CAN ISRAEL BECOME SWEDEN?

ANDERS BORG, MAY 2019

TWO SUCCESS STORIES

ISRAEL

- High growth compared to other industrial countries since the turn-around in the early 90’s.
- Strong macroeconomic stability anchored to an independent central bank, inflation targeting and a floating exchange rate.
- Credible fiscal framework with low relatively low public indebtedness.
- High-tech-industry growing on the back of digitalisation

SWEDEN

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Swedish reform strategy after the crisis in the 1990's

- A tight macro economic regime based on price stability, an independent central bank and a prudent budget framework (Maastricht debt has been reduced from 66% 1998 to 40% of GDP).
- Reinforced incentives to remain in the labour market:
  - Radical reduction of taxes for low and middle income earners (10-20pe lower marginal taxes).
  - Reformed pension system with strong incentives to work and to remain active.
  - Reduction of unemployment benefits and tighter eligibility criterias for early retirement, sickness benefits and others social security.
- New regime for wage negotiations with a norm setting role for the export industry and decentralised wage settings.
  - A more flexible employment protection regulation for temporary employment.
  - Overhaul of the traditional active labour market programmes
- Reinforced demand for labour in the service sectors
  - Tax credit for household services, lower social security taxes for youth, reduced VAT-rate for hotels and restaurants

…but remains a cohesive green welfare state

- Improved **entrepreneurial** climate:
  - Wealth and inheritance tax has been abolished, the capital taxation for unlisted companies reduced and corporate tax cut to 22%.
  - Radical reduction of regulatory burden and increased competition in domestic market, including retail sales, household services, transportation, utilities, welfare and education.
  - EU-membership: access to the single market and open FDI-regime.
  - Large scale privatisation of state owned companies and market based governance for remaining SOEs.
  - Large investments in R&D and infrastructure.
- Sweden remains a **cohesive society** with large **welfare sector**, **low income inequalities**, a unionised labour market, a high degree of trust in government and institutions and high ambitions to build a **green sustainable** economy

Emerging new challenges: productivity and labour force participation

Israel has seen low productivity growth and have challenges on the labour market:

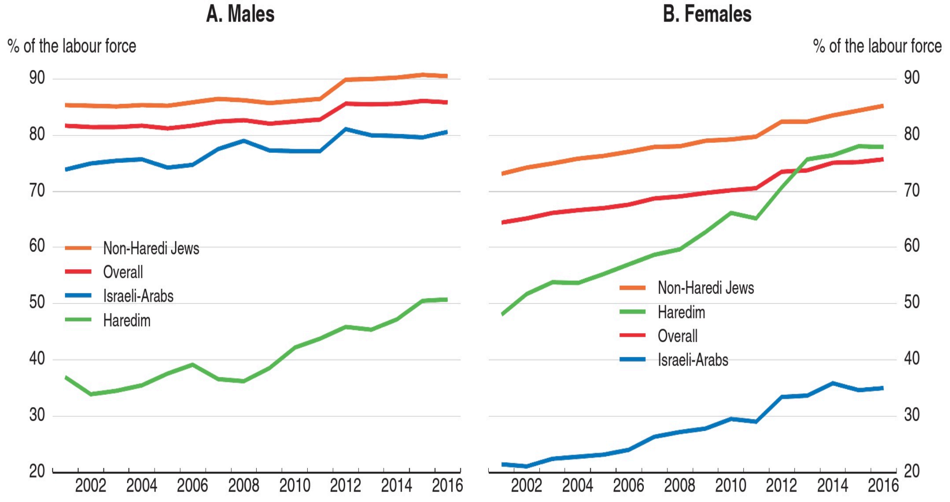
- Israel weathered the Great Recession well (GDP growth 3.1% and GDP per capita 1.1% since 2009,
- …but productivity growth has been slow in the aftermath (0.4% since 2007).
- Long term labour supply is a challenge, not the least to integrate the Haredim and Isreali-Arabs.

Sweden has seen low productivity growth and have challenges on the labour market:

- Sweden came out of the GR in decent shape, GDP growth 2.8% and GDP per capita 1.7 since 2009),
- …but productivity growth has been slow in the aftermath (0.7% since 2007).
- Long term labour supply is a challenge, not the least to integrate the community from the Middle East and North Africa.

Labour force participation will be major problem for Israel going forward

Participation rates have improved markedly, particularly for disadvantaged groups



Source: Ministry of Finance.

