

Socio-Economic Roadmap for Israel

by

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Four-part series

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1. **Israel's March of the Lemming**
"The Jerusalem Post", January 29, 2004.
2. **Three Paths to the Precipice**
"The Jerusalem Post", February 5, 2004.
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"The Jerusalem Post", February 12, 2004.
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"The Jerusalem Post", February 19, 2004.

Israel's March of the Lemming

first article in four-part **Socio-Economic Roadmap** series

by Dan Ben-David

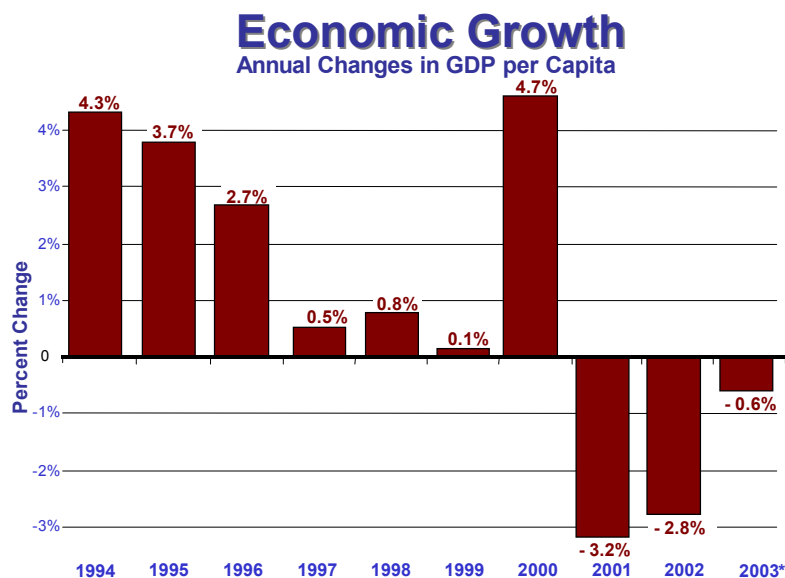
Their population multiplies at astronomical rates, thanks to years of high breeding. The rapidly increasing congestion and the daily pressures for survival lead them toward geographical expansion. "Behavioral changes intensify and [they] show more than their usual pugnacity, offering fight [in situations] they normally would avoid." Finally, they crowd together into a large, sweeping herd and march together blindly towards the edge of the cliff – and jump off it, to their deaths. Such is the behavior, says Encyclopaedia Britannica, of the Scandinavian lemming.

It is difficult to avoid parallel comparisons with other realities within a different setting. Our leaders tell us repeatedly that Israel is approaching the precipice, but their behavior and frequent "emergency" plans suggest that they themselves have not yet internalized how serious our situation really is.

Israel's economic growth is slower than the West's while its rate of unemployment is higher, as are its rates of poverty and inequality – and not just during the past couple of years. These three indicators reflect trajectories that are leading us in a steady and measured manner directly towards the rim of the socio-economic cliff. These trajectories are so steady, that they may appear as though etched in stone. They are not, however, the inflexible result of some heavenly decree.

Our destiny is in our hands, and if we understand the underlying sources of the problems – both in the short and long runs – we will be able to channel Israel's immense latent talent toward steady state paths that are not only better, but also sustainable over the long run. The objective of this four-part series is to detail Israel's main socio-economic problems, their sources and implications. The goal is to describe the interrelationships between issues and to lay out a road-map indicating how it is – still – possible for us to change direction. This article, the first in the series, focuses on the immediate, burning, issues, on the mistakes and misdirections in a public debate that is further and further reducing our ability to make relevant and courageous decisions.

As is shown in the graph, per capita growth (the common measure used by economists to gauge changes in standards of living) was quite high – in comparison with most industrialized countries – during the years 1994 and 1995. With the lone exception of the year 2000, stagnation and subsequent decline have been pretty much the main economic traits characterizing Israel since 1996. It should be pointed out that our growth slide began while other countries were still flourishing – long before the war with the Palestinians and the recession in the West that began in the end of 2000 and the beginning of 2001, respectively.



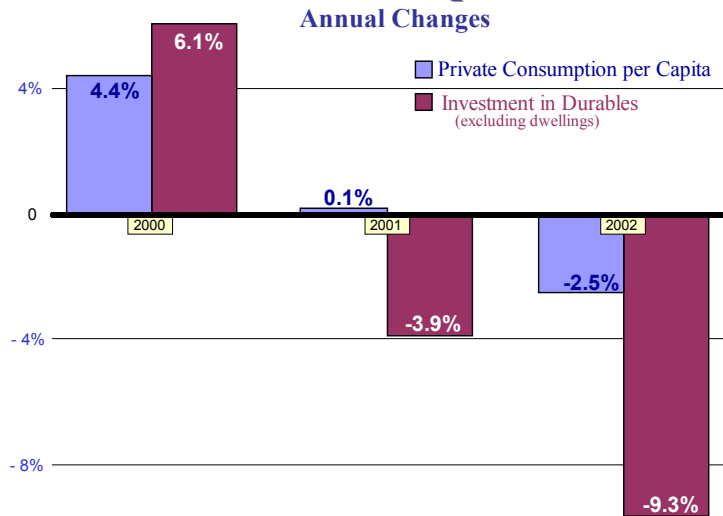
Source: Dan Ben-David, Tel-Aviv University, Data from Israel Central Bureau of Statistics (CBS)

* Forecast of CBS

In the years 2001 and 2002 alone, the negative growth rates were reflected in a cumulative drop of 6% in our per capita incomes. The year 2003 apparently ended with a further decline.

On the one hand, negative growth means less tax income for the government. On the other hand, it also means greater welfare expenditures, which are tacked on to the already increased defense expenditures related to the war with the Palestinians. When tax income cannot cover the government's expenditures, the resultant deficit means that the government is forced to borrow in order to finance its overdraft. The only way for the government to persuade investors to

Investment and Consumption 2000-2002



Source: Dan Ben-David, Tel-Aviv University, Data from CBS

At a time when economic growth requires stability and the minimization of uncertainty, Israel's economic policies left much to be desired in the realm of credibility and reliability. Unrealistic assumptions on the state of the economy, upon which one budget after another were based, in conjunction with accounting "magic" aimed at concealing failures, led to a substantial – and unnecessary – reduction in public confidence in our elected officials' ability and intentions. The resultant increase in uncertainty played a major role in the growth decline that we experienced.

When uncertainty of this magnitude is supplemented with the perception of a lack of vision in either the social, the economic, the diplomatic, and the defense spheres, then the socio-economic manifestation of the consequences should not come as a surprise to anyone. A vision radiating hope for better days increases the inclination to consume more today and to invest more for that future. The lack of vision, or the existence of a gloomy vision, radiates just the opposite – with the accompanying growth outcomes that this implies. It is no coincidence that the consumption and investment in the years 2001 and 2002 – as reflected in the graph – behaved as they did.

Trustworthiness requires an accurate and reliable public presentation of our predicament and the resolve to take serious steps to extricate the economy from the crisis. One of this government's stated objectives is to reduce government expenditures. The objective is correct, but the methodology for attaining the objective is extremely problematic.

Israel's public expenditures are indeed very high. They represent a greater proportion of Israel's GDP than in each one of countries belonging to the Organization for Economic Cooperation and Development (OECD), the organization of industrialized countries. In 2001, public expenditures reached 54% of Israel's GDP, compared with just 37% on average in the OECD countries. This difference reflects an excess of 80 billion shekels in Israel's public expenditures.

