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**POLICY OPTIONS FOR REDUCING POVERTY AND RAISING EMPLOYMENT RATES IN ISRAEL**

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## ABSTRACT/RÉSUMÉ

### Policy options for reducing poverty and raising employment rates in Israel

Welfare-to-work measures are a central theme of Israel's labour and social policies to tackle relative poverty, which is concentrated among the Arab-Israeli and Ultra-orthodox (Haredi) communities. Policies include pilot programmes involving private-sector job placement (the "Wisconsin" programme) and an earned-income tax credit. Also, there is increased policy attention to help parents to combine work and family through improvements to daycare and early education. Microeconomic simulations of taxes and benefits suggest room for augmenting these policies with adjustments to benefits and tax expenditures. In the labour market, hiring and firing regulations are light, while the minimum-wage is relatively high in comparison with OECD countries, but it is not strongly enforced. Poverty among pensioners is set to fall in the future with the recent introduction of mandatory second-pillar pension saving. But this reform has also raised questions about the structure of tax breaks on pensions. This Working Paper relates to the 2010 *OECD Economic Survey of Israel* ([www.oecd.org/eco/surveys/israel](http://www.oecd.org/eco/surveys/israel))

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*Keywords:* Israel; policy; reform; poverty; employment; welfare; labour market; tax; benefits; allowances; childcare; Arab; Arab-Israeli; Haredi; Ultra-orthodox; pensions.

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### Les options politiques israéliennes afin de réduire la pauvreté, et augmenter les taux d'emploi

Les mesures de remise au travail sont un thème central de la politique de l'emploi et des affaires sociales d'Israël pour lutter contre la pauvreté relative, qui est concentrée dans les communautés arabe israélienne et juive ultra-orthodoxe (Haredi). Les politiques incluent des programmes pilotes prévoyant des placements dans le secteur privé (le plan « Wisconsin ») et une réduction de l'impôt sur le revenu d'activités professionnelles. Les pouvoirs publics s'efforcent également d'aider davantage les parents à concilier travail et famille en améliorant les services de garderie et d'enseignement préscolaire. Des simulations microéconomiques des impôts et des avantages fiscaux donnent à penser qu'il est possible d'accroître ces politiques en modifiant les prestations et les dépenses fiscales. Sur le marché du travail, les réglementations en matière d'embauche et de licenciement sont peu contraignantes et le salaire minimum est relativement élevé si on le compare à celui des pays de l'OCDE, mais il n'est pas strictement appliqué. La pauvreté chez les retraités devrait baisser à l'avenir avec la récente introduction de l'épargne retraite obligatoire au titre du deuxième pilier. Mais cette réforme a également soulevé des questions sur la structure des allègements fiscaux dont bénéficient les retraites. Ce document de travail se rapporte à l'Étude économique de l'OCDE de l'Israël ([www.oecd.org/eco/surveys/israel](http://www.oecd.org/eco/surveys/israel)).

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*Mots-clés:* Israël; la politique; la réforme; pauvreté; emploi; protection sociale; marché du travail; fiscalité; prestations; allocations; garde d'enfants; arabe; arabe-israélien; haredi; ultra-orthodoxes; les retraites.

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## **Policy options for reducing poverty and raising employment rates in Israel<sup>1</sup>**

By Philip Hemmings<sup>2</sup>

High poverty and low labour utilisation are central and linked challenges for Israel's social and labour-market policy. Rates of relative poverty in the rapidly growing Arab-Israeli and Ultra-orthodox (Haredi) communities are high and largely account for Israel's very poor ranking on poverty when compared with OECD countries. Low labour utilisation is contributing to the poverty problem, and raising it is an avenue for narrowing the gap in GDP per capita with more developed economies. This paper focuses on conventional policy issues: taxes and benefits, benefit delivery systems (including employment services), childcare, labour regulation and pensions. Policy regarding non-Israeli workers is also discussed because of its implications for the low-wage job market. Though wide ranging, these topics clearly do not cover all factors affecting poverty and employment rates. In particular, discrimination in the labour market and policies to it tackle have been the subject of OECD review elsewhere (OECD, 2010a). In addition, public transport is not discussed, though many believe low service levels in peripheral areas are limiting labour mobility. Recommendations are summarised in a concluding box (Box 4).

### **Ministerial responsibilities and central themes of welfare policy**

The Ministry of Industry, Trade and Labor and the Ministry of Social Affairs are key players in labour-market and social policymaking (see Table 1). The latter is responsible for the National Insurance Institute (NII), which administers the majority of insurance and welfare payouts. However, the Ministry of Finance's unusually elevated position *vis-à-vis* line ministries means that it too is influential in reform initiatives and takes a stringent approach to their fiscal implications. Local government plays a relatively limited role in social and labour-market policy. As in many OECD countries, local government is responsible for providing certain in-kind social services and daycare for infants. However, it plays no role whatsoever in administering cash benefits.

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1. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.
  2. Head of the Israel Desk in the OECD Economics Department. This paper was originally produced for the OECD Economic Survey of Israel (<http://www.oecd.org/eco/surveys/israel>) published in January 2010 under the authority of the Economic and Development Review Committee. The author is indebted to OECD staff members Andrew Dean, Bob Ford, Peter Jarrett and Charlotte Moeser (Economics Department) and Mark Pearson and Willem Adema (Directorate for Employment, Labour and Social Affairs) for their valuable comments and to Françoise Correia for research assistance and to Mee-Lan Frank and Maartje Michelson for editorial support. The paper has also benefitted enormously from discussions with experts in government ministries, the National Insurance Institute and the Bank of Israel, with particular thanks to the Governor of the Bank of Israel, Stanley Fischer, and his team, in particular Karnit Flug, Michel Strawczynski and Noam Zussman.

Table 1. **The allocation of responsibilities in social and labour market policies among line ministries and other bodies**

Body	Responsibilities
Ministry of Industry, Trade and Labor	Labour inspectorate Active labour-market programmes (including the Light for Employment programme) Network of public employment offices (the Employment Service) Foreign and cross-border worker permits
Ministry of Social Affairs	In-kind social services Oversight of the National Insurance Institute (NII)
National Insurance Institute (NII)	Financial management of insurance contributions, outlays and balances. Disbursement of most cash benefits <i>via</i> a network of directly operated offices. The cash benefits covered include unemployment benefit, social assistance, disability benefit, child allowances, maternity leave and first-pillar pensions.
Ministry of Housing and Construction	Public housing, rent subsidies and mortgage assistance
Local authorities	Provision of in-kind social services Provision of daycare for infants

“Welfare to work” has been the central *leitmotif* of Israeli labour market and social policy for some years now, in line with thinking in OECD countries. This has included:

- *Use of contracted private-sector placement services* in which receipt of benefit is contingent on participation in full-time training (currently called the Light for Employment programme, widely known as the Wisconsin programme). These services have been operating in four areas of the country since 2005. Roll-out to the rest of the country is planned.
- *Sticks and carrots in benefit amounts and personal-income taxation for low-income households.* There were significant welfare cuts in the early 2000s. These were largely driven by specific budgetary problems at that time but also tied in with a philosophy that reducing benefits would increase labour-market participation. In terms of positive incentives, a pilot earned-income tax credit (EITC) was introduced in 2008 in the same areas of the country as the private-placement services. Country wide roll-out is planned here too.
- *Measures to induce more Israelis to enter low-wage sectors traditionally dominated by non-Israeli workers* (about three-quarters of which are now foreign workers from outside the Middle East and one-quarter are cross-border workers). Wage subsidies form one arm of this strategy, reduction in the supply of foreign workers the other.

## Assessing the policy options regarding taxes and benefits

### *Key elements of taxes and benefits for those on low incomes*

Tax and social-security deductions from gross pay for those on low incomes are modest, and the pilot EITC scheme means some low-income earners are net recipients, rather than payers, of income tax:

- Taxation on low-wage earners is light. The income tax schedule starts at 10%, which is in combination with “wasteable” tax credits (*i.e.* reductions in tax payable, but with no compensation if the credit is larger than the individual’s tax bill). Indeed, low-income earners often pay no income tax at all. Unusually, female earners get more credit than men (the credit is 22% higher), and the credits for children (see Table 2) may be claimed only by women (except in the case of lone parents).
- Social-security contributions by employees are modest for low earners, with a rate of 3.5% applying to earnings up to 60% of the average wage. The rate is then 12%, and at high earnings levels an absolute contribution ceiling applies. The corresponding employers’ contribution rates are 3.85 and 5.43%.
- The pilot EITC scheme targets families with children and those aged over 55 and principally aims to raise the incomes of working households vulnerable to poverty. There are two schedules, the more generous of which applies to those with three or more children. Both schedules start below the full-time minimum wage (thus making part-time earners eligible), reach a maximum value around the full-time minimum wage and are subsequently phased out. Applicants submit claims to the Tax Authority via the post office, and the payout is quarterly and based on declared income from earnings in the previous tax year.

Welfare and insurance benefits include means-tested social assistance, various insurance-based benefits (notably unemployment insurance and paid maternity leave), disability benefits and several family benefits (see Table 2). Notable features as regards low-income families are:

- Unemployment insurance benefit has a short duration. The monthly payout is linked to previous earnings according to two degressive scales (depending on age), and the maximum duration ranges from about 1½ to 6 months, depending on age and family situation. This benefit is therefore not a source of income for the long-term unemployed.
- The main welfare benefit (Income Support benefit) is not only means tested but also requires an employment test (this is discussed further below). It is possible to receive Income Support while earning. For example, a household with at least two children can earn up to NIS 4 673 per month and still receive some Income Support. Up to this ceiling a benefit withdrawal rate applies (62.5% in this instance), implying that, if receiving the full-time minimum wage (NIS 3 850 per month), the household is eligible for NIS 514 per month in Income Support.
- There are several channels of family support. Income Support increases only up to when a couple has two children. However, there are universal child allowances, which include increased amounts for families on welfare with three or more children. Also, there are annual “study grant” payments for families on welfare with four or more children. In addition, the housing support system includes special rules for families with three or more children.

