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Policy Guidelines for Boosting Labor Productivity in Israel

Working Group

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Abstract

- Today, per capita GDP in Israel is about 88% of that in OECD countries and about 62% of that in the United States. Since 1995, these disparities have narrowed by 4%–6%.
- Disparities in per capita GDP are measured in terms of those in employment and labor productivity. The **entire** gap between the Israeli GDP and the OECD and US averages **stems from a disparity in labor productivity**.
- The gaps in the employment rate between Israel and the OECD and US averages (approx. 3% and 9% in 1995) have closed, because the employment rate in Israel has increased. If the employment targets adopted by the government for 2020 are met (and this seems likely, based on policies and data), **the employment rate in Israel will be higher than in most developed countries**. This is definitely a significant achievement registered by the Israeli economy over the past decade.
- In 2013, labor productivity in Israel, measured as GDP per hour of work, was about 77% of the OECD level and 55% of the US level. The productivity gap has not narrowed since the 1990s and is actually widening relative to the US. **Both the average level of productivity in Israel and the rate of growth in productivity are low relative to those in the developed countries**.
- An analysis of the aggregate data, following conventional economic methods, indicates that the widening disparities in productivity stem from two factors: **a low rate of capital investment and a low rate of overall technological development and production efficiency (total factor productivity)**. The level of education as a measure of human capital is not a significant factor in explaining the productivity gaps that developed in the past.
- **A comparison by sectors indicates that productivity rose by 3.3% annually in the industrial sector (1960–2011), but by only 0.2% on average in the commercial and business-services sectors, where it has remained almost unchanged since 1990**. These differences between the sectors are also expressed in disparities in wage growth; in fact, the growth in inequality is fully consistent with the different productivity rates of the various sectors.
- **Studies conducted in Israel and abroad indicate that investment in R&D is strongly correlated with growth in productivity;** the impact on the economy even exceeds the impact on the individual firm (positive externality). R&D investments in Israel are focused in high-tech; it hardly exists in traditional industries, in the service sectors, and in commerce. The level of R&D investment in these latter sectors is low relative to investment in industry.

- **Government support for R&D through the Office of the Chief Scientist has declined considerably (from about 2.4% of industrial production in 2000 to 1% of industrial production in 2014).**
- Business sectors with low human capital are mainly local producers in the fields of traditional industry, commerce, construction, and other services. To some extent, these are also the sectors with a particularly low level of competition from identical imported products.

Some claim that commercial entrepreneurship in Israel aimed at domestic marketing of products has been negatively affected hurt by the general hostility towards entrepreneurship, particularly in local business rather than in high-tech initiatives that target international markets. Such a hostile atmosphere is liable to exert a strongly negative influence, especially in a free and open economy like that in Israel today. The portfolio of overseas assets owned by Israeli consumers and companies is larger than foreigners' investment in Israel. This phenomenon may have negative repercussions for investment in Israeli businesses and the ability to boost productivity and growth in Israel. It should be noted that an economy cannot grow in the long run based solely on investment in companies that export.

Key policy recommendations:

- The Ministry of the Economy and the Ministry of Finance should **formulate a detailed multiyear work plan with defined productivity targets for primary and secondary sectors** and action in the following fields:
  - **Expanded investment grant programs to allow companies to acquire technological improvements that boost labor productivity**. These programs should include accelerated depreciation and tax rates comparable to those set for export sectors.
  - **Increased funding by the Office of the Chief Scientist for R&D in industry, especially for traditional industries and other sectors**
  - Lower taxes on capital in sectors with high taxation and **a uniform tax rate on capital in all sectors**.
  - **Investment in human capital in technical and other professions** at a level similar to that provided to college and university students, and in all fields, with employer participation; in particular, development of training programs in traditional industries, construction, and computer use, and adoption of advanced technologies for high-school graduates and discharged soldiers who enroll in private or public vocational training frameworks rather than in institutions of higher education.
  - An end to **entry permits for foreign workers** in agriculture and construction, a limit on the entry of Palestinian workers, and a ban on the employment of unlicensed foreign workers.

  - Identification of competitive failures in the various sectors of the economy and their opening up to international commerce, while maintaining competition between importers and local service providers.

- **Support for small and medium-sized businesses by the removal financial impediments and bureaucratic obstacles**. This includes developing the possibility of credit ratings and competitive access to the capital market for small and medium-sized businesses.
- **Formation of a taskforce in the Ministry of Finance, led by the director general, to improve Israel's rank in the World Bank's Doing Business index, so that Israel will be among the top ten countries** in all fields and particularly in the overall index. Israel should also aim to become one of the top ten countries in the Davos World Economic Forum's index of competitiveness.