In contrast to the prevailing common perception, our budgetary difficulties do not begin and end with large defense expenditures. Even excluding defense expenditures in Israel and in the OECD, our government's civilian spending exceeds civilian public spending in the OECD by 11% of GDP, as is shown in the figure. In other words, if Israel were to reduce its non-defense expenditures to the average OECD level, we would save 52 billion shekels! It has been very convenient for Israeli governments over the generations to promote the perception that our security predicament precluded resolution of other difficult, but cardinal, issues. The time for resolving these issues has arrived since our cup runneth empty.

It should not come as a surprise that a country which imposes such a heavy tax burden on its people should have plenty of public money – compared to other countries – available to spend. The problem is not a lack of public money, but a lack of national direction. We do not have clear and defined goals that reflect our available resources and the reality that we live in – and we sorely need

to lend it – rather than to invest their money in the private sector – is by raising the interest rate that it pays. This yields two resultant outcomes, both of which are problematic: a drop in private sector investment, which is the oxygen required for future growth in the economy; and interest payments of roughly 30 million shekels a year, more than the entire education budget, or alternatively, more than all of Israel's public expenditures on health. This is valuable money that simply goes down the drain because our country does not know how to live within its means.

In fact, Israel's own policies were one of the main reasons for the serious socio-economic deterioration that occurred here since 2000. At a

leadership that internalizes the extent to which we are close to the precipice that they constantly preach to us about.

There are over a quarter of a million unemployed persons in Israel. In addition, the proportion of Israelis participating in the labor force is substantially lower than the labor participation rate in the OECD countries. Should the government succeed in its intention to raise Israel's labor participation to OECD levels by reducing incentives not to work – an important step in and of itself, had it been implemented correctly, as part of an overall plan meshing social sensitivity with basic economic fundamentals – the outcome will be 200,000 additional working-

age Israelis that will have to begin looking for a job. And if the government will really succeed in reducing the public sector, then even more working-age Israelis will begin looking for private sector jobs.

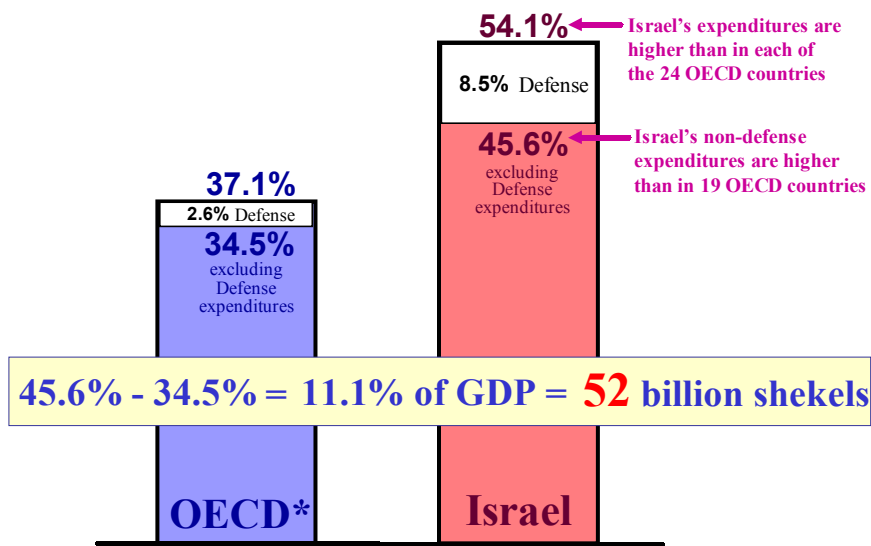
There is, however, one non-trivial problem. If over a quarter-million Israelis are already finding it difficult to land a job, then where will the additional hundreds of thousands work? And all this is occurring while the country continues to subsidize employers by allowing them to hire hundreds of thousands of foreign workers at a cost – according to paragraph 2 on page 84 of the original version of the Finance Ministry's economic plan presented earlier in the year 2002 – that is lower by 40-50% than the cost of an Israeli worker. That paragraph adds that this cost difference is due, among other things, to the fact that the Israeli employer does not pay for any social benefits for the foreign worker. Therefore, concludes the paragraph, there is a need to levy a 15% tax on wages paid to the foreign worker – without any mention of equating the social costs prior to the levying of the tax. As if this were not enough, MK Ayub Kara of the Likud and a member of the Knesset's Finance Committee, succeeded in lowering the proposed tax to only 8%.

Is this serious? Why would any employer be willing to pay an Israeli even the minimum required by law, when he is allowed to hire foreigners at substantially lower cost?

This is how many of our elected representatives (they represent us?) have been dealing with this issue for years – from the MKs to the Prime Minister. They know that they have nothing to fear from any serious investigative reporting in the press (democracy's "watch-dogs"?) on their personal and family relationships with the flourishing industry dealing with the import and hiring of foreigners in Israel. Does the expression "conflict of interest" still translate into the Hebrew language? Sometimes it seems as though the scent of bananas from republics across the sea is wafting towards us on the jet stream.

We have reached the situation in which one in every eight workers in Israel is not Israeli. However attractive the hiring of foreigners may currently be today, it should be quite obvious that this exploitation can continue for only a limited time more. After they have been here long enough, it will no longer be possible – from a moral perspective, from an international reputation perspective, and from the perspective of their overall strength in the workforce – to continue to discriminate against such a large population that is planting its roots deeply in what is still referred to as the "Jewish State"? Then, their cost will become equal to that of the Israelis, and in the meantime, we will have substantially enlarged the unskilled and poorly-educated population that is in any event finding it difficult to compete economically in Israel's modern economy. In other words, this is a case of a few becoming very wealthy for a limited time only – with serious long-term consequences for Israel's society and economy.

Total Government Expenditure, 2001 as a percentage of GDP



Source: Dan Ben-David, Tel-Aviv University
using data from Bank of Israel, President's Council of Economic Advisors, CIA, OECD, U.S. State Dept.

* 24 countries for whom the OECD publishes interest data

In the meantime, the government continues to permit thousands upon thousands of new workers from abroad unfettered legal entry into Israel each year since, after all, the publicly-stated objective of the government is to limit only the foreign illegals. The person most influential in toredpeding any concerted effort in curbing the influx of foreign workers is none other than the Prime Minister himself, who personally benefits from the hiring of foreigners on his own farm.

Apparently, we are dealing with a very domestic form of “capitalism”. The intention is to force unskilled Israelis to compete in the labor market under any condition, without any comprehensive vocational program tailored to the needs of the economy. At the same time, employers continue to be allowed to legally import thousands of foreign workers to work here under illegal conditions. When the human and physical infrastructures are neglected for generations, and one bright day the strong and the weak are told to “compete” with one another in the labor market – is this capitalism? A “free market” does not mean implementation of the rule of the jungle in which the mighty trample to dust all of the rest. This is not the “invisible hand”, but the brutal hand.

Another domestic contribution to our current state of affairs comes from a different direction: wanton exposure of Israel’s citizens to terrorism. Even if we do not have anyone to talk to on the other side – if that is really the case – this does not mean that there is nothing that we can do.

