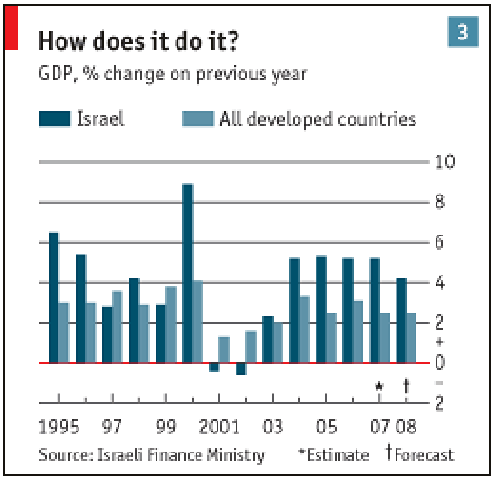
Economist.com **SPECIAL REPORTS**

Miracles and mirages

Apr 3rd 2008
From The Economist print edition

A strong economy built on weak fundamentals



How does it do it?
GDP, % change on previous year
Source: Israeli Finance Ministry *Estimate †Forecast

FOR a country with so many wars, Israel still has an economy with the power to astonish. Having taken a beating during the *intifada*, GDP growth per person has stayed above 3% for the past four years, well above the rich-country average (see chart 3), despite the costs of the 2005 Gaza pull-out and the 2006 Lebanon war.

Israel has spent years peeling back layers of its once-socialist economy. In 1985 reforms to the central bank and finance ministry reined in hyperinflation. In the 1990s a heady mix of military communications technology, policies that encouraged entrepreneurship, a wave of immigrant engineers and technicians from the former Soviet Union and the then-promising peace process allowed Israel to hitch its fortunes to the global technology boom. It now has the most NASDAQ-listed companies after Canada and America.

More recently privatisations, pensions reforms and deregulation have contributed their bit. Benefits were cut in 2003 in favour of a welfare-to-work scheme dubbed the “Wisconsin programme”, after the American state that pioneered it. A capital-markets reform in 2005 reduced the banks' dominance and boosted national savings. The government has introduced commercial budget-management systems, put a 1.7% cap on budget growth and committed itself to gradual cuts in taxes, thus providing a cushion against Israel's chronic political instability. According to Yarom Ariav, the finance ministry's director-general, this is one reason why the economy rode out the shocks of the 2005 Gaza disengagement and the 2006 Lebanon war so well; businesses now have confidence that “even if the leaders change, basic policy doesn't.” Last year Israel was invited to join the Organisation for Economic Co-operation and Development (OECD), official confirmation of its status as a developed country.

However, the engines of growth are punier than they look. Israel excels at creating start-ups, but is less good at turning them into big companies. “Our main natural resource is human capital,” says Israel Makov, a former CEO of Teva, the world's biggest generic-drugs maker, “but we treat it just like other natural resources: we export it at a low point in the value chain.” In the other direction, global technology giants such as Intel have long been putting advanced production facilities like chip-wafer fabrication plants in Israel, but now other countries are nipping at its heels. The tech sector employs a small proportion of the workforce, and its workers can most easily leave the country if things get sticky.

And beneath its gleaming high-tech skin, the body of Israel's economy is slightly worn. True, the country has some successful industrial giants and does well in a few export niches such as generic drugs, weapons systems and agricultural and water-treatment technology. Water scarcity has already led Israel to build the world's biggest desalination plant, and around ten more are planned. However, much of the country's traditional industry (eg, machinery, chemicals, clothing and food), which accounts for more than half of its jobs, is lacklustre. Average industrial productivity is around half that in America. One reason: Israel leads the world in R&D spending as a proportion of GDP, but this is heavily concentrated in high-tech. In more traditional industries the rate is just a quarter of America's.

Moreover, Israel's ability to capitalise on the internet boom was a lucky one-off. The big innovations of this century, argues Ze'ev Tadmor, of the Technion, a university in Haifa, will be in biotech, nanotech, smart materials, alternative energy and other things that the army's wellfunded research units are not particularly interested in. Much of this kind of work must be done in academia, where Israel is weaker. Its seven big universities have a combined government research budget of around $100m, whereas America's Massachusetts Institute of Technology alone gets $950m from the federal government.