Table 2. **Key unemployment and social benefits**

Item	Notable features	Indicative 2009 value, NIS per month
<i>Memorandum item</i>	Average gross monthly wage	NIS 3 850
<b>General cash support</b>		
Unemployment insurance benefit	Payout is according to a schedule of declining rates from 80 to 45% of previous earnings (60 to 35% for those aged under 28). In addition, there are benefit ceilings. Maximum duration ranges from 50 to 175 days according to age and number of dependents. Subject to regular income tax, but a special low UI contribution rate is applied. Those taking up “unsuitable work” can receive UI as an in-work benefit.	
Income support	Eligibility is means tested and employment tested. Notably, in the means test, ownership of a car generally removes eligibility.  Support increases with household size, but not beyond two children.  Support can be given when the family has income from other sources (including earnings), subject to means testing. There are modest earnings disregards, and, with earnings above these levels, benefits are withdrawn at rates ranging from 62.5 to 70%.	NIS 2 574 for a couple with two or more children.
<b>Tax support</b>		
Wasteable tax credits	Credit points system with a universal component, additional credit for women and a per-child credit, which is applied to the woman’s earned income (and men if they are a lone parent). Women also receive an additional tax allowance.  The credits mean that large numbers of earners, particularly women with children, do not pay personal income tax.	Each universal credit is worth NIS 189
Earned-income tax credit (EITC)	Applies to households with one or more children and those aged 55 and over. The credit is higher for those with three or more children.	Maximum credit for a family with one or two children NIS 290 (NIS 420 for three or more children)

Table 2. **Key unemployment and social benefits** (continued)

Item	Notable features	Indicative 2009 value, NIS per month
<b>Programmes exclusively for families</b>		
Paid maternity leave and birth grants	<p>Conditional on NI contributions for 10 of the last 14 months (or 15 out of preceding 22 months) preceding due date. Those on Income Support would normally be eligible for the hospitalisation grants as they pay a health-care contribution.</p> <p>A maternity allowance pays 100% of previous earnings for up to 14 weeks.</p> <p>In addition, there are one-off birth grants, which decline with number of children, hospitalisation grants and benefit for precautionary rest taken during pregnancy.</p> <p>Leave (and payment) can be switched to the father for up to six weeks.</p>	
Universal child allowances	<p>More generous allowances can apply to children born before May 2003, depending on birth order. Benefits for the second to fourth child are being increased in series of hikes due to end in 2012.</p> <p>Those on Income Support receive additional allowances equal to 70% of regular child benefit for both the third and fourth children.</p> <p>The allowances are paid until the child reaches 18 years.</p>	NIS 159 to 446 depending on birth order and age of child.
Study grants	<p>Eligible groups notably include lone parents and families on Income Support with at least four children.</p> <p>Annual payments for when children are aged 6 to 14. The payment is lower for when children are 12-14 years.</p>	NIS 64 or NIS 115 per child
Regulated and subsidised daycare and pre-school services	There are several systems of support [see main text].	NIS 716 (maximum possible subsidy)
Housing	<p>Eligibility for public housing includes a requirement of three or more children, alongside a minimum number of "credit points" and income criteria.</p> <p>There is a system of rent assistance in which support increases with family size. Assistance also depends on the area of residence, and there is a wage ceiling for eligibility. The rates for recent immigrants differ.</p>	NIS 1 170 per family

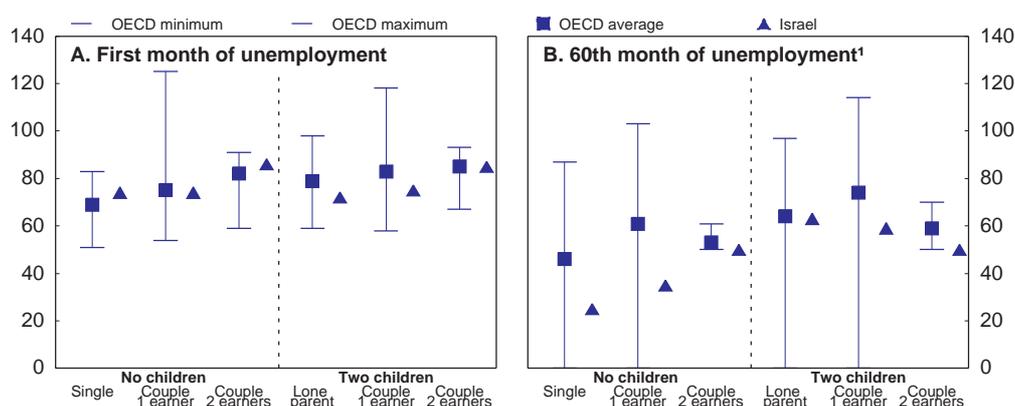
The universal child allowances are often at the heart of debate on welfare benefit. For large families where parents are unemployed, or in low-wage jobs, these benefits form a large share of income and are therefore of particular interest to the Haredi and Arab-Israeli communities. Several changes have been made to the allowances in the 2000s. By 2003 substantial cuts had been made, and another reform in May of that year saw further change. Prior to May 2003 a single schedule applied in which the allowance for the fourth child (and subsequent children) was much higher than that those for the first three children. Then, as part of the wider welfare cuts a new single-rate allowance schedule was introduced at a level equal to that applying to the first two children. But the new schedule was applied only to those born after May 2003, which is particularly significant given the allowances are paid until children are 18 years old. No further changes to the schedule (aside from regular indexing increases) were made until 2009 when the new government began increasing the allowances for the second, third and fourth children (both for those born before 2003 and those born after). The first increases were made in July 2009, and the final one will be made in April 2012. However, even with these increases the child allowances will remain well below those provided at the beginning of the 2000s. For example, in 2000 a family with six children received NIS 3 031

per month in child allowances, while after April 2012 the total allowance will range between NIS 1 254 and NIS 1 868, depending on the number of children born before the May 2003 cut-off.

### *Microeconomic simulation of the finances of low-income households*

International comparison of out-of-work and in-work net household incomes using micro-simulations shows Israel's system to be fairly close to the OECD average in the initial phase of unemployment but relatively less generous for long-term unemployment. Figure 1 shows the ratio of total net out-of-work household income to in-work income (*i.e.* the replacement rate) for six standard household types when potential earnings are two-thirds of average earnings. The ratios for Israel in the first month of unemployment are close to the OECD average for all household types (Panel A). In Israel, as in a large number of OECD countries, at this stage of unemployment, insurance-type benefit is key in bolstering the replacement rate. At the 60<sup>th</sup> month of unemployment, insurance benefit has invariably been exhausted and families rely more heavily on safety-net welfare support, where this is available (see footnote to Figure 1). In Israel's case the replacement rate in this scenario of long-term unemployment is substantially lower than the average OECD value for three of the household types at the 60th month of unemployment (Panel B).

Figure 1. Replacement rates at two-thirds of average earnings in the standard OECD micro-simulations



1. The microsimulations normally cover only benefits for which there is a general entitlement. For both Italy and Greece, where no broad social-assistance programmes exist, the simulations indicate that benefits are zero for some types of household at the 60<sup>th</sup> month of unemployment. Hence the minimum OECD replacement rates are zero in some cases. However, in Italy and Greece, and possibly in other countries, local authorities or sub-national governments may provide some form of cash support on a case-by-case discretionary basis.

Source: OECD, Tax-Benefit Models; see [www.oecd.org/els/social/workincentives](http://www.oecd.org/els/social/workincentives).

Arab-Israeli and Haredi households are often large, which has an important bearing on poverty rates. Figure 2 examines scenarios of in-work and transfer income for couples with up to eight children (based on tax and benefit settings in 2009). All but one of the scenarios assume all children are born after May 2003 and include the full increase in allowances currently being phased in. Therefore, the calculations represent where the system is heading, not where it is right now. It is assumed that, when earning, individuals are on the full-time minimum wage. The chart also shows the relative poverty threshold based according to the OECD's "square root" approach and that typically used by the NII (see Box 1). To provide a metric, values in the chart are expressed relative to the minimum wage. The results suggest the following:

- Non-working households are universally and often substantially below relative poverty thresholds, and the gap widens with family size. Net income for a couple with no children is about 50% of the minimum wage and can be as high as 180% of the minimum wage when there are eight children. However, the corresponding poverty thresholds are roughly 90 and 200% by

the OECD measure and 90 and 270% by the NII measure. Furthermore, these are generous estimates of out-of-work household income because low-income households are often not eligible for Income Support (see below).

- Families with a single-earner on the full-time minimum wage and eligibility for Income Support are close to the OECD poverty thresholds, but typically fall well short of the NII thresholds. The EITC and in-work Income Support make an important difference. Large families who are not eligible for these fall substantially below even the OECD poverty thresholds.
- Single-earner minimum-wage Ultra-orthodox families with small numbers of children are probably better off than other single-earner households but have roughly similar net incomes when families are large. These families are typically not eligible for Income Support, because the male head of household studies full time. Ineligibility for Income Support means that in principle such households also do not receive the additional child allowances or “study grants”. However, they do receive study grants of around NIS 700 per month from the Ministry of Religious Affairs. These are often boosted by private-sector grants, which typically raise income from grants to around NIS 1 500 per month (the estimate used in the calculation for Figure 2).
- The ratio of out-of-work income to in-work income for families with children ranges from 70 to 80% without the EITC and from 65 to 70% with EITC (Panel B). The effective “return” to one person shifting into a minimum-wage job is modest because of the withdrawal of Income Support. Without EITC, family income increases only by an amount equivalent to 35-40% of the minimum wage (Panel C). With the EITC, the return is better, but nevertheless never more than 50%. However, Israel is not exceptional in this regard. Examination of similar calculations for OECD countries reveals that the transition from unemployment to employment also often involves a fairly heavy “tax” on earnings, particularly for a move into a low-paid job. Similar to Israel, benefit withdrawal is likely to be playing a significant role.

