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The Eli Hurvitz Conference on Economy and Society

November 3–4, 2014

Dan Carmel Haifa Hotel



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Foreword

Foreword

The Eli Hurvitz Conference on Economy and Society (formerly the Caesarea Economic Policy Planning Forum), now in its 22nd year, has established a unique tradition of professional, reliable, profound, and unbiased deliberations about core issues of Israeli public life. Over the years, it has dealt mainly with the appropriate socioeconomic policy for the government to adopt. In recent years we have witnessed a substantial improvement in government ministries' ability to plan and define policy. That is why this year we chose to focus on the executive branch's ability to get things done and its influence on the economy, starting from the understanding that the government's ability to implement the policies it has decided on is currently the greatest challenge on the road to increasing economic growth, reducing social gaps, and dealing with the root problems of Israeli society and the Israeli economy.

The annual conference is the pinnacle of extensive work that included meetings with decision-makers and the sessions of six heterogeneous research groups that drafted policy recommendations in six areas: regulation, legal corruption, innovation, education, civil service personnel, and productivity. Each of the research groups addressed a different aspect of the government's ability to get things done—latitudinal topics and test cases ranging from devising policy to implementing it.

1. **Regulation.** Traditional “command and control” regulation is the prevalent method of regulation in Israel today. The relations between the public, the regulatory authority, and the regulated entities are characterized by a high degree of mutual distrust. This climate of distrust hampers the government's ability to operate, because it must invest great efforts in formulating detailed rules and in measures for enforcing them. The business sector's distrust of the government is a disincentive for investment in areas that will be strongly affected by future regulation, which is inconsistent and unpredictable. There are also heavy costs entailed in complying with specific rules and in reporting on their implementation. The working group, directed by Dr. Assaf Cohen, maintains that the addition of self-regulation and co-regulation to the regulator's toolbox would be an important step towards enhancing the government's ability to get things done and industry's ability to make plans and carry them out. It would also help develop trust between the regulator and the regulated entities.
2. **Legal Corruption.** Boosting the effectiveness of the public sector is considered one of the most significant reforms a government can pursue in order to help raise the quality of life and standard of living. Rampant public corruption severely compromises a government's ability to achieve this objective and undermines the performance of the public sector. The working group, led by attorney Yoav Segalovich, focuses on legal corruption, sometimes referred to as “white corruption” (actions perceived by decision-makers and public opinion as tolerable corruption, even though perhaps they should not be tolerated) and as “gray corruption” (actions about which there is no consensus among decision-makers and public opinion as to how corrupt they are). Their report proposes an initial framework for understanding the causes of legal corruption and strategies for dealing with it.
3. **Innovation.** In most countries, strategies for growth and social development increasingly emphasize innovation as a key factor in ensuring comprehensive and sustainable growth. When

it comes to innovation, Israel's ability to leverage its many advantages (including an innovative culture, knowledge-based industry, an educated society, and a strong global brand) and forge a growing and evolving socioeconomic system that serves all its citizens requires action in both the global and local arenas. The working group, led by Dr. Leonid Bakman of the Israel Innovation Institute, identifies innovation as a broad and multidimensional arena that is not restricted to high-tech and proposes a program based on existing support mechanisms.

4. **Education.** The Ministry of Education, backed by the government as a whole, has a longstanding commitment to equal opportunity in education and to eliminating disparities in the education system. It recognizes that achieving this objective requires affirmative action so that differential budgets will provide a solution to the special needs of pupils from impoverished socioeconomic backgrounds. The report drafted by the working group, which was headed by Prof. Moshe Justman of the Van Leer Jerusalem Institute, presents the underlying principles of differential funding of the education system, looks into why previous attempt to implement it have met with only limited and inadequate success, paints the current picture, and suggests principles for differential funding that could deal with the challenges that have stood in its way thus far.
5. **Human Resources in the Public Service.** The working group, led by Doron Cohen, focused on possible tools for improving the Israeli civil service, especially service units and their personnel. Its report examines how the service provided to citizens can be enhanced, starting from the idea that the public administration in Israel can realize its potential for greater efficiency by paying attention to two important aspects of revamping the organization from the ground up. The first aspect is the need to improve the motivation for public service; the second, to improve the performance of the field units—that is, the units that actually provide services—and to assess their output by integrating external evaluation (by the public and interested parties) with internal evaluation (by workers and managers).
6. **Productivity.** Average productivity in Israel and its rate of growth are low relative to those in the developed world. It is true that the employment gap between Israel and most of them has been closed, but the same is not true of the disparity in labor productivity, which has if anything grown larger. The working group, led by Prof. Zvi Eckstein, focused on the causes of low productivity—a low level of capital investment, of overall technological development, and of efficient production—and drew up policy recommendations for increasing productivity in Israel.

