

Poverty in Israel: Reasons and Labor Market Policy

Zvi Eckstein and Tali Larom*

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This is a short summary, for the full paper (in Hebrew) see

<https://www.idc.ac.il/he/research/aiep/pages/policy-papers.aspx>.

* Prof. Zvi Eckstein is Dean of the Tiomkin School of Economics and Head of the Aaron Institute for Economic Policy, Interdisciplinary Center Herzliya, zecsktein@idc.ac.il. Dr. Tali Larom is a senior researcher at the Aaron Institute, tlarom@idc.ac.il.

Poverty in Israel: Reasons and Labor Market Policy

This policy paper presents the current situation of poverty and inequality in Israel. It analyzes their main determinants, characterizes the poor in Israel and suggests a long-term labor market policy program that will reduce poverty.

The poverty rate in Israel is very high relative to other countries, and the second highest among OECD countries. In 2013, the poverty rate in Israel was 18.6 percent, in contrast to an average of 11.2 percent in the OECD countries and 8 percent in the benchmark countries.¹ Inequality in Israel is also high, both according to the Gini coefficient and in particular according to an index of income gaps between the upper and lower deciles. This index stood at 14.9 in Israel in 2013 in contrast to 9.6 in the OECD and 6.5 in the benchmark countries, rising at an average of about 2 percent per year in Israel in contrast to 0.5 percent in the OECD countries.² Despite the recent stabilization of poverty and inequality, it is very likely that if we do not understand and change the generators of these trends they will continue in the future, and Israel will return to a process of growing poverty and widening income gaps. Since this phenomenon is a result of, among other things, stagnation of wages and productivity of the lower deciles, it also affects long-term economic growth. In order to deal with these trends, we must study their characteristics and determine the tools that can be used in order to moderate or even reverse them in the short and long terms.

The OECD Report (2011) concludes that the main source of inequality is the rise in labor income inequality. In Israel, labor income constitutes about 75 percent of total gross household income for the main working age group (18-65) and therefore the gaps in labor income are the main source of inequality in household disposable income, both due to the differences in employment rates and the growing gaps in income per hour worked. The report presents the three main sources of the prolonged upward trend in inequality, which is similar in character to that of poverty: 1) skill-biased technological changes; 2) globalization; and 3) weak regulation and lack of enforcement of labor laws that are meant to protect low-salaried workers. In this paper, we show that all three sources are significant in Israel, and

¹ The benchmark countries were chosen in research done at the Aaron Institute as a group of developed OECD countries that are similar to Israel in size (about 8 million citizens on average), in level of openness to international trade and in the nature of growth which rests on human capital, but whose GDP per capita is higher than Israel's and their poverty rate is lower. Therefore, this group constitutes a reference point (or target) for Israel. The group includes Sweden, Denmark, Netherlands, Austria, Switzerland, Finland and Ireland.

² Poverty and inequality are obviously not identical. Nevertheless, the commonly used indexes for both are relative, and the long-term trends in Israel and other countries show an increase in inequality is usually accompanied by an increase in poverty.

some of them even more so than in other countries, and that they are increasing in intensity over time. These factors lead to a relative—and in some cases absolute—decline in wages and employment in the lower deciles and thus account for the increase in poverty and inequality and the fact that their levels are higher than the OECD average.

Skill-biased technological changes increase the productivity of highly educated individuals more than that of the general population and therefore the demand for highly educated and skilled workers increases while the demand for uneducated and low-skilled workers declines. As a result, and in spite of the change in the educational composition of the population and the increased supply of skilled workers, employment and wages of these workers has increased while that of uneducated workers has declined. The OECD report states that this is a general phenomenon and the data that we present suggests that it indeed exists in Israel and with even greater intensity. It is important to emphasize that the increase in income of the upper deciles, which reflects the increase in productivity of this population, does not constitute an economic problem; rather it is the relative stagnation in the income of the lower deciles that is the main problem and the main cause of the increase in poverty.