In sum, the scenarios underscore that households without earners are very likely to be poor. At best, single-earner minimum-wage families are on the threshold of poverty. If the family is large and earnings are substantially below the full-time minimum or the family is not eligible for Income Support, then it too is likely to be below poverty thresholds. One final observation; as Box 1 and Figure 2 show, by construction standard relative poverty thresholds for large families are much higher than those of more typical family sizes in OECD countries. For example, the threshold for a couple with six children is 41% higher than that of a couple with two children under the OECD’s square root approach and 63% higher

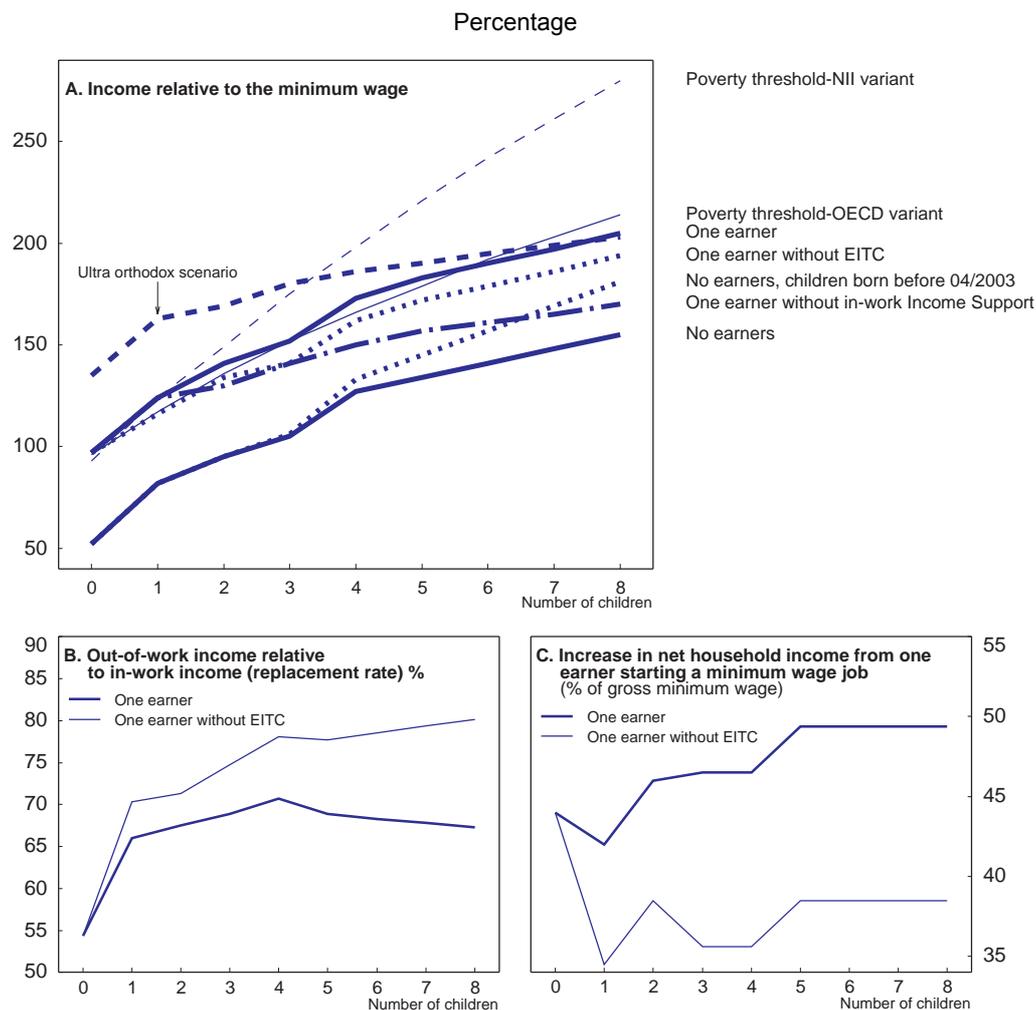
#### Box 1. The OECD “square root” and NII measures of relative poverty

Relative poverty thresholds are commonly calculated as half “standardised” median income. The standardisation procedure divides household income by an adjusted figure for family size that gives progressively less weight to each additional family member (conceptually allowing for overheads and economies of scale in the cost of living). However, weighting procedures differ, and this can make big differences to the thresholds:

- One approach commonly used by the OECD is to use the square root of family size. The marginal weights for each additional household member are therefore as follows: 1, 0.41, 0.32, 0.27, 0.24, etc.
- The NII uses a different weighting system; the marginal weights are 1.25, 0.75, 0.65, 0.55, 0.55, 0.45 and thereafter 0.4.

For small households, the NII and “square root” OECD approaches generate practically the same relative poverty thresholds, but the NII thresholds increase faster than the OECD ones with increasing family size. Thus, poverty rates calculated by the NII method are higher than under the “square root” method, especially for large families.

Figure 2. Net household income for couples with earnings capacity at the minimum wage



Source: OECD calculations from Central Bureau of Statistics, *Statistical Abstract of Israel*.

according to the NII method. Even strongly “family friendly” tax-benefit systems are unlikely to make such generous provisions, and it seems very likely that large families often fall below poverty thresholds, so defined, elsewhere too.

### Recommendations for tax-benefit adjustments

Tax-benefit reform can help ease poverty and strengthen welfare-to-work incentives, but it is tricky to design a combination of adjustments that do both of these things, especially without significant fiscal cost or compromise elsewhere. Raising universal benefits or introducing tax breaks does not affect work incentives too severely because both out-of-work and in-work incomes are increased. However, universality means that such measures are inefficient at targeting the poor and can therefore be expensive. Conversely, increases in means-tested social assistance, or similar policies, target better but can compromise work incentives. Aside from these general considerations, there are some “non-starters” in the Israeli context. Because effective tax rates are already modest for low-income households, lowering the bottom end of the income-tax schedule, reducing social-security contributions for low-income workers or raising wastable tax credits are unlikely to either relieve poverty or raise work incentives to any great

degree. These avenues have therefore largely been exploited (though reportedly the government is looking into cutting social insurance contributions for low earners).

In light of these considerations and the likelihood of tight fiscal budgets for some time to come (see OECD, 2010b), benefit and tax adjustments must focus very tightly on the low-income households. This suggests the following approach:

- *Make more use of the EITC* (“negative income tax” in Israeli parlance, though it is not strictly that).<sup>3</sup> Expand coverage to the whole of the country, and consider increases in credit and increased differentiation according to the number of children. That said, vigilance regarding the take-up of the scheme is called for, as to date this has been limited. The shortfall in take-up could prove to be temporary, but permanent weaknesses may emerge. For instance, OECD (2010a) suggests that it may be the case that administration of the EITC by the National Insurance Institute would be better than by the Tax Authority and Post Office, on the grounds that this body is more proximate to the low-income population.
- *Reduce the wastable personal-income tax credits.* Reduction in the regular (*i.e.* wastable) tax credit for earners would also focus policy on helping low-income families (especially if combined with an increase in the EITC). Parenthetically, on equity grounds the credit ought to be made available on an equal basis to men and women, *i.e.* the basic credit should be the same and the extra credits for children should be claimable by either their fathers or mothers. Making this adjustment in a revenue-neutral way would probably anyway require reduction in the child credits.
- *Increase the Income Support*, and bring in new levels of benefit for families of more than two children. More generous levels of Income Support are the most direct route to reducing poverty, since it is, in principal, well targeted on both non-working and working households. Furthermore, the use of an employment test as well as a means test in judging entitlement means the benefit has a strong welfare-to-work component, especially under the Light for Employment programme (see below). The micro-simulations described above suggest that adjustments to ease the “taxation” of those with low earnings through the withdrawal of Income Support would also be beneficial to work incentives.
- *Refrain from further increases in the rates of child allowances beyond those already scheduled;* indeed, consider making economies. In the Israeli context, increasing child allowances would boost the incomes of many low-income households. But the universality of the allowance means increases also go to the less needy and do not enhance work incentives. Indeed, increases in child allowances arguably send negative welfare-to-work signals to large, low-income households. Economies in the child allowances could, for example, be made by applying the lower rates for children born after May 2003 more widely.

### **Creditable initiatives, but some weaknesses in benefit-delivery systems**

Households’ participation in the labour market is influenced not only by the straightforward financial implications of taxes and benefits but also by employment services and benefit delivery systems. These administer the benefits (including the application of eligibility criteria) and have wider responsibilities for

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3. The term negative income tax is generally reserved for the (largely untried) concept of a large *universal* non-wastable tax credit (effectively a universal basic income) that would obviate the need for means-tested welfare systems.

activating the workforce and dealing with social problems. To this end such systems are usually armed with a range of activation tools.

The majority of cash benefits are processed by a network of offices run directly by the NII. For example, in the case of Income Support the offices carry out the means test, organise benefit payment and so on. However, the employment tests for Income Support (and unemployment benefit) are carried out by public employment services (the Employment Service), or by private-sector companies in those areas where the Light for Employment operates. Entitlement processes for other benefits in the NII system vary; notably, that for disability benefits involves assessment by a doctor approved by the NII and a rehabilitation officer. Benefits not run by the NII include: housing support (which is managed by the Ministry of Housing) and subsidies for childcare and early education (which are run by the Ministry of Education and the Ministry for Industry, Trade and Labor; see Table 1).

### ***Stringent restrictions on car ownership in means tests***

In principle, the Income Support benefit provides core financial support to low-income households, both when in and out of work. However, it is sometimes reported that certain criteria in the means test exclude otherwise deserving applicants. The fact that only 120 thousand families are recipients, while an estimated 400 thousand are below the poverty line certainly suggests there is room to expand coverage.<sup>4</sup> A general investigation of the coverage of Income Support should be conducted.

