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BETTER POLICIES FOR BETTER LIVES

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This Survey *is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.*

The economic situation and policies of Israel were reviewed by the Committee on 6 November 2013. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 20 November 2013.

The Secretariat's draft report was prepared for the Committee by Philip Hemmings under the supervision of Peter Jarrett. Research assistance was provided by Françoise Correia.

The previous Survey of Israel *was issued in December 2011.*

BASIC STATISTICS OF ISRAEL, 2012

(Numbers in parentheses refer to the OECD average)[a]

LAND, PEOPLE AND ELECTORAL CYCLE

Population (millions)	7.9		Population density per km^2	357.0	(34.5)
Under 15 (%)	27.9	(18.1)	Life expectancy (years, 2011)	81.8	(80.0)
Over 65 (%)	10.2	(15.3)	Men	79.9	(77.3)
Foreign-born (%, 2011)	23.9		Women	83.6	(82.8)
Latest 5-year average growth (%)	1.9	(0.5)	Last general election	January 2013	

ECONOMY

Gross domestic product (GDP)			Value added shares (%, 2011)		
In current prices (billion USD)	258.1		Primary	1.9	(2.5)
In current prices (billion NIS)	993.4		Industry including construction	20.9	(27.5)
Latest 5-year average real growth (%)	3.8	(0.6)	Services	77.3	(69.8)
Per capita, PPP (thousand USD)	32.0	(37.1)			

GENERAL GOVERNMENT

Per cent of GDP

Expenditure (2011)	42.1	(42.6)	Gross financial debt	68.2	(110.6)
Revenue (2011)	37.9	(36.2)			

EXTERNAL ACCOUNTS

Exchange rate (NIS per USD)	3.848		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	3.942		Manufactured goods	33.1	
In per cent of GDP			Chemicals and related products, n.e.s.	26.8	
Exports of goods and services	36.2	(53.5)	Machinery and transport equipment	24.6	
Imports of goods and services	36.0	(50.1)	Main imports (% of total merchandise imports)		
Current account balance	0.1	(-0.5)	Machinery and transport equipment	28.8	
Net international investment position	20.4		Mineral fuels, lubricants and related materials	22.0	
			Manufactured goods	20.5	

LABOUR MARKET, SKILLS AND INNOVATION

Employment rate (%) for 15-64 year olds	66.5	(65.0)	Unemployment rate (15 and over) (%)	6.9	(7.9)
Men	70.7	(73.1)	Youth (15-24) (%)	12.1	(16.2)
Women	62.4	(57.0)	Long-term unemployed (1 year and over) (%)	0.8	(2.7)
Average worked hours per year	1 910	(1 766)			
Gross domestic expenditure on R&D (2011) (% of GDP)	4.4	(2.4)	Tertiary educational attainment 25-64 year-olds (%, 2011)	46.4	(31.5)

ENVIRONMENT

Total primary energy supply per capita (toe)	3.1	(4.2)	CO_2 emissions from fuel combustion per capita (tonnes, 2010)	8.9	(10.1)
Renewables (%)	4.8	(8.5)			
Fine particulate matter concentration (urban, PM_{10}, µg/m^3, 2010)	21.4	(20.1)	Water abstractions per capita (1 000 m^3, 2010)	0.2	
			Municipal waste per capita (tonnes, 2011)	0.6	(0.5)

SOCIETY

Income inequality (Gini coefficient, 2010)	0.376	(0.304)	Education outcomes (PISA score, 2009)		
Relative poverty rate[b] (%, 2010)	20.9	(10.9)	Reading	474	(493)
Public and private spending (% of GDP)			Mathematics	447	(496)
Health care (2011)	7.7	(9.5)	Science	455	(501)
Pensions (2009)	5.2	(8.7)	Share of women in parliament (%, July 2013)	21.7	(25.8)
Education (primary, secondary, post secondary non tertiary, 2010)	4.3	(4.0)	Net official development assistance (% of GNI)	0.1	(0.4)

Better life index: *www.oecdbetterlifeindex.org*

a) Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exists for at least 29 member countries.

b) Poverty rate after taxes and transfers, poverty line 50%.

Source: Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, World Bank, International Monetary Fund and Inter-Parliamentary Union.

Executive summary

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.

Israel's output growth remains relatively strong, unemployment is at historically low levels, its high-tech sector continues to attract international admiration, and new off-shore gas fields have come on stream. However, average living standards remain well below those of top-ranking OECD countries, the rate of relative poverty is the highest in the OECD area, and there are ongoing environmental challenges. Making progress on these fronts will require maintaining prudent macroeconomic frameworks, stronger momentum in structural reforms, particularly in education, social and competition policy, and ensuring environmental externalities are more fully incorporated into government, household and business decisions.

Social policy, education and health care. The incomes of about one in five Israeli households fall below the (relative) poverty line, though poverty is low among families with two providers. Among Arabs and in the rapidly growing Ultra-orthodox Jewish community poverty is over one in two, mainly due to low employment rates among Arab women and Ultra-orthodox men, which are still far below those of the rest of the population. Weak outcomes in the OECD's PISA tests indicate the challenges in improving educational standards and earnings capacities. Israel's health-care system, the subject of in-depth review in this *Survey*, has contributed to impressively high life expectancy. But it faces challenges: hospitals are overcrowded, and population aging is fuelling demand. Furthermore, this rising demand and the imminent retirement of many physicians and nurses pose problems and amplify tensions between public and private health care. Many are concerned that the universal character of the system is under threat.

Monetary policy and financial-market regulation. With 3¾ per cent output growth projected for 2013 and 3½ per cent for 2014, Israel's economy continues to perform better than many others. New flows of natural gas have boosted growth by an estimated 1 percentage point for 2013 and 0.7 percentage point for 2014. Consumer price inflation is well within the target band, but little spare capacity remains, and inflationary pressures may strengthen in the coming two years, if demand accelerates, and require a policy response. House prices and mortgage lending continue to rise rapidly, despite macro-prudential tightening measures. The central bank resumed foreign-currency purchases last spring to counter perceived excessive appreciation. This allowed it to limit interest-rate reductions in the context of the hot housing market.

Fiscal policy. Weak revenue growth plus additional spending pressures arising from structural reforms have inflated the public deficit. For 2012 the central-government deficit target had been 2% of GDP, but the outcome was about 4%. Even though the targets have been made less ambitious, the government had to push for substantial savings and additional revenues in the 2013-14 budget, targeting deficits of 4.65% and 3% of GDP in 2013 and 2014, respectively. Remaining within the spending rule has become difficult in recent years, because multi-year spending commitments mean squeezes in other areas. Furthermore, fiscal objectives are not the sole priority of taxes and transfers. Using them to help address socio-economic problems, enhance competitiveness and tackle environmental issues are also important goals.