DPI

Doing his bit to reduce income inequality

The power of prayer

Israel's workforce also has its peculiarities. Overall, the proportion of the population in the labour market is 56%, considerably lower than in America, though almost the same as in the first 15 European Union members. However, in two subgroups it is much lower than that: *haredim* (ultra-Orthodox Jews), many of whose young men spend years in the *yeshiva*, the religious seminary, and then find it hard to get jobs because they have no secular training; and Arab-Israelis, whose women are less likely to seek work, and who also suffer job discrimination. Officially, only about 40% of these two groups take part in the labour market, although the counting method is flawed and the real rate may be a bit higher. Together they account for 29% of the population, and rising. Economists fear that unless more of them start working, growth will be sluggish and the taxes of those who do work will have to support an ever heavier burden.

Lastly, the country's bureaucrats still have a lot of catching up to do. In its latest annual ranking for the ease of doing business in different countries, the World Bank found vast disparities in Israel (see table 4): credit and investor protection are excellent, but bureaucracy is overweening. The World Economic Forum's global-competitiveness index rated Israel 17th out 131 countries last year, but again found big gaps between the high quality of innovation and technological readiness on the one hand and mediocre institutions, infrastructure and labour-market efficiency on the other.

Part of this is a legacy of the socialist past. For example, 93% of Israel's land is owned by the state, so everybody leases. Part dates back to the centralised control of the British Mandate. Moti Sasson, the mayor of Holon, a satellite city of Tel Aviv, has spent ten years trying to pass a by-law that would allow him to tow away illegally parked cars, as other cities do. He is still waiting for approval from the interior ministry. “You go to the ministry and you find an official with papers on his desk piled so high you can't see him, and more on the floor,” he fumes. “It drives me nuts.”

Mixed bag 4

How businesspeople see Israel

2007

	Ranking*
Overall ease of doing business	**29**
Starting a business	17
Dealing with licences	109
Employing workers	87
Registering property	152
Getting credit	7
Protecting investors	5
Paying taxes	69
Trading across borders	8
Enforcing contracts	102
Closing a business	40

Source: World Bank *Out of 178 economies

Perhaps the most serious threat to Israel's long-term prosperity, and the one that most troubles ordinary Israelis, is the state of the education system. Israel's spending per student is close to the OECD average, yet in the OECD's PISA rankings of 57 countries in 2006, which focused on science education, Israeli 15-year-olds came 39th overall. Israel also had the biggest gap between the best and the worst students. Both are bad signs for a country with few natural resources that relies on a knowledge-based economy. “What they learn here in 9th grade is what I was doing in Moscow in 7th grade," grumbles a teenager who recently arrived from Russia (ranked 34th).

What is needed, said the government-appointed Dovrat commission in 2004, is not more money but better-quality teaching. According to a study published last autumn by McKinsey, a consultancy firm, that is what has made all the difference in many other countries. The Dovrat recommendations included giving school principals the right to sack poor teachers and reward the better ones with higher pay, which they currently lack. But such moves have been blocked by Israel's two teachers' unions, one of which has paralysed secondary schools with a series of long strikes over the past few years. At the end of last year it settled for a wage rise in return for token increases in flexibility, but other reforms remain blocked.

In higher education, teaching is in better shape, but research funding is inadequate and thinly spread. Central-government bodies have tight control over salaries, hiring and firing, and universities were only recently given the right to decide on launching new study programmes. As a result, says Mr Tadmor, they cannot compete globally by attracting the best staff to excel in particular fields. Tenured lecturers held their own three-month strike last autumn over a pay dispute with the finance ministry.