Rules on car ownership in the means test for Income Support are unusually strict as they generally exclude applicants if they own or even have access to a car (motorcycle ownership is acceptable). There are exceptions: the rule is waived if the applicants (or their children) are disabled, or if the vehicle is required to attend medical treatment. Also, if the applicant is working the rule can also be waived if earnings are above a certain level, the car is a relatively old model and below a certain engine capacity and if no other vehicle is owned.<sup>5</sup> Such stringent constraints are rare in OECD countries. To be sure, means tests for welfare benefits often have limits on the value of vehicles but typically do not rule out ownership.<sup>6</sup> Denying benefits because applicants have *access* to a car is unheard of. In fact, in the United States there are programmes helping those on welfare buy cars, on the grounds that this widens job opportunities. Interestingly for the Israeli context, Raphael *et al.* (2001) find that in the United States the positive effects on the employment rates are especially large for segregated minority populations. At a minimum the eligibility conditions regarding car ownership and use should be lightened, by imposing a limit only on the value of the car. Indeed, a programme that helps low-income households access automotive transport could be considered, particularly in areas with limited public transport options.

### ***Assessment of the Employment Service and the Light for Employment Programme***

The Employment Service operates along lines familiar in many OECD countries. The employees are regular civil servants and the Service is under the Ministry of Industry, Trade and Labor. Each person is dealt with by a single case officer and is required to register regularly in person. The case officer periodically arranges face-to-face meetings to discuss job opportunities, progress in applications, training options and so on. Importantly, the officers are responsible for signing off on the client's employment test

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4. According to the NII, as of 2007, 120 218 families received Income Support benefit (National Insurance Institute, 2008, p. 123), while for 404 400 families net incomes were below the poverty line based on the Institute's relative poverty index.
  5. The model of the vehicle must not have been available for at least seven years for engine capacities up to 1 300 cc and for 12 years for engines up to 1 600 cc.
  6. Exceptions among OECD countries include some US states, Canadian provinces and Swiss cantons.

and, on a discretionary basis, can impose temporary bans on benefit eligibility for transgression of rules. Use of information technologies is advanced. Most remarkably, finger-print readers are used for registration (on arrival, clients register with the readers and are informed whether they have an appointment with their case officer).

The private placement programme was initially titled the Mehalev Programme and, following alterations in 2007, the Light for Employment programme but is widely referred to as the Wisconsin Programme. Private-sector operators run the employment test for Income Support under a performance-based contract. The project started in 2005 and is being piloted in four localities (each with a separate company), which in total cover about one-fifth of the country's Income-Support beneficiaries. Individuals are transferred from the Employment Service on a non-discretionary basis with certain exemptions, notably those unemployed for a short period, mothers with infants and beneficiaries above a certain age.<sup>7</sup> The employment test is far more demanding than that conducted by the Employment Service. It requires following a "personal plan" of training and job search, which, at least on paper, absorbs 30 to 40 hours per week. To fund this, the operators are provided with government grants for activation and have wide discretion on their use. The operators' profits are generated from a separate payment. Initially, this attached significant weight to the savings in benefits implied from getting individuals off welfare rolls. The alterations made in 2007 resulted in job placement being given more prominence in the performance contract and the introduction of a "perseverance grant" to beneficiaries that encourages them to remain in employment.<sup>8</sup> However, the reforms in 2007 also excluded 45+ year-olds from compulsory participation, which practically halved the programme's client base.

Assessment by the official monitor (JDC-Myers-Brookdale Institute) has focussed on the impacts of the programme on the number of benefit recipients, employment levels and household incomes. The impacts in part stem from individuals passing from the programme into employment. But, in addition, a large share of those referred to the operators does not attend the programme, choosing to forego Income Support. Some may have already been in undeclared jobs, others are prompted into finding work and some simply decide to remain unemployed. Comparison of experimental and control groups has shown sizeable impacts on the number of beneficiaries and on employment (Box 2). Also, the programme increases employment from earnings. However, reduction, or complete withdrawal, of Income Support has not led to any significant positive effect on total household incomes in the comparisons made so far. That said, positive effects are likely to emerge over the longer term. As yet, neither the net fiscal implications of the programme nor the wider implications for local labour markets have been explored in any great depth.<sup>9</sup>

As of October 2009, there were plans to roll the programme out to the rest of the country (as early as 2011) but also to precede this with further adjustments. This is broadly welcome. Provisional proposals for adjustment include expansion of coverage up to age 60 and increased cash bonuses for participation, which seem sensible. The proposals also include some "softening" through new exit routes that would allow a person (under certain conditions) to be released from the programme. Clearly some care is needed in designing these. Too many clients may exit the programme or the operators may be able to use these routes for cream skimming.

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7. The operator's "client base" includes some in employment, for instance those who entered the programme, subsequently found jobs but who remain eligible for Income Support.

8. The contract with the operators now includes payment of 7% of calculated savings in welfare benefits and payments ranging between 20 and 30% of the wages of programme participants' annual earnings once in employment. For further detail on the changes made to the programme in 2007, see OECD (2010a).

9. Interestingly, the Employment Service appears to be run with relatively few resources. OECD comparisons of the number of registered unemployed per PES staff member is very high in Israel compared with available figures for OECD countries (OECD, 2010a).

### Box 2. The impact of the Light for Employment programme

Analysis by the official monitor of Light for Employment, the JDC-Myers-Brookdale Institute, has principally comprised comparisons between “experimental groups” in the areas where the programme operates and control groups in other parts of the country. The latest results look at the impact of the programme between November 2007 and July 2008 (National Insurance Institute, 2009):

- Over this period the experimental group’s employment rate increased by 10.5 percentage points (from 41.4%), while that in the control group increased by 1.4 percentage points (also from 41.4%).
- In July 2008 59% of the experimental group were receiving Income Support, compared with 78% in the control group.
- In the experimental group, average monthly income from earnings increased by NIS 441, but income from benefit dropped, on average by NIS 447 per month.

The future role of the Employment Service needs to be clarified in advance of the programme roll out and dovetailed appropriately with contracted services. In those areas where private-sector placement operates, the Employment Service’s client base is narrowed to the short-term unemployed and those beneficiaries who are exempt from Light for Employment. There may be better ways of dividing the roles of the Employment Service and private operators. Furthermore, there are potential complications. For example, if some Employment Service offices are awarded contracts under Light for Employment (such a move is being mooted), the relative merits of them having a dual role have to be considered.

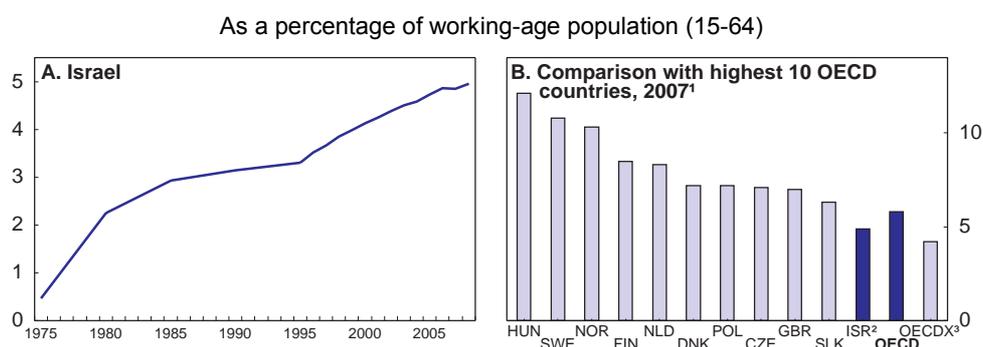
Following roll out, it will be important to keep an open mind to further adjustment of the programme, as significant uncertainties remain as to its effectiveness. In particular, very close attention should be paid to competition issues. At present there is no “immediate” competition to operators and no plans to introduce it. Currently, the system relies on initial competition for the tenders backed by supervision to ensure that the contract is being fulfilled. On a day-to-day basis the operators are effectively local monopolies. This could prove to be a significant weakness in the system. Some countries have arrangements that overcome this problem. For example, in the Australian “Star Rating” system clients can choose between several approved placement services (OECD, 2010a). The Israeli authorities claim that ensuring choice of provider in the Israel context would not, on balance, be beneficial, because this would reduce economies of scale in costs and service quality. While this is a plausible counter-argument, it cannot be presumed correct and should, as far as possible, be gauged in the monitoring process. Multiple-provider systems operate not only in Australia, which has a large number of remote communities, but also in Denmark (at the regional level) and in some small US states. This suggests that efficiency losses from multiple provision and other difficulties, such as ensuring provider competition in remote areas, are perhaps surmountable.

Differentiation of clients according to difficulty of placement and other criteria may also need to be strengthened. Operators are required to run four types of programme (for immigrants, disabled persons, long-term beneficiaries and “academics”). However, the activation funds given to providers do not distinguish between different client types, which is a source of potential inefficiency. If client characteristics play an increasing role in the system, then profiling processes may also need upgrading. And, the impact of absenteeism on the programme’s effectiveness needs to be closely watched. Reportedly, around 30% of clients do not show up on the grounds of sickness on any given day.

### *Worrying trends in disability benefit*

The number of working-age individuals receiving disability benefit has been increasing rapidly. There was a 30% increase in those receiving the core benefit (the “Disability Pension”) between 2001 and 2007 and an even larger increase in those receiving additional benefits. The number of recipients as a share of the working-age population has been increasing rapidly since the mid-1990s and is currently 4.5% (Figure 3).<sup>10</sup> Mental impairments are the most common form of disability among prime-age recipients, and muscular and other conditions among older cohorts. Around 80% of recipients are classified as “100% incapacitated”, entitling them to the maximum level of benefit, which is well above the level provided by Income Support.

Figure 3. **Disability benefit recipients**



1. Or latest available year.
2. Israel has the 18th rank.
3. OECD average excluding top ten.

Source: National Insurance Institute Annual Survey 2008 and OECD, *Disability Database*.

Such a rapid increase in beneficiaries is worrying. Experience in OECD countries (for example, Hungary, the Netherlands and the United Kingdom) has shown that if disability benefit becomes prevalent, it becomes difficult to tighten rules for new entrants and to implement reforms that re-assess existing recipients with a view to integration in the labour market. As a result, disability benefit can end up undermining welfare-to-work policies. Although incidence of disability-benefit receipt in Israel has not reached the levels faced by some OECD countries, it could do so if recent trends continue.

