



The Labor Market as an Engine for Growth and Poverty Reduction

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Policy Paper 2018.03 / September 2018

This is a short summary, for the full paper (in Hebrew) see
<https://www.idc.ac.il/he/research/aiep/pages/policy-papers.aspx>.

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The Labor Market as an Engine for Growth and Poverty Reduction¹

Two main processes characterize the labor market in Israel since the beginning of the 2000s: the major increase in employment among individuals and households, and the increase in households' labor income. The employment rate at the main working ages (25-64) rose from 66.8 percent in 2002 to 76.6 percent in 2016. This dramatic increase followed more than a decade of decline in employment, which occurred only among men and began already in the 1980s, simultaneous with a gradual increase in the employment rate among women. However, starting in 2002, the trend reversed among men and their employment rate began to rise, reaching 81.4 percent in 2016, while the increase among women accelerated and their employment rate grew even more, from 56.5 percent in 1995 to 72 percent in 2016.

The increase in employment in Israel is particularly noticeable when compared to the global trends during this period: in the OECD countries and the US, employment rates plummeted following the economic crisis in 2008, and as a result of the slow recovery they have not returned to their previous levels. In contrast, Israel was hardly affected by the crisis and employment in Israel is currently very high relative to both the past and other countries. The overall employment rate in Israel (76.6 percent) is higher than in the US (73.9 percent) and the OECD (73 percent). Among men aged 25-64 the gap with the OECD average and the US has closed, and among women in that same age group employment rate is higher by 7.8 percentage points than in the OECD and by 4.5 than in the US.

The increase in employment has encompassed all population groups, education levels and age groups; however, a breakdown of the increase in employment shows that the most significant increase has occurred among the ultra-Orthodox Jews and the Arabs, individuals with low levels of education and older workers (aged 55-64). There is also a trend away from single-provider households to two-providers, which characterizes all types of households but is particularly pronounced among households with three children or more. The main question addressed in this policy paper is what has caused the reversal in trend and the significant increase in the employment rate since 2002, and why was this increase biased towards groups with low earning potential.

¹ For the main findings of this paper in English see: Tali Larom and Osnat Lifshitz (2018), "The Labor Market in Israel, 2000–2016", in *Country Labor Markets*, Daniel S. Hamermesh (ed.), IZA World of Labor, <https://wol.iza.org/articles/the-labor-market-in-israel>.

In order to answer these questions, we estimate employment and wage equations using data from the Labor Force Surveys, Income Surveys and Expenditure Surveys. The equations were estimated both on a pooled sample for the years 2001-15 and for each year separately, in order to examine the changes in coefficients over time. In order to separate between changes in traits and changes in returns, we use a variance decomposition procedure for various cross-sections: by education, by age, by household structure and number of children, and a separate analysis for two specific populations (the ultra-Orthodox and the Arabs). The goal of this decomposition is to determine whether the increase in employment was the result of demographic changes or changes in returns that altered incentives.

An analysis of the empirical findings and the disaggregation shows that the increase in individuals' level of education, and in particular in the share of those with an academic education, is responsible for about 20 percent of the increase in the rate of employment among men and about 40 percent among women.² Not only did the rest of the demographic changes not contribute to the growth in employment, they even worked to lower the rate of employment. The aging of the population had a negative effect on the rate of employment, despite the significant increase in the employment of older individuals (74 percent of men and 60 percent of women aged 55-64 were employed in 2015 in contrast to 61 and 39 percent in 2002), which can be attributed to, among other things, the raising of the age of retirement. Changes in the structure of the household and the number of children had a negative effect on employment since the share of households with three or more children rose. The increase in the share of the ultra-Orthodox population and the Arab population also made a negative contribution to the overall employment rate. This occurred in spite of the dramatic increase in the rate of employment among these groups. Therefore, the demographic changes as a whole do not provide an explanation for the increase in employment during the sample period.

² In this dimension of the effect of education, the rest of the growth in employment is due to the increase in employment within each education group.

The second hypothesis examined is whether changes in the return to education and experience are what led to the increase in employment described above. The estimation results show that during the sample period there was no change in the return to education at each level of education, apart from individuals with a Master's degree or higher where an increase in return was observed. However, as mentioned above, the increase in employment was in fact focused at the lower levels of education. An examination of the return to experience did not show any major changes over time either. An examination of the variation over time in the coefficients for the characterization of a household as Arab or ultra-Orthodox found that the wages of the two groups did not increase over time. In other words, the changes in returns cannot explain the increase in employment.

