

Yaron Amir: Bank of Israel's recommendations for increasing the standard of living while maintaining fiscal discipline

Remarks by Mr Yaron Amir, Governor of the Bank of Israel, at the Calcalist conference, Tel Aviv, 2 September 2019.

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Good morning.

I greatly appreciate the opportunity to speak here today. This is a very important time, with the election campaign drawing to a close, while millions of children are returning to school to further their education and obtain the tools necessary to lead the country into the future. I would therefore like to take the opportunity to discuss issues that involve each one of us as individuals, and all of us, particularly the Bank of Israel, at the societal level: the future of our children and further generations, and the standard of living that we want to improve for their benefit, and also of course for our benefit as a country.

A few days ago, the Bank of Israel Research Department published a document that dealt entirely with the measures necessary to increase the standard of living in Israel. At the Bank of Israel, we asked ourselves how to do this, and the answer is that the focus must be on improving worker productivity in Israel. This is the “roadmap” that we created. These recommendations illustrate the Bank of Israel’s commitment to deal with the most pressing macroeconomic issues for the economy as part of my job as economic advisor to the government, and based on a professional in-depth analysis. I will expand on this in a few moments.

But before that, I would like to briefly discuss the vision that I and the Bank have in dealing with, and guiding policymakers in dealing with, the issue even now. The informed decisions made by policymakers in our country from its founding until today established and strengthened the Israeli economy, its stability, and its power, and led us to a situation in which we are now ready to begin taking the necessary steps to prepare the economy for the coming decades. Israel must, and can, implement these recommendations. Implementing the Bank of Israel’s recommendations will help take Israel into the future with a higher standard of living. I say this with complete certainty.

This obviously requires considerable investment. The cost of the measures that appear in the report, when fully implemented a few years from now, is not low—close to 3 percent of GDP, which is about NIS 44 billion per year in current GDP terms. The cost is high due to the large gaps that have developed in various areas over recent decades. However, the investment will be very well worth it. Our assessment of the additional GDP in the long-term from implementing the recommendations is much higher—about 20 percent of GDP per year. Or, to put it more simply, about NIS 270 billion shekels more, in current GDP terms, for our children and future generations.

I emphasize that the implementation of this program will not come at the expense of the need to deal decisively with fiscal issues and the growing deficit. I have previously enumerated the measures that the government and the Knesset will have to take in order to deal with the fiscal necessities: reducing inefficient expenditures to start, cancelling tax exemptions, and apparently also raising tax rates. This does not contradict the need or the possibilities of starting to implement the recommendations right now. First and foremost, the stage of planning and building the tools to implement the reforms, which is an essential part of adopting the recommendations, will take time, and its cost is relatively negligible. In addition, there are many recommendations that can be implemented even today, since they deal with diverting existing sources, and with administrative processes.

I will now briefly discuss the main points of the recommendations and the background of the report. Output per work hour in Israel, what we economists define as “labor productivity”, is 24 percent lower than the OECD average, and this gap has not declined in recent decades. This gap has large implications for the standard of living in Israel. The low level of productivity compared with other advanced economies is reflected in lower wages and standard of living in Israel than in other western countries. We found that the labor productivity gap to Israel’s disadvantage is mainly due to a number of factors: the relatively low quality of education and teaching in Israel; the lag in the level of infrastructure and the quantity of business capital; and public sector regulations and bureaucracy.

In the field of education: In recent years, there is a greater recognition that despite the fact that Israel is the Startup Nation that gave us the flash drive, WAZE, Mobileye, and a wealth of complex cyber solutions, most Israeli workers lack the ability to solve more basic problems. In addition to our marked lag in average skills, Israel also feature a high level of inequality in scholastic achievements, with large differences in basic labor skills among workers, large wage gaps, and large differences in productivity levels between the various industries. While the strong workers in Israel are similar in output and skills to the strong workers in other countries, the weaker workers in Israel are far weaker than their peers abroad.

So how can we strengthen the “weaker” workers and raise the output per worker in Israel?

There is a direct—and causal—connection between a labor force’s quality of education and productivity, with an emphasis on the importance of basic cognitive skills that enable a change in profession during one’s lifetime. Eric Hanushek of Stanford University shows this in a series of studies he conducted in recent years.

It is important to state that the gaps in the quality of education in Israel exist in almost all age groups and education groups, and are not the purview of a certain segment of Israeli society. Therefore, the treatment of the problem must encompass all levels of education, and begin in preschool. In his research, Nobel prize winner James Heckman found how important the preschool starting point is for economic success during life, particularly for children from lower socioeconomic backgrounds. It is therefore important that daycare centers for children from weaker backgrounds begin the educational process at very young ages. At the same time, it is important that subsidies for the cost of daycare for weaker population groups be adjusted to increase the incentives to work for both parents. Such steps lead to a double benefit. They can materially contribute to future growth, and can contribute to reducing gaps and increase equality of opportunity.