In recognition of this issue, welcome reforms have recently been made that encourage disability beneficiaries to enter the labour market. Following the recommendations of the Laron Committee, more generous rules regarding employment were introduced at the beginning of 2009. In particular: those classified as permanently incapacitated will not be re-assessed if they start working; benefit withdrawal rates have been made more favourable; individuals who leave employment can return to previous disability benefit levels without re-assessment; and, recipients can opt for a new “incentive” pension.<sup>11</sup> To maximise effectiveness, closer attention to facilities for disabled workers may be required.

10. According to the NII’s Annual Survey (National Insurance Institute, 2009), Disability Pension recipients numbered 150 512 in 2002 and 194 988 in 2008. Among the auxiliary benefits, the Attendant Allowance beneficiaries for instance increased from 20 614 to 29 390 over the same period, an increase of nearly 50%. Increases of similar magnitudes were seen in the other auxiliary benefits.

11. Further detail on the reform can be found on the NII’s website.

Entitlement procedures should also be examined with a view to stemming inflows to disability benefit, especially as the Laron reforms make it even more attractive relative to other benefits. The entitlement procedure comprises a first assessment by a doctor (authorised by the NII), who determines whether the person is eligible for any level of disability benefit. In a second stage, the doctor consults with a rehabilitation officer to set the degree of incapacity (and therefore the level of benefit). However, the rehabilitation officer's assessment is allowed to be influenced by other factors such as the "labour-market situation in the disabled person's area of residence".<sup>12</sup> The authorities should reconsider this rule and more generally the eligibility procedure. Also, a shift in the approach of medical assessment from general disability to capacity for work should be contemplated.

### **Increasing government support for daycare and early childhood education**

Ensuring there are feasible options for parents with young children to combine work and family is important for the success of welfare-to-work strategies. Israel's relatively short period of paid maternity leave (three months) means that parents organise some form of full-time childcare from an early stage if they both continue working. This is reflected in international comparisons. Nearly 50% of infants aged under 2 years attend daycare (the OECD average is 30%), and over 90% of those aged 3 to 5 years are in early education (the OECD average is a little over 70%) (OECD, 2010a).

Government support primarily comprises:

- *Daycare* (children aged three months to three years). The Ministry of Industry, Trade and Labor supervises and financially supports various NGOs (such as the Women's International Zionist Organisation (WIZO), Na'amat and Emunah) that have long been the main providers of daycare. Home-based daycare is being supported by a special programme (the Mishpachton programme). Parents' fees for daycare are regulated and subsidised according to a means test.
- *Nurseries and Kindergarten* (three to four years and five years, respectively) policy is under the Ministry of Education, while municipalities are directly responsible for provision. The Ministry sets and supervises minimum provision requirements, administers state transfers for running services, and regulates and subsidises parents' fees. Provision is flexible; municipalities can operate services directly or contract out to private-sector providers.

Welcome attention is being paid to improving services. Significant additional resources, both for infrastructure and recurrent spending, have been pumped into childcare support in recent years. And regulatory changes are underway. A law extending the number of hours of pre-school is gradually being implemented; and compulsory provision of free services for three-to-four year-olds by municipalities in Arab-Israeli localities is being introduced.<sup>13</sup> However, childcare services for Arab-Israeli infants warrant further attention. Only 10% of Arab-Israeli children aged 0 to 2 participate in formal care compared with 45% for the rest of the population (OECD, 2010a). While this may well partly reflect differences in demand, it probably also reflects low priority on childcare facilities among the NGOs serving Arab-Israeli communities.

Also welcome are efforts to limit the impact of a controversial Supreme Court decision in 2008 that ruled in favour of a claim that childcare expenses should be tax deductible. Indeed, the Court ruled that 100% of expenses towards private childcare (such as a nanny) should be tax deductible and 63% of

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12. The entitlement procedure is described in National Insurance Institute (2008, page 202).

13. The authorities also see significant growth in unofficial daycare centres as a cause for concern and are taking countervailing measures. Private unlicensed daycare is forbidden by law. However, according to a report commissioned by the OECD, there were an estimated 96 000 children in unlicensed daycare in 2008, compared with 77 600 in approved daycare.

daycare and pre-school expenses. This could be helpful in encouraging some parents to combine work and family responsibilities. But it is highly regressive, implying potentially significant tax breaks for middle- and upper-income earners and little or no benefit to low-income households. The government has sensibly endeavoured to limit the impact of the decision by proposing a bill that would introduce a tax break for each child aged under five.

### A mixed picture in labour regulation

Successful welfare-to-work policy requires labour markets conducive to absorbing typically low-qualified individuals who have either not worked for some time or who have never worked before. The volume and turnover of jobs in sectors requiring limited qualifications and experience are often strongly cyclical but are also affected by wage-setting processes and labour-market regulation. These were once set predominantly by collective agreement, but declining union influence has seen a rise in company and individual-level bargaining and greater reliance on state-sponsored regulation *via* the legislature and the courts (see Box 3).

#### Box 3. Industrial relations in Israel

Wage setting and labour regulation began shifting away from a corporatist system in the mid-1980s as part of the wider move to a more market-oriented economy. Prior to this, the vast majority of employees were members of a single union body, Histadrut, and non-members were typically covered by extension through collective-agreement rules. The fall-off in union membership and coverage has been greatest in the private sector. The decline has been partly driven by the compositional shift in employment away from sectors with strong union membership and but also by employers opting out of the collective-agreement system. Legislative reform has also played an important role. Notably, health insurance funds were separated from the unions in the mid-1990s, and new regulations ensured access to medical insurance, regardless of union membership. A survey conducted in 2006 revealed that only about one third of all employees were union members, with coverage of collective agreements at around 55% (Cohen *et al.*, 2007). In recent years Histadrut and the main employers' representative bodies (the Manufacturers' Association of Israel and the Federation of Israeli Economic Organizations) have increasingly presented a common front on key issues.

Nevertheless, centralised wage setting and regulation *via* collective agreements remain important. Industrial relations in the public sector remain strongly centralised and annual increases highly uniform. For instance, in 2008 Histadrut signed an agreement with the government for an increase of 5% in three stages between November 2008 and December 2009, which the union successfully defended in negotiations over the draft 2009/10 budget. Collective agreement over non-wage issues also remains important. For example, the introduction of mandatory second-pillar pensions (see below) was made *via* collective agreement, not government legislation.

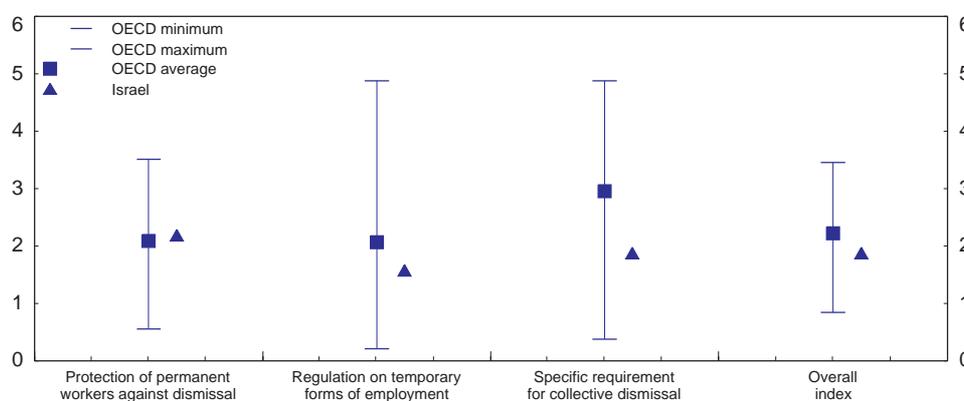
Declining union influence over the 1990s saw growth in employment *via* temporary-work agencies (both in government and the private sector).<sup>\*</sup> This process undermined the collective agreements, providing greater flexibility without reforms to the agreements themselves. There was no specific regulation until 1996 when new legislation included a rule that agency employees working beyond three years in the same establishment would have the same rights as regular employees. Additional regulations have been added through collective agreements. In 2000 a law was passed that agency workers would have the same rights as those working directly for the same employer and that an employee of an agency cannot be employed with any user firm for more than nine months. The latter rule was, however, not implemented until January 2008.

\* One estimate is that, by the end of the 1990s, around 5% of employees worked for temporary-work agencies, a large share of which for government. Unfortunately, more recent estimates are not available (OECD, 2010a).

Hiring and firing regulations generally fall well within the norms of developed countries and are overall less restrictive than the OECD on average. Indicators show protection of permanent workers against dismissal is slightly stronger than the OECD average, while requirements for collective dismissal and regulation of temporary employment are relatively light (Figure 4). In fact, the score on temporary employment would be even lower, were it not for the implementation of more stringent conditions at the

beginning of 2008 (see Box 3). In Israel, as well as in a number of OECD countries, collective agreements provide additional conditions which are not included in the indicators used in Figure 4. However, information gathered during meetings conducted with employers' representatives for this paper suggests that in Israel's case these additional regulations are not generally onerous. In broad terms, the absence of heavy employment-protection legislation helps "outsiders" such as the long-term unemployed get a foothold in the labour market. Nevertheless, policymakers need to be mindful of adverse behavioural reaction to regulatory changes. For example, the more stringent conditions on employment *via* temporary-work agencies are believed to be prompting a switch to self-employment contracts, which could have consequences for tax and social-security revenues.

Figure 4. **Employment protection in OECD and Israel, 2008<sup>1</sup>**  
Scale from 0 (least restrictions) to 6 (most restrictions)



1. Horizontal bars represent the minimum and maximum score in OECD countries.

Source: OECD Indicators on Employment Protection.