According to Tel-Aviv University economics professors, Zvika Eckstein and Dani Tsiddon, most of the damage from the Palestinian terrorism – apart from the terrible and tragic human cost – emanates from acts of terrorism within Israel’s pre-1967 borders, where most of the country’s economic activity is located. In a study completed last year, together with Vered Dar and Avi Tillman, they find that terror within pre-1967 Israel costs the country 14-19 billion shekels in lost production each year. According to Major General (res) Uzi Dayan, who headed, until August 2002, the National Security Council, the total cost of erecting a physical barrier – including transit points – sums to 3-4 billion shekels. Is there another investment more attractive in all of Israel?

The Prime Minister announced two years ago that a security fence would be erected. After more than three years of war with the Palestinians, only one-third of the entire route from the Gilboa to the Dead Sea has been built. This is how the State of Israel “protects” its citizens lives and shamelessly enables annual losses at a rate of several billion shekels a year – all the while claiming that there is not even enough money to include life-saving drugs and treatments in the country’s official health basket.

As if this were not enough, the current plan is not to go with the straightest, cheapest, and most defensible fence but rather to build a fence twice as long as the internationally-recognized eastern border between Israel and the West Bank, a fence that will cost several billion extremely scarce shekels more than necessary, and will require more troops to defend than our standing army can allocate – with the obvious security implications. The resultant nasty foreign policy ramifications are almost beside the point, given the carnage, both in human terms as well as socio-economic terms, that our own government consciously permits to occur.

They say that there are insufficient funds to aid the weak and the needy while overall public expenditures are at high levels unheard of in the West. They say that they are dealing with the problem of foreign workers while continuing to allow their employment to remain economically attractive, and allowing the inflow of newcomers to continue unabated. They say that they are building a security fence, but two years after the declaration, all we have received are hundreds of additional deaths and an economy headed south. The overwhelming results of last year’s elections provide vivid proof that we have in Israel professionals who could give private tutorials to the former Iraqi minister of information on the most advanced methods known to man for projecting honesty and sincerity.

It is time for this society to remove its blinders and see where it is being lead. We still have the ability and the time to do what needs to be done, as difficult as it may be. But that requires leaders with the integrity and the courage to put everything on the table, to show us where they want us to go, what will be required for the journey – and what sacred cows we will have to leave behind.

Three Paths to the Precipice

second article in four-part **Socio-Economic Roadmap** series

by Dan Ben-David

The State of Israel is facing a number of serious socio-economic problems that, although they have been substantially exacerbated over the last few years, have in fact been steadily and seriously deteriorating over a period that is not measured in years, but in decades. The catch-words are familiar to all: growth, unemployment, poverty, inequality and welfare payments. What is less known are the dimensions of these problems – and what is particularly disturbing: the extent to which they have deteriorated since the seventies.

The turning point was the year 1973. This period was a turning point for many Western countries. The difference between us and them was the degree of the turnaround. While most of the industrialized countries shifted to healthy long-run paths, we moved to multi-decade trajectories that are leading us straight toward a national abyss.

How stable are our socio-economic trajectories? They have survived wars, hyper-inflation and massive immigration. In the latter two cases, the scale was beyond anything that the West has known since the Second World War. But all these were simply reflected in gyrations around the long-run trajectories rather than causing changes in trend. The stability of our long-run paths, in spite of all that we have gone through, leads to the impression that these trends are etched in stone and that our fate is not in our hands. Nothing could be more dangerous, or more distant from reality.

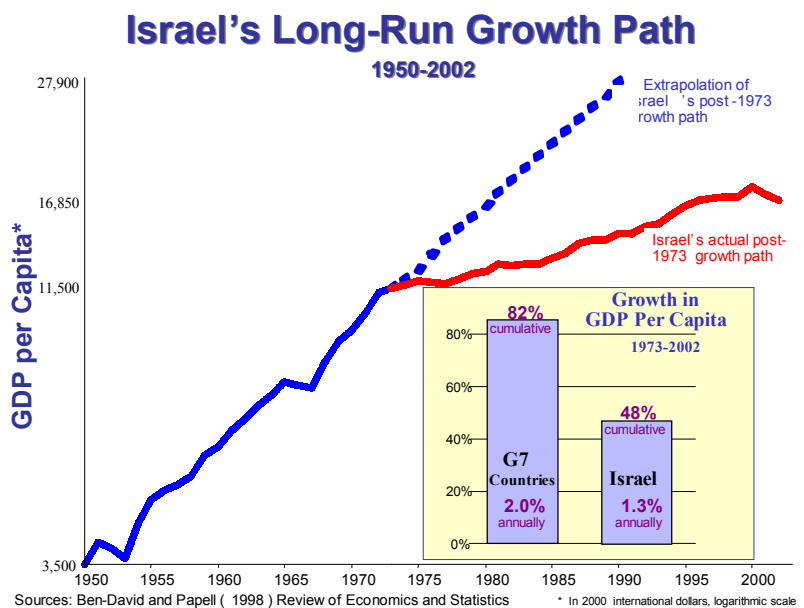
What do our trajectories leading to the national abyss look like?

1. Growth

Israel's output per capita – the common measure used to determine living standards in a country – rose by more than 5% per year between 1950 and 1972, one of the highest growth rates in the world. The income gap between Israel and the leading industrialized countries decreased rapidly.

Since 1973, everything looks different. As the graph indicates, the steep growth path that reflected the high growth in the years 1950-1972 turned into one of the West's shallowest growth paths. While living standards in the G7 countries rose by 82% between 1973 and 2002, Israel's standard of living rose by just 48%. In other words, instead of continuing to close the income gap with the leading countries, we have been steadily falling behind in relative terms since 1973.

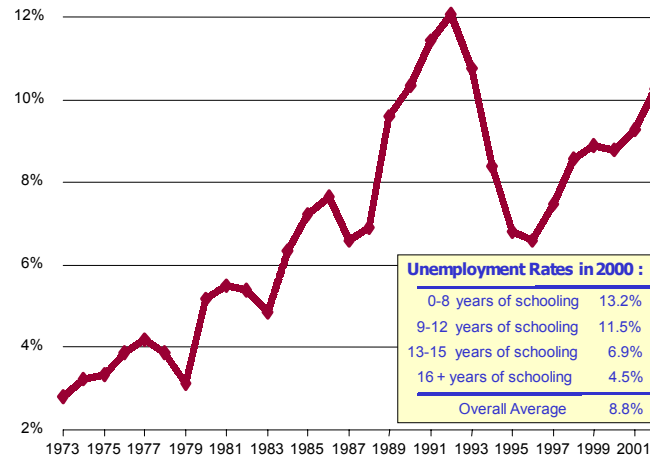
The primary key for improving living standards is through technological improvements – that is, through improvements in the qualities of production factors and through improvements in the way that they are utilized. In this area, Israel has a problem. During the past several decades, in spite of the substantial increases in government spending, the country's set of national priorities led to a massive neglect of its physical and human capital infrastructures – which are key ingredients driving technological progress.



2. Unemployment

If one excludes the temporary unemployment bubble in the early nineties caused by the huge wave of Soviet immigration into Israel, the figure indicates steadily increasing rates of unemployment from 1973 until today. The main problem, which is continuously worsening, is among the unskilled and least educated working-age population. A modern, open and competitive economy needs more and more educated and skilled workers – and relatively less unskilled and poorly educated. While this is a problem faced by all industrialized countries, it is particularly acute in Israel. As though the declining relative demand for unskilled workers wasn't enough, Israel has been importing hundreds of thousands of these types of workers from abroad and exacerbating an already deteriorating employment situation.