The business environment. Prioritising deficit reduction forced the authorities to abandon their multi-year schedule of corporate and personal income tax rate cuts; indeed, these rates have recently been increased. Also, administrative processes remain burdensome: Israeli businesses spend on average 235 hours annually filling out tax forms, far longer than elsewhere. Progress towards market-based structures in the network industries has been patchy, notably in electricity. The strength of competition in the wider economy remains a prominent issue; legislation to improve the corporate governance of Israel's influential business groups is imminent, amidst concerns that high prices are due to weak domestic competition.

Environmental policies. Fiscal priorities have also put some energy efficiency spending on hold, making it tougher to achieve the planned 20% cut in GHG emissions from baseline by 2020. Israel has given its substantial purchase tax on cars a greener dimension, but there remains room for further fine tuning of vehicle taxation; and, the public transport network, especially rail, remains thin compared with those in other OECD countries. Economic instruments in environmental policy are not fully developed.

Key recommendations

Social policy, education and health care

- Raise education standards. Ensure full implementation of the reforms to primary and secondary education, as agreed with the teaching unions, and implement targeted policies, particularly those to improve education for Arab-Israelis. Encourage more forcefully the teaching of core secular subjects in Haredi schools.
- Make work pay. Move quickly to introduce a nationwide welfare-to-work programme, reform disability benefits and ensure a better take-up of the earned-income tax credit. Continue to strengthen enforcement of labour regulation, while allowing gradual erosion of the minimum wage relative to the median.
- Keep public care at the core of the health-care system. Ensure public funds are adequate. Pursue the expansion of medical schools and nurse training, and improve the utilisation of the existing workforce. Extend the scope of discounts on co-payments, if possible within the system's current resources. Change the status of government-run hospitals. Adjust funding mechanisms throughout the system. Encourage vigorous competition among the health funds. Investigate hospital overcrowding.
- Ensure health and pension systems are able to cope with aging. Pursue reforms to the tax treatment of pensions, and increase women's retirement age. Simplify procedures for accessing long term care.

Monetary policy and financial-market regulation

- Monitor and respond to financial-market risks. Take further macro-prudential actions, as necessary, to constrain high-risk mortgage lending. Continue to expedite planning approvals for new housing. Follow through on the establishment of a financial stability board.
- When global monetary conditions normalise and capital flows stabilise, look toward starting interest-rate increases and terminate systematic "unannounced" intervention in the foreign-currency market.

Fiscal policy

- Strongly prioritise reaching the current deficit targets unless growth falls substantially below assumed rates to avoid further deterioration in fiscal policy credibility.
- Be ready to raise tax revenues further, preferably by base broadening and further reducing avoidance and evasion. Prioritise environmental taxes, exploit immobile tax bases, and prune tax expenditures. If needs be, raise the rate of VAT rather than income-tax rates, and tackle the resulting poverty and distributional issues through the social welfare system.
- Strengthen spending discipline. Bolster the medium-term budgeting framework by monitoring the multi-year budgetary impact of new policy measures.

The business environment

- Strengthen competition. Closely monitor the new legislation aimed at improving the governance of business groups. Persevere with investigating and strengthening competition in retail supply chains.
- Press on with network industry reform. Follow through on the intended reform of the electricity sector. For gas, remain vigilant on competition and the risk that policies end up providing implicit fuel subsidies.

Environmental policies

- Make transport policy even greener. Continue to invest in economically efficient public transport, with a focus on urban areas. Enhance the role of efficiency considerations in project selection. Raise taxes influencing vehicle use, rather than ownership, and prune tax breaks for company cars.
- Develop economic instruments further and use targets to drive policy forward. *Inter alia*, increase involvement in international emissions trading; consider using existing duties imposed on primary fuels as a basis for a "carbon tax".

Assessment and recommendations

Israel's output growth has been impressive, considering global economic weakness, and the output gap is close to zero in contrast to much of the OECD area. The unemployment rate is at a 30-year low, and labour force participation has been rising steadily. Furthermore, new natural gas fields have provided an additional boost to GDP in recent quarters. Substantial public spending cuts and revenue-raising measures legislated in the latest government budget are set to bring fiscal balances back on target for this year and next. However, staying on track with consolidation beyond this will remain challenging. In the monetary domain foreign-currency purchases have resumed, and macro-prudential measures have been needed to contain potential financial risks associated with the surging housing market.

Considerable room remains to improve average living standards and to lower poverty, particularly among working families with children, including the Arab-Israeli and Ultra-orthodox (Haredi) communities. Furthermore, the middle-class concerns that surfaced in the 2011 "tent protests" remain prominent, notably housing costs, high retail prices and the associated dissatisfaction with the degree of competition in the economy, the role of large family-run business groups and the distribution of the tax burden. These issues were echoed in the January 2013 general election, which saw the formation of a governing coalition that included two new political parties created in the wake of the protests.

This *Survey* examines macroeconomic and structural policy issues in this complex conjuncture. Shifts in strategy on taxation in response to the fiscal difficulties, political developments and ongoing socio-economic problems have prompted an in-depth review of the tax and transfer systems (Chapter 1). Israel's health-care system, which faces severe future human resource problems alongside more typical challenges in delivering quality health care in the context of constrained budgets and aging populations is then examined (Chapter 2). These chapters build on previous *Surveys'* in-depth assessments: welfare and education in 2010 and housing, finance and energy in 2011 (OECD, 2010; and OECD, 2011a). The policy analysis in this *Survey* does not cover the territories known as the Gaza Strip, the Golan Heights or the West Bank including East Jerusalem.

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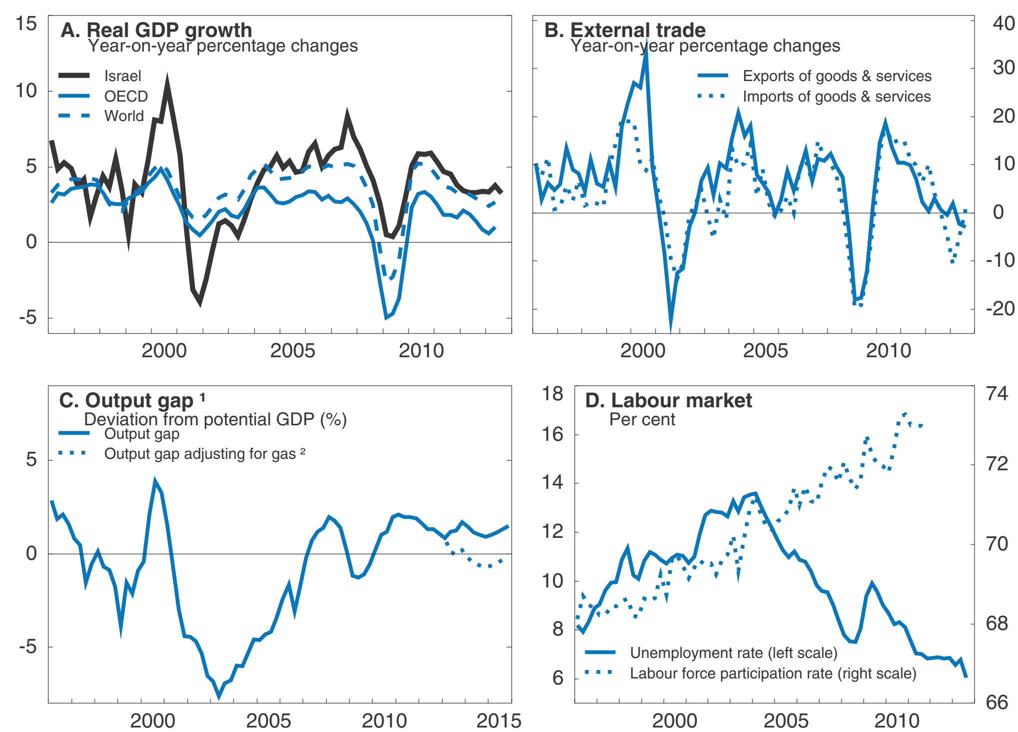
Growth remains relatively strong