Enforcement of the minimum wage and other labour regulation has, at least in the past, been light. A report by the State Comptroller in 2007 estimated that between 8 and 11% of employees were paid below-minimum wage rates but found that labour inspections paid scant attention to the issue and that legal follow-up on cases of abuse in general was slow.<sup>14</sup> Steps have been taken to strengthen labour inspection, including hiring more inspectors, improvement in IT systems and changes to processing procedures. It is too early to gauge the full impact of these measures, though OECD (2010a) suggests that more measures may well be required. For instance, international comparison shows the number of employees per inspector is still high. Some argue that minimum-wage enforcement is particularly difficult in some segments of the Israeli labour market, for instance due to intra-family employment and distrust of the authorities among the Arab-Israeli population. This suggests that enforcement efforts may have to be rather more intense than elsewhere to achieve results.

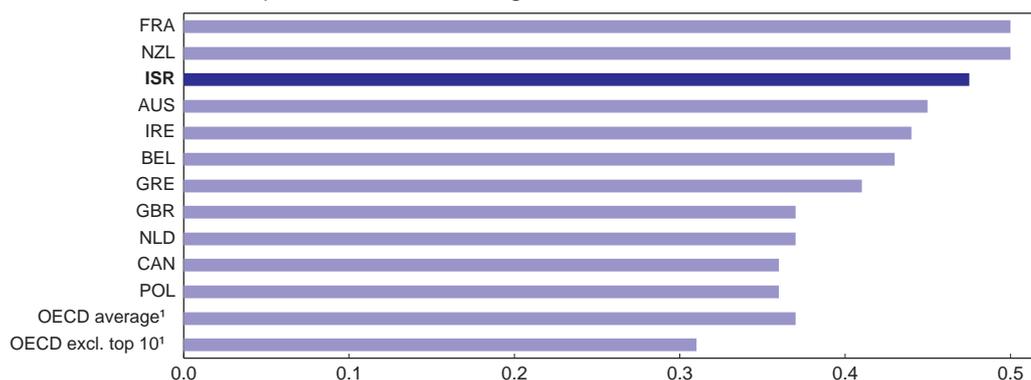
At the same time, the ratio of the minimum wage to the average wage is worryingly high. Minimum-wage legislation sets a floor to the ratio of the minimum to the average gross wage. For example, a floor of 47.5% applies to all those aged 18 or above (lower floors apply to younger workers).<sup>15, 16</sup> This is very high compared with the equivalent ratios in most OECD countries (Figure 5). It

14. The State Comptroller and Ombudsman (2007) reports that only 11% of the inspections conducted by the enforcement unit of the Ministry of Industry, Trade and Labor covered minimum wage issues, a share which severely underrepresented the scale of the problem. The report also found that 70% of cases requiring legal follow-up had been left unattended for an average of nearly 15 months. Other evidence on enforcement is cited in OECD (2010a).

15. There is also an indexing system comprising legally binding, economy-wide floors to wage increases when inflation is above a certain level. The index is partial, guaranteeing a nominal increase of 90% of the

is likely the floor is curtailing demand for low-productivity workers. There are also better mechanisms for ensuring a decent living standard for workers, not least because the statutes anyway are widely ignored. In light of this, some erosion over time in the minimum wage relative to average earnings should be considered, especially if enforcement activity is ramped up further. An increase in Income Support (that would also increase in-work benefit in the case of low-earning households) and/or a larger EITC, as suggested above, could be used to guard against an increase in-work poverty.

Figure 5. **Ratio of minimum to mean wage**  
Comparison of Israel with highest ten OECD countries, 2008



1. Nineteen countries available for OECD average.

Source: <http://dotstat.oecd.org/wbos/Index.aspx>.

### Policy towards non-Israeli workers and the poverty issue

Non-Israeli workers account for a significant share of employment. Employers have become accustomed to low-wage labour on temporary work permits, particularly in agriculture and construction. Also, a large number of non-Israelis are employed as domestic carers for the elderly and disabled, many *via* a scheme for long-term care (OECD, 2010a).<sup>17</sup> In past decades these workers came mainly from the West Bank and Gaza Strip.<sup>18</sup> Security issues restricting the number of permits created inconveniences in cross-border employment and led to a widening of channels for workers from further afield. For instance, Thai workers have become common in agriculture, Chinese in construction and Filipinos in households. Permits for these workers are administered by separate systems for each sector (quota systems operate in

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margin of inflation above 4.25%. The mechanism is a remnant of the once comprehensive system of indexing in the economy used to cope with high inflation in the 1970s and 1980s. It has not been triggered since 2003 and is unlikely to re-emerge as an important influence on wages unless there are serious failures in monetary policy.

16. The legislated minimum wage can deviate slightly from 47.5% of the average wage in any given year due to the annual updating mechanism. It is initially updated at the beginning of the year according to a cost-of-living index, which may bring it above or below the threshold. If it is below the threshold, it is increased again in April.
17. The long-term care programme provides individuals with the right to a certain number of hours of domestic help per week. The carers are employed through private-sector agencies, which receive payment from the government. Recently, the ability of foreign workers to change from one agency to another was improved in an attempt to reduce abuse of these workers (OECD, 2010a).
18. Workers from the West Bank and Gaza Strip are employed *via* permits linked to their employer that are renewed every one to three months and must also pass an annual security check. Non-wage labour costs comprise various levies and fees; for instance, there is an 11% “equalisation tax” (OECD, 2010a).

agriculture and construction but not for domestic carers).<sup>19</sup> Despite efforts to tightly control flows, many foreign workers do not have valid employment permits. As of 2008, estimates suggest that non-Israelis accounted for nearly 12% of business-sector employees, comprising one quarter cross-border workers, another quarter reported foreign workers and half unreported foreign workers (Bank of Israel, 2009).

The presence of large communities of poor Israeli households with weak earnings capacity certainly implies that non-nationals in low-wage jobs may be substituting for local labour. In-depth research confirms this. Analysis of non-Israeli employment by the OECD's Directorate for Employment, Labour and Social Affairs discusses a number of papers that find a negative effect on Israeli participation rates from the presence of non-Israeli workers (OECD, 2010a). Hence, in the Israeli context there appears to be a policy trade-off between the economic benefits of cheap imported low-skilled labour and costs in terms of undesirable socio-economic outcomes.

The number of foreign workers in the domestic-care sector continues to rise, but the number of foreign workers in construction and agriculture has to some extent been contained. In construction the number of foreign-worker permit holders has fallen substantially since peaking in the mid-1990s, according to official statistics. In an agreement with employers, the present government envisages there being no foreign-worker permits in this sector by 2012. In agriculture the number of foreign-worker permit holders has stabilised in recent years, and an agreement with farmers will, in principle, bring some decline in the future. However, it remains to be seen whether these goals will be achieved; similar efforts by previous governments were often compromised by successful lobbying by employer organisations. Also echoing previous administrations, the government has proposed mechanisms for making it more attractive to employ Israelis. There is a pilot programme to grant households more hours of subsidised long-term care if they hire an Israeli worker, in addition to plans to boost vocational training for Israelis in construction and to set up a pilot programme (for about 300 workers) in agriculture.

Employers' preference for non-Israeli workers in some sectors lies partly in straightforward gross labour costs, but there are additional incentives. Non-Israeli workers are reportedly often willing to work longer hours than Israeli workers and under conditions that fall below regulated standards. Employers also have monopsony powers over permit workers, and some profit from "visa floating". As in some other countries' visa systems, a market for work permits has developed that allows employers and intermediaries to extract rents from the permits. It is believed that this is particularly prevalent in permits for foreign workers and that it is one factor causing employers to prefer foreign workers over their cross-border counterparts, as well as over nationals.

These considerations further amplify the need for rigorous enforcement of labour law. In addition, measures to tackle rent-taking could also prove useful in putting the employment of Israelis on a more equal footing with that of non-Israelis. Furthermore, positive discrimination in favour of Israeli workers *via* "labour-market tests" could be exploited. Such measures are preferable to wage subsidies in that they do not involve direct fiscal outlays. They might also be easier to implement than cuts in permit numbers because it is harder for employers to argue against them. That said, tighter enforcement of labour regulation and permit rules might drive up undocumented and clandestine employment; any such reactions should obviously be closely monitored.

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19. A separate procedure applies to small numbers of specialised workers outside these areas. Unlike in many OECD countries, the permit system does not require employers to advertise jobs internally or justify hires from elsewhere prior to the recruitment of foreign workers (OECD, 2010a).

## Policy options for reducing poverty among retirees

Poverty in retirement is relatively high: around one quarter of households headed by those aged 65 and over fall below the relative poverty threshold. Part of the solution lies in reducing poverty and increasing employment rates among those of working age, thus providing more scope to save for retirement and reducing the risk of poverty for retirees living in extended family situations.<sup>20</sup> But policy on pensions obviously also plays a role in providing transfers to those in retirement as well as tax incentives and regulations that guide long-term savings.

### *Key features of the pension system*

Until recently, only the first pillar of the pension system provided universal coverage. It comprises an insurance pension combined with means-tested income support under the same system as that for working-age households described above (though in this instance it is called the Income Supplement). Men are eligible for the pension at age 67 and women currently at age 62 (see Table 3). The vast majority of those reaching retirement age (insured or otherwise) are eligible for the insurance pension; among households headed by those aged 65 or above, around 90% currently receive the NII pension (Bank of Israel, 2008a).

The second pillar of the pension system has undergone significant reform over the past 15 years or so with a shift from occupational defined-benefit schemes (that had proved financially unsustainable) into defined-contribution schemes with a choice of provider. The second pillar has three key elements (see Table 3 for further detail):

- *Occupational defined-benefit pensions* (Old Pension Funds). These are being wound down (new members have not been allowed since 1995) but will nevertheless account for a significant share of pensioner incomes for some time to come.<sup>21</sup>
- *Defined-contribution pensions with the private sector* (New Pension Funds). This sector has expanded significantly with the closure of the defined-benefit funds. In January 2008 mandatory contribution rates to these funds were introduced for earnings up to the average gross wage under an agreement struck between unions and employers.
- *Tax advantages in the contribution and accumulation of long-term savings and in annuity payouts.* The tax advantages apply not only to traditional pension products but also life-insurance products and savings in so-called provident funds.<sup>22</sup> In fact, the breadth of pension products contributes to concerns that many households find it difficult to make informed choices and that it is too easy for those selling long-term savings products to mislead them.<sup>23</sup>

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20. According to the Central Bureau of Statistics, 12% of households headed by an individual aged 65 and over comprise four or more individuals. In the Arab-Israeli population the share is nearly 30% (Statistical Abstract of Israel, 2008, Table 5.7).

