INTERNATIONAL MONETARY FUND

ISRAEL: STAFF CONCLUDING STATEMENT OF THE 2018 ARTICLE IV MISSION

March 14, 2018

Key Messages

Israel's economy is thriving, enjoying solid growth and unemployment declining to historic lows. Near-term prospects are for further robust growth in the next few years and inflation is expected to rise although the pace of that increase is uncertain. But relative poverty is the highest among OECD countries, partly owing to wide gaps between the employment and productivity of the Israeli-Arab and Haredi subgroups relative to non-Haredi Jews. Unless these gaps are narrowed, the substantial shifts in population composition that will unfold in coming decades could undermine growth and stability.

Israel should seize this opportunity to implement further reforms, especially in education and training, product markets, and the business environment, to sustain strong and inclusive growth. The effectiveness of such reforms in raising productivity, narrowing gaps, and reducing living costs, would be bolstered by addressing Israel's infrastructure needs in parallel. Demand management is the immediate priority but a rise in high-quality public investment would pay dividends in time. Proposed increases in the earned income tax credit will aid low-income working families while protecting labor participation, and further redistributive steps that support labor participation and productivity should be considered.

Macroeconomic and financial policies should maintain stability, which will also help realize the full benefits of reforms and public investment. Monetary policy must stay accomodative for now to support the return of inflation to the target band, while being ready to tighten if needed. The fiscal deficit should be reduced moderately in coming years to keep debt on a declining trend in normal times. A stronger framework for managing public investment is needed to ensure that new infrastructure investment is high-quality and timely, while adequate fiscal buffers must be preserved. Welcome measures to strengthen financial sector competition also heighten the potential for new risks to emerge, making it urgent to approve the Financial Stability Committee.

Economic developments and outlook

1. Israel's macroeconomic performance is strong yet inflation remains low. The economy grew 3.4 percent in 2017 on the back of robust domestic demand and higher global growth, despite some drag from an unwinding of one-off factors that boosted GDP in 2016. Unemployment has declined steadily in recent years, falling below 4 percent in early 2018, supporting broad-based wage growth averaging 3.3 percent in 2017. Core CPI inflation remains below the 1–3 percent target range of the Bank of Israel (BoI), at 0.5 percent in January, reflecting the combined effects of the appreciation of the shekel, low inflation in key import sources, increased competition, and government measures to reduce the cost of living.

2. The economic outlook is favorable in the near term but challenges will increase over time. Growth is expected to remain strong at about 3.5 percent in the next few years benefitting from the completion of major projects. With trend productivity gains relatively modest at ¾ percent annually, growth is projected to average about 3 percent in subsequent years. But Israel faces two major challenges to sustaining solid growth in the longer run. Subgroups with lower average labor market skills and labor force participation, especially Haredim and to a lesser extent Israeli-Arabs, will rise as a share of the working age population from one-quarter in 2015, to one-third by 2025, and two-fifths by 2045. Moreover, Israel faces sizable infrastructure needs, most evident in traffic congestion already the worst in the OECD, that will increasingly drag on productivity as the population and per capita incomes rise.

Monetary policy

3. Domestic and international conditions are supportive of an increase in inflation, yet significant uncertainty remains around the timing of such an increase. A continuation of solid nominal wage growth together with some firming of international inflation rates will likely translate into higher CPI inflation over time. Yet, prolonged low inflation in recent years cautions that significant uncertainty remains around the timing of an eventual inflation increase. For example, competitive pressures could lower inflation for some time as Israel's price levels remain relatively high by international standards.

4. Monetary policy should remain accommodative pending a durable rise in inflation and inflation expectations. The BoI maintained an appropriately accommodative stance in 2017 given low inflation and the spillovers from easy monetary policies in major advanced economies. The BoI's guidance that policy will remain accommodative as long as necessary to entrench the inflation environment within the target range has also helped anchor long-term inflation expectations. Yet, with expectations for the next few years below or close to the lower target bound, tightening should wait until inflation is clearly heading back to target, with the pace of eventual rate hikes being data driven. Given comfortable foreign reserve levels and the economy at full employment, exchange rate flexibility should continue to be the first line of defense in the event of external shocks, with foreign exchange intervention limited to addressing disorderly market conditions, which may arise from significant exchange rate deviations from fundamentals.

Financial sector and housing policies

5. Reinforcing the financial stability framework is critical to complement the progress being made on enhancing competition. Israel's banking system is healthy yet highly concentrated. Measures being implemented by the authorities are expected to strengthen competitive pressures, including "one click" bank account mobility, facilitating price comparisons for financial services, establishing a credit register, lowering minimum capital requirements for insurance companies, divesting two credit card companies, and reducing bank entry costs through access to IT services. Already, the sources of credit are shifting, making it urgent to approve legislation to establish the Financial Stability Committee to avoid gaps in financial system oversight. Entry by new banks would be welcome with appropriate deposit insurance and resolution arrangements to contain fiscal costs from potential failure. The Banking Supervision Department should continue to operationalize a risk-focused supervisory approach to lower compliance costs while maintaining high standards. The adoption of Solvency II by the Capital Markets, Insurance and Savings Authority is welcome. It is essential for financial regulators to harmonize regulations in areas of overlapping activity to avert regulatory arbitrage. Regulators are also taking welcome steps to enable innovation while enhancing technological risk management, where close coordination may facilitate Fintech development and utilization. Safeguarding the operational independence of financial regulators remains critical to their effectiveness.