Limited exposure to foreign toxic debt and an absence of home-grown credit crises or of domestic financial institution failure have helped to keep growth above the OECD average. The output gap is now close to zero, and there is little sign of substantial spare capacity (Figure 1; Table 1). The economy is nevertheless exposed to global developments, with annual real growth dropping from 4.6% in 2011 to 3.4% in 2012 leading to some erosion in the positive output gap (Box 1). Quarterly data for 2013 show continued weakness in exports and investment. According to the latest *OECD Economic Outlook* output growth in 2013 and 2014 will be 3.7% and 3.4%, respectively, but 2.7% in both years, abstracting from the impact of new offshore gas fields that came on stream at the end of March 2013, replacing fuel imports. A pickup in external demand will help drive output growth to 3.5% in 2015.

Inflation is currently low, but on OECD growth projections inflationary pressures, albeit relatively mild, will gradually re-emerge. Against the backdrop of slower underlying growth, recent CPI increases (Figure 2) have been affected by exchange-rate appreciation, lower world oil prices, and higher indirect taxes and prices for food, electricity and house rents. The last reflects a renewal of house-price appreciation and associated vigorous housing credit growth, which have been underway since early-2012 (Figure 3). Aside from

Figure 1. **Output performance has weakened but remains better than in many other economies**



1. OECD calculation of output gap based on a production-function approach [for more details, see Johansson et al. (2013), "Long-term growth scenarios", *OECD Economics Department Working Papers*, No. 1000].
2. A mechanical adjustment on the basis that the new natural gas field coming on stream boosted GDP by 1 percentage point in 2013 and 0.7 percentage point in 2014.

Source: OECD Economic Outlook 94 Database.

StatLink http://dx.doi.org/10.1787/888932964091

Table 1. **Macroeconomic indicators and projections**

Annual percentage change, volume (2005 prices)

	2010 current prices (billion NIS)	2011	2012	2013	2014	2015
GDP	**866**	**4.6**	**3.4**	**3.7**	**3.4**	**3.5**
Private consumption	493	3.8	3.2	3.4	2.7	3.6
Government consumption	201	2.5	3.2	5.0	4.0	3.6
Gross fixed capital formation	160	15.7	3.5	-4.0	3.6	5.8
Housing	49	11.6	5.4	0.1	3.0	3.5
Final domestic demand	854	5.7	3.3	2.3	3.2	4.0
Stockbuilding[1]	-3	-0.1	0.5	-0.7	-0.1	0.0
Total domestic demand	851	5.5	3.9	1.6	3.1	4.0
Exports of goods and services	303	7.3	0.9	1.1	3.3	4.6
Imports of goods and services	288	10.5	2.3	-4.5	2.7	6.5
Net exports[1]	15	-0.9	-0.5	2.0	0.3	-0.5
Other indicators (growth rates, unless specified)						
Potential GDP[2]	-	3.7	4.0	3.7	3.5	3.3
Potential GDP adjusting for natural gas[2]	-	3.7	4.0	4.7	4.2	3.3
Output gap[2]	-	2.0	1.3	1.2	1.1	1.3
Output gap adjusting for natural gas[2]	-	2.0	1.3	0.3	-0.5	-0.3
Employment[3]	-	3.0	3.2	2.2	2.1	2.4
Unemployment rate[3]	-	7.1	6.9	6.7	6.9	6.6
GDP deflator	-	2.0	4.0	2.4	2.3	2.5
Consumer price index	-	3.5	1.7	1.5	2.0	2.4
Core consumer prices	-	3.0	1.3	0.9	1.8	2.4
Trade balance[4]	-	-3.3	0.2	2.3	2.6	2.1
Current account balance[4]	-	1.0	0.1	2.6	2.6	1.9
General government financial balance[4]	-	-4.2	-4.9	-5.0	-3.9	-3.5
Central government financial balance[5]	-	-3.1	-3.9	-	-	-
Underlying government primary balance[4]	-	-1.3	-1.8	-1.8	-0.7	-0.4
Gross government debt[4]	-	69.7	68.2	68.4	67.6	66.4
Three-month money market rate, average	-	2.8	2.3	1.3	1.2	2.3
Ten-year government bond yield, average	-	5.0	4.4	3.9	4.1	4.7

1. Contribution to changes in real GDP, actual amount in the first column.
2. As a percentage of potential GDP. For 2013 and 2014 the figures are probably biased upwards because of new production from natural gas fields, which is not taken into account in calculating potential.
3. Employment and unemployment data prior to Q1 2012 are derived from a quarterly Labour Force survey that has since been replaced by a monthly survey, which included a number of methodological changes. The data prior to Q1 2012 have been adjusted to be compatible with the new series.
4. As a percentage of GDP.
5. Excluding Bank of Israel profits and including the implicit costs of CPI-indexed government bonds.

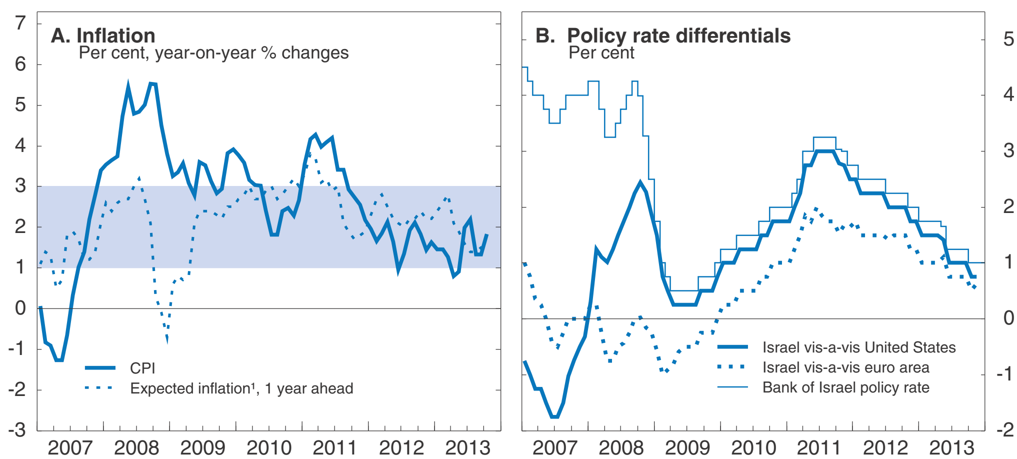
Source: OECD Economic Outlook 94 Database.

housing, inflation pressures will mount as output growth heads back towards potential rates. So far, strains emanating from the labour market have not been great even if unemployment has reached historically low levels, despite a steady increase in the labour-force participation rate. However, it is uncertain how much further labour utilisation can go; not least because this partly depends on the success of policies raising employment rates in some sections of Israeli society (see below).