The next hypothesis that was tested was whether changes in policy that worked to increase work incentives, and in particular the far-reaching changes in social welfare payments and taxation in 2002 and 2003, caused the reversal in trend and the growth in employment. The sample period was characterized by dramatic policy changes in this context: a cutback in unemployment benefits and the tightening of eligibility criteria; a reduction in income supplements and a change in the conditions of eligibility; a reduction in the child allowance and a restructuring of the value of each additional child; a reform in the income tax that focused on low income earners; an increase in the age of retirement; implementation of "welfare to work" programs for the population receiving income supplements and programs to promote employment in specific populations; a labor grant ("negative income tax"); a reduction in the number of foreign workers; and an increase in the minimum wage.

The aforementioned policy changes worked to increase work incentives and focused on low income earners and large families. These groups were characterized by the highest increase in employment. In order to support the hypothesis that the increase in work incentives is what caused the growth in employment, we calculated the change in the share of social welfare payments within total income for households of various types and looked at the correlation between these changes and the increase in employment. According to the results, the increase in the rate of employment was larger for a particular type of household to the extent that the reduction in its social welfare payments was larger. Although in recent years, the cutbacks in social welfare payments have been partially rolled back, the use of other policy measures and active labor market tools has in the meanwhile been expanded and therefore the rate of employment has continued to rise.

We conclude that most of the increase in the rate of employment can be attributed to the aforementioned series of policy measures to increase work incentives and in particular the reduction in income supplements and the child allowance. The only other change that contributed to employment is the increase in the level of education, which can also be attributed to the change in the policy of permitting the opening of colleges at the beginning of the 1990s following the amendment of the Council of Higher Education Law.

The second question examined in this policy paper is the effect of the growth in employment on wages, income and poverty. It was found that at the same time employment increased and despite the entry of relatively weak populations into the work force, hourly wages and wage gaps remained almost unchanged. The share of labor income within total household income grew significantly, particularly in ultra-Orthodox and Arab households (62 percent and 75 percent, respectively, in 2015), while the share of income from National Insurance payments fell and the proportion of households receiving income supplements dropped from 7.2 percent in 2002 to 2.7 percent in 2015. As explained above, this drop is not only the result of the increase in employment but also its main cause, since the tightening of the conditions for eligibility and the significant cutback in the amounts of the income supplement changed the structure of incentives in the labor market and incentivized households whose welfare payments had been reduced to enter the work force.

A main result of the growth in employment is increased household income. Standardized (equivalent) labor income has increased for households of all types and in all sectors of the population; but more so in households that increased their employment the most. Standardized disposable (net) income has also increased. The increase in disposable income implies that despite the substitution between income from labor and income from social welfare payments, and even though an increase in household employment often involves the loss of eligibility for an income supplement, the overall effect of the increase in employment on household income was positive and the increase in employment was accompanied by an improvement in the measured household standard of living.

The change in income was, as mentioned, positive for all households; however, there are important differences in the rate of change. Thus, labor income rose faster for ultra-Orthodox and Arab households while disposable income rose more slowly for these households. In other words, the gaps in labor income between the groups have narrowed while the gaps in disposable income have widened. These opposing trends were manifested also in the indexes of poverty and inequality, such that the poverty rate according to labor income fell continuously from 36 percent in 2002 to 32 percent in 2015, while the poverty rate according to disposable income rose from 18 percent in 2002 to 21 percent in 2005 and dropped back down to 19 percent in 2015. Since the increase in employment was in large part due to the cutback in social welfare payments, it is not surprising that these two forces operated in opposite directions and during the initial years their effect on the poverty rate according to disposable income was negative. Nonetheless, it is important to reiterate that, as mentioned, after a few years the trend of growth in poverty came to a halt and in the later years there was even a reduction. These opposing trends also explain the position of Israel relative to other countries. Thus, the poverty rate before taxes and transfer payments in Israel is among the lowest in the OECD while the poverty rate after taxes and transfer payments is the highest in the OECD. The level of poverty and inequality reflect the gaps that still exist between groups and sectors in employment, wages and birth rates.

The conclusion is that most of the drop in poverty according to labor income and in recent years also according to disposable income can be attributed to the aforementioned policy measures which were aimed at increasing work incentives.

It is important to remember that there is a certain tradeoff between the two measures of poverty, since a more generous social welfare policy can reduce poverty and inequality in disposable income; however, since social welfare payments cause a negative work incentive it is reasonable to assume that over time they will increase poverty and inequality in market income and will harm economic growth. **We recommend the adoption of policy measures that will focus on the labor market and will continue to position it as an engine that will bring about both growth in output and a reduction in poverty. First, work incentives for individuals and households should continue to increase, which will maintain the growth trend in employment in general, and among the lower employment groups in particular. Second, tools should be developed and implemented to raise productivity and increase workers' human capital, which will increase earning ability in general, and that of the lower half of the distribution in particular, and will reduce poverty and inequality. We believe that a policy which combines both these types of policy measures will have a major effect on the welfare of households, on economic growth and on economic and social resilience.**