We will meet, listen, and express our own views in the plenary sessions, working groups, and official and unofficial gatherings. All of us—government ministers, Knesset members, senior ministry officials, academics, private sector executives, and journalists—will roll up our sleeves and work to enhance the economic and social resilience of the State of Israel.

Hoping to see you at the conference,

Yarom Ariav

Director, the Eli Hurvitz Conference on Economy and Society

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Legal Corruption

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Legal Corruption

Working Group

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Abstract

Boosting the effectiveness and productivity of the public sector is considered one of the most significant reforms a government can pursue in order to help raise the quality of life and standard of living. There is no doubt that rampant public corruption severely compromises a government's ability to achieve this objective.

The level of public corruption in Israel, relative to the world, as expressed in indexes that examine the level of corruption perceived by experts and the public and indexes that examine factors related to corruption, such as the ease of doing business, is not encouraging. Efforts should be made to curb corruption wherever it exists, because the repercussions of the various patterns of corruption—including injury to human life, profound harm to democratic values, damage to the national economy and the wellbeing of citizens, reinforcement of inequality, and a decline in trust vis-à-vis government institutions—are extremely negative.

Israeli society ostensibly faces a cruel choice between governance and incorruptibility. On the one hand, intensive government action coupled with broad discretionary powers leads to government corruption and public scandals; and on the other hand, strict adherence to incorruptibility, rules, procedures, oversight, and enforcement (in other words, a fight against public corruption) can lead to a lack of governance, paralysis, and harm to democracy. Our working assumption is that it is possible to achieve both governance and incorruptibility and that we should aspire to achieve both.

In order to produce an ability to govern while at the same time preventing corruption, we propose creating a new Israeli ethos about public corruption. This ethos would require a new systemic and multidisciplinary approach that takes account of economic, organizational, managerial, psychological, and cultural aspects instead of the patchwork approach that is standard in Israel today.

Unfortunately, Israeli society's attention tends to be focused on combating criminal corruption (illegal, of course) through traditional means of legislation, enforcement, and punishment. But there is also public corruption, which is multifaceted. One feature of public corruption is that it can be lawful. This raises fundamental questions, such as: How should we regard large contributions to a candidate for public office that are designed to influence the way the candidate performs his or her job if and when elected? How should we relate to lobbyists who curry favor with a particular elected official? How should we relate to a senior official in a public organization who gives preferential treatment to the organization's donors?

This paper focuses on "white corruption" (actions perceived by decision-makers and public opinion as tolerable corruption, even though perhaps it should not be tolerated) and "gray corruption" (actions

about which there is no consensus among decision-makers and public opinion as to how corrupt they are). The assumption is that “black corruption” (actions perceived as corrupt by both decision-makers and public opinion) is handled by the law-enforcement system. Legal or institutional corruption has a systematic and strategic influence, which is legal and may even be considered to be ethical at a particular time—and which undermines the effectiveness of a public institution by diverting it from its purpose or by weakening its ability to achieve its objective. This may include undermining the institution’s inherent trustworthiness or the public’s trust in it.

The new conceptualizations of corruption emphasize that the causes of corruption do not necessarily include decision-makers’ and public officials’ deficient morality. Instead, these factors are rooted in the institutional structures and the political culture. Severe punishment does not suffice to reduce and eliminate corruption. Rather, it is essential to identify the deep-rooted factors that sometimes lead even those who are basically honest to act improperly. Action must then be taken to change the institutional structures and culture that engender legal corruption.

In order to effect the desired change in institutional structures and culture, essential questions must be addressed: What can be done to foster an ethos of faithfulness to the public? How can elected officials and public servants be made to understand the great importance of efficiency and fairness in performing their jobs, contrary to the approach that views a public position as a means for acquiring personal benefits or ensuring personal survival?