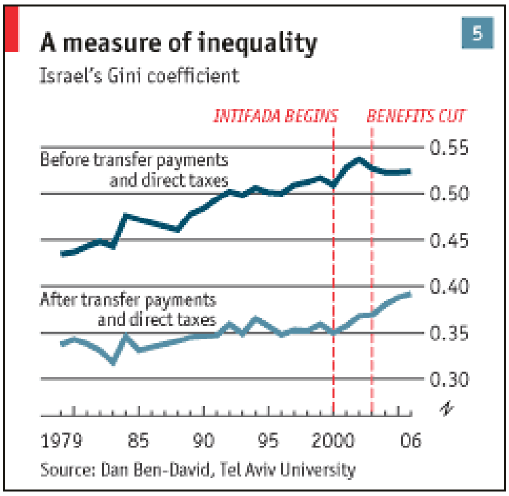
The unions' powers of disruption are another socialist legacy. Israel's Histadrut union federation used to run most of the health-care system, the pensions system and the schools, as well as some of the biggest firms in banking and construction. Today it is far weaker but still holds a lot of sway in the public sector. Ports, airports and other essential services all suffer periodic strikes. The government deals with the unions by working around them, says Ozer Carmi, a professor of business administration at the Ono Academic College. Israel's public sector is a world leader in employing contract workers, who have fewer benefits and less job security.

The Gini is out of the bottle

All this means that Israel's new wealth is highly concentrated. Despite four years of strong growth, the proportion of families below the poverty line (defined as 50% of the median net income per person) has remained the same, at around 20%. That of children living in poverty has actually grown, reaching 36% last year, because as part of the benefit reforms of 2003 extra payments for families with five or more children were abolished.

Israel's Gini coefficient, a measure of income inequality, has also climbed steadily to reach one of the highest levels in the developed world. For years the government tried to contain inequality, but when benefits were cut to keep a ballooning welfare budget in check, it shot up again (see chart 5). In theory, reducing benefits in favour of welfare-to-work was a wise move which even many civil activists supported. But in practice, although the Wisconsin scheme has got people into jobs, it has not made them better off. In the past five years the proportion of poor families with at least one wage-earner has risen by a third.

The government professes to be very worried about poverty. It is adopting a range of social measures that includes better enforcement of the minimum wage, negative taxation for the poorest and employment schemes targeting both Arabs and *haredim*. "The way to close gaps is through the labour market," says Mr Ariav.



Middle-class discomfort

But there is evidence that even the labour market is not delivering the goods. Yedid, a network of citizens' advice bureaus across Israel, was set up in 1997 to be easily reached by public transport so that the poor could get there. Now, says Yuval Elbashan, Yedid's deputy director, "we have so many people coming by car that the neighbours complain about the streets being blocked." The reason: more and more middle-class people are dropping in too, for things like legal advice and workshops on budget management. ("The poor", Mr Elbashan notes, "don't have budgets to manage.") According to the housing ministry, new mortgages in 2006 were 50% down on 2003, a sign that the squeeze has affected much of middle Israel too.

It is probably too early to say whether these problems are caused by delays in the impact of reforms or signal a longer-term trend. Yaron Zelikha, a former finance-ministry official who helped to draw up the current set of policies, argues that reforms still in the pipeline, including privatisations and infrastructure upgrades, should make industry more efficient and bring down supply costs to launch the next wave of growth.

In addition, says Mr Ariav, there are plans to turn Israel into an exporter of financial services by harnessing its high-tech expertise to further capital-market reforms; as an added bonus, this might entice some of the many Israelis who work in finance abroad to come home. The government also wants to cut red tape by putting more services online and keep reducing public-sector debt (which reached over 100% of GDP in 2003 and is still a hefty 80% today).

Will all this be enough? Yossi Hollander of the Israeli Institute for Economic Planning calculates that the country's GDP per person needs to grow at a bracing annual rate of 4.5% for the next two decades to raise it to three-quarters of the American level, from less than half now, while coping with Israel's changing demography. Over the past 20 years average growth per person has been just 1.8%. His target is not impossible, he says: Ireland managed over 5% a year between 1986 and 2005. But he calculates that Israel's industrial investment will have to rise to three times its level over the past two decades. Encouraging that money to flow will require far-reaching reforms.

There is no shortage of plans and ideas. The trouble is carrying them out. “Implementation is a science in itself, and in the current Israeli reality it's not possible to carry out long-term, top-down reforms,” says Shimshon Shoshani, a former director-general of the education ministry. Political instability, frequent staff changes, over-centralisation, lack of long-term planning by bureaucrats, aggressive unions and the occasional war all get in the way. And in Israel, where wealth gaps coincide with ethnic and social ones, economic policy is about a lot more than malnourished children and bad housing. It also affects the country's political and social stability.

Copyright © 2009 The Economist Newspaper and The Economist Group. All rights reserved.