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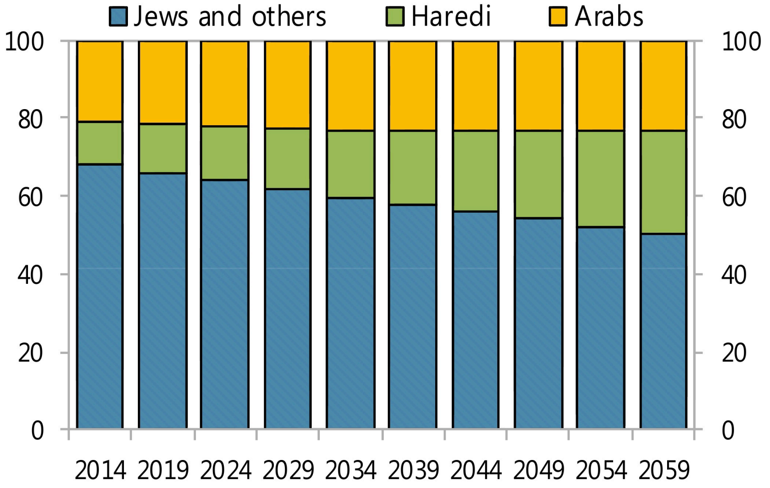
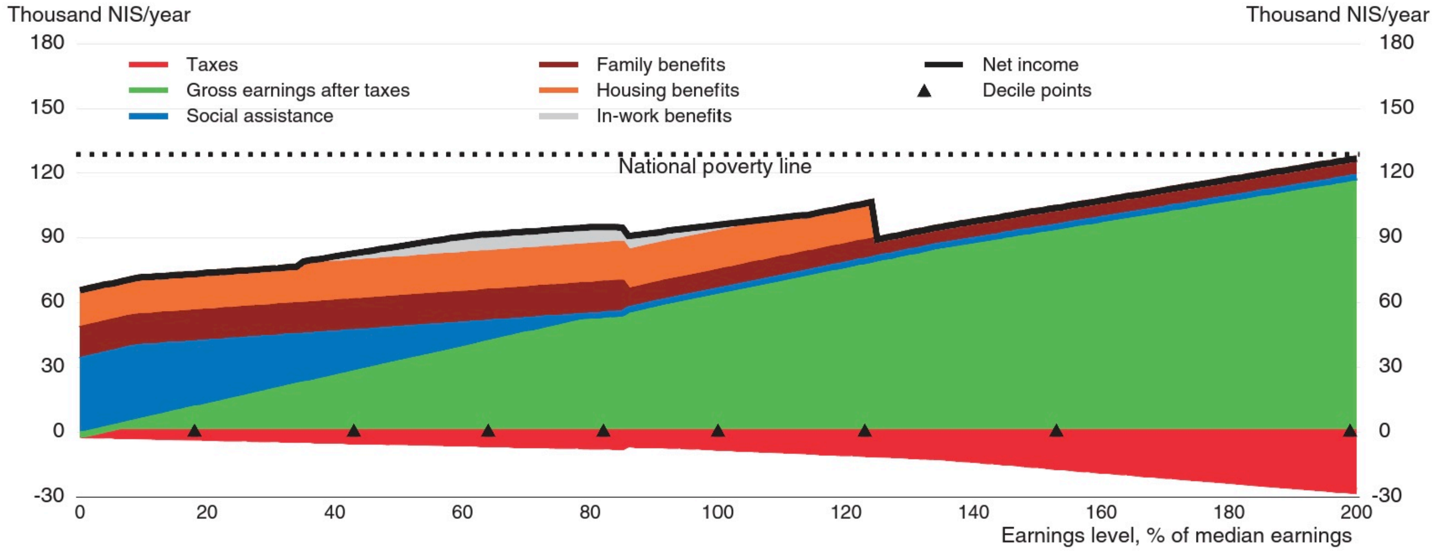
Population Composition: Official Projections

(Percent)