21. The Old Pension Funds were often funded only by employer contributions. Government subsidised the schemes by providing special bonds with above-market returns (funds were required to invest a certain percentage of portfolios in these bonds). Closure of the funds in 1995 transferred all public-sector employees to defined-contribution schemes and nationalised the remaining Old Pension Funds.

22. Provident funds are a “pure” savings instrument, notably excluding any insurance components. The return is calculated according to the individual’s share in the fund’s assets. Withdrawal can begin only at age 60 or above and, up to a certain value, must be in the form of an annuity.

23. The Capital Market Insurance and Savings Division in the Ministry of Finance has released a “pensions handbook”, is setting up an interactive website and, in co-operation with the Ministry of Education, plans to introduce more financial education in school programmes (OECD, 2010a).

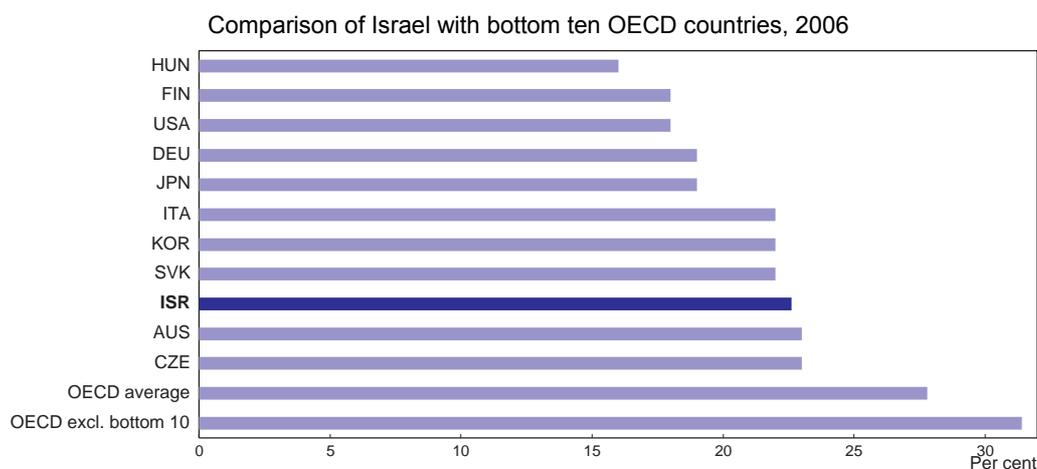
Table 3. Key features of first- and second-pillar pensions

<b>First pillar</b>	
Retirement age	A schedule increasing the ages of entitlement to the NII pension retirement began in 2004 with increases from 65 to 67 years for men and from 60 to 64 years for women. Men's retirement age reached 67 years in 2009, while women's is 62 years and not due to reach 64 years until 2017. There are limits on earnings while in receipt of pension up to age 70 for men and age 67 for women (this is being increased to age 70).
Contributions	Total mandatory employee and employer contributions to the NII have several components, including one for pensions. The NII's accounts are fungible in this regard, and the amount of contribution has no bearing on the pension payout.
Coverage	Practically universal. Exceptions include immigrants who arrived in Israel when over the age of 60 who are covered by a special arrangement.
Payout	Payouts vary according to household composition. For example, as of 2009 the pension for a single person is NIS 1 268 per month and for a couple NIS 1 906.  A seniority increment increases the pension by 2% for each year of full insurance after the first 10 years of insurance (with a ceiling on the total increment of 50% of the pension). Thus, for instance, the pension for a single person with 35 years of full contribution is NIS 1 902 and for a couple it is NIS 2 858.
Income Supplement	The income-support system guarantees minimum income levels subject to means testing. As of 2009, for example, single persons under the age of 80 are guaranteed NIS 2 368 and couples NIS 3 511.
Deductions	A deduction for medical insurance is made on the basic pension (which is lower if the individual is eligible for the Income Supplement).
<b>Second pillar</b>	
Contributions	As of January 2008, mandatory contributions have applied to employees earning up to the average gross wage. Initially the rates were 2.5% but are undergoing stepped increases and will reach 15% (5% from employees and 10% from employers) by 2013. Five percentage points of the contribution also serves as severance insurance.  Non-mandatory pension fund contributions to the new pension funds typically range between 5 and 5.5% for employees.
Tax incentives	Tax incentives not only apply to "regular" pension products but also to saving <i>via</i> life-insurance and so-called provident fund products.  Employer contributions are not counted in employees' taxable income (with a ceiling). Employee contributions are subject to a 35% (wastable) tax credit (with a ceiling). Returns on pension saving are not taxed.  Payouts (annuities) are taxed according to regular income-tax rules except there is: a) a tax credit of 35% on the annuity (with a ceiling equal to about 30% of the average wage); and, b) an additional "credit point" (worth NIS 197 per month in 2009) if one's spouse does not work and has no pension.
Other dimensions	Tax incentives generally guide the retirement age (or equivalent) in long-term saving products. But there are some regulations too. For example, provident fund savings can be withdrawn only at age 60 or above.  Defined-contribution pensions include insurance for severance pay, withdrawal of which affects the pension payout.  As of January 2008, pensioners must redeem their pension on a monthly annuitised basis (and not, for example, make capital withdrawals), unless the person already has a monthly income of at least NIS 4 000 ( <i>i.e.</i> about 60% of the average wage).  In 2008, the tax treatment of long-term saving products was made the same and portability provisions for switches between them introduced (in the past unions or employers often chose the savings vehicle).

### ***Benchmarking the first-pillar pension***

When measured relative to the gross average wage, the first pillar of the pension system is less generous than that in many OECD countries. Standardised calculations of gross pension replacement rates show that, even with the Income Supplement, Israel ranks alongside the lowest ten in the OECD (Figure 6) with a replacement rate of 22% compared with an OECD average of 28%. This comparison of course does not reflect the "generosity" of pension systems as a whole because many countries also have mandatory second-pillar pensions, and Israel itself now falls into this group (this is discussed further below).

Figure 6. Total first tier of pensions as a percentage of average wage



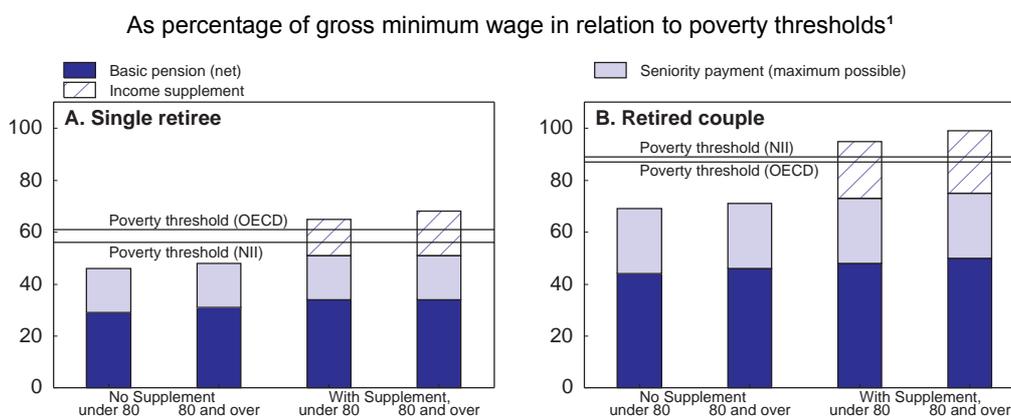
Source: OECD, *Pensions at a Glance 2009*.

However, in relation to poverty thresholds, the first pillar of the pension system ensures, in principle, adequate support for retired single people and couples. The basic pension is very modest, but top-ups from seniority payments and/or the Income Supplement can bring income close to or above the thresholds. For example, among single retirees aged under 80, the net basic pension is equivalent to 28% of the minimum wage, while the poverty threshold is estimated to be equivalent to 61% under the OECD method and 56% under the NII method (see Figure 7). The seniority payment can raise the pension to up to 44% of the minimum wage. And, if eligible for the Income Supplement, the retiree is guaranteed an income equivalent to 61% of the minimum wage which puts them at or above the estimated poverty thresholds. The results are qualitatively the same for those aged over 80 and for retired couples.

However, echoing Income Support, only a small share of retirees is eligible for the Income Supplement, and the seniority payment is typically modest. For instance, in 2007 only 16% of those receiving regular state pensions received the Income Supplement, though this figure is higher once special arrangements targeting older immigrants are taken into account.<sup>24</sup> As for working-age households, it is likely that the eligibility conditions are in some way limiting access to means-tested benefits for retirees in similar ways to other households (see above). Limited access to Income Supplement implies greater reliance on the basic pension and seniority payments. But the latter are typically smaller than shown in Figure 7, which shows maximum possible values. For example, in 2007 for four out of five pension recipients the seniority payment was worth on average only 29% of the basic pension (compared with the maximum possible of 50% after 35 years of contributions).

24. The 16% figure quoted in the main text refers to the share of those receiving the Income Supplement among those who have become eligible for a pension according to the standard regulations, notably the minimum ten years of contributions. However, according to a special arrangement between the NII and Ministry of Finance, the Ministry funds the pensions of some who do not fulfilled the contribution criteria, the chief target being older immigrants. Reportedly, many of those benefiting from this scheme are also eligible for the Income Supplement. As a result, the overall share of pensioners receiving the Supplement was 27% in 2007, according to the Ministry of Finance.

