at least in the initial stages of their children’s upbringing by granting them paternity leave (men have this legal right in Israel), and later by obligating women and men to share maternity/paternity leave between them.

- **Expanding employment opportunities for educated Israeli-Arabs**

To encourage higher education among the Israeli-Arab population, steps must be taken in the job market to expand employment opportunities for Israeli-Arab university graduates. Without such opportunities, many educated Israeli-Arabs find themselves without work, or compelled to take jobs suitable for those with less schooling. With regard to the educational system, there is a need to examine, understand and eliminate the obstacles that inhibit a more complete participation of Israeli-Arabs in the country’s top academic institutions.

- **Systemic cooperation against employment discrimination**

Israeli-Arab citizens experience job discrimination; many places are not willing to hire them, and in many instances in which they are employed, Israeli-Arabs are limited to working in specific occupations. This is a glass ceiling that must be shattered, and this requires extensive cooperation among the governing institutions, employers’ organizations, and the legal system.

2. Demand for workers – the long run

The key to stepping up the demand for workers is productivity. Labor productivity in Israel is relatively lower than in western countries. This makes it difficult for Israeli businesses to compete with foreign firms, which adversely affects the demand for Israeli workers. As noted in the recommendations concerning labor supply, upgrading the human capital infrastructure will help people find jobs. It will also help raise productivity and increase the competitiveness of Israeli companies.

Other areas that are critical for increasing productivity:

a. Transportation infrastructure

Traffic congestion seriously impedes the flow of raw materials to production sites and of products to the markets. Overcrowded roads and the lack of a serious rail alternative raise the costs of production and significantly impairs economic growth. The better the transportation infrastructure, the lower production costs, which will enable Israeli companies to become more competitive abroad. Improved competitiveness leads to expansion of sales and to a subsequent increase in the firm's demand for additional workers.

b. Research and development

Research and development (R&D) is an extremely crucial source of commercial creativity that enables Israeli companies to stay one step ahead of the competition – and the country to remain one step ahead of fast growing developing countries. So long as Israeli companies are able to remain at the technological frontier, they will be able to sell quality products at a lower price than the competition, leading to increased sales and a demand for more workers. Research and development also yields benefits to a much broader circle of firms than those who engage directly in R&D: As firms who invest in R&D become more competitive, they increase their demand not just for workers, but also for raw materials produced by other companies, who then have to increase their own demand for workers.

Conclusion

The severe state that Israel's economy deteriorated to and the critical descent of its society were not an inevitable result of destiny. They cannot be attributed solely to the conflict with the Palestinians, nor to the global recession. This situation can be stabilized and the long-term picture, dramatically improved.

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.

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.

Israel is the socio-economic anomaly of the West. No other country with such stark economic and social realities is also the home to points of light that shine so brightly in areas so important for its success. This is an anomaly that will not be able to survive over time. Either the light will prevail and reach every corner of the country, or it will eventually flicker out – with all this implies for the future of the country.

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 report proposes an economic blueprint for rehabilitating Israel's labor market and for raising its economy and society to healthy and sustainable new trajectories.