Box 1. **A substantial upward revision in the level of GDP**

In 2013, as in several other OECD countries, Israel's GDP was revised, in part because of implementation of the SNA 2008 methodology as well as inclusion of new source data and input-output information. The revision raised the level of nominal GDP by approximately 7% in 2012. This is a substantially greater figure than elsewhere because Israel's accounts were more affected by the improved treatment of research and development activity under SNA 2008. The new methodology has so far been backdated to 2006, and the results show annual growth rates in GDP between 0.1 and 0.2 percentage point higher than that generated in the previous data. These changes have implications for a number of important indicators, such as GDP per capita and public debt and deficits as a share of GDP. Since countries are adopting the new SNA 2008 methodology at different points in time, international comparisons will be affected.

Figure 2. **Inflation, interest rates and currency developments**



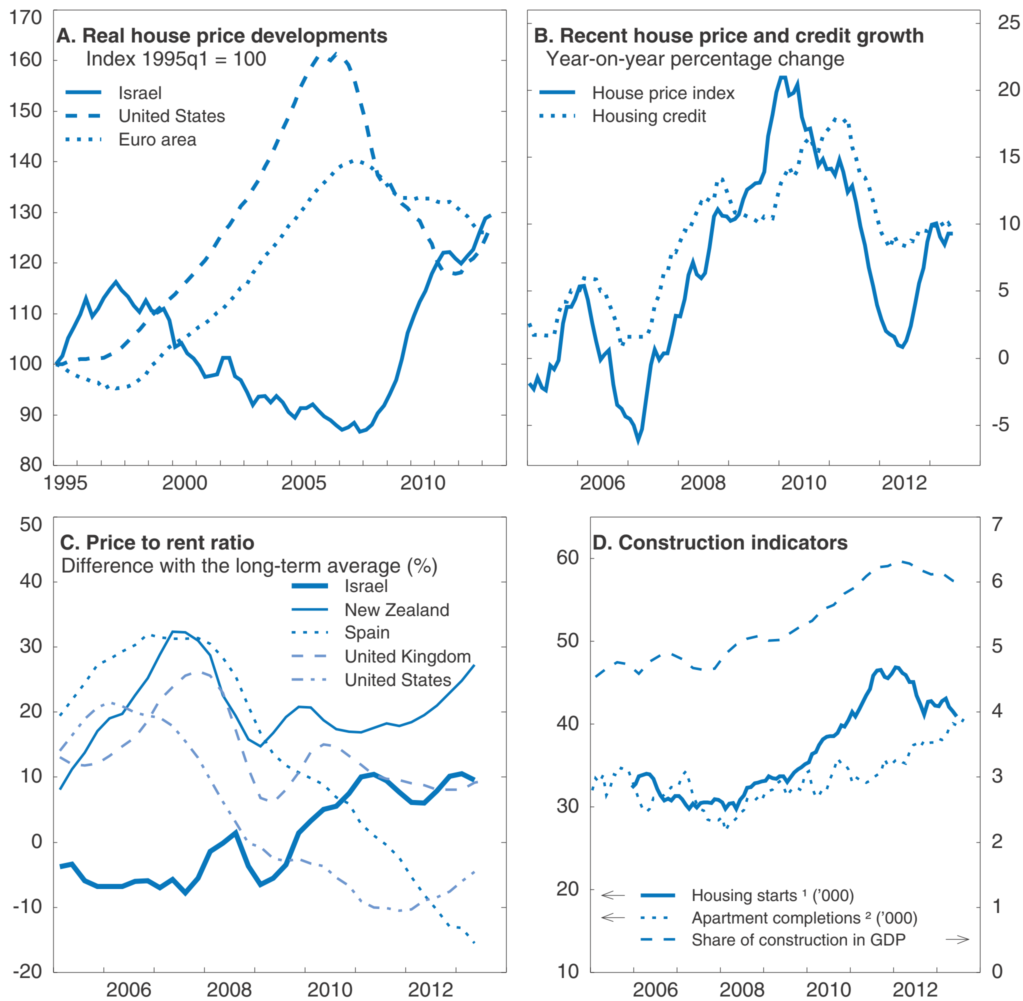
1. From December 2004, the expectations were derived from the zero-coupon interest curve based on market prices of CPI-indexed bonds, based on the forward interest curve.

Source: Central Bureau of Statistics; Bank of Israel; and Datastream.

StatLink http://dx.doi.org/10.1787/888932964110

One risk to these projections is whether there will be a turnaround in the buoyant housing market, and, if so, the fallout on the economy. Some of the steep price increases of recent years reflect market adjustment following years of declining real prices (Figure 3, Panel A), but probably not all of it. The price-to-rent ratio is now about 12% above its long-term average trend (Figure 3, Panel C). This increase is in line with the development of long-term interest rates. Also, the construction sector has not expanded significantly relative to GDP, and thus far price increases have been less extreme than in other cases where significant price corrections ensued. Furthermore, the authorities have taken measures in a variety of domains to mitigate these risks (see below). Nevertheless, the situation and the implication of a rise in interest rates bear continued close monitoring because experience elsewhere has shown that developing bubbles have been hard to detect and the feedback on households' and banks' balance sheets and the construction sector was substantial. The number of housing starts (Panel D) has eased in the last two years, but probably from supply-side obstacles rather than from easing demand. Another risk relates to exports; the risk profile surrounding the projections will also be heavily influenced by

Figure 3. **Housing market developments**



1. Total over previous 12 months.
2. Six months moving average, annualised.

Source: Central Bureau of Statistics, Bank of Israel and OECD.

