POLICY RECOMMENDATIONS, 2003–2008

INTRODUCTION

The Israeli economy has been in deep and ongoing recession since 2000:IV, with a continuous decline in total and per capita GDP and the standard of living, and a rise in the unemployment rate. The main causes of the recession are the persistence of the Intifada since October 2000 and the slowing of world trade in general, and of the high-tech industry in particular. To date, the Intifada has exacted a high price, estimated at some 8 percent of GDP—approximately NIS 40 billion.

The point of departure for delineating macroeconomic policy is not a comfortable one. Public-sector expenditure accounts for 55 percent of GDP, higher than in any of the OECD countries; the public-sector debt is 107 percent of GDP (the government debt constituting 103 percent of it) and is rising; the tax burden is also large by international standards, making it difficult for Israeli firms to compete with those from other industrialized countries. What is notable in all these spheres is the lack of progress in Israel, in some cases even constituting retrogression, compared with the marked progress made in them in most western countries over the past decade. Alongside these trends, in the last year there have also been adverse developments in the financial markets: profits in the banking system have declined, and the quality of credit has deteriorated, there has been a sharp increase in foreign-exchange volatility, a decline in share prices, and a rise in yields on government bonds. The trend of capital flows has reversed, with foreign direct investment and inward capital flows declining and capital exports by residents rising. This point of departure restricts the options available to economic policymakers.

In this document we present policy recommendations which constitute key elements of an economic program aimed at restoring the economy to sustainable growth and stimulating employment while halting the increase in poverty. The components of the program, especially those dealing with the labor market and the infrastructure, will serve—even in the current situation—to prevent a further worsening of the levels of economic activity and employment, while maintaining financial stability. However, unless there is a substantial shift in the political-security situation and global economic recovery, expressed *inter alia* in increased demand for high-tech products, it will not be possible to restore the economy to a path of real growth. It will be possible to fully utilize Israel's growth potential only when there is a turnaround in the trends described above.

The principal components of the policy intended to attain these objectives are a macroeconomic mix based on budgetary restraint enabling some monetary expansion alongside reforms in the labor market, the budget, and infrastructure investment.

Budget policy should be implemented in the framework of long-term targets and the implementation of substantial changes in budget expenditure rules. These changes should ensure that the reduction of the public-sector debt is consistent with lowering the share of government expenditure and the overall tax burden, as well as with a declining deficit path, as prescribed by the Budget Deficit Reduction Law and the tax reform. The policies outlined here should be implemented in conjunction with certain operational changes in the Budget Deficit Reduction Law proposed here which will reinforce its ability to function as an instrument for maintaining budgetary discipline and limiting private legislation. The various proposals made with regard to the infrastructure define long-term targets which will reduce the gaps between Israel and other western countries in these fields while delineating ways of attaining these goals. The proposals regarding the labor market are intended to increase the employment rate while reducing the gap in this respect between Israel and the OECD countries. This can be achieved by slashing the number of foreign workers, making it more expensive to employ them in comparison with Israelis, while at the same time providing incentives to employ Israelis and improve their skills and employability.

The macroeconomic framework which will support the revival of economic growth while maintaining stability requires first of all adherence to fiscal discipline in accordance with the path defined in the Budget Deficit Reduction Law, that will lead to a decline in long-term interest rates. This decline will enable the gradual lowering of the Bank of Israel's key interest rate while maintaining price stability. A policy mix of this kind will be expressed in declining long- and short-term interest rates and real depreciation, thereby serving to check economic contraction and support a return to sustainable growth once external conditions and the security situation improve. In our view, the 2003 budget approved by the Knesset is not consistent with attaining a deficit target of 3 percent of GDP. Because expected revenues appear to have been overestimated, and assuming that defense expenditure is implemented as budgeted, and that there is no reduction in other current expenditure, the deficit will reach 6 percent of GDP. Note in this connection that the point of departure for fiscal policy is problematic: the high initial level and rising trends of public expenditure, the public-sector debt and the tax burden, reflected in the low credibility of budget policy as expressed in both yields on government bonds and the stance of the rating agencies, make it necessary to adhere to the deficit target and ensure that it is attained in order to ward off the threat of a financial crisis. Improving the credibility of budget policy by reducing current expenditure could allay the threat of a future tax hike, thereby serving to stimulate private consumption and investment. This effect can only be moderate, however, while the security situation continues to be bad. Given the current economic situation of deep and ongoing recession and external conditions that do not presage change, a reduction in current expenditure could serve to deepen the recession because of its moderating effect on consumption. Nevertheless, the reduction of current expenditure will ease the government's financing needs, so that savings will be diverted to investment and loans to encourage private-sector activity, allowing for a decline in long-term interest. This will have an expansionary effect on economic activity and reduce debt-service payments in the government budget. In order to reinforce this effect it is necessary to change the composition of government expenditure, increasing the weight of items that stimulate growth, such as infrastructure investment, and to avoid raising taxes. This should be accompanied by policies in various areas, including the following three:

1. In the *labor market*, it is necessary to act to reduce the number of foreign workers and increase the cost of employing them relative to that of Israeli workers, thereby increasing demand for the latter. We also propose reforms in the structure of income supplement benefits, the education system, and vocational training and placement, which will act to increase employment in the business sector. One of the results of structural problems in the economy and the ongoing recession has been the expansion of poverty in the last few years. Tackling the problem involves preparing a special long-term program and utilizing a variety of instruments, among them establishing the infrastructure for a reform of transfer payments. One of the findings of economic research is that there is a high correlation between employment and emergence from poverty; most of the reforms proposed in the framework of the ‘Program to Stimulate Employment’ are intended to increase the employment rate among the working-age population, and thereby to reduce poverty.

