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Sivan 5776, June 2016

Recommendations & Findings on Labor Productivity in Israel

EXECUTIVE SUMMARY

In recent decades, Israeli labor productivity is not closing the gap with more developed countries, and in many respects the gaps are even widening.

- A key factor in the widening productivity gap in the past decade are welcome changes in the labor market, in particular tremendous growth in the labor participation rate alongside a decline in the unemployment rate. By comparison, employment growth in other developed countries has been quite modest. We should not fall into the trap of viewing the extraordinary ability of Israeli young people from varied backgrounds to find gainful employment in the local job market as a type of failure. We emphasize that maintaining the economy's ability to create jobs is no less important than increasing labor productivity.
- Highly inflexible employment practices harm productivity in the public sector. The collective agreements in this sector make the proper allocation of the labor force very difficult. For example, it is very complicated to transfer an employee from one position to another, or to implement streamlining plans. Israel's labor laws are such that the strong labor unions in the public sector – and particularly in the government monopolies – can prevent reforms and arrangements that could increase labor productivity, their employment conditions and the quality of life of all Israel's citizens.
- It is important to improve the elementary and high school education system, especially in the Arab and Haredi (ultra-Orthodox Jewish) sectors. The scholastic achievements in the Arab sector are similar to those in Jordan and Tunisia, while in the Haredi sector male students are not taught at all skills essential in the modern job market. Research indicates that Israel has a dual job market, in which industries with high-end jobs cannot attract workers from low-income sectors. A possible reason for this is likely the exceptionally high number of poorly skilled young people with who cannot compete in industries that demand higher skills.
- Israel has significant obstacles to entrepreneurship and establishing businesses. A study by the OECD found that the legal hurdles for fledgling businesses in Israel are among the most daunting of any OECD country. Other comparative studies have shown that an anti-competitive regime tends to hinder the adoption of international improvements that increase labor productivity. There should therefore be efforts to reduce regulation and the protection of existing business, and lower the other barriers to entrepreneurship.

INTRODUCTION: DESCRIPTION OF THE PROBLEM

Israel's achievements in the productivity field are disappointing. Countries with low productivity generally exhibit "conditional convergence" – the gradual narrowing of the productivity gap with countries that have similar institutional structure. However, even though Israel is considered an advanced country and is a member of the OECD, the productivity gap compared to the other OECD countries has actually widened in recent decades. Productivity per worker in Israel increased by 28% in 1987-2014, compared to an average increase of 40% in OECD countries and 56% in the US. This surprising and disappointing phenomenon has been the subject of several studies in the past few years. The following is a summary of the findings of research by Kohelet Policy Forum on this issue.

The major influence in recent years is the changes in the size and composition of the work force

The widening of the productivity gap since 2000 is largely due to the positive changes that began to unfold in the Israeli labor market in the past two decades. Twenty years ago the participation rate in the Israeli labor market was one of the lowest among OECD countries. Since then the participation rate in Israel has caught up with the OECD average, which has risen only slightly. The growth in the participation rate in Israel has been quite dramatic, increasing 12 percentage points between 1999 and 2013 - from 62% to 74%. During this same period the participation rate in the OECD countries rose from 71% to 76%.

In addition, the rate of population growth in Israel is particularly high, such that the number of people of working age – the basic component of the participation rate – increased disproportionately to other OECD countries. Between 1999 and 2013 the Israeli labor force (citizens of working age) grew by 57%, while in the other OECD countries work force growth was an average of just 16%.

During this period the total number of workers in Israel rose by 61%, versus an average of just 14% in the other OECD countries. These changes affect labor productivity in two ways: The growth in the number of workers in itself demands a higher level of investment in order to maintain the level of capital per worker; and the new employees entering the labor market are, on average, younger and less educated than they would have under a static participation rate.

The fact that fertility is greater among the Haredim and the Arab minority – population groups characterized by lower human capital than in the non-Haredi Jewish population – increases the impact of the second effect. According to the Social Survey of Israel's Central Bureau of Statistics, between 2002 and 2014 the ratio of Haredim and Arabs among all employees rose from 14% to 19%. Thus the unique population mix in Israel magnifies the structural impact of natural increase on the younger and less experienced labor force.