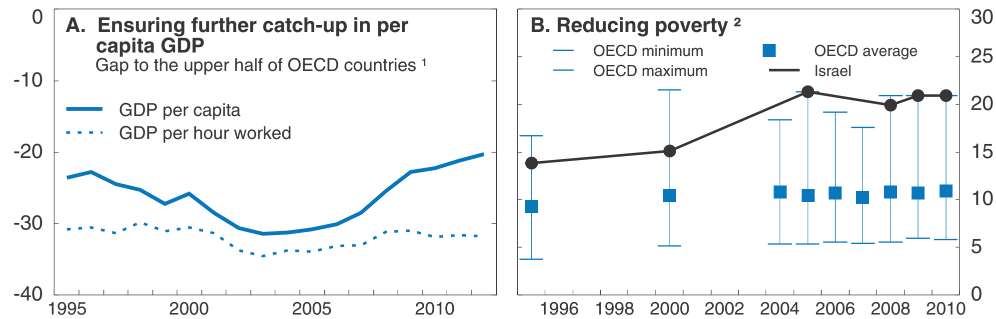
StatLink http://dx.doi.org/10.1787/888932964129

the global economic outlook, with concerns about European recovery weighing on the downside and better US performance posing upside risks (Europe and the United States each account for about one-third of Israel's exports). Shifts in the geopolitical situation, particularly as regards developments in Iran, Syria and Egypt, will continue to influence the risk landscape.

Challenges in long-run productivity performance, poverty and the environment

Gaps in income per capita and labour productivity relative to the top half of the OECD have been narrowing since 2002-03 but remain substantial (Figure 4, Panel A). And, the socio-economic divides that have been the focus of several OECD reports (most recently OECD, 2013) remain large: the rate of relative poverty is still among the highest in the OECD area (Figure 4, Panel B). Although there has been a welcome increase in employment among vulnerable groups, this has yet to translate into sustained reductions in poverty, underscoring a problem of in-work poverty, especially among households with one

Figure 4. **Core economic challenges for the longer term**



1. The gap measures how far below (in percentage terms) Israel's GDP per capita (or per hour worked) lies in relation to the unweighted average of the top half of the OECD distribution. An upward sloping line indicates that the country is catching up with better performing countries.
2. The share of individuals with "equivalised" disposable income less than 50% of the median for the entire population based on weighting household members according to the square root of household size. The reference years vary by country. The greater the value, and the higher the line, the greater is the rate of poverty.

Source: OECD, *Annual National Accounts Database*; OECD, *Labour Productivity Database*; *OECD Income Distribution and Poverty Database*; and OECD calculations.

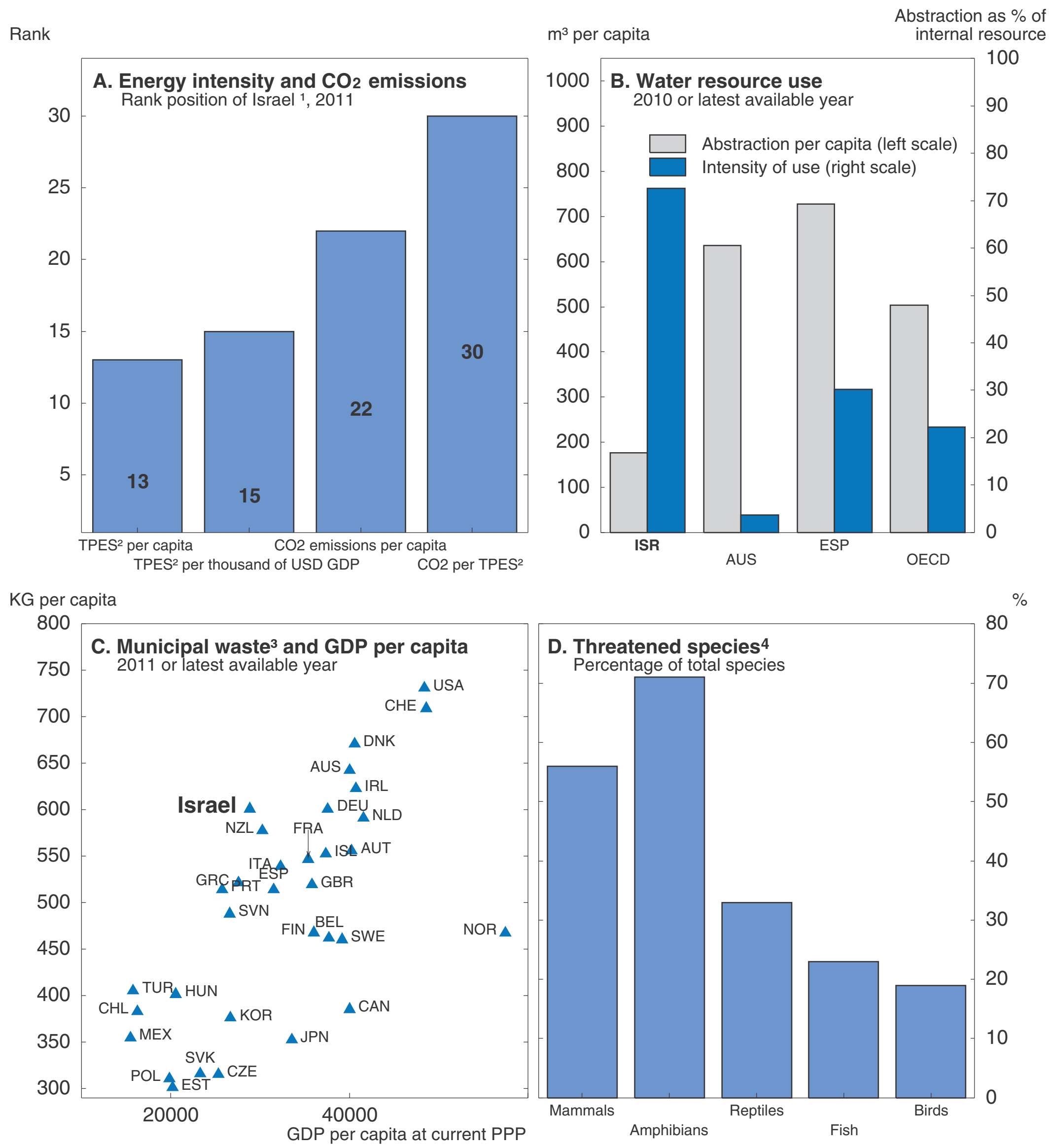
StatLink http://dx.doi.org/10.1787/888932964148

breadwinner. Poverty among households with two providers who work full time is almost non-existent. Such deprivation prompts significant social concern in itself. However, it also implies underutilised human-resource potential, and so it is linked to the problem of raising overall material living standards.

Israel's environmental challenges chiefly originate from past rapid increase in population and economic activity. Energy use per capita is low, principally because the industry mix is not very energy intensive and transport distances are relatively short. Despite this, greenhouse gas (GHG) emissions per capita (or per unit of GDP) are comparatively high (Figure 5), mainly because electricity generation is almost entirely based on hydrocarbon fuels, partly due to a shortage of potential renewable energy sources, such as hydro-electric opportunities. Economic and demographic pressures, in combination with an arid climate, also imply sizeable engineering and economic problems managing water resources. Furthermore, Israel generates a relatively large volume of municipal waste on a per capita basis, which is principally deposited in landfills. The country's geographic position means it has a high level of biodiversity and is an important route for many migratory species (see OECD, 2011b). Progress in policies to tackle these environmental issues is assessed in a later section.