The professional literature on the topic of legal corruption is still in its infancy. This paper proposes an initial framework for understanding the factors behind legal corruption and describes strategies for addressing it.

The proposed model distinguishes among several types of corruption:

- Individual rational corruption, stemming from the expectation of benefit versus the slight chance of being caught and punished
- Individual dispositional corruption, stemming from personality traits that make a person more inclined to cheat
- Institutional corruption, caused by institutional flaws that pose difficulties for officials and cause them to act improperly
- Corruption as dependence, found when a public institution is inappropriately dependent on certain entities
- “Political” corruption as the result of power struggles between interest groups.

Strategies for the solution include:

Legal Corruption

- Conservative strategies of legislation, enforcement, and punishment
- Strategies of education and human resources
- Organizational and managerial strategies
- Economic strategies
- Consciousness strategies

A comprehensive and multidisciplinary approach to legal corruption could produce real change in the effectiveness of the public sector in Israel.

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Regulation

November 3–4, 2014 **Dan Carmel Haifa Hotel**

Expanding the Regulatory Toolbox: Trust Building and Co-Regulation

Working Group

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Research Assistant	Ms. Morin Hayo-Hemo , The Israel Democracy Institute

Abstract

The prevalent method of regulation in Israel is traditional “command and control” regulation. This type of regulation essentially entails placing rigid restrictions on economic activity by setting mandatory standards and prohibiting certain activities; these measures are also accompanied by the threat of various types of sanctions (criminal, administrative, and so on). In general, the extent of government involvement in formulating and implementing regulations ranges from extensive (command and control) to minimal (self-regulation). In Israel, the regulatory involvement of the government is substantial. However, there are a number of cases in which there is also self-regulation and co-regulation.

The relations between the public, the regulatory authority, and the regulated entities are characterized by a high degree of mutual distrust. The public fears that a close relationship between the regulatory authority and the regulated entity produces weak and “captive” regulation that favors private interests over the broader public interest. The government (the regulator) does not trust the regulated entity; this attitude sometimes dictates an aggressive formulation of new regulations, with very specific directives (micro regulation) and broad prohibitions. For its part, the regulated entity does not believe in the regulator’s sincerity, professionalism, or consistency.

This climate of distrust hampers the government’s ability to operate, because it must invest great efforts in formulating detailed rules and measures for enforcing them. The business sector’s distrust of the government is a disincentive for investment in areas that will be strongly affected by future regulation, which is inconsistent and unpredictable. There are also heavy costs entailed in complying with specific rules and in reporting on their implementation.

In these circumstances, it is understandable why the regulatory authorities in Israel do not promote approaches that include the regulated entity in the formulation and enforcement of regulations (self-regulation or co-regulation). The regulatory authority is afraid that the public may perceive self-regulation as a sign of the regulator’s weakness and that the industry may violate the trust placed in it and fail to achieve the objectives of the regulation. These fears prevent the realization of the benefits inherent in self-regulation. One of these benefits is closer familiarity with the sector, which enables more precise measures for achieving the goals than those drawn up by the regulator in the command and control method. In some cases, self-regulation also enables a reduction in the supervision apparatus and allows the regulatory authority to channel its resources to more useful places.

In appropriate cases, self-regulation tools can be an important means for enhancing the efficiency of regulation processes and the government’s ability to function. It can help build trust between the government regulator and the regulated entities and other stakeholders, with an optimum balance among the various interests. Co-regulation is based on relations of trust among the various

stakeholders, including the public, the regulators, and the regulated entities. Co-regulation cannot exist without relations of trust; such relations are hard to develop without the transfer of some responsibility from the government (with its command and control approach) to industry.

The inclusion of processes of self-regulation and co-regulation in the regulator's toolbox is an important and significant step towards improving the government's performance and the industry's ability to plan and operate, as well as towards building relations of trust between the regulatory authorities and the regulated entities. In addition to the adoption of self-regulation and co-regulation when appropriate, the team recommends efforts to improve the relations of mutual trust between the various entities during consultations about new regulations.