2. In the area of *infrastructure* we propose long-term goals for reducing gaps between Israel and the industrialized countries in various areas, relating to budgetary and extra-budgetary aspects, as well as to increasing competition and efficiency in various infrastructure spheres. Defining a plan of work for investment in the infrastructure by the government, government corporations, and private companies—as well as the sources for financing it—and the monitoring of its implementation by the economic-social cabinet, will help to give the plan its rightful place in the government’s priorities.

In order to expand the extent of infrastructure investment it is necessary to act to increase the sources of financing available to the business sector participating in infrastructure investment, and this is contingent upon reducing the deficit, thereby cutting the government’s financing requirement. In this context it is necessary to proceed with the reform of the pension system, which will channel resources from the pension funds to the capital market, and help to create long-term sources for financing infrastructure investment projects. In addition, if loan guarantees are received from the US government, it is necessary to establish a mechanism for directing them to financing increased infrastructure investment. Steps should be taken to ensure that the framework of the guarantees enables them to be disbursed in accordance with the ability to implement the planned infrastructure projects.

3. Progress should also be made on reforming the *money and capital markets*, in order to stimulate the return to sustainable growth by developing and deepening the extra-bank financial intermediation system; in addition, as regards both the social aspect and the development of the capital market, it is necessary to reform the pension

system so as to extend pension coverage to both salaried and self-employed workers while maintaining actuarial balance and channeling pension fund money to the capital market.

The Main Policy Recommendations

Within the framework of the economic policy recommendations, the following main measures are proposed, including specific steps which can and should be implemented as soon as the new government is appointed:

Stimulation of employment

The principal objective of government policy in the labor market should be to expand employment. In order to do so, it is necessary to pursue a policy that will serve to increase the participation rate and reduce the unemployment rate to the level prevailing in the OECD countries. Attaining the target of expanding employment will help to reduce poverty, limit income inequality, and restrict the social alienation of those currently outside the labor force.

The policy changes required can be divided into several principal areas:

- Macroeconomic policy to stimulate sustainable growth, thereby increasing demand for workers, as described above.
- Microeconomic policy whose influence is felt in the long and medium run, including:
  - ➢ Enhancing the human capital of people who are unable to find employment by making changes in the education system, focusing particularly on areas with a high unemployment rate.
  - ➢ Making changes in the system of transfer payments and associated benefits in order to make employment more attractive.
    - ➢ In this connection, it is necessary to reduce the effective tax on labor income implicit in the income support system.
    - ➢ The structure of child allowances should be changed so as to grant a uniform allowance for each child, irrespective of family size, for children born in the future. At the initial stage, the increment for large families awarded under the Large Families Law should be canceled.
    - ➢ In view of the more stringent terms of the Unemployment Insurance Law in Israel than in the rest of the world, it is necessary to ensure that the period of eligibility for unemployment benefit provides unemployed persons with a reasonable period of time in which to look for appropriate work.

  - The implementation of the employment test for recipients of unemployment and income support benefits due to inability to find appropriate work should be tightened.
- The accessibility to areas of potential employment by residents of areas with a high unemployment rate should be improved by investing in the infrastructure and encouraging the creation of regional centers of employment.

- Microeconomic policy whose influence could be felt in the short run, includes:
  - Changing policy as regards the employment of foreign workers so as to reduce their number and make it more expensive to employ them, bringing their cost to employers in line with the cost of employing Israelis.
  - It is desirable to set a government target for reducing the number of foreign workers by 50,000 a year over three years, bringing their number to 100,000—about 4 percent of the labor force—similar to the median rate in the OECD countries.
  - Until this target is attained, it is necessary to refrain from issuing additional permits for foreign workers, and to take active steps to reduce the number of those who are in Israel illegally, taking action against their employers.
  - In order to raise the cost of employing foreign workers (by about 40 percent) and bring it into line with that of employing Israelis, it is necessary to impose equivalent employment fees and payments. Employers will thus be obliged to pay the same for a foreign workers as they do in National Insurance payments for an Israeli worker, and the amount paid for insurance for which foreign workers are not eligible (e.g., unemployment and dismissal insurance funds) will accrue to the foreign worker's benefit, to be withdrawn upon leaving Israel.
  - The permits that are currently handed to employers should be given to the workers, thereby helping to determine their cost to the employer in accordance with the market.
  - Centers for classifying and placing workers should be set up immediately, in accordance with the recommendations of the Tamir Committee, and at a later stage they should be extended to the entire relevant population.
  - Steps should be taken to improve the institutional structure of the labor market, including increased efficiency in the placement of workers by the State Employment Service and the amendment of the Minimum Wage Law.
  - It is desirable to enable the use—to a limited extent—of public works programs in the private sector, as well as the subsidization of wage, and the provision of support for firms in temporary difficulties.
- The vocational training system should be made more efficient.