The work force composition in Israel will continue to be affected by the rapid growth of groups with low human capital, such that the average growth of human capital will be slowed, relative to other developed countries. This finding is not an indication of any dysfunction in the Israeli economy, but is rather a natural result of Israel's unique demographic characteristics.

A LABOR FORCE WITH DEFICIENT BASIC CAPABILITIES

Many studies indicate a strong connection between the cognitive capabilities of high school students both with the earning ability of those same students in the future, as well as with the growth rate of the economy as a whole when these young people join the work force. Higher productivity employment tends to require a higher level of cognitive skills.

There is a large gap between the Program for International Student Assessment (PISA) scores of Israeli students and the scores of students in most other OECD countries. PISA test subjects in 2000 – the 15-year-olds of that year, who are today's 31-year-old workers - scored an average of 60 points lower than the OECD average. Although there has been a marked improvement in PISA scores in recent years, as well as in the Israeli Meitzav standardized test scores, gaps remain large and it is reasonable that the large past gaps in particular are a significant factor in the productivity gaps over the past decade.

Israeli high school students not only have lower than average scholastic achievements, there is also relatively high variance among their achievements. As a result, the percentage of students with very low scores is particularly high. In the 2006 PISA exams in all OECD countries, the percentage of students who scored below 400 (one standard deviation below the international mean) was about 16% - exactly as could be expected in a normal distribution of student performance. In Israel, however, the ratio of such low-scoring students was 35%, or more than double the OECD average.

The abilities of the students in the Arab education system are particularly poor. The average PISA score of Arabic-speaking students is a full standard deviation below that of the OECD countries and that of students in the Hebrew-speaking education system. The PISA scores of Israeli Arabs are almost identical to those of their contemporaries in Jordan, a poor and undeveloped country compared to Israel. Still, there was a marked improvement in the PISA scores of Israeli-Arab students between 2006 and 2012 and in the Meitzav scores in recent years. There is cause to hope that these skills gaps, and the consequent drag on productivity, will continue to shrink.

Year	OECD	Israel: Overall	Israel: Hebrew speakers	Israel: Arabic speakers
2000	500	440	(No breakdown)	
2006	497	445	458	382
2012	497	474	497	395

The situation in the Haredi sector appears even worse than in the Arab sector. The boys' schools in the Haredi education system do not teach core subjects such as mathematics, English and sciences, that provide the students with the essential skills for integrating into the modern job market. However, it is difficult to quantify the performance of Haredi students compared to international standards, because hardly any school in the Haredi sector allows its students to participate in international tests such as the PISA, or even in standard Israeli tests such as the Meitzav.

LABOR UNIONS IN THE PUBLIC SECTOR

Kohelet Policy Forum conducted an in-depth comparative study of Israeli labor unions. The following is the link to the full research report: <http://goo.gl/wqAuaX>.

This study found that Israeli unions are considerably less accountable toward their members and toward the public than unions in other countries. The reason for this is the outmoded regulatory regime, which does not empower substantive democratic representation of the workers, and does not hold the unions minimally accountable for harmful consequences of strikes and sanctions.

The excessive power of the unions has negative implications on productivity mainly in the public sector and especially in the government monopolies, in several ways:

- **A marked surplus of manpower**, due, among other reasons, to the employment of workers whose productivity is negligible, instead of dismissing them so that they could be employed in other industries, in which such employees could achieve much higher productivity.
- **Excessive wage payments**, not as a reflection of the workers' productivity, but rather to quell the potential threat and damage the unionized workers could do. The public purse pays for these extra wages, as well as the generous and special fringe benefits the workers receive. The funds for the payments come from higher taxes and at the expense of government services such as education and infrastructure. Both the excessive payments and the reduced services negatively impact productivity throughout the economy.
- **The labor unions wield tremendous power** to oppose reforms (such as structural changes and the introduction of new technologies) that could benefit both the employers and the workers when such reforms are not in line with the interests of the labor unions. The non-implementation of such reforms prevents vital productivity growth.
- **Inefficiency at the government monopolies** indirectly hinders productivity in branches of the business sector that depend on those monopolies (for example, industrialists and farmers need high quality, efficient port services for exporting their products).