The team recommends:

1. Publication of a predefined work plan that focuses on the issues and fields the regulator will address in the coming years, pursuant to the general work plan of government ministries. The team also recommends consulting with the various stakeholders. Publication of the work plan and consultation with stakeholders will enable the regulated entities to prepare in advance and increase their certainty and the regulatory expectations. Of course, this would not detract from the regulator's power to initiate new regulations as needed, as a function of changing needs, even if they were not envisioned in the work plan.
2. Creation of system-wide mechanisms to facilitate the rapid and accurate flow of information and to prevent miscommunication and inaccurate or slanted information that undermine trust
3. Assignment to the relevant regulatory authority of responsibility for setting, implementing, and enforcing policy in a particular field and defining the mix of regulatory instruments. Nonetheless, stakeholders and the public, including the entities to be regulated, should be allowed to propose tools of self-regulation or co-regulation to help attain the policy objectives, as an alternative to traditional regulation.
4. Expansion of the processes of consultation among stakeholders as part of the improvement of trust and enhancement of the government's ability to function. There are two stages here:
 - A. The preliminary stage: In this stage, the problem and the regulatory objective will be presented to all relevant parties and the public. This is intended, inter alia, to clarify aspects of what is needed and to elicit proposals for a solution.
 - B. The hearing stage: In this stage, hearings will be held on the proposed solutions drafted by the regulator.

The discussions will be as transparent and open as possible. In the preliminary stage, the regulator will have no obligation vis-à-vis the regulated entity with regard to the suggestions. The latter will have to recognize that it is a preliminary stage aimed solely at improving the process of deliberation—in contrast to the official hearings, at which the regulator will address such concerns.

5. Formulation of the principles of self-regulation or co-regulation in accordance with the principles of “better regulation”: proportionality, accountability, consistency, transparency, and definition of goals.
6. The drafting by the regulator of guidelines for co-regulation, as needed.
7. Constant examination by the regulator as to whether the self-regulation or co-regulation ensures the protection of the relevant public interest and the public good and helps achieve the policy objectives. In this context, the regulator will study the implementation of the self-regulation or co-regulation and the means employed to enforce it. If it is found that the self-regulation or co-regulation fails to protect the public interest and the public good, or does not achieve its goals, the regulator will move to apply other instruments from its toolbox.
8. In order to strengthen public trust in the mechanisms of self-regulation or co-regulation, examination of the possibility of government review of self-regulation. In appropriate cases, the extension of official government sponsorship to self-regulation will also be examined, as will the possibility of involving independent third parties in shaping and enforcing self-regulation.

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Innovation

November 3–4, 2014 **Dan Carmel Haifa Hotel**

Innovation as a Key Factor in Inclusive and Sustainable Growth

Working Group

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Abstract

In most countries, strategies for growth and social development increasingly emphasize innovation as a key factor in ensuring comprehensive and sustainable growth. The economic and social challenges—such as ensuring sources of energy and food, an aging population, and socioeconomic disparities—tend to be marked by complexity, cross-system dependency, and uncertainty. Therefore, an ability to think and act outside existing paradigms and to translate possible ideas into valuable products is a key element in the development of states, organizations, and individuals.

When it comes to innovation, Israel has many advantages, including an innovative culture, knowledge-based industry, an educated society, and a strong global brand. To leverage these assets and foster a growing and evolving socioeconomic system that serves all its citizens, Israel must take action in both the global and local arenas. **The idea presented here is that innovation is broad and multidimensional and not limited to technology. In this context, the proposal builds on existing support mechanisms and focuses on adding two levels of activity that go beyond support for R&D.**

- **In the world arena,** we should continue to position Israel as a center of innovation for global challenges. When international innovators (countries, companies, scientists, and investors) look for a place to develop and test innovative solutions, Israel should be a competitive choice. Realization of this vision would enable Israel to be a leader in the next stages of the knowledge revolution and thus make a significant contribution to the country and the world.
- **In the local arena,** realization of the dream depends on our ability to improve the government's ability to promote innovation environments and to expand this process into a comprehensive national effort. In the spirit of the digital revolution, we argue that Israel's ability to leverage its unique qualities and translate them into a sustainable competitive status demands modification of the "operating system" of government institutions as well as cross-sector collaboration. The term "operating system" is meant to convey the depth and multidimensionality of the required change. The government must become a facilitator that works to develop innovative infrastructure, forward-looking regulation, and cross-sector integration that catalyze the activity of the free market and reinforce it in fields of national importance.