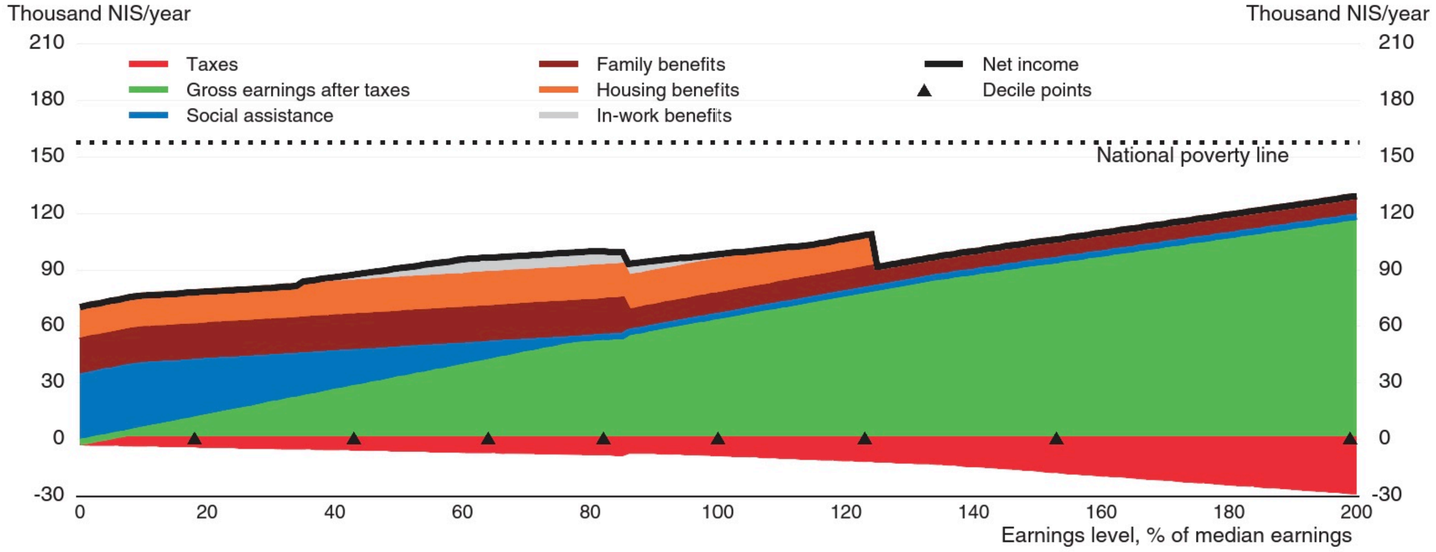


Sources: Central Bureau of Statistics; and IMF staff calculations.

Family with one breadwinner and four children



Family with one breadwinner and six children



1. One-earner couple where the breadwinner works 40 hours per week.

Source: OECD calculations using the OECD Tax-Benefit model.

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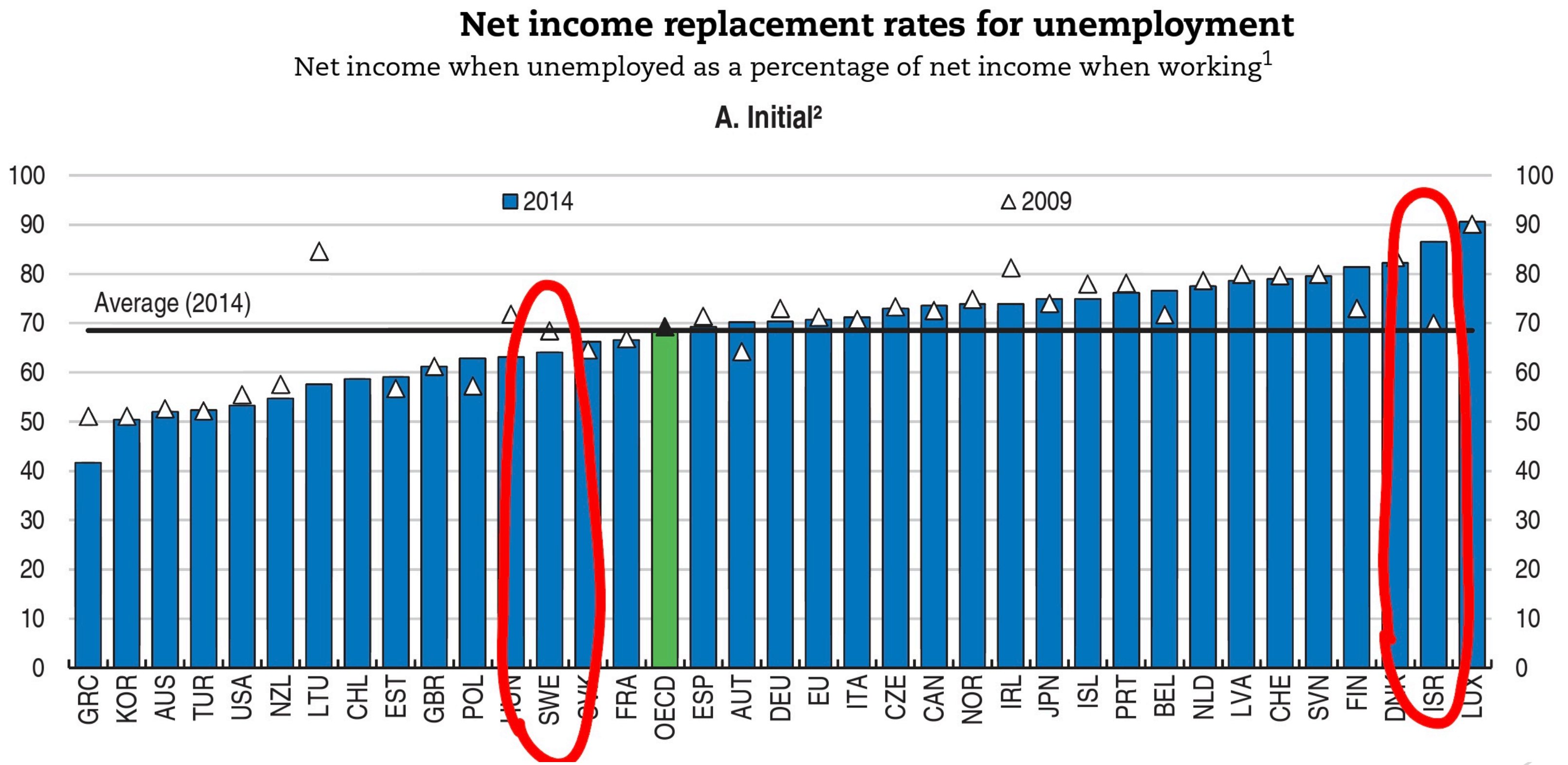
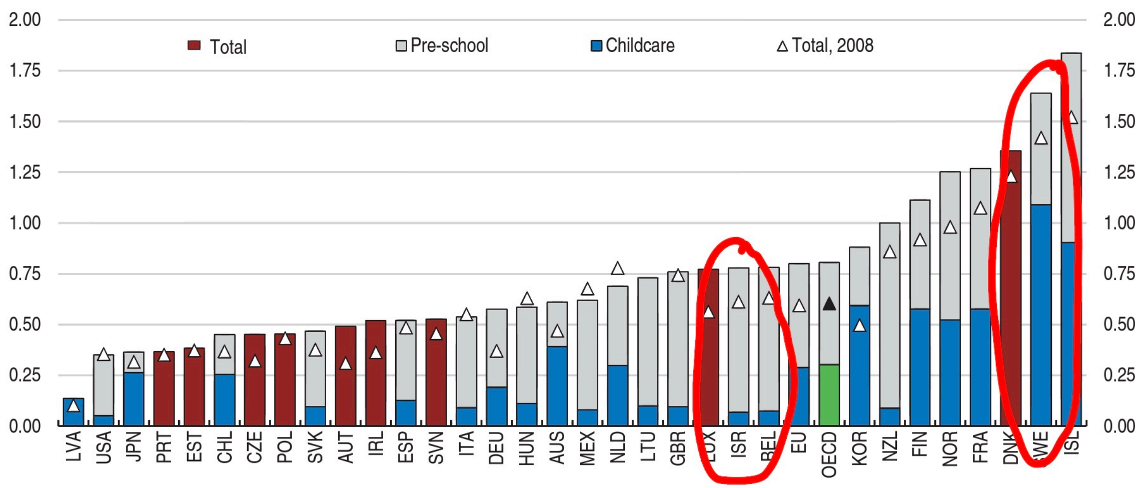
Benefit levels have an impact