6. Slowing housing construction despite still high housing prices calls for continued reforms to make supply more responsive to needs and to improve housing affordability. Housing price increases have slowed to just 2 percent y/y alongside a decline in turnover that may reflect proposed tax measures on investors and the market digesting the impact of the Buyer's Price program. But dwelling investment declined during 2017 and falling housing starts indicate a further decline in 2018, raising concerns that the recent stability may not last. Continued reform efforts are therefore needed, including:

- **Land supply, competition, and regulation.** Increased auctions of land are important to avoid land availability constraints and to help make housing supply more responsive to variations in demand. Construction costs and time to build should be reduced by streamlining building regulations and expanding foreign construction company access.

- **Municipal incentives.** To encourage timely municipal approval of residential development, residential property taxes should be raised coupled with predictable central government support for the up-front costs of additional infrastructure and public services.

- **Expand commutable areas and increase urban density.** A well-developed public transportation system can expand commutable areas and relieve demand in major centers, hence plans to establish metropolitan authorities are welcome. Urban renewal should be increased as urban density in Tel Aviv is relatively low, making the proposed fast-track approvals for mixed-use developments especially useful.

Fiscal policy and infrastructure

7. Israel's underlying fiscal deficit widened in 2017, with one-off revenues helping keep debt on a declining path. Revenues were boosted by taxes on the sale of major Israeli companies and by a temporary cut in dividend tax rates in 2017, at the cost of lower dividend tax revenues in coming years. These one-off revenues limited the central government deficit to 2 percent of GDP, helping general government debt decline to 61 percent of GDP. However, the underlying deficit was 2.9 percent of GDP, and, although this matches the 2017 budget target, the structural fiscal deficit increased modestly despite strong growth.

8. The budgets for 2018-19 include valuable measures but leave the deficit too high. The deficit target for 2018 remains at 2.9 percent of GDP, with fiscal reserves allocated to expanding disability benefits and subsidies for after-school childcare. But a reform of eligibility requirements and testing for new entrants to disability benefits is urgently needed to protect labor participation and contain fiscal costs. The proposed 2019 budget also includes support for technical training in schools together with an expansion of the EITC that assists low income families with two working parents. However, the deficit target is raised to 2.9 percent of GDP. Adhering to the former target of 2.5 percent would entail little drag on growth at a time of full employment, and would reduce the general government deficit to around 3 percent of GDP, sufficient to gradually reduce debt in normal times. Ensuring the Buyer's Price program is temporary would also support Israel's fiscal health as the subsidies given through heavily discounted land sales are reducing receipts from the Land Authority.

9. It is welcome that the government is assessing how to best address Israel's infrastructure needs. Cross-country benchmarks suggest an infrastructure gap on the order of 20 percent of GDP, with traffic congestion the most prominent issue. A government committee is developing an integrated long-term national infrastructure strategy until 2030, while also preparing a list of additional projects for implementation in the next five years.

10. An immediate priority is to ensure that the existing infrastructure is efficiently utilized through demand management tools. Given the lengthy processes to complete new infrastructure such as mass transit, there is a need for frontloaded action to manage demand. Some demand-side tools (e.g., ride sharing, car-pooling, high occupancy vehicle lanes), could have near-term benefits at low cost. The "Going Green" initiative is a welcome pilot that should be ramped up. Charging for road use at peak hours is an approach used successfully in cities around the world, although it would need to be coupled with flexible working arrangements to be most effective in practice. If bottlenecks remain after these steps, the areas that should be the focus of additional public investment are more clearly identified.

11. The framework for managing infrastructure investment needs to be strengthened to ensure investments are high-quality and timely, including by:

- Establishing a body with clear accountability and sufficient powers for upgrading Israel's infrastructure, supported by staff with the necessary technical expertise.
- Making project evaluation and selection more rigorous and transparent, including by ensuring consistency with the long-term infrastructure strategy.
- Streamlining the zoning and permitting processes and addressing other bureaucratic impediments to timely project implementation.
- Improving coordination between ministries and between the central and local governments. Broadening the coverage of the medium-term fiscal framework to the general government could contribute to improved coordination and planning as local governments implement around three-quarters of public investment.
- Phasing any scaling up of public investment judiciously to avoid waste.
- Using public-private partnerships (PPP) only where private sector know-how improves efficiency, and designing and monitoring PPPs carefully to protect the public interest.
- Maintaining a high level of transparency around the level and composition of investment, including to help protect public investment against short-sighted cuts.