Unemployment Rates, 1973-2002



Source: Dan Ben-David, Tel-Aviv University, Data from CBS and Bank Israel

3. Increasing gap between poverty in gross incomes and poverty in net incomes

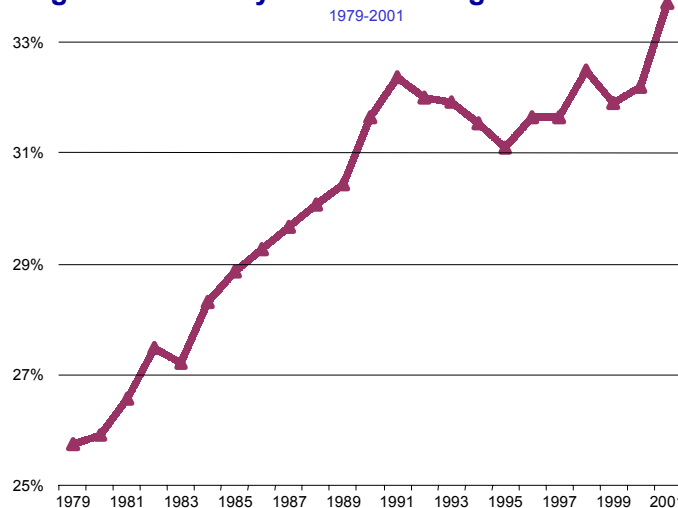
The more unskilled workers cannot find work, the greater their chances of falling below the poverty line. But the public discourse on poverty in Israel is missing the main point.

One of the primary attributes of an “enlightened” country is the assistance that it provides its weaker population. Welfare payments comprise an important facet of this assistance. The greater the assistance, the higher the net incomes (i.e. after-tax and after-welfare incomes) of the poor, and the greater the chance that the net incomes of the poor will raise them above the poverty line.

In lieu of the aid, poverty in gross incomes (i.e. pre-tax and pre-welfare payments) – which represents the behind-the-scenes actual state of affairs had the State not intervened with aid for the poor – continues to rise unabated. As can be seen in the figure, the percentage of Israeli families that would have lived under the poverty line had it not been for state aid – i.e. according to gross incomes – has been steadily rising since the seventies. If, once, roughly one-quarter of the families in Israel would have lived under the poverty line, today this percentage has passed the one-third mark, and it is continuing to climb. On the other hand, about one-sixth of the families live under the poverty line today, a similar share as in the late seventies.

Society is able to prevent the continuously rising poverty rates based on gross incomes from being translated into continuously rising poverty rates based on net incomes. The dual problem that has developed has social as well as economic ramifications. It means that a growing share of Israel's families is dependent on the welfare system in order to live above the poverty line. This growing dependency is translated into increasing social unrest and a

Percent of Families in Population Living under Poverty Line according to Gross Incomes



Source: Dan Ben-David, Tel-Aviv University
Data from Israel Social Security Institute

* before welfare transfers and direct taxes
Old series until 1997 adjusted to new series that includes non-salary workers

burgeoning economic burden that is not sustainable in the long run. The rising gap between gross income inequality and net income inequality yields a similar picture that is similarly untenable in the long run.

The First Threat

The three socio-economic trajectories are related. In Israel, a large and increasing segment of the population is unable to successfully deal with a modern, open and competitive market economy. The unemployment trajectory reflects this and the poverty and growth trajectories are derived from it. The result threatens the socio-economic base that enables Israel to defend itself. There are two implications to this threat.

First, the non-utilization of a growing percentage of Israel's population diminishes the country's ability to absorb, assimilate and to develop new technologies – not just in the high-tech sector. All sectors of the economy that compete with foreign firms, be it as exports abroad or locally against imports, need state-of-the-art technologies in order to compete successfully. The less a country is able to tap the potential ability of its populace, the more the situation becomes akin to a motor that is using less and less of its cylinders. Eventually, it no longer has the power to carry its own weight. It is no coincidence that Israel's economy is on its current low-growth trajectory since the seventies.

Second, the non-utilization of a growing percentage of Israel's population is reflected in the steadily rising gross-income-based levels of poverty and income inequality, which in turn require steadily increasing welfare budgets in order to prevent similar increases in net-income-based levels of poverty and income inequality. Larger welfare budgets are financed by taxes. The greater the tax burden, the lower the incentive to work and invest – and this inhibits growth, an outcome that limits the country's ability to sustain ever-increasing welfare budgets. But an economic burden that steadily increases in conjunction with abject inattention to the root problems simply breeds further increases in gross-income-based poverty and inequality, and this only increases the tax burden that further inhibits growth. The State of Israel has not been able to break out of this swirl for several decades. It is a steadily accelerating swirl with ominous long-run implications regarding the country's ability to sustain and defend itself in the future.

By combining a number of facts, it is possible to get a glimpse of what our current future holds. Roughly 80% of working-age ultra-orthodox Jewish men and Arab women are not even looking for work. Most do not have the necessary tools to find and hold jobs, while the country provides them with enough aid and assistance to enable them to choose joblessness as a way of life. These two groups are still enough of a minority so that the country is currently able to finance such lifestyle choices – albeit just barely. However, the fact that one-half of all first-grade pupils today are either in the ultra-orthodox or Arab school systems (as detailed in a working paper prepared by a group headed by Tsvi Tsameret a couple of years ago) should provide a pretty good indication of what the future holds in store.

The writing is on the wall. The population in need is not receiving the minimum tools necessary for competing in a modern work force, and it is growing at a much faster rate than the population that is financing it. Current demographics already make it extremely difficult to change existing policies and laws. In one or two more generations, it will be impossible to do so.

The Second Threat

The current set of national priorities is becoming – at a growing rate – an existential threat to the State of Israel. The physical and human capital infrastructure require huge infusions of resources in order for the country to be able to change its current socio-economic trajectories. But where will the money come from?

To this day, sizeable public funds have been directed toward a non-negligible portion of society to enable it to choose non-work as a way of life. Sizeable public funds have been directed towards construction, maintenance and defense of entire areas that could never be a part of a future Israel that is both Jewish and democratic. Sizeable public funds have been directed toward high-income families: over a billion shekels a year, for example, in the form of child benefits for the highest three income deciles. We have over-extended ourselves in every conceivable way. Our unconstrained desire to fulfill every special-interest demand has not left enough money for financing the true needs of the country.

The message here is not one of helplessness and despair, but of warning and hope. The level and slope of Israel's socio-economic trajectories depends on us. There is no other country in the

world with such problematic rates of growth, unemployment, poverty and inequality, that have steadily deteriorated for such an extended period of time – that is also the home of cutting-edge public and private institutions in the areas most vital for pulling a country up to newer and healthier trajectories.

At the top of the human capital pyramid are some of the best universities in the world – internationally-renowned for their innovative research, while also serving the country as the training centers of future generations. In some research fields, the departments are second to none outside of the United States. In the field of economics, for example (see chart), average research publications per Israeli faculty member are nearly four times that of the runner-up country, England – and this is not the only example of academic excellence in the country. All of this occurs despite the fact that only a fraction of Israel's most gifted youth actually reach the universities as a result of a failing educational system that is the worst in the western world.