The challenges of raising living standards and tackling environmental challenges are echoed in the components of the OECD's Better Life Index (BLI) (Figure 6). The indicator on income and wealth is close to the OECD average, but there remains plenty of room to catch up with top-ranking countries in this dimension. And, the environment indicator confirms there is further work to be done in this regard too. The BLI also highlights other challenges, in particular a need to improve some aspects of the education system (this is discussed further below). However, health status is above average in large part because of good life-expectancy outcomes. In any case, the BLI indicators do not cover inequality and poverty, and so this particular issue for Israel is not readily apparent. Also, some of the indicators require careful interpretation. In the case of the housing indicator, the relatively large number of children in the Israeli population compared with most other OECD countries pushes up the sub-component that measures the number of rooms per person.

Figure 5. **Environmental indicators**



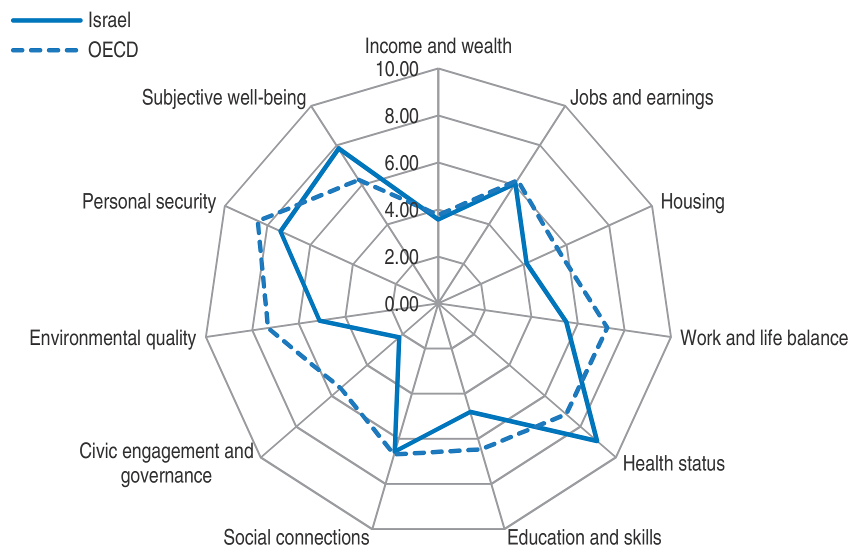
1. Out of 34 OECD countries. 2010 for CO_2 emissions. A low rank indicates lower intensity of energy use or emissions.
2. Total primary energy supply.
3. Household waste only for Canada.
4. International Union for Conservation of Nature (IUCN) categories “critically endangered”, “endangered”, or “vulnerable” species in per cent of known species.

Source: OECD, *Environment Database*, *Energy Database* and OECD calculations.

StatLink http://dx.doi.org/10.1787/888932964167

Israel’s poor score in the indicator covering civil engagement and governance partly reflects data on voter turnout where there are some technical difficulties. But, the low score also stems from a low ranking in terms of public consultation on laws and regulations (see OECD, 2011c and 2011d).

Figure 6. **The OECD Better Life Index for Israel**



Source: OECD Better Life Initiative, *www.betterlifeinitiative.org*.

How to read this figure: Each well-being dimension is measured using one to three indicators from the OECD Better Life indicator set with equal weights. Indicators are normalised by re-scaling to be from 0 (worst) to 10 (best).

StatLink http://dx.doi.org/10.1787/888932964186

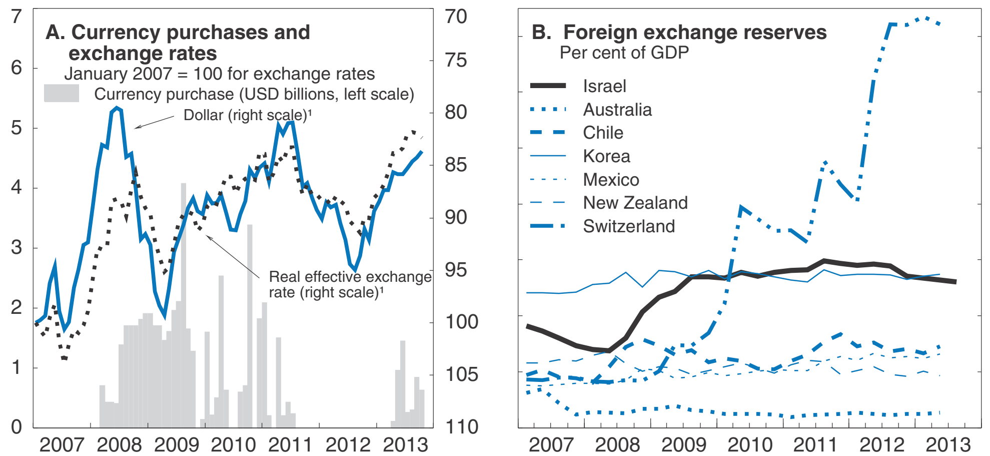
Balancing inflation targeting and financial stability objectives is a challenge

The Bank of Israel's primary legal remit requires it to ensure price stability; it is also to support other objectives of the government's economic policy (especially growth, employment and reducing social gaps) and to ensure financial stability. Rate-setting decisions are now made by a six-member monetary council (three of whom are external) led by the Governor. The Governor is also officially an economic advisor to the government and to this end researches and comments on a wide range of issues. For instance, it has been a vocal supporter of the establishment of the sovereign wealth fund (SWF) that is currently being legislated, to ring fence some of the future tax revenues accruing from the offshore natural gas.

Foreign-currency purchases have resumed

Following sustained shekel appreciation, the Bank resumed purchases of foreign currency in April 2013, despite already having ample reserves (it had previously intervened from early 2008 until mid-2011, initially to replenish them; Figure 7). These discretionary interventions represent efforts to "fine tune" monetary policy with regard to domestic and external demand, allowing a smaller rate reduction than otherwise external demand weakness would dictate under a single-instrument policy. The goal is to support aggregate demand and prevent abrupt shocks to the tradable sector, while tempering stimulation of the hot housing market. According to the Bank, the decision to intervene is based on the extent to which the market exchange rate departs from estimates of the equilibrium exchange rate. In May 2013, with "Dutch disease" in mind, the Bank announced that, in addition to discretionary interventions, it would make regular foreign-currency purchases to offset the impact of new natural gas flows on the current account of the balance of payments until the new SWF is operating (so far the impact has taken the form of reduced fuel imports).

Figure 7. **Currency developments and foreign exchange reserves**



1. Inverted scale for exchange rates, increase indicates appreciation.

Source: Central Bureau of Statistics; Bank of Israel; IMF, *International Financial Statistics Database*; and OECD *Economic Outlook 94 Database*.