Figure 7. The insurance pension and income supplement



1. A deduction for medical insurance applies to the basic pension which is lower if the person is eligible for the Income Supplement. Data refer to 2009 values. The poverty thresholds are based on the latest available thresholds (2005 for OECD measure and 2006 for NII measures).

Source: OECD calculation based on data from the National Insurance Institute.

The above suggests that measures to stem poverty using the first-pillar pension should focus on widening access to the Income Supplement, rather than increases in the universal component of the pension, which could prove costly. The Income Supplement itself appears to guarantee incomes close to poverty thresholds, so that large increases in generosity do not appear necessary.

As regards other dimensions of the first-pillar pension, the retirement ages are particularly remarkable. As Table 3 notes, the age at which men can first access the state pension has been increased to 67 years, which is ahead of developments in many OECD countries. Women's retirement age is currently 62 years. While it is being increased, the schedule will bring it only to 64 years by 2017 (a rate of increase around three months per year). This is a reasonable pace of increase, but the process should be extended beyond 2017 so as to eventually equalise women's and men's retirement ages.

### *The implications of mandatory second-pillar pension savings*

Introduction of the new mandatory contributions in January 2008 *via* a formal agreement between employers and unions implies the share of retirees with income from a defined-contribution pension fund is set to rise sharply; currently only around half of households headed by retirees have income from a second-pillar pension fund (Bank of Israel, 2008a). However, the full impact on pension payouts will take time because the compulsory contribution rates are initially small (see Table 3), and those approaching retirement who were prompted into starting pension plans by the agreement will initially have only short contribution periods.

A weather eye should be kept on compliance with the agreement, adverse behavioural reactions and its impact on coverage among households in general. There is a risk of low compliance; employees and employers may see advantages in avoiding the regulation. Indeed, it is believed that certain details in the agreement might prompt employers into undesirable employment practices: rotating employees to avoid contributions or shifting to self-employment contracts.<sup>25</sup> These, and other factors, could detract from the agreement's coverage.

25. Rotation may arise because mandatory contribution levels must be implemented immediately for employees who already have a pension plan but do not have to start until after six months of employment

During the phase-in of the mandatory savings, the outcomes for older workers should be closely monitored with a view to granting temporary exemptions. Phase-in of the agreement makes no exceptions for older workers, which is unusual. When similar schemes have been introduced elsewhere, concerns about risk on market returns from short contribution periods and disproportionate overheads in management fees have led policy designers to exempt employees above a certain age. Contributions are initially small in the Israeli case, so that the financial commitment will not be large for those close to retirement. But this also means possibly trivial payouts, with the risk of poor effective rates of return once administrative costs are taken into account.

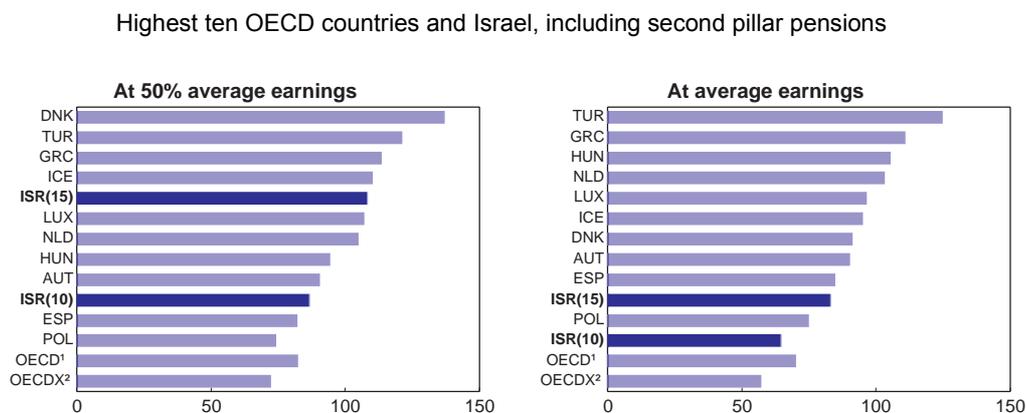
Once the agreement's effects have fully worked through, the value of mandated pensions in relation to previous earnings will be much higher than at present. By 2013 the mandated contribution is scheduled to reach 15% of the gross wage (capped at the average wage; see Table 3), which is high compared to similar systems elsewhere. For example, Australia's rate is 9%, Hungary's 8% and the Slovak Republic's 9% (OECD, 2009). That said, 5 percentage points of the Israeli contribution also serves as severance-pay insurance, and so an individual might get a pension payout based only on a 10% contribution rate if the insurance is fully utilised. To illustrate the implications of the mandatory saving, Figure 8 simulates the net pension replacement rate for males starting full-time careers at age 20 and compares this with the equivalent calculation for OECD countries (the calculations factor in other forms of pension income as well as that from mandatory defined-contribution schemes). Assuming a contribution rate of 15% implies a replacement rate of 108% at half of the average wage and 83% at the average wage. Assuming a 10% contribution rate lowers these figures to 87 and 47%, respectively. Certainly, at a 15% contribution rate, these replacement rates are high compared with those in many OECD countries, particularly for low-wage earners. On this basis, the contribution rate would appear too high. But, as pointed out below, vulnerable groups in the Israeli context are likely to accumulate particularly short contribution periods, a point that is also raised in analysis by the Bank of Israel (Bank of Israel, 2008b). Unlike in the Bank's analysis, however, the evidence here suggests that future evaluation should not look toward raising the contribution rate beyond 15%.

For low-income households, the net benefit of the agreement is uncertain. Similar to seniority payments in the first-pillar pension, Arab-Israeli and Haredi households are likely to accumulate far fewer contribution years than assumed in the simulations for Figure 8. Also, they are quite likely to use the severance insurance. Furthermore, for those eligible for the Income Supplement in retirement, the effective return to second-pillar saving is lowered because income from the mandated pensions will reduce the supplement. Also, the deduction of the 5 percentage-point employee contribution may have a significant marginal effect on living standards for low-income households. The fact that many households were not voluntarily making such saving before either means that it genuinely does not make economic sense for them to do so, or that they are making systematic "mistakes" in their decisions. As for all mandatory saving schemes, the economic justification rests on presumptions that: *a*) a significant share of households is myopic as regards pensions savings; and *b*) mandating a single minimum level of savings is therefore worthwhile, despite the risk that this floor forces some non-myopic households into saving that is excessive from a life-cycle point of view.

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for those without a plan. Thus, some employers might be tempted to sack staff with pension plans and replace them by a rotation of workers who are kept for no more than six months (Bank of Israel, 2008b).

Figure 8. International comparison of simulated net pension replacement rates by earnings levels, men



1. Unweighted average.
2. OECD average excluding highest 10.

Source: OECD, from OECD pension models.

Reforms to the tax treatment of pensions should be considered. Now that mandatory saving has been introduced, tax incentives for pension contributions are at least partially redundant from a policy perspective. The incentives anyway have practically zero value for low-income households, because other credits anyway cut tax bills to zero, or close to it. And for middle- and upper-income earners the mandatory contributions are arguably now dealing with “myopia” concerns in pension savings. Indeed, it is somewhat unfortunate that employers and unions were allowed to strike a deal without adjustment of the tax breaks. At some point reforms should be made so that at least the tax credits on pensions contributions apply only to long-term savings that are over and above mandatory levels. These credits might also be made “non-wastable” so as to boost the lifetime returns to defined pensions for those on low incomes. For instance, the government’s initial proposal for a mandatory pension credit for low-income workers (that did not make it into the final agreement) could be resuscitated. Furthermore, cuts in the tax concessions in pension payouts could be made on the grounds that they too are not particularly benefiting low-income households.

**Box 4. Summary of recommendations on labour-market and social policies**

**Tax breaks and benefit payouts**

- Make more use of the EITC: expand coverage to the whole of the country, and consider increases in the credit rate and greater differentiation according to the number of children. That said, heighten vigilance to the take-up of the scheme as to date it has been limited.
- Increase payout in Income Support, and bring in new levels of benefit for those with more than two children. Refrain from further increases in universal child allowances beyond those already scheduled. Indeed, consider making economies, for instance through wider application of the lower rates that currently apply only to children born after May 2003.
- Reform other tax credits. For instance, consider reducing the regular (*i.e.* wasteable) tax credits, (especially if combined with an increase in EITC). However, on the grounds of equal treatment, the same credit should be applied to men and women. The extra credits for children should be made claimable by either fathers or mothers and not just the latter.

**Entitlement conditions and employment services**

- Ease the prohibition on car ownership and access to a car in the means test for Income Support and related benefits and conduct a general investigation of eligibility with a view to widening coverage.
- Nationwide adoption of the Light for Employment Programme should proceed, but it is important to define the future role of the Employment Service before doing so. Further monitoring should pay particular attention to competition issues.
- The moves to lighten employment rules for disability-benefit recipients should be followed by removal of rules allowing labour-market conditions to have a bearing on eligibility and a general review of the eligibility procedure. Also, a shift in the approach of medical assessment from general disability to capacity for work should be considered.

**Childcare services**

- Support for childcare services is moving in the right direction; daycare services for Arab-Israeli children warrant particular attention.

**Labour regulation**

- Efforts to increase the enforcement of labour regulation should be intensified but combined with lowering the value of the minimum wage relative to average earnings.
- In sectors dominated by foreign workers increased enforcement of labour regulation should be accompanied by measures to limit rent-taking in the permit system.

**Pensions**

- For first-pillar pensions, as with regular Income Support, eligibility rules to the Income Supplement should be reviewed with a view to widening coverage.
- Increases in women's retirement age for eligibility for state pensions should be extended beyond 2017 so as to eventually equalise with that of men.
- Tax breaks on pensions should be pruned. The credits on long-term saving should apply only to savings that are over and above mandatory levels and credits in pension payouts reduced. Credits might also be made "non-wasteable" to boost their value to those on low incomes.
- During the phase-in of the mandatory savings, the outcomes for older workers should be closely monitored with a view to granting temporary exemptions and a weather eye should be kept on compliance with the agreement.

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