Israel Economic Review Vol. 17, No. 2 (2019), 127–130

# REVIEW OF “THE ISRAELI ECONOMY IN THE LAST TWENTY YEARS: LIGHTS AND SHADOWS IN THE MARKET ECONOMY”, EDITED BY AVRAHAM BEN-BASSAT, REUBEN GRONAU AND ASAF ZUSSMAN[1]

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In the last two decades, the Israeli economy has matured and stabilized along various macroeconomic dimensions, conquering inflation and eliminating current account imbalances. Yet, perhaps as expected, this new economic phase has been characterized by new challenges and opportunities.

This fascinating book provides a dual service. It reviews the evolution of the Israeli economy during this period, while also identifying the key challenges that Israel will face going forward.

In this brief review of the book, I intend to discuss what I consider the work’s key messages. Naturally, it is impossible for a short review like this to do justice to the wealth of information, analysis, and insights provided in the book. Rather, I decided to concentrate the discussion around five topics that, in my view, are central to the future success of the Israeli economy: (i) the evolution of public sector expenditures, (ii) the various (or, in some cases, lack of) market reforms, (iii) the labor market, (iv) productivity, and (v) the evolution of inequality within the Israeli economy. In what follows, I briefly discuss the main lessons I took from this work with respect to these issues.

## The Public Sector

In the background (or, perhaps, at the forefront) of this book, it is first important to acknowledge the dramatic evolution of public sector expenditures as a share of GDP. In particular, one of the key figures to look at is Figure 2 in the book’s Introduction. Public sector expenditures as a share of GDP declined by almost 10 percentage points during the two decades under review in this book, converging to a level of about 40 percent. Interestingly, this fall manifested itself across many categories, including defense, education, health, welfare, and physical investment. As one would expect, such a significant change in the magnitude of public sector expenditures was accompanied by a similarly substantial change in the degree of taxation levied on the economy, and, interestingly (as discussed

[1] The publication of the book is forthcoming. In Hebrew, it will be published by Am Oved, and in English by Cambridge University Press.

below), in the composition of those taxes. These dramatic changes, accompanied by actions taken by the monetary authority, have essentially resulted in price stability.[2]

The first lesson that emerges from the book is that, whatever one's view on the benefits and costs of such a dramatic change, almost none of the other pressing issues in the Israeli economy can be understood without considering these background developments.

**Market Reforms**

The decline in the public sector's share of GDP has occurred alongside market reforms that have touched on various aspects of the Israeli economy, which the book provides a unified framework to analyze.

Consider first the reform in the capital markets. A key reform implemented during this period is the one touching on "pensions and retirement savings". The discussion of the changes enacted in Israel and the effects of those changes on the economy provides important insights regarding the effect of such reforms, insights that might be particularly helpful during a time when many industrialized countries are coping with changes in the age composition of the labor force. Moreover, the book includes a detailed discussion about the additional impacts of the financial reforms, with special emphasis on the significant decline in the concentration measures of financial intermediation and nonfinancial institutions during the last two decades.

Next, consider reforms in the goods market. The book nicely demonstrates the price effect of opening some of the Israeli sectors to foreign competition (see Figures 6A and 6B in the first chapter) and draws attention to the relative lack of (successful) reforms in the utilities sector, contrasting it to the communication sector and, to a certain extent, the air transportation market.

To summarize, then, the theme emerging from this part of the book is a hybrid one. The last two decades in Israel have been characterized by various market reforms, yet, at the same time, some key reforms that are essential to increases in productivity are still waiting to be adopted and implemented.

**Labor Market**

The book impressively summarizes the aggregate evolution of the labor market in Israel, and, on the positive side, the picture that emerges is one where (i) unemployment is low and (ii) the labor force participation rate has been increasing. Importantly, the work demonstrates that policies that incentivized individuals (in various forms) to participate in the labor force have been crucial to these two developments.

[2] The fact that this is the only reference to inflation in this review is a testament to the changes the Israeli economy has experienced. No reference to earlier phases in the Israeli economy could leave out a detailed discussion of price stability.

Yet, the demographic composition of the labor market is such that issues of labor force participation will probably be central to the evolution of the Israeli economy. Specifically, the demographic projections are that in the next few decades the Jewish ultra-Orthodox and Israeli Arabs, jointly, will account for almost half of the Israeli population. Since these groups are characterized by lower labor force participation rates than those of their Jewish non-ultra-Orthodox fellow citizens, increasing their labor force participation is critical for the ongoing economic strength of Israel.

Naturally, in order to sustain such increases in labor force participation (and to ensure that these increases are accompanied by rising wellbeing, i.e., wages), an increase in labor productivity is required. With this in mind, the review continues by discussing what is perhaps the most challenging issue that the Israeli economy faces: labor productivity.

**Labor Productivity**

The improvement in the financial wellbeing of an individual is commonly measured by the growth of output per capita. While economists disagree about what the best (and most efficient) method to achieve such growth is, there is no doubt that sustained growth in output per capita is intimately linked to the growth in labor productivity.

The book demonstrates that advanced and more sophisticated measures of human capital in Israel suggest that the country's level is not as high as previously thought. This deficiency can account for a significant fraction of the difference in labor productivity vis-à-vis other comparable countries. Moreover, the work also convincingly demonstrates that Israel lags behind the same comparable countries in its physical capital per worker measures (which directly affect the labor productivity).

Interestingly, and perhaps related to the declining share of public expenditures in GDP discussed above, the book highlights that Israel has very low measures of public physical capital per worker. This fact, together with the alarming results regarding the measures of human capital in Israel, seems to suggest that the improvements of human and public physical capital markets should draw more attention from Israeli policymakers.

Addressing the lackluster performance of labor productivity in Israel is doubly important given the demographic diversity and the demographic projections discussed above. It is also central to addressing the evolution of inequality within Israel.

**Inequality**

Israel's measure of inequality after taxes and transfers is one of the highest across comparable countries, and has increased during the period studied in the book. That said, perhaps surprisingly, the work documents that over the last 15 years, pre-tax income inequality in Israel has actually declined.

The book suggests that (i) the low unemployment rate and increased labor force participation rate referred to above, (ii) the catching up of immigrants from the ex-Soviet Union, and (iii) the reduction in entry of foreign workers, have all contributed to this declining inequality trend.

Yet, as mentioned above, the inequality in after-tax and transfers income has not fallen. The book argues that this is due to three reasons: first, changes in the tax structure which made it more regressive; second, an overall reduction in welfare transfers; and third, conditional on the welfare program, these transfers are less directed to those in the lower deciles of the income distribution.

**Conclusions**

The book reviewed herein makes important contributions to the literature regarding the state of the Israeli economy and the challenges that the economy is facing. The work is rich in its analysis and careful in its diagnosis and its discussions. The conclusions reached therein should be read with great interest by anyone engaged in studying the Israeli economy as well as the policymakers who shape it.