In the private arena, high-tech Israeli firms combine creativity, imagination and improvisational ability in areas that will only grow and develop in the future. After all, hardware and software have become key ingredients in every area of production, while technological change throughout the world is spurred by developments in this field – all of which promises increasing demand for the high-tech sector's products, despite the decline of the past few years.

The problem is not in the innate ability of the people of Israel, but in our prioritization of national goals. The current national priorities reflect unsustainable long-term goals. It is – still – possible to change direction.

Ranking of European countries by publication in leading academic journals in economics

Average publications per faculty member*
(U.K. = 100)

1	Israel	396
2	U.K.	100
3	France	79
4	Ireland	79
5	Belgium	57
6	Switzerland	46
7	Sweden	43
8	Turkey	39
9	Germany	36
10	Austria	32
11	Netherlands	32
12	Italy	32
13	Norway	32
14	Spain	25
15	Denmark	21
16	Finland	11
17	Greece	7
18	Portugal	4

* Avg number of pages per faculty member published in top 8 academic journals in economics
Source: Combes & Linnemer (2003)

On Haze and Policy

third article in four-part **Socio-Economic Roadmap** series

by Dan Ben-David

It is not clear how much of the haze of uncertainty and vagueness is created on purpose and how much of it emanates from a deeply imbedded culture of “haltura”, a slang Hebrew term that serves as a cross between amateurism, improvisation and simple shoddy work. What is certain without a doubt is that this very damp and heavy fog is steadily corroding the pillars upon which Israel’s society and government are based. Telenovelas from Latin America are not the only cultural vestige that we are increasingly adopting from former banana republics.

It begins with increasingly lax enforcement of laws and regulations in as diverse fields as labor, transportation, sanitation, construction and environment that is cumulatively tearing away at the very fiber that provides us with civil, consumer and property rights which are the very essence of human rights upon which free and democratic societies are based. But lax enforcement is only one indicator the we have embarked down the banana highway.

One significant example, though certainly not a lone example, of the institutional usage of haze is the area of socio-economic policies. In recent years, forecasts that were widely dismissed as unrealistic regarding future growth rates served as the basis for creation of the government’s annual budgets. Similarly, forecasts of future tax incomes, which clearly had no basis in fact, provided the government with a comfortable background that gave a false premise of higher than actual incomes in order to avoid having to drastically cut fiscal spending prior to the most recent national elections. As if this weren’t enough, Israel’s government implemented some very “creative” accountancy (according to former finance minister Prof. Yaakov Neeman, and many others), in the weeks preceding the elections, in order to present a misleading picture of the budget deficit.

These are just the outer reaches of the enormous cloud that are visible to the naked eye. It is inside this cloud that our tax shekels are being divvied up – and this is the main source of the problem. There are a non-negligible numbers of excellent economists at the Finance Ministry that have to deal with a political reality that is unconscionable. In practice, the annual budgets are made public. But in fact, these provide very little indication regarding the actual allocation of public money. This underlying lack of transparency leads to a funneling of considerable amounts of public money towards some segments of society – where actual need is coincidental at best – while crowding out other segments of society into situations of abject poverty.

We avoid carrying out a nationwide mammography that would help us discern the degree to which this cancerous haze has spread. If we would at least perform “manual” checks, then we could get some idea of the dimensions of the problem.

On the one hand, comparisons made by academic researchers as well as non-academic research institutions suggest that Israel’s welfare expenditures are not excessive when compared to other Western countries. On the other hand, the government has begun to cut these without remorse under the argument that they have reached proportions that the country can no longer bear the burden.

What is going on here? How can other countries bear the burden while we cannot? Maybe it is due to the fact that in Israel there is more assistance provided than meets the public eye. After all, Israel’s civilian budget is one of the largest in the Western world.

Once, when our economic growth was rapid and our levels of unemployment, poverty and income inequality were low, our public expenditures were also low – even after discounting the amounts spent then and today on defense and on interest payments on the public debt. In the years 1960-1966, public expenditures were just 21% of GDP, compared with 40% last year. As can be seen in the table, total government expenditure rose substantially after the Six-Day War, and not just because of

Public Expenditure in Israel*

as a percentage of GDP

Period	Total	Excluding defense and interest payments
1960-1966	29.1	21.2
1967-1972	49.8	30.0
1973-1985	73.5	41.4
1986-2001	55.9	37.1
2002	55.1	39.8

* average expenditure each period

Source: Dan Ben-David, Tel-Aviv University, Data from Bank Israel

defense expenditures. Since the Yom Kippur War, civilian public expenditures – that is, excluding defense and interest payments – grew substantially once again, to a level that we have not been able to reduce since.

A large number of mushrooms grew in the thick fog we call public policy. While they were never legibly registered in an official and orderly fashion, the signs pointing to their existence are very difficult to hide. As the chart indicates, the number of Israeli woman choosing non-work lifestyles is 9% higher than in the West (compared to 22 OECD countries).

Non-participation of Israeli men in the work force is 22% higher than the OECD average. It is important to point out that even without the ultra-orthodox men, the rate of non-participation of non-orthodox Jewish men is still 16% higher than in the West.

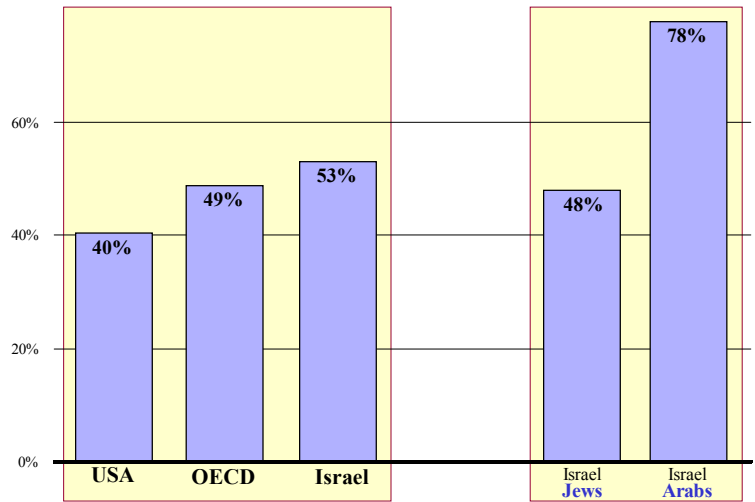
If job participation rates in Israel were to equal the OECD average, an additional 200,000 workers would join the labor force here. How is it possible to reconcile such gaps in labor force participation rates between the OECD countries and us with the fact that welfare payments in Israel are not particularly high in relation to other countries?

One possibility is that a large share of the population is working in the underground economy. To the extent that this is indeed the situation, then we are talking about extraordinarily high levels of fraud and deceit that enable entire segments of the population to avoid shouldering the already-heavy tax burden – while these same people dip their hands into the public till, falsely posing as needy individuals. Ignoring such wholesale breaches of the law, to the extent that these actually occur, is another facet of the haze that we have created in this country.

Another possibility, no less problematical, is that enormous sums of money are flowing behind the scenes toward various segments of the population in the accountancy haze that dominates Israel formal budgets. These are amounts not officially listed as aid by the Social Security Institute, or other formal aid channels. But in lieu of such hidden aid flows, it is not possible to reconcile the contradiction between a seemingly low degree of formal welfare assistance according to all international standards, and the degree of non-willingness to even look for work in Israel that is clearly extraordinary in its dimensions.