Globalization is a process involving the opening of local markets to international trade. Large poor countries, such as China and India, which possess cheap labor, have become dominant in international trade and in the determination of the prices of goods, in particularly goods that are produced by uneducated workers in developed countries. In Israel, this phenomenon is manifested in a number of ways: a massive reduction in taxes on imports and the opening of the economy to global trade at the beginning of the 90s, which reduced the activity of the traditional manufacturing industries and raised the productivity of the non-traditional industries; a wave of immigration from the FSU in the 90s, which increased labor supply in low-wage sectors and which led to an additional erosion in wages; growth of the hi-tech sector and its share of GDP and employment, together with an increase in the wage gap between hi-tech and the rest of the economy; the entry of temporary foreign workers (especially from Asia) who are largely unskilled, which led to a drop in wages in all sectors that do not require skilled workers, particularly construction, agriculture and household services.

The labor market in Israel is characterized by a weak regulatory system and limited enforcement of the labor laws that are meant to protect workers' rights. The non-enforcement of minimum wage laws in particular contributes to inequality, since the proportion of individuals earning less than minimum wage is higher among unskilled workers and among workers in the lower deciles.

Another unique characteristic of Israel is its high birthrate: Average household size in Israel was 3.3 in 2013, in third place after Mexico and Turkey, and significantly higher than the OECD average of 2.5 and the average of 2.2 among the benchmark countries defined above. Since there is a positive and clear correlation between household size and the poverty rate, this factor is a significant component in the trends of inequality and poverty in Israel, particularly since large households are concentrated in the lower deciles and the growth rate of this population is greater than that of small households.

Characterization of the poor in Israel according to family structure, employment status and social sector (ultra-Orthodox Jews, Arabs, single parents and all others) provides additional evidence that the poverty rate rises with the number of children and falls with the number of providers. The effect of each of these factors on their own is intensified further by the negative correlation between household size on the one hand and number of providers and wage level on the other. Reducing poverty therefore requires two channels of policy: first, raising employment rates and the number of workhours among poor households and second, raising the labor income of the working poor, primarily by increasing their human capital and shifting them to jobs that pay wages commensurate to levels of human capital over time.³

In order to examine future trends and to determine the optimal policy, we calculate forecasts for the number of poor households and for the poverty rate for the next 10 years, under various assumptions regarding the changes in the population composition and in disposable income. These assumptions allow us to differentiate between the effect of the rate of growth in population, which varies between sectors of the population, and the effect of the rate of growth in disposable income, which varies between deciles. We find that population growth alone (according to the rate of growth used in the forecasts of the Central Bureau of Statistics), with household disposable income fixed, leads to a slight decline in the poverty rate of each of the sectors but also to an increase in the overall poverty rate and inequality, since the relative weight of the poor sectors becomes larger. In contrast, an increase in disposable income alone (according to the average rate of increase during the last 30 years), with population size fixed, leads to a significant increase in poverty rate and in inequality, since the gaps between the deciles widen. A policy that leads to a situation in which the disposable income of households in the lower quintile grows at the same rate as

³ In this policy paper, we take the birthrate and the rate of population growth as exogenous, both in the analysis and in the forecast, and do not discuss the possibility of influencing family size by means of economic policy.

that of the upper decile somewhat reduces the poverty rate but inequality increases. This result does not depend on the source of the increase in income of the lower quintile nor on the way it is achieved; It can be accomplished by various combinations and intensities of policy tools as described below. The most important conclusion from the analysis is that if there are no significant changes in birth rates, employment rates and wage growth rates, we will not see any significant change in the poverty rate in Israel.

In view of the aforementioned trends and characteristics, and since it is reasonable to assume that the main reasons for the high poverty rate in Israel will continue to exist, we ask the following question: what is the correct policy to reduce poverty and inequality? Piketty (2014) believes that the most effective way to deal with inequality is by heavily taxing the upper deciles and transferring the proceeds to the lower deciles, thus increasing their income. This policy can reduce the gaps between rich and poor but will not necessarily reduce poverty since it does not fundamentally change the trends in the main determinants of poverty which are concentrated in the labor market, as explained above.