12. If public investment is increased, there is a need to preserve adequate fiscal buffers. As infrastructure enhances growth and revenue over a long horizon, there is a case for financing a portion with debt or PPPs. But any increase in the public debt ratio should be modest and temporary, as Israel needs strong fiscal buffers to cope with potential shocks, and liabilities from PPPs should be managed carefully and reported in line with international best practices. The low level of Israel's civilian spending, together with reform needs (see below) in education, training, and active labor market policies, indicate that revenues should be the main source of non-debt financing. Within revenues, the focus should be on sources with the least drag on potential growth, especially reducing tax benefits, which total 5 percent of GDP.

Structural reforms

13. Israel can sustain strong growth by narrowing gaps in skills and participation across population subgroups and genders. Compared with the hourly wages of non-Haredi Jewish men, those for non-Haredi Jewish women are about one-fifth lower, Haredi about one-third lower, and Israeli-Arabs about half. Employment rates of Haredi men and Arab women have risen but remain very low, at 47 and 35 percent respectively. It is notable that Haredi male participation has been flat in recent years, indicating a need to avoid measures that defer entry to the labor market or undermine incentives to work. To illustrate the scale of potential gains, narrowing the gaps in employment and hourly wages by half—leaving the proportion of part-time workers unchanged—could raise output by almost 14 percent.

14. Reforms of education and vocational training are central to enhancing skills, which boost employability as well as productivity and wages. Israelis spend substantial time and resources on education, yet the average skill level of workers is low by OECD standards. The quality of education and training needs improvement:

- **Education.** Education spending has been raised in recent years, primarily by increasing teacher's salaries. The effectiveness of schools should also be increased, such as through higher standards for teachers, covering core subjects at all grades in Haredi schools, improving Hebrew teaching in Arab schools, and extending the short school day. School reforms are the first best option, but more innovative solutions, such as subsidizing voluntary participation in after-school educational programs, should be considered where progress is not feasible.

- **Vocational training.** It is welcome that vocational training reforms are being developed. These reforms should ensure that the courses offered meet business needs and the quality of courses should be evaluated. The modalities for delivering training should facilitate participation by Haredi and Israeli-Arabs. Career centers should guide the unemployed to suitable training where appropriate, which may include business-oriented Hebrew. Low wage workers should also receive support for training-related costs to upgrade their skills.

15. Raising the employment rates of key population subgroups will require tailored measures. The authorities are updating targets for the employment rates of key subgroups through 2030, and are developing policies to help reach those targets. To raise labor participation and work hours of women, childcare support needs to be further expanded, especially for younger children. Moreover, increases in the retirement age for women should continue without introducing new incentives for early retirement. Career centers in 46 communities are achieving significant employment gains through low-cost programs such as "Employment Circles" and resources for active labor market program should be expanded from only 0.2 percent of GDP. Enhancing public transportation such as bus services is important to ease access to workplaces. But, in some cases, e.g. Arab women, enabling workplaces to locate near communities may also support greater participation.

16. Fundamental upgrades of the business environment are critical, especially reducing bureaucracy. The government has undertaken key product market reforms such as personal imports and the long-delayed electricity sector reforms. Implementation of the product market reform agenda should continue, including replacing trade barriers on agricultural products with targeted subsidies. However, numerous regulations and their high compliance costs remain major impediments to competition and investment. The proposed reforms of fire safety regulation and business licensing are important steps forward. But there is a need for broader progress to achieve simple and timely administration of regulations, such as a "one-stop shop" that would assess all regulatory requirements within a reasonable period. All proposals for new regulations should be subject to robust regulatory impact assessments. The lengthy process of contract enforcement indicates a need to make court procedures more efficient, and the establishment of a specialized court for complex antitrust cases would support competitive markets.

17. Measures to contain poverty can also support participation and productivity if carefully designed. Priorities are threefold:

- **Further expand the amount and coverage of the Earned Income Tax Credit (EITC).** Even after planned increases, Israel's EITC remains small with a fiscal cost of 0.16 percent of GDP annually, compared with 0.4–0.5 percent in the U.S. or the U.K. As wages are the main source of income for 60 percent of population below the poverty line, expanding the EITC can effectively reduce poverty. Experience in other countries indicates that expanding the EITC will increase take-up by the eligible population, adding to the impact on poverty, which would be even larger if labor participation also rises.

- **Implement the EITC more effectively.** At present, the EITC can be claimed only at the end of each year, and it is received with a delay. More frequent and timely payments would better incentivize work and streamlined administration could improve take-up.

- **Make transfers more targeted to support EITC expansion.** Israel's current transfer system is not progressive, providing a similar shekel amount to all households, even those in the top income decile. Modifying the transfer system to make it better targeted to low income households can reduce poverty at less fiscal cost. Using the resources released to expand the EITC, as well as for transfers that are conditional on additional education and training, would ensure they reinforce incentives to work and upgrade skills. For those unable to work, the modest levels of welfare support should also be reviewed.

The mission team thanks the Israeli authorities and other counterparts for the candid and insightful discussions and greatly appreciates their warm hospitality.