In order to meet these challenges, we must spread the practice of fostering innovation, while developing a pluralistic and decentralized network of knowledge and implementation centers. Each of these, in its own way and in its own context, will contribute to Israel's development as a center of innovation. This document calls for getting all government and civil-service entities to engage in practices that foster innovation and for utilizing these practices as a tool for achieving defined organizational and national goals.

As a basis for meeting this challenge, the authors recommend action in four complementary areas:

1. **A community of innovators**, to steer the country in pioneering directions by preparing a systematic, organizational, and conceptual infrastructure
2. **Organizations as catalysts of innovation, so that** the public sector facilitates and promotes innovative activity
3. **Living laboratories** in fields that are experiencing paradigmatic change worldwide, by supporting the establishment of consortia of partners from complementary content worlds; for example, service providers, a leading business entity (one or more), and academic and government institutions. Working together to develop enabling infrastructure and an effective interface between the various agents of innovation, the partners will increase the efficiency of entrepreneurs, companies, researchers, and policymakers in the particular field of activity.
4. **Fields of national importance as catalysts of innovation**, developing national nuclei of innovation in fields marked by a defined local need, a global trend of paradigmatic change, and the feasibility of developing a broad coalition for consolidating local activity.

Upgrading the government “operating system” is a difficult and complex task. Adding a proactive dimension to policy planning, developing abilities for interministry and cross-sector collaboration, and granting legitimacy to trial-and-error policy tools are all essential components the government should add to its pool of abilities. Israel has the culture and consciousness needed to support this change. The change will begin with the rapid launch of several test cases and their subsequent expansion to work processes that cut across government ministries and agencies. The success of the process, in our view, will preserve Israel’s standing as a powerhouse of innovation and lay a strong foundation for socioeconomic development in the coming years.

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Education

November 3–4, 2014 **Dan Carmel Haifa Hotel**

Differential Budgeting in Israeli Education

Working Group

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Abstract

On international tests such as the OECD Program for International Student Assessment (PISA) and Israel's own standardized national tests (GEMS), Israel exhibits greater inequality in outcomes than most other OECD countries. This inequality is strongly correlated with the student's socioeconomic background.

The Ministry of Education, backed by the government as a whole, has a long-standing commitment to equal opportunity in education and to closing the gap between rich and poor in an education system that is publicly funded almost in its entirety. The ministry has always understood that this requires investing additional resources in children who have greater needs as a result of their deprived socioeconomic background. Indeed, this principle has been reiterated and fleshed out by two prominent public commissions established by the ministry to investigate this issue—the Shoshani and Dovrat commissions. (Dr. Shimshon Shoshani served three terms as director general of the Ministry of Education; Shlomo Dovrat is a prominent businessman with a long history of involvement in education.) This principle has also been embodied in various funding formulas used by the ministry over the years, including the current "Strauss formula."

In practice, however, the very modest level of differential budgeting clearly falls short of the far-reaching recommendations of these two prestigious government commissions—and of public expectations. The Strauss formula is applied only to hours of instruction in primary and middle schools and is limited to 5%–7% of the budget. It does not apply to earlier or later stages of schooling or to other expenditure lines.

Moreover, this very modest degree of differential budgeting is offset by the regressive pattern of contributions by local authorities to the schools within their own jurisdictions. There are no official statistics on the socioeconomic gradient of all spending on Israel's education system—this lack of a clear picture is part of the problem—but it cannot be ruled out that at least in parts of the system funding is actually regressive, with children from stronger socioeconomic backgrounds enjoying greater resources.

This report sets out the theoretical and empirical underpinnings for promoting equal opportunity in education through differential budgeting that compensates for socioeconomic deprivation; examines past efforts to try and understand why they were not as successful in practice as was hoped; surveys the current state of affairs; and proposes guidelines for differential budgeting that address the challenges that blocked successful change in the past.

The purpose of these proposed changes is to promote equality of opportunity in education in Israel and to reduce the correlation between students' educational outcomes and their socioeconomic background.

Two objective difficulties must be recognized in this regard. First, the preponderance of empirical evidence indicates that there is no direct link between spending and educational outcomes, but only links mediated by specific policy interventions: it is not how much is spent that matters, but what is done with the money. Second, education in itself cannot do all the work. Israel has among the highest levels of child poverty among the OECD countries. Educational gaps that result from children's socioeconomic background cannot be closed without addressing the huge socioeconomic gaps themselves.

