

Karnit Flug: The formulation of long-term economic policy – strategic thinking about challenges to the economy

Remarks by Dr Karnit Flug, Governor of the Bank of Israel, to the Eli Hurwitz Conference “The formulation of long-term economic policy: Strategic thinking about challenges to the economy”, Tel Aviv, 25 May 2016.

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Per capital GDP in Israel is about 40 percent lower than that of the US. According to a study conducted by the OECD, in a “business as normal” scenario – relying on the existing trends regarding the development of factors of production and productivity in Israel and around the world – the gap is not expected to be closed in the next few decades. This is the non-encouraging point of departure. Given that this is not sufficient, we need policy aimed at achieving long-term goals, based on the formulation of a strategic plan in key areas and its actual implementation.

This plan must be based on an assessment of the situation at the point of departure, and of the trends and forces that the plan will need to take into account: projected demographic trends, the unpredictable geopolitical situation, and the global environment – which is expected to be far less pleasant than it was in previous decades. All of this must also be analyzed in view of the current state of the fiscal aggregates, including the level of public debt, the level and composition of public expenditure, and the tax system – rates and composition. Based on these trends and forces, we can assess the main challenges with which the strategic plan will need to deal.

The demographic trends are among the fundamental factors that policy makers must take into account in formulating strategic plans in main policy areas. The combination of an aging population – the elderly population is expected to grow from 10 percent of the total population to 17 percent in the next four decades – and a significant decline in proportion of the working age population, alongside an increase in proportion of the population groups that tend not to participate as much in the labor force (there are expectations of a marked increase in proportion of the ultra-Orthodox population and a moderate increase in proportion of the Arab population), require preparation in almost all areas in which government policy operates.

To illustrate, I would like to provide a brief overview of some of the implications of these trends for two key areas in which the formulation and implementation of a broad strategic plan is required – the area of healthcare and long-term care, and the area of human capital. The examples will illustrate that without the implementation of such a strategic plan, not only will we not move forward toward closing the gaps vis-à-vis the other advanced economies, the gaps vis-à-vis the countries at the forefront will widen.

It is important to state at this point that in recent years, there has been significant progress in the government’s strategic planning led by the National Economic Council. A deputy directors-general forum for planning and strategy has been established, and is preparing a plan for the government’s work; seven areas in which the government has chosen to focus have been identified; interministerial cooperation has been intensified; and detailed targets have been set in a number of areas, and work has begun toward achieving them.

However, the challenges are large, and the way toward formulating a work plan, and more importantly toward implementing such a plan, remains long.

In the area of healthcare and long-term care, in view of the trend of aging population, we can estimate that the volume of needs for medical and long-term care services will increase sharply, and we must already prepare for this now. While the general population is expected to increase by 23 percent, the number of elderly citizens is expected to increase by more than double that – 52 percent. As a direct result, the demand for various healthcare services

will also increase by about 60–70 percent, all while the overcrowding in the hospitals is already very high. In addition, about half of the physicians in the system are aged 55 or more – the highest figure in the western world – and the rate of those completing medical and nursing school is lower than in other countries, even after the increase in recent years. As such, the number of physicians per capita is expected to decline.

The Israeli healthcare system is considered very high-quality by international comparison. However, given the overcrowding in the hospitals, the long wait for various procedures, and the low rate of doctors and nurses per capita, the level budgeting for the healthcare system must be adjusted to the tasks imposed on it, a significant increase in the physical infrastructure and human capital in the system, and streamlining the long-term care system, with particular attention to improving systemic coordination. These can be advanced only through a multi-year plan based on a detailed analysis of future needs. Only the formulation and implementation of such a program will be able **to maintain and improve the high-quality Israeli healthcare system**, in view of the trends that are expected to weigh it down even more in coming years.

In terms of human capital:

The increase in education over the past four decades has been a main component in economic growth during that period. Average annual per capita growth has by 1.8 percent, of which 0.8 percent is due to the increased stock of human capital. The question is **whether the current trends in the creation of human capital will be reflected in a similar contribution to future growth.**

In order to answer this question, we must examine what level of education is expected to be relevant to the labor market in the coming years, in view of the demographic trends. A study conducted by Dr. Eyal Argov of the Bank of Israel Research Department translated actual years of schooling into years of schooling in terms of earning capacity, and indicates that while the ultra-Orthodox have an average of 17 years of schooling, **these are the equivalent of just 10 years of effective schooling in terms of earning capacity.** This finding, particularly against the background of the projected demographic trends, indicates that a marked slowdown in the effective schooling of the entire population is expected in the coming years – which is expected to markedly lower the contribution of increased education to per capita GDP growth. The extent of the slowdown depends on the extent to which the actual number of years of schooling is translated into effective schooling in terms of the labor market, or in other words, to what extent the learning content is in line with what is required to successfully integrate into the labor market, which will lead to increased earning capacity and a higher standard of living. I should note that in the rest of the population groups examined (ultra-Orthodox women, Arabs, and non-ultra-Orthodox Jews), no difference was found between the average actual number of years of schooling and the number of years of effective schooling for the labor market.

In terms of the quality of education of the working-age population and its compatibility with the needs of the labor market, it turns out that despite the fact that the rate of workers with post-secondary degrees in Israel is relatively high by international comparison – about 30 percent – this is not reflected in labor productivity in most industries.

For instance, the rate of those with higher education required according to the composition of occupations in the non-export-oriented manufacturing industry is about 3 percent. The actual rate is about 18 percent, more than in parallel industries in the OECD countries. But productivity – or output per worker – in those industries is 33 percent lower in Israel than the OECD average. **We can see from this that the extra education does not translate into effective education that provides skills that contribute to high labor productivity.**

The quality of the education system, as reflected in international tests, is also relatively low, which does not bode well for the skills of workers that will be joining the labor market in the next few years. We do not have relative advantages compared to the rest of the world, other

than human capital and our innovation and creativity. As such, these trends are worrisome in this context.

Against the background of these trends, a study conducted by the OECD indicates that the future contribution of human capital to the expected growth in Israel in the next 15 years is near zero – almost the lowest among OECD countries.

In view of the analysis of the trends I have presented, it is clear that in order to support sustainable and inclusive growth, which will lead to a higher standard of living, constant improvement is required in the level of human capital of the entire population. The education system, and the education required to provide the content and skills that will enable effective integration into the labor market for all parts of the population, including schooling in Mathematics, English, Hebrew, Sciences and Computers.

- An increase in investment in the education system is required, with an emphasis on expanding affirmative action in all aspects of the system, and for all levels of education.
- In particular, the quality of secondary and college education must be strengthened and improved, including in the post-secondary technological schools and in professional training for graduates.
- The future needs of the labor market must be examined, and skills and qualifications must be adjusted to dynamic needs, including by providing cognitive skills that will provide the ability to adjust to a changing labor market.

The conclusion arising from the analysis that I have briefly provided in the areas of healthcare and education is clear, and illustrates the importance of formulating and implementing a long-term policy that deals with the fundamental demographic trends and other trends and forces facing the Israeli economy in the coming years.

The future is already here, and we must deal with it now.