Since the labor market is the main source of poverty and disposable income inequality, in this policy paper we focus on reducing poverty and improving the situation of weak sectors of the population by means of labor market policy programs and measures, rather than the direct transfer of resources from the upper deciles to the poor. These policy measures require resources that are financed for the most part by taxing the rich, but in contrast to the policy of transfer payments we recommend policy measures that focus on integrating the poor into the labor market and raising their wages and productivity. In addition to their direct effect on short-term income, these kinds of measures, which help individuals shift from dependence on welfare to employment, also have a long-term effect on both their potential earning power and their family and social domain. The measures proposed here can moderate and even neutralize the effect of the three main causes of growth in poverty mentioned above.

Furthermore, the labor market trends that increase poverty and inequality have significant components that support growth but also components whose influence on growth is neutral or even negative. The strategy to reduce poverty proposed here focuses on policy tools that also have a positive effect on growth in general and that of the lower deciles in particular.

The proposed policy strategy can be divided into two main parts:

1. **Policy to support employment and experience** in a flexible labor market for low-skilled populations. This policy includes all the measures that provide access to employment under equal conditions for low-skilled populations: welfare-to-work programs operated by employment one stop centers, in which participation is mandatory for those receiving welfare and who meet an employment test and voluntary for all other groups; increasing the employment bonus (earned income tax credit); preventing the entry of temporary foreign workers who are not residents of the country; and providing support services, such as day care centers and cheap public transportation.⁴
2. **Policy to support productivity and wages** in a flexible labor market for individuals with a low level of education. This policy includes all the measures that increase the vocational skills of individuals who do not enter higher education: vocational and technological post-secondary education; equalizing corporate tax rates in all sectors of the economy and cancellation of the export criterion for tax exemptions; incentives to invest in capital and R&D in traditional manufacturing, in commerce and in private and public services; and more stringent enforcement of labor laws, particularly minimum wage laws, in all sectors and industries.⁵

The policy tools of the first type are necessary though not sufficient. Only the implementation of both types of policy tools will make it possible to arrest the trends of recent years and to ensure that wages and employment among the poor and low-skilled populations will grow significantly and efficiently. Furthermore, clear quantitative targets for employment, productivity and wages must be set, both as a guideline for designing policy and as a measure of its success. We propose the following targets:

1. Increasing the employment rate of the age group 25–64 to 80% and of the age group 20–24 to 71% by 2020, and in particular raising the employment of ultra-Orthodox men and of Arab women. This is an update of the current employment targets adopted by the Israeli government in 2010.

⁴ Policy measures to do with employment programs and the earned income tax credit are described in Chapter 4 and 5 of this paper.

⁵ Policy measures to do with technological education and corporate taxation are described in separate Aaron Institute policy papers, see Eckstein, Lifschitz, Sagi and Trilnick (2016), Hercowitz and Lifschitz (2016) and Zimring and Moav (2016).

2. Increasing the productivity and wages of the lower quintile by 10% more than the average wage growth rate (of all workers) in 2016-2020. As explained above, this does not imply holding back neither general growth nor growth in productivity and wages of the upper deciles; rather this target reflects inclusive growth relying more significantly on the lower deciles.

The policy tools detailed in this paper, which concentrate on employment incentives, will at most make it possible to reduce the poverty rate from its current level by about 1–2 percentage points, and without their implementation poverty will increase to a level of 20 percent and higher in coming years. In order to stimulate growth and deal with poverty in a more significant and effective way, a wider policy should be implemented, as presented at the Aaron Institute annual conference.⁶

⁶ For details see Eckstein, Lifschitz and Kogot (2016).

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In the name of Aaron Dovrat z”l

The vision of the Aaron Institute for Economic Policy is to sustain economic growth and social strength in Israel, by researching, modelling and developing modern, innovative and up to date strategies and policy tools for the Israeli economy, based on up-to-date global knowledge.

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The institute's main aim is to develop policy strategies that eliminate weaknesses and empower the strengths of the Israeli economy. We propose broad reforms as well as policy changes to particular industry sectors. In this framework Israel's relative advantages in technologic innovation and advances in the public and services sectors can be maximized. At the Aaron Institute, we crucially define quantitative goals while involving some of the countries' best economists in research and policy paper discussion meetings.

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Contact details:

The Interdisciplinary Center Herzliya - IDC, P.O. Box 167, Herzliya, ISRAEL 4610101

Phone: 972-9-9602431, Email: aaron.economics@idc.ac.il, Website: aiep.idc.ac.il