StatLink http://dx.doi.org/10.1787/888932964205

The authorities should set their sights on returning to more orthodox monetary and exchange-rate policy over the next couple of years if global monetary conditions return to normality. While monetary policy became even more accommodative in autumn 2013 (the base rate was lowered to 1% in October) in response to concerns about domestic and external demand and the pace of exchange-rate appreciation, a tightening phase will have to begin at some point. The fact that in the years immediately prior to the global financial crisis the policy rate was typically within a range of 3.5 to 4.5% provides a rough indication of how far rates may eventually have to rise to reach "normal" levels (Figure 2, Panel B) in Israel and globally. However, to what extent these rates are relevant in the shorter term, when the "natural" rate may prove much lower, is an open question. In addition, discretionary intervention should be wound down when economic conditions permit. Difficulties in estimating the equilibrium exchange rate mean that, even with good intentions, interventions may prove, *ex post*, to have been inappropriate, resulting in heightened inflation. And there is an ever present risk that good intentions will get corrupted by political pressures such that efforts to prevent currency appreciation are pursued well beyond reasonable levels.

Reasonable progress in strengthening risk provisions and oversight in the financial sector

Mortgage lending rules have been tightened several times in an attempt to quell its growth. Notably, by end-2012 restrictions had been imposed on variable-interest-rate mortgages; reserve and capital requirements for housing loans with loan-to-value (LTV) ratios above 60% (and later 45%) had been raised; and limits on LTV ratios for first-time buyers and investors had been set. The latest round of measures (August 2013) included new guidelines on the ratio of loan repayments to income, stronger limits on the use of variable-rate loans and a limit of 30 years on the duration of mortgages. Meanwhile, the government has been trying to boost housing construction by expediting approvals for new housing development. Initially the number of housing starts rose but then, curiously, started to fall (Figure 3, Panel D), probably due to bottlenecks in the planning approval process; this serves as a reminder that, as recommended in the special chapter on housing in the 2011 *Survey* (OECD, 2011a; Hemmings, 2012), the process needs to be reformed. Government intentions on this front were announced in June 2013, along with new targets for the number of planning approvals. This is good in principle and will hopefully be more successful than previous initiatives. Various tax measures have also been taken, or are in the offing; in particular, tax relief on capital gains from second homes or investment properties has now been completely removed (Chapter 1).

Minimum capital ratios in the banking sector have been raised through the implementation of "Basel III" regulations. Similarly, such capital requirements were increased in the insurance sector. Among other steps taken, in 2012 insurance companies were banned from selling long-term savings products that guarantee the conversion rate between savings and annuity pay-outs, due to concerns that the companies were not properly incorporating risks surrounding increasing life expectancy. Also, there has been a healthy market-driven increase in the share of foreign holdings in pension fund portfolios, as the funds are large relative to the size of the domestic market (Bank of Israel, 2013a). As recommended in the 2011 *Survey*, the authorities are considering allowing securitisation (current rules and regulations essentially preclude it), though with strong checks against undesirable behaviour in the light of recent experience elsewhere. The authorities have established a committee to look into the matter.

A macro-prudential oversight team comprising representatives from the Bank of Israel, the Ministry of Finance and the Israeli Securities Authority was formed in January 2012. The establishment of this working-level macro-prudential team has brought a worthwhile strengthening of co-ordination in supervision. Also, there are welcome plans for a more senior body along the lines of the US Financial Stability Oversight Council to ensure co-ordinated activity of regulators in light of common goals, both on a daily basis and in a case of a crisis. Otherwise, there is little sign of profound change in the institutional structure of financial oversight, in particular as regards the recommendation in previous *Surveys* to move the Capital Markets, Insurance and Savings Division out of the Ministry of Finance to avoid perceptions of a lack of independence, even though the Division is governed by special legislation that is intended to guarantee such independence.

Financial-stability concerns outside the banking sector originate among the large and influential business groups who are heavily leveraged to the fragile corporate bond market. Numerous debt restructurings are underway, there are problems in rolling over debt, and new issues are an option mainly for rated companies. Recent rapid increases in direct (i.e. non-bank) loans to business by institutional investors (such as insurance companies and pension funds) have also sparked concern. This development is probably in part a response to a previous tightening of rules on corporate bonds (see the special chapter on finance in the 2011 *Survey*) and is worrisome because this type of credit is relatively unregulated and non-transparent. Interim findings of the Goldschmidt Committee, established to investigate the direct-loan channel, were published in June 2013. Among their recommendations, they advised that these institutional investors improve their transparency and that limits be placed on their exposure to borrowers and new risk-management rules be implemented.

Traditionally, most of Israel's financial entities have been controlled by one of several large business groups, but this is changing. As part of measures to curtail their scope and power (see below) and limit risks to financial stability, welcome legislation is in the pipeline that will prevent them from simultaneously having control over large financial institutions alongside a portfolio of non-financial business interests.

Box 2. **Recommendations on monetary policy and financial-market regulation**

- Monitor and respond to financial-market risks. Take further macro-prudential actions, as necessary, to constrain high-risk mortgage lending. Continue to expedite planning approvals for new housing. Follow through on the establishment of a financial stability board.
- When global monetary conditions normalise and capital flows stabilise, look toward starting interest-rate increases and terminate systematic "unannounced" intervention in the foreign-currency market.