Reforms to increase participation

- Labour force participation is a result of labour market institutions, education system, taxes, social security, EPL and cultural patterns.
- Welfare systems, that gives incentives to remain outside the labour market and encourages large families, should be reconsidered.
- Driving forces have to be adjusted:
  - Marginal taxes are low, but the earned income tax credit is much larger, more than 10 times, in Sweden.
  - Income and housing benefits support encourage large families and creates a poverty trap.
  - Minimum wages are very high in Israel. Is there a need to increase flexibility in employment protection?
- Underspending on child care: Improve the ability to speak Hebrew and conditioned on participation.
- Maternity benefits based on labour force participation should be considered.

Under-spending on child care



1. Childcare expenditure covers children under three enrolled in childcare and children between the ages of three and five enrolled in pre-school. Childcare refers to formal day-care services, such as day-care centres and family day-care. Pre-school includes kindergartens and day-care centres which usually provide an educational content as well as traditional care for children (ISCED 0 under UNESCO's classification system). Local government spending may not be properly captured in the data for federal countries. For Austria, Czech Republic, Denmark, Estonia, Ireland, Luxembourg, Slovenia, Poland and Portugal, the data cannot be disaggregated by educational level.

Source: OECD, *Family and Social Expenditure Databases*.

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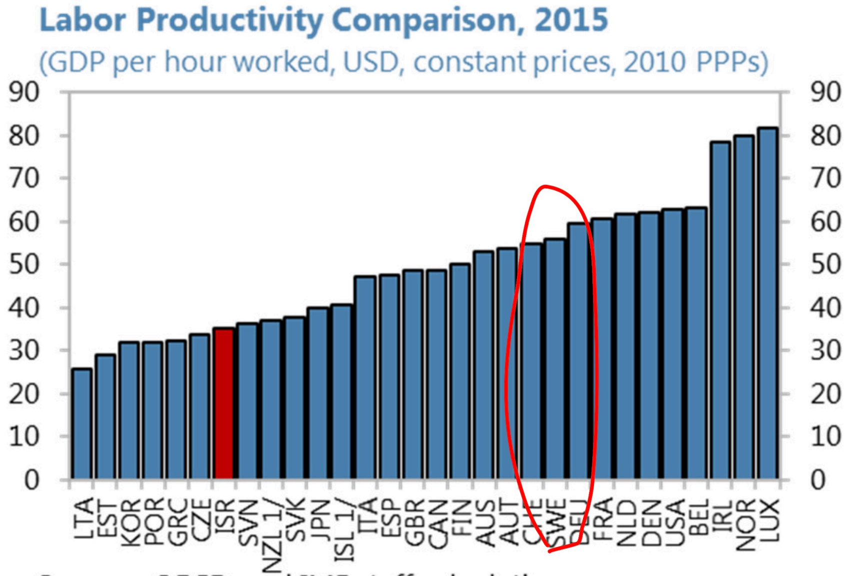
Large potential to improve productivity level in Israel