It is a fact that even after discounting defense expenditures, Israel's total civilian public expenditures are higher than the OECD average by 11 percent of GDP – an amount equal to 52 billion shekels a year of excess civilian public expenditure in Israel. If this excess is not going to defense (by definition) nor to formal welfare payments, then what exactly are we spending all of this extra money on? Israel's public sector is undoubtedly bloated, but the degree of non-participation in the labor force is so

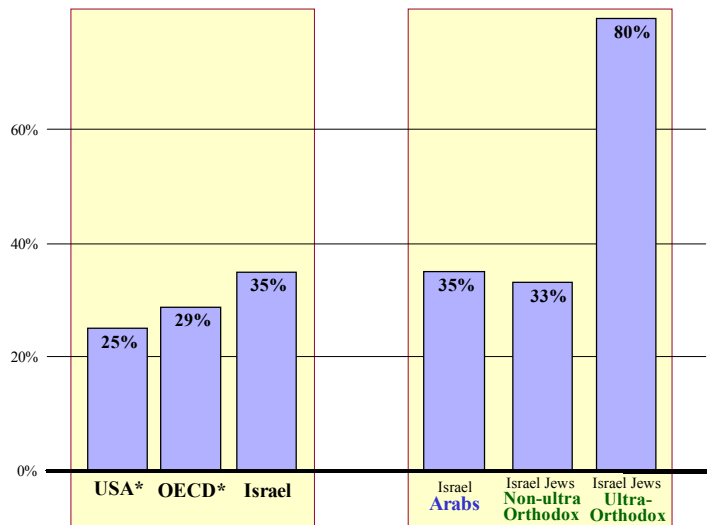
Percentage of Women Not in Labor Force, 1998*



Source: Dan Ben-David, Tel-Aviv University, Data from CBS and ILO

* ages 15+. U.S. data and 22 OECD countries is for 1997

Percentage of Men Not in Labor Force, 1998*



Source: Dan Ben-David, Tel-Aviv University, Data from CBS and ILO

* ages 15+. U.S. data and 22 OECD countries is for 1997

much higher in Israel that this provides a clear hint that there are quite a few fog-covered crevices in the budget through which substantial sums of public money are apparently flowing.

The problem becomes acute when the country is no longer able to finance such a huge public expenditure. Then, the government looks at the 280,000 unemployed workers and the 200,000 additional (compared to the OECD) people who aren't even bothering to look for jobs claiming that it is the bloated budget that facilitates this behavior – and then the government proceeds to cut back on the formal channels of welfare assistance. The problem is that these formal channels are not particularly generous in comparison to other industrialized countries, so those who do not have access to one of the informal channels of hidden aid are in danger of falling into some very severe poverty traps, with the non-negligible danger of actual hunger beginning to appear. This process has already begun and there are signs that it may increase substantially in magnitude.

In all of our huge budget, is there really not enough money to help the truly needy? Why is it that so many elderly are so poor in Israel? How come “free” education for the children costs their parents so much money? Why is the basket of eligible medicines (for the medically insured) being reduced instead of enlarged? Why don't we have suitable vocational training that is tailored to the needs of the economy? How come our physical and human capital infrastructures are in such dismal condition? How did we reach this point and why are we just steps away from the precipice? Where is all of our tax money going?

It is no coincidence that the word “accountability” has no suitable translation into the Hebrew language. People here first have to be familiar with the concept before it can become possible to translate it.

A confluence of events has brought us to one of the more important junctures in the country's history in which a number of important issues are simultaneously coming to a head in all of Israel's main spheres of debate: the defense-diplomatic sphere, the socio-economic sphere, the religious-secular sphere, and the internal Arab-Jew sphere. But we are being forced to decide between varying world views in these spheres while in the midst of a dense factual fog.

For example, should we – and can we afford to – continue to settle the areas of Judea, Samaria and Gaza, or not? Should we – and can we afford to – continue to allow entire segments of the population to choose non-work and non-shouldering of the combined burdens of taxes and military service, or not? These are not the only destiny-determining choices that we are facing, but the way that these issues have been dealt with thus far reflects the reality that has brought us very close to the national precipice.

The entire discussion of budgets directed at settling the territories, for example, is completely beside the point. The degree that Israel “pampers” the settlers by subsidizing them in a differential manner than is common for citizens residing within the green line – if that is indeed the case – represents only the tip of the iceberg on this issue. The real question is how much the presence of settlements and settlers beyond the green line costs us in terms of building transportation infrastructure to areas with minimal access (at best), in terms of a public sector that builds subsidized housing in order to attract people who would otherwise not come, in terms of artificially creating public sector jobs and subsidization of private employers so that the settlers will have employment, in terms of physical defense of every settlement, hilltop, road, and lone mobile home – in comparison to the cost of protecting a fortified country behind a serious security fence along as short and defensible a route as possible close to the green line.

The answer is that no one has any idea what the total cumulative cost actually is of moving Jews to settle on the other side of the green line – which begs the question: why not? After all, the people would appear to be in favor of such settlement, and in their name government after government has acted. So why don't they spread before us all of the facts and data so that we will be able to make educated decisions? Why is everything hidden and implemented in the haze? Could it be that this haze-creation may be due to doubt on the part of the policy-makers as to whether a public that is more knowledgeable about the actual costs would still be willing to continue supporting the channeling funds to settle areas that could never be a part of a country that is both Jewish and democratic – and may prefer to use these budgets to fund other national needs? Isn't democracy not just about giving people the right to choose, but also about providing the transparency that will enable the voters to make informed choices? Tyranny can manifest itself not just in the deprivation of free elections.

Another aspect of our hazy budget is defense. As the country hurtles down the road to the precipice, our home-made blinders prevent us from getting a real view of what our defense budget is

really being spent on. The strategic threat from Iraq has dissipated. Isn't this supposed to save us money? Why have office clerks in military uniform been allowed to retire dozens of years before their counterparts in the civil service (a custom that is apparently about to be reigned in somewhat). Do all areas of the military really need separate systems for providing food, medical care and communications? What's wrong with the systems that we civilians have to live with?

A year and a half ago, Amir Oren wrote in Haaretz about the army's intention to purchase stretch Isuzu Troopers for 230 Lieutenant Colonels – and their spouses – at a cost of 220,000 shekels per vehicle. In the late seventies, Lt. Colonel's drove in simple Carmels with fiberglass bodies and tiny Ford engines.

There is no money for infrastructure, not to mention aid and medicine for the needy, but there is apparently no shortage of funds when it comes to enabling the defense establishment to build bases on the most expensive land in Israel that is situated in the heart of Tel-Aviv and is a non-negligible target for enemy missile fire (and we complain about the Palestinians whose combatants hide among civilians when they shoot at us). Why isn't it possible to rent out this valuable land, move the general staff headquarters and other key military installations to new bases in the Negev? Maybe then we would finally have to start building a respectable transportation infrastructure to these areas that could also serve the civilian population of the Negev.

One of the most dissonant notes that is so indicative of the asymmetry between civil rights and civil responsibilities in Israel is the large and increasing share of Israel's population that does not serve in the army – despite the fact that military service here is purportedly an obligation and not volunteer-based. According to a publication over a year ago by former head of Akka (the army's personnel branch), Major General (res.) Gideon Sheffer, roughly 42% of the males in each age-group do not serve in the IDF – a number that is increasing by 0.7% each year. The situation among women is even worse. One thing that needs to become increasingly clear is that this combination of declining conscription, during a period in which defense needs are not falling, is reflected in an enormous economic (not to mention personal) burden that is placed on the waning share of shoulders that continue to serve their country. So why don't this same country's leaders perform the minimum service of at least informing the public the enormity of the cost being placed on these shoulders from the increasingly unequal division of responsibilities regarding military service in this country?