Labor law reforms in accordance with the recommendations outlined in this study will contribute significantly to improving productivity throughout the Israeli economy.

PROXIMITY TO THE GLOBAL PRODUCTIVITY FRONTIER

Productivity growth stems not only from increased resources available to each worker (the capital/labor ratio), but also from improved efficiency in the worker's use of a given quantity of resources (often denoted "total factor productivity"). Companies around the world find ways to improve the efficiency of their employees' work on an ongoing basis by introducing new technologies, upgrading employee qualifications and instituting more efficient organizational and administrative practices. The productivity of Israeli companies depends to a large extent on their ability to duplicate and internalize such efficiency measures. The professional literature often calls most efficient manufacturing methods "the global frontier," and the overall productivity gap is expressed as the distance from this frontier.

Research conducted in recent years offers many insights into the factors that affect this distance. At the end of 2015 the OECD published an extensive survey of these insights.

Israel has some characteristics advantages that position the economy close to the global frontier. The research found that the local expenditure on R&D – which is aimed mainly at developing innovativeness – also has a major effect on the ability to internalize existing innovations. Investment in R&D in Israel is very high compared to other countries around the world.

At the same time, the Israeli economy has many characteristics that seem to impede Israeli firms from reaching the productivity levels of leading international firms. Thus for example, the Israeli job market is quite rigid, making it difficult to efficiently allocate employees among workplaces. In addition, barriers to entry and to exit for firms are high and make it difficult for new and more efficient firms to establish themselves and for outmoded and less efficient ones to close up shop and free up their resources – physical capital, human capital and intellectual property – to move to other firms. Israel must work toward the lowering of these entry and exit barriers.

Another problematic feature is the extent of the Israeli foreign trade. Israel is a small open economy with extensive trade, but the scope of international trade in Israel is less than that of countries with comparable characteristics, even considering Israel's geography. Since the 18th century there has been consensus among economists that openness to international trade contributes to a country's economy by offering opportunities for concentration in industries in which that country has an existing comparative advantage. In the past few decades there has been a growing emphasis on the effect of international trade on the incentive to adopt more efficient practices, in order to compete successfully in the global economy. More recently there is growing awareness of a third benefit of trade: international trade exposes companies to advanced practices from around the world and improves the companies' capability (and not only the incentive) to draw closer to the global productivity frontier. It is very important to lower the obstacles to imports, as this will benefit Israeli consumers directly via the lower prices of imported goods, and no less importantly will contribute to increasing productivity and wages among Israeli workers.

CONCENTRATION AND THE LACK OF COMPETITION IN THE BANKING-FINANCE SYSTEM

Israel's bank finance system (which includes the banks, the credit card companies owned by the banks and the credit clearing system owned by the credit card companies) suffers from high concentration and lack of competition. These two factors find expression not specifically in the high profits of the financial institutions, but in the very high costs of labor (an excessive number of employees with inflated salaries and fringe benefits). The excessive costs impose a heavy burden on small businesses and households, the captive customers of the system, and the result is a decrease in productivity throughout the entire economy in addition to the low productivity in the finance industry itself.

Kohelet Policy Forum published in-depth policy paper on this subject. The following link is to the complete Hebrew document: <http://goo.gl/8neN2v>.

ADDITIONAL LIKELY OBSTACLES TO LABOR PRODUCTIVITY IN ISRAEL

Finally, there are many other obstacles to labor productivity in Israel, that need to be addressed with a clear policy. The following is a partial and far from exhaustive list:

- Excessive regulation of businesses.
- Inefficient public transportation.
- Inefficient incentives in higher education.
- The Israeli postal service does not function.
- The government payment ethic is problematic.