- Productivity growth has been very weak the last decade.
- Other small open economies indicate a large potential for improvement.
- Productivity is high in the manufactoring/export sector and low in the domestic sector



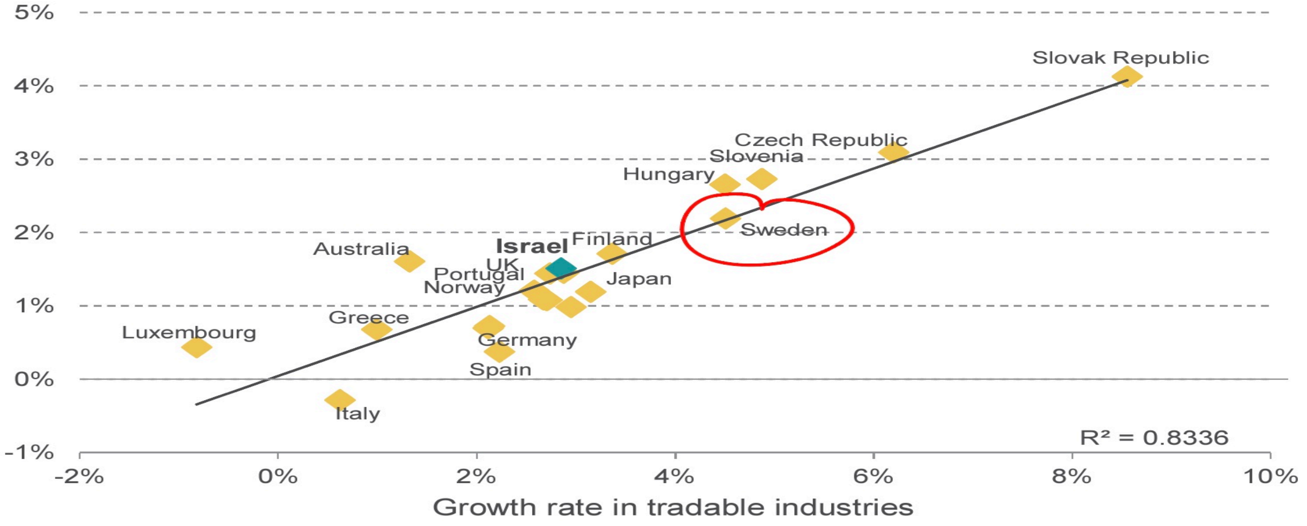
Sources: OECD; and IMF staff calculations.
1/ 2014 data is used due to data availablity.

The relationship between productivity growth in the business sector and productivity growth in tradable and non-tradable industries