A nation that is told by its leaders that it is nearing the precipice deserves the right to have the beaurocratic and budgetary haze lifted so that each one of us will be able to internalize the degree of severity of our predicament. Only then can a real consensus, based upon clear and transparent figures, begin to form on the allocation of our very limited resources. This is the only possible manner in which a national consensus for essential sectoral concessions can be achieved.

A Tale of Two Countries

fourth and final article in the **Socio-Economic Roadmap** series

by Dan Ben-David

The contribution of Jews to science, literature and to the overall development of human knowledge, is in no way proportional to the Jewish people's population share in the family of nations. The number of Jewish Nobel Prize laureates during the past century provides a hint of this contribution. In the most prestigious scientific conferences, Jewish names tend to stand out in terms of the number and the quality of their participants.

The Jewish state has provided a non-negligible contribution of its own. The very fact that it arose at all, against every conceivable odd, shows what a group of determined people – only 672,000 Jews in 1948 – with incredible resourcefulness and a remarkable ability to think outside the conventional boxes in areas of defense and policy are capable of creating. Instead of drowning in a sea of immigrants, the multivariate talents arriving on Israel's shores were channeled into strong currents of creativity and prosperity. At the same time, Israel was one of the countries with the highest degrees of income equality, while simultaneously becoming a country with one of the highest economic growth rates in the modern world.

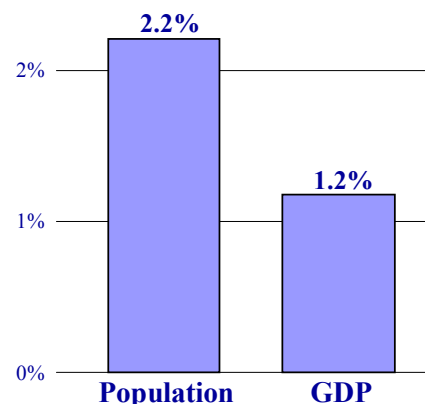
In key areas crucial to its survival, the Jewish state continues to shine. Its universities are at the world's knowledge frontier and push forward the technological envelope. World-class researchers educate generations of students from which some of the best and brightest are accepted to the most prestigious graduate schools in the world. Some of our graduates led a high-tech sector in Israel that produced one of the most innovative and successful revolutions outside Silicon Valley, while other Israeli graduates in the field of medicine are among the world's leading researchers and doctors. The Israeli army is one of the best – per soldier and pilot – in the world. Its fighting techniques are copied abroad and its fighting tools are desired trademarks in other armies.

This is a country that has not simply managed to survive in areas that are key to its existence, it has become a symbol of excellence, creativity and daring. That is why the anomaly of Israel is so great, for this is a country with other attributes as well. Over the years, it has become one of the least equal countries in the West, with poverty and income inequality rising steadily year after year, decade after decade, with no signs of slowing down on the horizon – let alone signs of the trends changing direction. As the chart indicates, a population that in 1998 was 2.2% of the U.S. population was able to produce just 1.2% of what America produced. In other words, Israel's GDP per capita – which represents the average income level per person – is considerably lower than GDP per capita in the States.

Israel's per capita income level in 1950, just a couple of years after the country's birth, was only 37% of America's. It managed to close the income gap throughout the fifties and sixties, reaching 61% of the U.S. income level in 1972. Since 1973, we have been falling farther and farther behind. As the year 2003 comes to a close, our standard of living has declined to 47% of America's (i.e. American income levels are currently over twice as high as Israeli incomes, compared with "just" 65% higher in 1972). We have fallen back, in relative terms, to where we were in 1960 – though then we were in the process of catching up to the western leaders, while now ...

What's happening in Israel? This is not simply an academic question aimed at explaining one of the greatest socio-economic anomalies in the world. It is a question for which we must find the answer before we pass the point of no return, lose this country's most valuable assets – and fall into a terminal abyss.

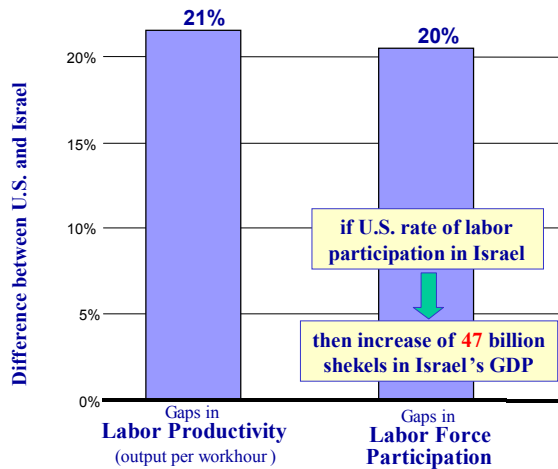
Comparison of Israel and U.S., 1998



Source: Dan Ben-David, Tel-Aviv University, Data from OECD

On the face of it, the latent qualities of the Israeli people reflect an ability that can turn the country into one of the world's wealthiest. But we are not only unable to close the gap with the leading countries, this gap is getting progressively larger as we have been steadily falling behind in relative terms for the past 30 years. This is a country that tried to ameliorate every political, ethnic and ideological sector – while not being able to draw the line between the many varied desires and the very limited resources. The inability to make decisions and resolve issues, alongside a culture of non-enforcement of laws and norms, have led the country to a gradual loss of its scarce resources and is reducing the possibility of ever being able to collectively agree to policies that will enable us to change direction.

Comparison of Workforces in Israel and U.S., 1997



Source: Dan Ben-David, Tel-Aviv University, Data from ILO and World Bank

Why do we produce less than the Americans? Two simple comparisons, shown in the chart, provide a hint to this answer. First, Americans work more than us. They don't work more hours – the length of the average U.S. work week of employed workers in 1997 was identical to the Israeli average work week. The difference is that 20% more working-age Americans actually participate in the work force.

The prevalence of non-work lifestyles costs us a lot of money. More money must be taken from the few (relative to the Americans) who do work in order to support the many more (again, relative to the Americans) who do not participate in the work force. But this is just one type of cost. We also lose what those people could have produced, had they worked – and we are not talking about small amounts here. If the labor participation rate in Israel would rise to U.S. levels, GDP would increase by an additional 47 billion shekels.

Just working more provides only part of the additional output that Israel could attain. The second comparison is one of productivity. The average American worker produces 20.5% more each hour than his Israeli counterpart, and this is not due to any genetic deficiencies inherent in the Israeli worker. After all, as was pointed out above, in the areas that are central to the growth and defense of the country, the accomplishments of Israelis are among those that push the international envelope.

The primary problem is one of a country that is simply choking its inhabitants. For example, Israel placed people in what is referred to here as the “periphery” without supplying them with the minimal tools and conditions for survival in a modern and competitive world. It begins with a disgraceful physical infrastructure that inhibits free flows of workers and goods and it reaches the neglected human capital infrastructure that does not provide the necessary skills for a large part of the people. The wonder is not why we compare so badly vis-à-vis the United States, but how did we even manage to reach the achievements that we did. But we are steadily losing a large and growing share of the Israeli society that is becoming a burden that the rest of society is slowly collapsing under.

