

Karnit Flug: Where is society headed?

Main points of a speech by Dr Karnit Flug, Governor of the Bank of Israel, at the Central Bureau of Statistics Conference, Jerusalem, 17 February 2014.

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I will begin my remarks with data from the OECD, which compared GDP per capita in its member countries with the US, broken down into factors which explain the gap between the various countries and the US. In 2011, the gap between GDP per capita in Israel and the US was close to 50 percent. The OECD also tried to project what the picture will look like in 2060, assuming that current policy trends in the various countries, and expected demographic trends, continue. The gap between Israel and the US is expected to remain more or less the same, as Israel is forecast to decline by four places in the country ranking. This is clearly a troubling picture.

Economic policy is conducted under various trends and constraints, though we must obviously remember that over the long term we can affect the overall framework of the constraints as well. These trends and constraints include demographic trends, the geopolitical situation, the level of governance and efficiency in the public sector, the scope of public expenditures, taxes and the debt, and of course, the global environment in which we work is very challenging.

Expected demographic trends point to two very dominant factors. A change is expected in the composition of the population, by sector, with an increase in the share of the Arab sector, and more so of the ultra-Orthodox sector, in the overall population. There is also a change expected in the age distribution – Israel's population is relatively young, compared with advanced economies, but there is an aging trend by us as well, and the share of those 65 years and older, currently around 10 percent, is expected to reach 17 percent.

In the labor market, the employment rates of ultra-Orthodox men and Arab women, as known, are low. The productivity of the people from those population segments who do participate in the labor market is low, on average. The good news is that there is improvement, albeit slow, in the employment rate of these two segments of the population. However, if we make a radical assumption, that the participation rates of those sectors will remain at current levels, demographic trends on their own are expected to reduce the employment rate by 7 percent in the long term. Thus, it is important that we continue to invest in increasing the participation and productivity of the Arab and ultra-Orthodox sectors; otherwise, not only will we not remain in place, but we will even widen the gap vis-à-vis the advanced economies. For example, in educational achievements, already today there is some gap between Israel and advanced economies, and it can be assumed that the Arab and ultra-Orthodox sectors are themselves at some gap vis-à-vis the general population in such achievements. The implication is that under current conditions, the increase in labor force participation of these sectors will be reflected in the addition of employees whose productivity is low to the workforce.

The data indicate that in recent decades, the gap between Israel and advanced economies in output per hour has remained. Among the factors in this phenomenon are an unfriendly business environment, as reflected in international indices such as the Doing Business index, the problem of low competitiveness in specific industries, and a low rate of investment which leads to insufficient capital stock. Looking at per capita GDP, as well, indicates that we have not closed the gap in recent decades. Although we have seen more rapid growth of our per capita GDP in recent years, in light of the relatively moderate negative impact of the crisis on Israel's economy compared with other advanced economies, we clearly don't want to hope for a continued contraction of the gap between Israel and other advanced economies based on this factor. The two demographic trends that I discussed – the decline in the share of the working age population, and the increase in the share of sectors with relatively low

employment rates – are expected to deduct 1.3 percentage points from the annual growth rate. In this regard, I of course noted the improvement, which is still slow, in the employment trends in the Arab and ultra-Orthodox sectors.

The aging of the population is expected to lead to a sharp decline in the ratio of number people of working age to the number of the elderly, from 5.5 today to 3 in 2050. The meaning of this is that there will be a need to increase the allocations for old age allowances, on healthcare expenditure, nursing care, and such, in order to maintain the current level of these allowances and services. Poverty is another issue with which we will need to deal. In recent years there has been a trend of increase in the poverty rate among families with workers, while the stability in the general poverty rate is the result of an increase in the share of families with one or both parents working, which is an outcome of the trend of increase in labor force participation. The picture is essentially of workers whose earning power does not allow them a respectable livelihood, and so there is an increase in the number of poor families in which there are one or two wage-earners. In this context, expanding the earned income tax credit (negative income tax) is an efficient policy tool to deal with the problem, as it focuses on the working poor, and in contrast to a policy of allowances, it does not contain negative incentives. In the long term, of course, the main key to solving the problem of poverty is continued investment in education and increasing earning power.

The challenges I have presented here will require a significant increase of civilian expenditure on services such as education, healthcare, welfare, and infrastructure, even if only to maintain the current level of services, given the expected changes in composition of the population. In order to ensure that maintaining the civilian expenditure level will not negatively impact on the important effort to continue to reduce the debt burden, there will be a need to continue to increase tax revenues. This can be achieved in 3 ways, each on its own or in some combination of the three:

1. Increasing tax rates, which obviously increases the burden on activity and growth.
2. Reassessing the tax exemption system. In this regard, it should be remembered that some of the estimates of the cost of existing exemptions are biased upward, since they do not take into account the expected change in activity resulting from the cancellation of the exemption.
3. Reducing the shadow economy and enhancing collection. It is clear that from the perspective of statistics bureaus worldwide, estimating the extent of the unreported economy poses a large challenge. A very rough estimate by the World Bank, which apparently has a large margin of error, assesses that the unreported economy is about 20 percent of GDP in Israel. In this regard, there are several processes which are being discussed: definition, in legislation, of severe tax crimes as source crimes under the Prohibition on Money Laundering Law, which would allow the transfer of information between the Israel Money Laundering and Terror Financing Prohibition Authority and the Israel Tax Authority, and making punishment for tax crimes more severe; collaboration between all the enforcement entities and transfer of professional and intelligence information which will make enforcement against tax evaders more efficient; and a reduction in the use of cash and third-party checks, which is currently being considered by the Locker Committee.

To the extent that we will be able to do more in increasing the efficiency of the tax exemption system and enhancing tax collection, we will be able to increase overall tax revenues without increasing tax rates.

To summarize, the economy faces the challenge of supporting inclusive growth, which integrates population sectors with low participation rates, while increasing their human capital and earning capacity and increasing productivity. To that end, we must formulate a focused strategic plan, which will include integrating population sectors into employment (ultra-Orthodox, Arabs, older workers), dealing with increasing human capital, dealing with the factors leading to slow growth of productivity (infrastructure, business environment,

competitiveness), preparing public services systems (healthcare, nursing, etc.), and reducing the unreported economy by collaboration between all entities.

The data I presented in the beginning of my remarks showed that an “automatic pilot” policy will not lead us to reducing the gaps with other advanced economies; however, there is some room for optimism, as an effective and well thought-out policy can definitely improve our situation over the long term.