Average growth rate from 1995-2015 in real terms

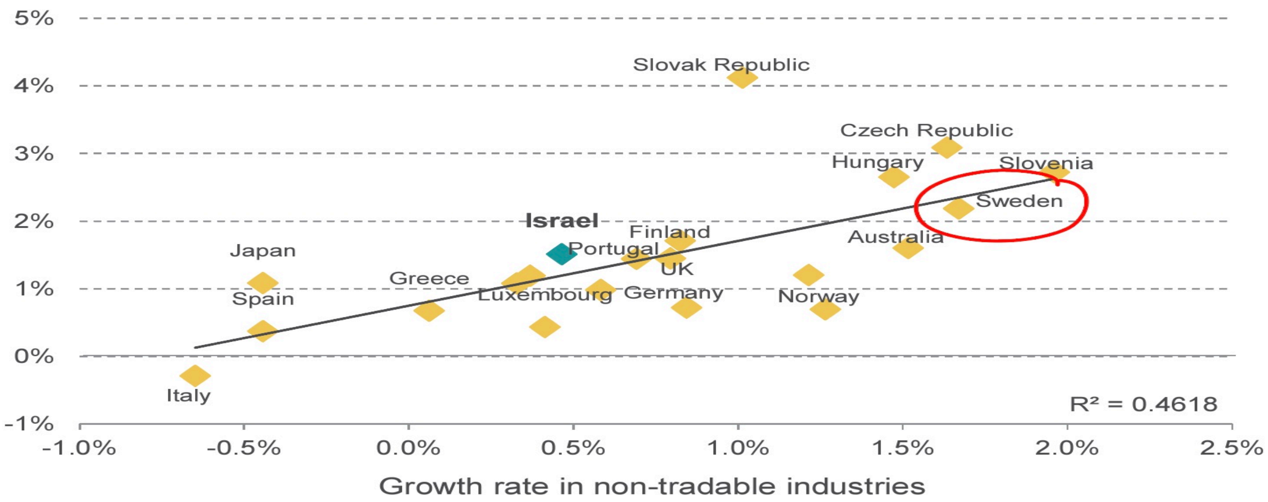
Tradable industries

Productivity growth rate in business sector



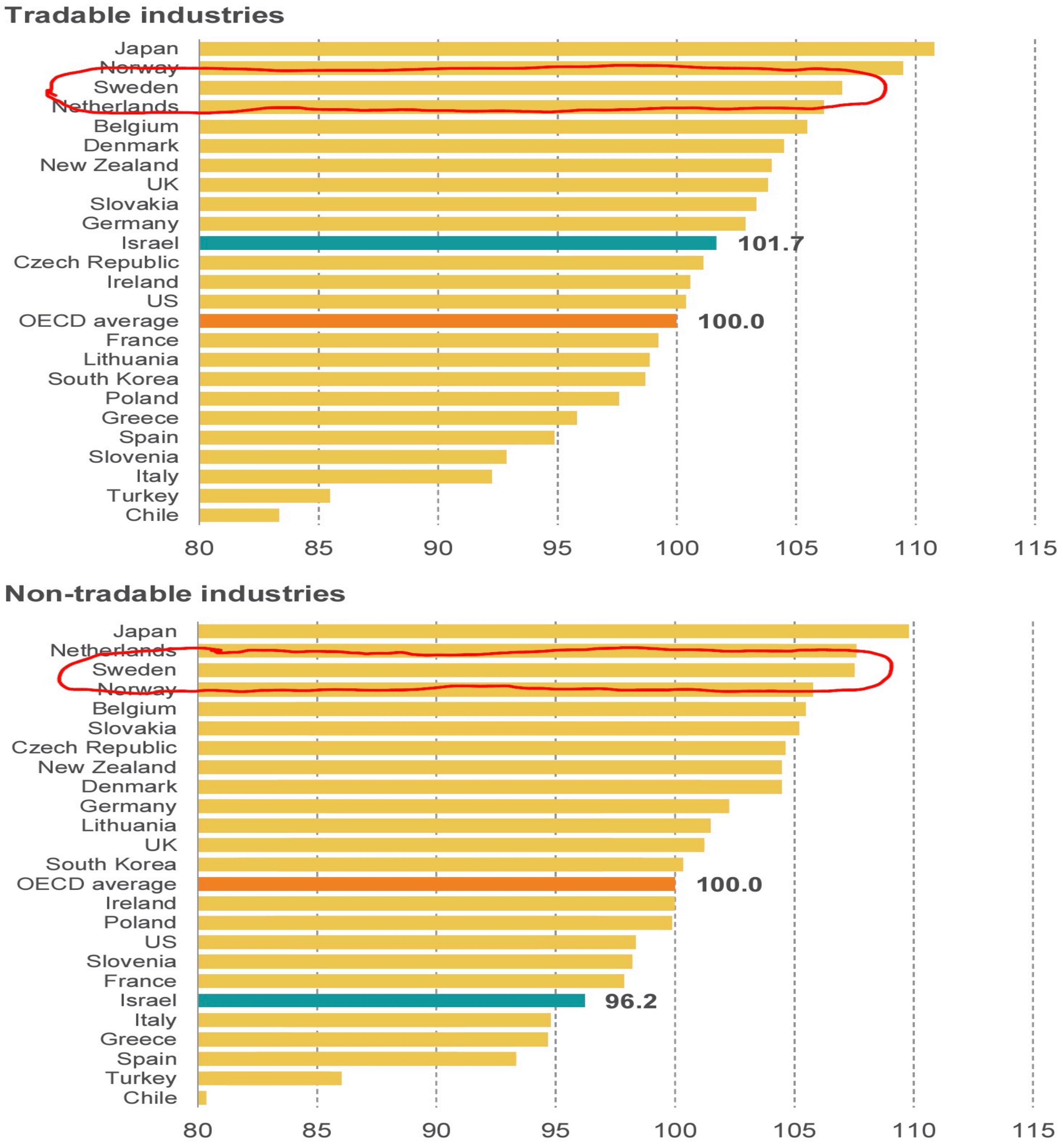
Non-tradable industries

Productivity growth rate in business sector



Skill level of workers in the business sector

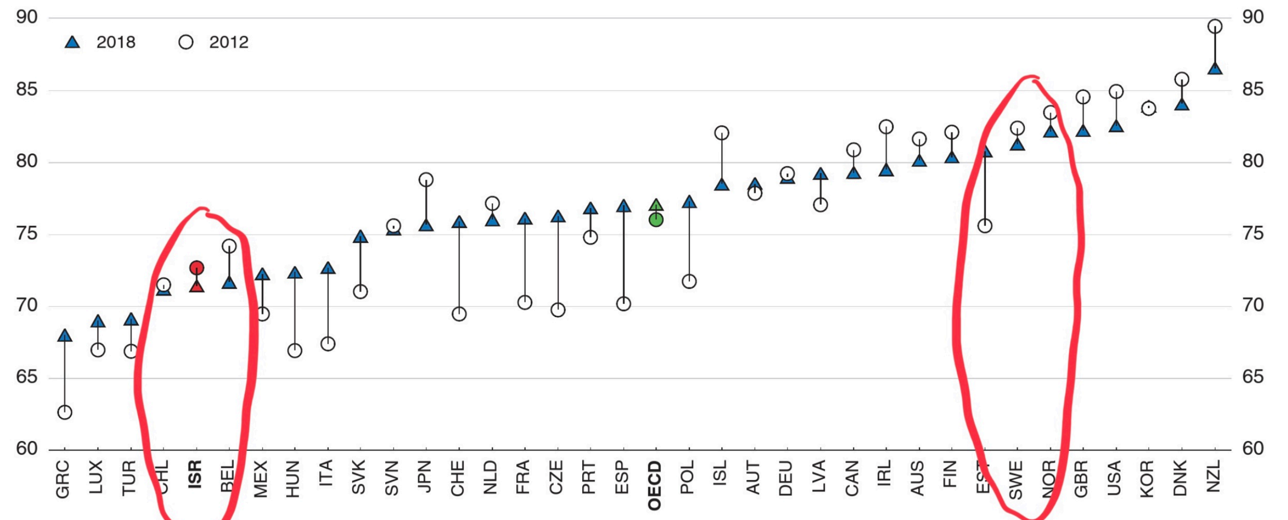
Achievement on the adult skills exam (PIAAC), average of 24 countries = 100



Is Israel over-regulated?

Israel's business environment remains less favourable than in other OECD countries

Distance to frontier, from 0 (worst performance) to 100 (best performance)



1. The distance to frontier helps assess the absolute level of regulatory performance over time. It measures the distance of each economy to the "frontier", which represents the best performance observed on each of the indicators across all economies in the Doing Business sample since 2005.

Source: World Bank (2017), *Doing Business 2018: Reforming to Create Jobs*.

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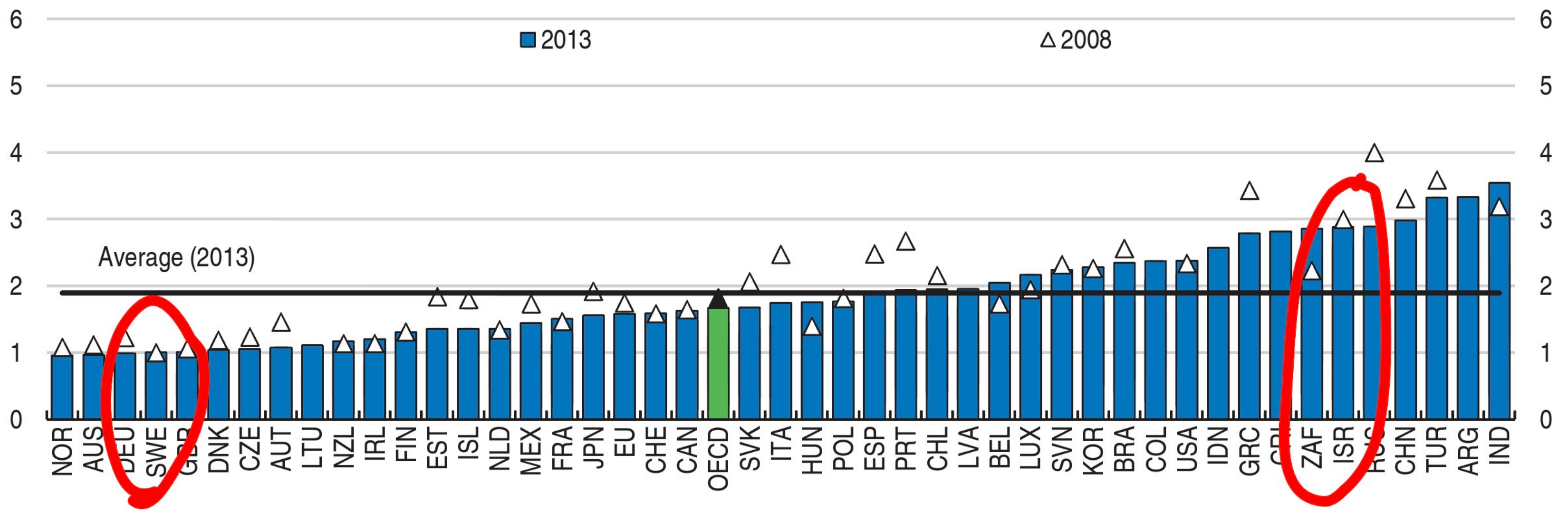
Excessive government involvement

State control: involvement in business operation



Source: OECD, *Product Market Regulation Database* and Koske, I., I. Wanner, R. Bitetti and O. Barbiero, (2015), "The 2013 Update of the OECD Product Market Regulation Indicators: Policy Insights for OECD and non-OECD Countries", *OECD Economics Department Working Papers, 1200/2015*; *OECD-WBG Product Market Regulation Database* for Argentina, Colombia and Costa Rica.