As economists, we avoid dealing with pedagogical issues. We focus on incentives that will help improvement in an area, and recommend adjusting the payment structure for teachers to the urgent needs of the system: improvement payment for those with training in subjects where there is a lag in achievements and a lack of teachers (mathematics, sciences, and English), and improving salaries for teachers to teach in schools that cater to students with weaker backgrounds. This is all on condition that there are continuous evaluations of the success of the teachers and of the schools in creating scholastic, educational, and social improvements.

In addition to the investment required at young ages, there are also measures that are necessary for the older population. In Israel, too little is invested in developing human capital at older ages through professional training programs. The increasing flexibility of the labor market, and the extension of a person’s working life as life expectancy and the effective retirement age increase require significant reforms in this area, both in improving the output of technological colleges, and in adapting the content of the courses. The reform that the government recently adopted in the technological colleges is an important step in the right direction, and the recommendations that appear in this field in the draft report of the 2030 Committee appointed by the government point to additional important measures that will help Israel to better deal with the issue of professional

training.

In the field of business capital: The high level of variance in the Israeli economy is also reflected in the extent of innovation and the volume of investment in physical capital in different industries. In this area, the situation is good in exporting industries, particularly in software industries, but it requires improvement in the rest of the economy, compared to parallel areas in other countries. Why is this happening? First, it is reasonable to assume that some of it is a natural result of market forces. Israel developed a relative advantage in the field of high-tech, which makes successful investments and attracts select software and hardware people. However, the government's involvement encourages these successful areas of activity directly and almost exclusively, thereby raising the costs of human and physical means of production for the other industries, which employ most of the workers in the economy. Over time, the productivity of export companies will have difficulty continuing to grow, as companies that provide them with raw materials and services remain so far behind.

Therefore, a gradual change is required that will make support of the principle industries based on incentivizing the various areas of activity and industries by economic criteria that will lead the economy to higher returns on investment and government support—among exports, which can continue to benefit from it, and among domestic manufacturers. It is important to focus on running programs that support the removal of market failures that delay production and the implementation of unique knowledge, innovation, and management methods that can spill over to other companies. Such a policy, alongside the effect of streamlining and the reduction of regulation, which I will discuss later, may contribute significantly to increased stock of capital in exporting industries and in domestic industries as one.

In the field of infrastructure: The rate of investment in transport infrastructure in Israel has been similar in recent years to the average rate of investment in OECD countries, but is far from what is necessary to reduce the gap in transit efficiency compared with the leading countries. This is due both to the accumulated gap and to the rapid population increase in Israel. Improving the transport system, particularly public transit, will shorten the time wasted in traffic. An example that I heard, and which illustrates the issue well is that a plumber in Gush Dan manages to get to half the amount of homes that a plumber who works in areas without large traffic jams can service. This is a situation that, obviously, creates lower output for that plumber, and raises the cost of his service to the consumer.

Regulation and the business environment: Israel is ranked 29th out of the 34 OECD countries in terms of the regulatory ease of doing business. Despite the government's recognition of the importance of the issue, actual improvement is confused and very slow. It is therefore important to accelerate the process of adopting regulations from other advanced economies, unless there are significant reasons to avoid this in individual cases. This will help to both ease the regulatory burden and to increase international competition in the economy. In addition, in order to streamline bureaucratic processes, we suggest setting targets in public sector wage agreements for the adoption of digital processes in government services to the business sector.

The current fiscal situation is weighing down on the ability to finance the required investment. The government's structural deficit has increased in recent years to more than 3.5 percent of GDP, and without a significant correction, it is expected to continue growing in 2021 and onward. The implementation of this program will not come at the expense of the need to deal with fiscal issues and the growing deficit. On the contrary: the required investments make it necessary to rapidly and decisively deal with the existing deficit.

Since the large expenses due to the programs presented are expected only in a few years' time, after the initial steps have been implemented and the plans for advancing infrastructure are fully prepared, it is important that the government prepare for early implementation in terms of the fiscal frameworks that will allow those investments that have the capability of significantly

improving the standard of living in Israel. Such preparation is important, first and foremost to ensure the continued stability of the economy, but also to ensure greater ability of sources for financing the required investments. This means the early convergence of the deficit, which will ensure at least the stabilization of the public debt to GDP ratio, and maintaining this level in the coming years alongside the gradual implementation of the growth-supporting measures proposed in this program.

I would like to emphasize that we do not intend to recommend financing the investments—even though their expected return will be high—through deficit spending and the accumulation of public debt to be repaid in the future. In general, there is some logic to this argument, but the question is what level of deficit is sustainable. The current deficit level is, in our assessment, too high to allow for further increase, due to the short-term macroeconomic risks it entails. In addition, deficit financing creates risks to the quality of project selection and of a loss of control over costs. When public projects are financed without effective short-term budgetary restrictions that show the public and decision makers in real time what the cost of the sources required for the investment is, the risk of inefficient allocation of investments and excessive costs increases.

In conclusion, these recommendations illustrate the material possibilities that we are presenting to policy makers to increase the standard of living in Israel. I believe that their strength is in their interconnectedness and in their being sufficiently detailed in terms of the cost of realizing each item in the report. Their concurrent implementation will maximize the chances of success of the project. The report is available for viewing, and was already presented to the various government ministries as it was being formulated.

Thank you.