The solution must be comprehensive and system-wide with two primary targets: (1) a reduction in gross income inequality and poverty, and (2) faster economic growth. Improving education in the periphery, for example, without providing the other important infrastructures, will lead to a weakening of the periphery towns from the resultant brain drain instead of strengthening them as inexpensive places that it would be worthwhile to invest and reside in.

There are still many Israeli policy-makers that have yet to shed the mistaken concept that a country cannot take care of its needy and also grow at the same time. Those policy-makers are under the impression that emphasizing one must come at the expense of the other and therefore, a country must find the optimal point of balance between the two. What is the source of this mistake? If there is an emphasis on poverty, than this is taken to mean that welfare payments must be increased, which then implies that

taxes must be raised in order to finance the payments and this will act as a negative incentive to invest, which in turn harms growth.

But this is only a symptomatic treatment of poverty. The alternative is to deal with the source causes of poverty, and this is based on the same central elements that contribute to economic growth. One important key – though not the only key – in this regard is education.

A growing economy undergoes a process of structural changes that require a work force which is continuously becoming more educated and more skilled. That is why, as education levels increase, so do incomes and the chances of finding work. As a result of the importance of education in both these instances, the number of people who even bother to look for a job declines the lower their level of education.

The role played by education can be seen in the figure. For example, out of the working-age population with 0-4 years of education, 89% do not even try to look for work. Of the remaining 11%, 14% are unsuccessful in finding work and remain unemployed. Fortunately for Israel, this is a relatively very small group – but the relationship between education, unemployment, and labor force participation should be clear.

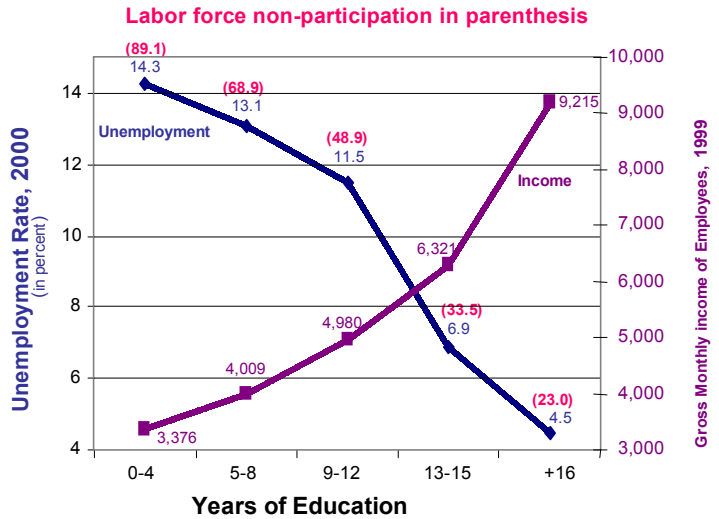
It is possible to divide Israel's population into two main groups: those with up to 12 years of education, and those with more than 12 years of education. As the chart indicates, the two groups are of nearly identical size. But they are substantially different in their incomes and in their job prospects. Herein lies one of the main keys for reducing poverty and inequality and for increasing growth.

Policies that will contribute to a movement of sizeable population from the right-hand side of the population pie in the chart to the left-hand side will contribute to a reduction in income inequality along three main routes. First, those who make the move will benefit. Second, there will be an improvement for those who remain on the right-hand side of the pie (i.e. with up to 12 years of education) as a result of reduced labor competition with other relatively low-skilled workers. Of course, it should be noted that we are talking about a normal country that is not losing its collective mind by adding hundreds of thousands of low-skilled laborers from Thailand, Rumania, and elsewhere to the right-hand side of the population pie. Third, an increase in the number of people with more than 12 years of education will dampen the wage increases of this income group. In other words, this is similar to a simultaneous pincer movement on both sides of the population pie that should lower the income and employment gaps between them.

But a policy that increases the overall level of education in Israel also acts as a direct impetus for increasing the nation's ability to assimilate, utilize and develop new technologies – and this is one of the keys to increasing economic growth.

Will there be enough jobs available for the increasingly educated workforce? An example

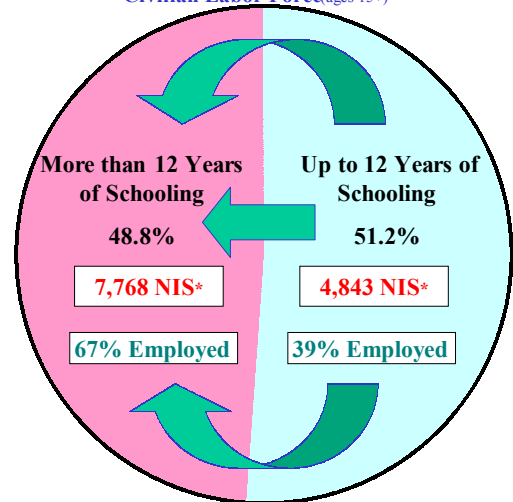
Relationship between Education, Unemployment and Income



Source: Dan Ben-David, Tel-Aviv University, Data from CBS

Distribution of Education, 2000

Civilian Labor Force (ages 15+)



* Gross monthly income of employees

Source: Dan Ben-David, Tel-Aviv University, Data from CBS

from the United States (in a well-known study by Chinhui Juhn, Kevin Murphy and Brooks Pierce) demonstrate how thirsty the modern economies are for skilled workers. The number of U.S. university graduates doubled during the 1970's and 1980's, an outcome that seemingly should have led to a reduction in wages of graduates, had these graduates flooded the market and found it difficult to find a job. But in fact, the American economy needed even more graduates than it received, and the competition between employers for available graduates led to a 25% increase in the salaries of people with B.A.'s.

The current high-tech crisis has led to the unemployment of many educated workers. But there is a need to distinguish between cyclical unemployment and long-run trends. The high-tech workers will eventually find jobs as things begin to turn around since this sector will become one of the pillars of production in the future. Those who will not fare so good, in steadily increasing numbers, are the poorly-educated – and the country has to provide them with the skills and the conditions to compete.

It appears that we will be able to continue on our current trajectories for only a limited period of time. When those who bear the increasingly unequal economic burden are also those who bear the increasingly unequal burden of physically defending the country, then no one should be surprised when the more talented and promising of our younger generation will read the writing that is on the wall and reach the inevitable conclusions while their special gifts are still marketable abroad. If this stream should ever become a torrent, our fate will be sealed. In any event, it should be clear: as long as the dependent segment of society is growing faster than the segment of society that is underwriting this support, and as long as we continue choking the engine of growth, then it is only a matter of time until the engine will no longer be able to carry the national load.

The path upon which we are blindly marching toward the precipice is entirely self-determined and it is totally avoidable. Our socio-economic trajectories are not etched in stone, even though they may seem to be. Our destiny is not in the hands of heaven – it is in ours. But there is limit as to how much marketing – as a substitute for serious stabilization and actual strengthening of the country's socio-economic foundations – can help the State of Israel in the 21st century to keep its citizens and to attract new ones from abroad. The desire to live here can be translated into considerable sums of money that many in Israel are willing to forego in order to take part in the building and strengthening of the Jewish people's only country. But there should be no illusions that this desire can perpetually withstand any cost and every man-made obstacle that we put before it.