In addition, past experience indicates that there are formidable political and bureaucratic obstacles that must be surmounted. The political obstacles derive from the need to change the allocation of resources to the population groups in Israel; specifically, increasing the share received by the two poorest segments—the Arab and the Ultraorthodox. This must necessarily come at the relative (and possibly the absolute) expense of the other streams that serve the more dominant elements of society and will likely entail a greater fiscal contribution by the more affluent local authorities to offset subsidies to poorer local authorities. The bureaucratic obstacles revealed by efforts to implement the recommendations of the Shoshani Report stem largely from opposition to budget cuts and to a reduction in the powers and influence of senior ministry officials.

Three key principles underlie the proposal. The first states the obvious: closing socioeconomically based education gaps is desirable only if it is achieved by improving the education outcomes of the disadvantaged and not if it means lowering the achievement of the more affluent. The second principle is transparency, which can be achieved only through a clear and simple funding formula, applied fairly to all. The proposed formula is predicated on a basic grade-specific per-student allocation, modified by loadings for special tracks (e.g., vocational studies), special ethnic or religious-based cultural and language needs, and socioeconomic deprivation, with extra allocations to small or geographically remote schools on a graduated basis. The third principle is that a viable policy must be seen to be effective. This entails, on the one hand, specifying the policy interventions for which the supplementary budget allocations for socially disadvantaged children are earmarked; and, on the other hand, measuring their success in terms of a lower correlation between educational outcomes, both positive and negative, and socioeconomic background.

In addition to these principles of policy design, no policy can be successful if it fails to firmly and explicitly address the political and bureaucratic obstacles to budget reform that stymied past efforts.

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Human Resources in the Civil Service

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Defining a National Strategy for Human Resources in the Civil Service

Working Group

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Abstract

This paper focuses on potential tools for improving the Israeli civil service, as reflected in the processes of evaluating government performance and boosting the motivation for public service—especially with regard to service units and their personnel. The team identified a significant global development in these fields and suggests engaging in comparable thinking in Israel that would contribute to enhancing and developing the civil service. We believe that it is very important to develop high standards of human capital, with an emphasis on quality and excellence; comprehensive assessment of performance is essential. We argue that an excellent civil service is built on a broad understanding of what makes for outstanding personnel. In a technologically, economically, and socially advanced world, our civil service needs the best people—in planning and staff roles, but also, and primarily, in field positions that are in close and direct contact with the public.

In Hebrew, we chose to give the position paper the title **Improvement from the Ground Up**. We examine how the service provided to citizens can be enhanced, starting from the idea that the public administration in Israel can realize its potential for greater efficiency by paying attention to two important aspects of revamping the organization from the ground up.

1. **The first aspect is the need to improve the motivation for public service**, identifying and recruiting the most suitable people and placing the best of them in the field units that come into direct contact with the public. We are only beginning to relate to the issue of motivation for public service, having finally come to understand that the problem exists. (Are the best people joining the ranks of government and public administration in Israel?) But we do not have sufficient tools for addressing this. Improving the quality of human capital in the service units would ultimately result in enhanced performance by government and the public administration.
2. **The second aspect is to improve performance in general and, primarily, that of the field units—that is, the units that actually provide services—and to assess their output by integrating external evaluation (by the public and interested parties) with internal evaluation (by workers and managers)**. Assessment of the service will provide a foundation of information and knowledge, standardization, and a common language, as well as a uniform basis for defining a reference point for quality service. In addition, the information collected will function as a management tool for staff work, planning, budgeting, and definition of goals and objectives. The results of the assessment will be used to compare service performance on various levels; for example, comparing different units, comparing services within a unit. and comparing types of target populations.

- ✓ Therefore, we recommend drafting a **master plan** whose primary objective will be to motivate high-caliber candidates to apply and make their career in the service units. This strategic plan includes:
- Developing a nucleus of professionals for civil-service jobs and defining the profile of service providers
 - Improving the processes for identifying the most suitable candidates for civil-service positions; designing and developing career tracks and a pool of future managers, in part by promoting outstanding workers and assigning them to senior positions
 - Formalizing the processes for assessing government performance; creating measurement and evaluation mechanisms and a specific system of compensation and incentives for civil-service positions
 - Establishing a national agency to evaluate the performance of the public sector in Israel and the government's success in meeting its targets.

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Productivity

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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.

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- 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.

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