With regard to the administrative framework, it is desirable to focus treatment of all the policy issues associated with fostering employment in the hands of a ministerial committee that is part of the economic-social cabinet, which will guarantee cooperation between the various ministries and act to introduce the necessary legislation.

The budget

- The 2003 budget must be amended, bringing it into line with a deficit target of 3 percent of GDP, while refraining from raising taxes.
- The Budget Deficit Reduction Law must be amended, making it an efficient tool for maintaining budget discipline. For this purpose it is necessary to:
    - Define the reduction of the deficit in the Budget Deficit Reduction Law as a binding target ex post as an integral part of the budget process, and not merely part of the planning process.
    - Determine stages for monitoring the budget during the year, whereupon adjustments will be made, if needed.
    - Designate a substantial part of budget expenditure, e.g., one percent of GDP, as being contingent upon revenues.
    - Defer the implementation of private legislation with budget implications to the following budget year, and incorporate it within the general budget framework.

- The budget expenditure path resulting from current policy, the specific decisions made and the tax path derived from the tax reform lead to budget deficits of the order of 6 percent of GDP as of 2004, and hence do not enable adherence to the declining deficit path agreed upon by the government, and embody a continued rise in the public-sector debt/GDP ratio. Moreover, bridging the gap between Israel and the industrialized countries as regards the infrastructure, and the implementation of labor-market reforms similar to those in place in most industrialized countries, require increased expenditure in these spheres of about another one percent of GDP, which will have to be offset from other current expenditure. Hence, it is necessary to plan a long-term budget that will ensure consistency between all the budgetary aggregates, including the declining budget deficit path and the implementation of the tax reform.

This path requires taking far-reaching steps to moderate the growth rate of the government’s current expenditure alongside extensive reordering of expenditure priorities. In order to do this, the government will have to prepare for a change in the rules of the game as regards expenditure, including transfer payments and public-sector wages. These new rules will have to ensure a shift in public expenditure, with a long-term planning horizon of five years and longer—alongside its gradual implementation.

- In order to enable the rise in transfer payments to be slowed, we propose examining a transition, for some of them, to selectivity on the basis of a means test. In this connection it is necessary to re-examine the possibility of going over to a comprehensive report of income. Alternatively, the possibility of combining the databases of the Income Tax Authority and the National Insurance Institute as a basis for implementing means tests should be considered.

- In view of the need to reduce expenditure in order to attain the deficit target for 2003 and in light of the development of business-sector wages, it is necessary to endeavor to attain agreement regarding the progressive reduction of wages in the public sector for this year, reaching wage agreements which will not grant retroactive compensation for the wage reduction. In the next few years it will be necessary to ensure that total real public-sector wage expenditure does not rise.
- It is necessary to act to bring the public-sector wage mechanisms into line with the conditions of price stability.

Infrastructure investment

- It is necessary to adopt a long-term target for bridging the gap in the infrastructure sphere between Israel and the industrialized countries, and to make the pace of infrastructure investment commensurate with the level derived from the need to utilize Israel's growth potential to the full. For this purpose, it is necessary to invest NIS 90 billion in the infrastructure in the next five years.
  - In the sphere of land transport, we propose investing NIS 9 billion a year until the gap is closed in 2010.
  - Investment in all areas will be both direct from the budget and indirect by government corporations and private entities.
  - Future infrastructure projects must be put in the pipeline.
    - In the framework of the economic-social cabinet, it is desirable to set up a ministerial committee for the infrastructure which will delineate the government's policy in that sphere, including setting an overall framework of targets and furthering its implementation.
    - The economic-social cabinet will receive periodical reports on the implementation of infrastructure investment from the implementing entities, and will publish the main results.
    - It is necessary to act in order to increase competition in the infrastructure spheres that have traditionally operated on a monopoly basis (e.g., public transport, electricity, ports).
    - The prices of infrastructure services must reflect their cost; this includes water.
    - If the US government loan guarantees are received, a mechanism will have to be set up to enable them to be earmarked for financing the expansion of infrastructure investment. Steps must be taken to ensure that the framework of the guarantees enables them to be spread out in accordance with the ability to implement the planned infrastructure projects.

- Issuance of earmarked government bonds to new members of pension funds will have to end, so that the money of the pension funds can be gradually channeled to the capital market. This will make it possible to involve them in financing infrastructure investment.
- It is important for planning procedures to ensure that the balance between development needs and their implications for land allocation in the long run and environmental considerations is maintained.