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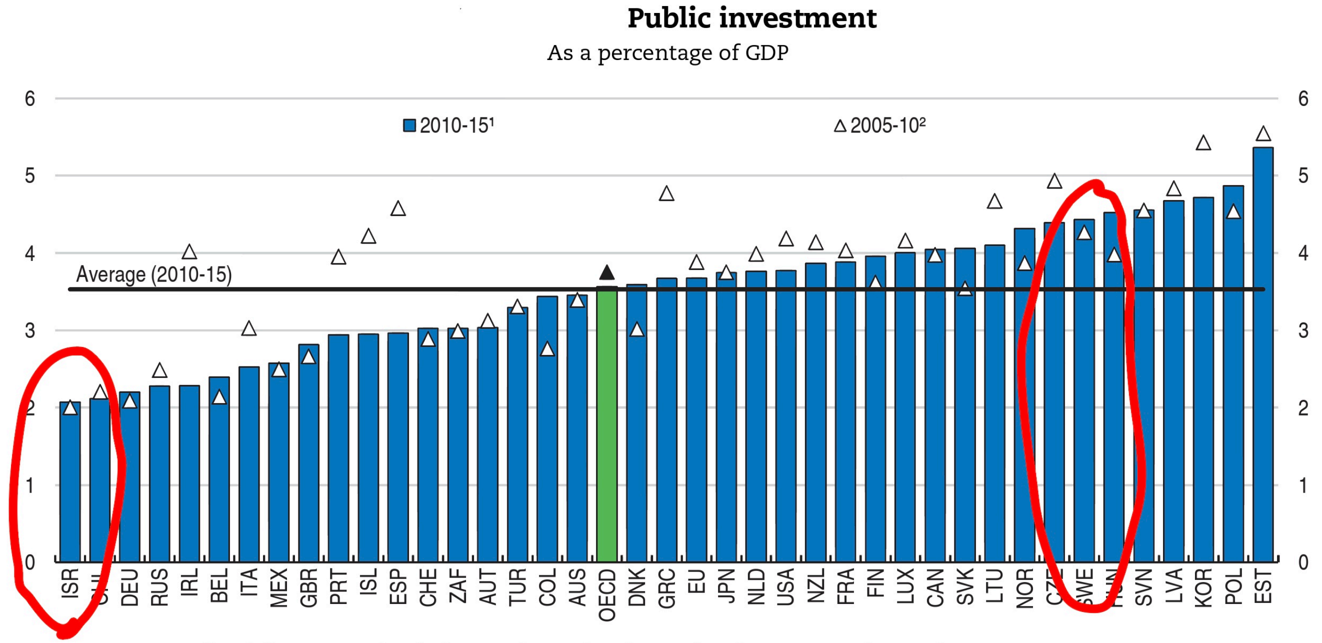
A systematic approach to deregulation is necessary

- Crucial to start a systematic and sustain effort:
  - A government commission on deregulation should be set up and co-operate with the World Bank on evaluating Cost of Doing Business
  - Domestic sector, particularly retail, needs to be overhauled.
  - Regulatory barriers to enter hinders entrepreneurship.
  - Regulatory barriers drives up cost level for consumers.
  - Deregulated sectors increase productivity and employment during a period.
  - Technological frog leaping should be encouraged.

Under-investments in infrastructure



1. Average 2010-14 for Chile, New Zealand, the Russian Federation and Turkey; 2010-13 for Mexico.
2. Average 2006-10 for Turkey.

Source: OECD, *Economic Outlook Database*.

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Systematic approach to infrastructure investments

- Systematic long term planning is necessary
  - Infrastructure plans should be for at least a decade
  - Systematic cost-benefit approach to priorities project
  - Open and transparent procurement important
  - Invite international competition
- Congestion fees and CO_2-taxes are a efficient way to increase investments
- Privatisation of land can be used systematically to improve infrastructure investments
- Urbanisation should be supported

Call for action, serious challenge ahead

- GDP per capita growth has slowed down and will deteriorate even further in the long run (GDP per capita to 0,7% to and TFP to 0,4% to 2065 according to BoI).
- Potential to improve growth with structural reforms are substantial (roughly 20%).
- Structural problems reinforce each other: over-regulated domestic sector, low labour market flexibility and weaknesses in the education is a toxic combination.
- Skill level of the domestic sector is low and mobility between the export and the domestic sector is low.
- Better education, de-regelation and labour supply reforms narrows the productivity gap and increase mobility