Fiscal balances are set to come back on track

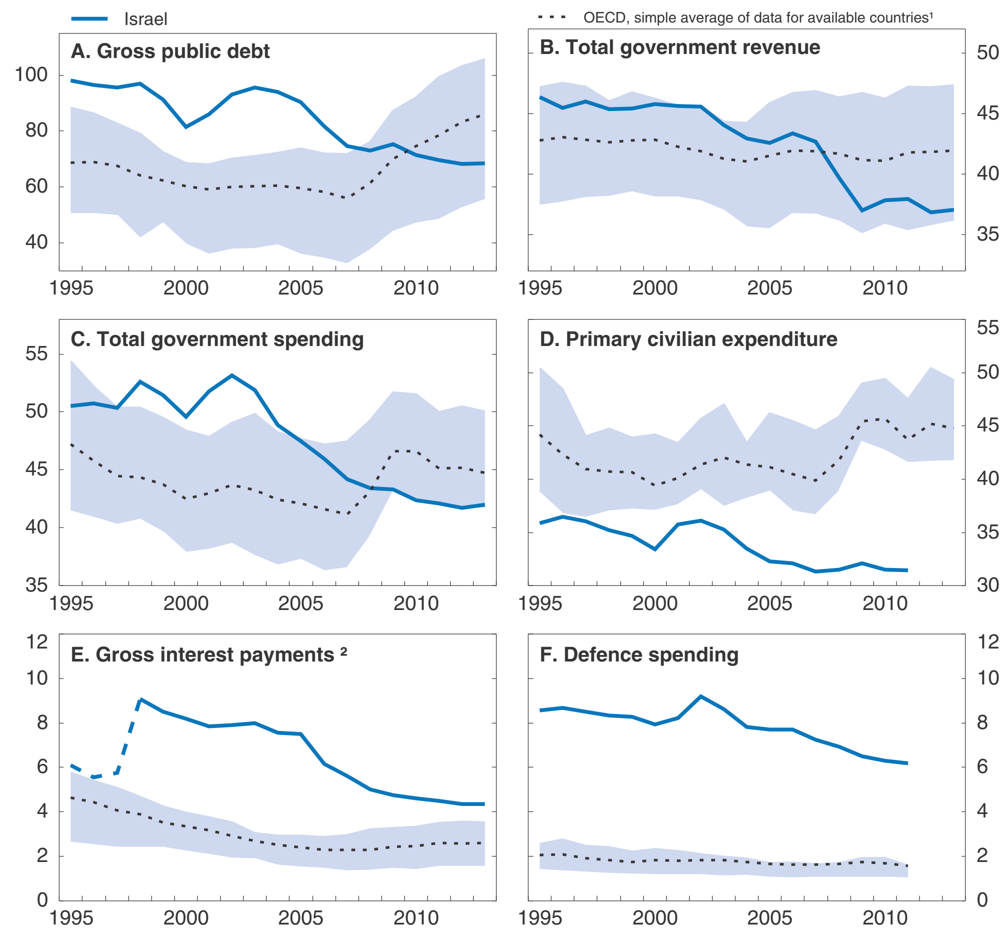
Recent years have seen the authorities retreat from an aggressive drive towards lower income tax and smaller government. For many years, governments had prioritised not only debt reduction and income-tax cuts but also reduced public spending by combining deficit targets with a very tight lid on outlays (via an expenditure rule). The scale of total government spending indeed fell back from lofty levels (Figure 8, Panel C). However, the sizeable debt-servicing costs (Panel E) plus the large defence budget (Panel F) still have to be accommodated by some combination of greater taxation and lower civilian spending. Indeed, civilian public spending has long been parsimonious and is currently among the lowest levels in the OECD area as a share of GDP (Panel D). Recognising that public spending could not be reasonably pushed much lower, a slightly softer version of the expenditure ceiling has applied to budgets since 2011 (see the 2011 *Survey*). And, in 2011 the authorities abandoned multi-year schedules of cuts in rates of corporate and personal income tax (the latter concentrated in the upper rates of tax). In part this was a response to political pressure arising from the tent protests for "capital" to carry a greater share of the tax burden, but it also reflected recognition that the benefits of tax-rate cuts (principally second-round effects on private investment and consumption) had diminished over time.

Fiscal-policy credibility may have been damaged by deficit overshoots in recent years. Despite the relatively healthy state of the economy and the halt to income-tax cuts, the authorities have struggled to remain on target with budget deficit reduction. The general government deficit widened from 3.9% to 5.1% of GDP in 2012 (according to the common international definition). Shortfalls in revenues, an important part of which is attributable to macroeconomic developments, were the primary cause. In addition, it has become increasingly difficult to abide by the spending rule. The central-government deficit for 2012 was 3.9% of GDP, a significant miss in relation to the original target of 2%, and despite a package of measures launched in August 2012 that included hikes in the rate of value-added tax (VAT) and the upper rates of personal-income tax (PIT) and introduced a "surtax" on high-income earners (Figure 9). Ensuring future deficit targets are met has to be a high priority to ensure falling indebtedness and to prevent possible further losses in policy credibility.

Measures included in the July 2013 budget for 2013 and 2014 represent a significant step towards getting back to a feasible fiscal strategy (budgeting for 2013 was postponed due to the January general election). Deficit targets for the central government were raised to 4.65% of GDP for 2013 and 3% for 2014 but it was estimated that the deficits would have been 5.4% and 5.7%, respectively, in the absence of policy measures (Bank of Israel, 2013b);

Figure 8. **Government revenues, expenditure and debt**

As a percentage of GDP



1. The shaded areas are the 25th to 75th percentile range of available data for OECD countries.
2. Break in Israeli data in 1998.

Source: *OECD Economic Outlook 94 Database* and *OECD Annual National Accounts*.

StatLink http://dx.doi.org/10.1787/888932964224

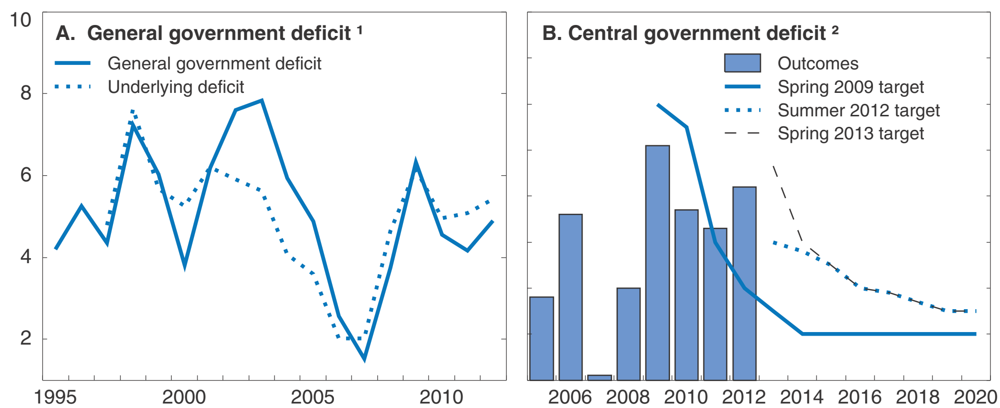
therefore the consolidation is substantial and would seem to be at an appropriate pace, given the potential risks to fiscal credibility. Moreover, based on performance so far, it is likely that the actual deficit in 2013 will be below the target. The package of deficit-reduction measures, which will mainly impact 2014, comprise the following:

- Spending cuts of NIS 19 billion (about 2% of GDP) in total over 2013 and 2014, with targeted savings, notably in child allowances, transport infrastructure, education, public-sector wages and defence; plus, some across-the-board spending cuts.
- Revenue measures totalling NIS 14 billion (around 1.6% of GDP) over 2013 and 2014. These include: another rise in VAT (from 17 to 18%), increases in all rates of PIT, a hike in the corporate income tax (CIT) rate, heavier duties on cigarettes and alcohol.

Policymakers must now begin to look beyond 2014 when, very likely, further savings in spending and revenue-raising actions will be required. For instance, Figure 10 illustrates that, assuming adherence to the expenditure ceiling, there would have to be a substantial upside surprise in real GDP growth for deficit targets to be reached without further

Figure 9. **Deficit outcomes and targets**

As a share of GDP



1. The underlying deficit adjusts the deficit for cyclical variation and one-off items.
2. These data are not adjusted for the 2013 national accounts historical revision.

Source: Bank of Israel and *OECD Economic Outlook 94 Database*.

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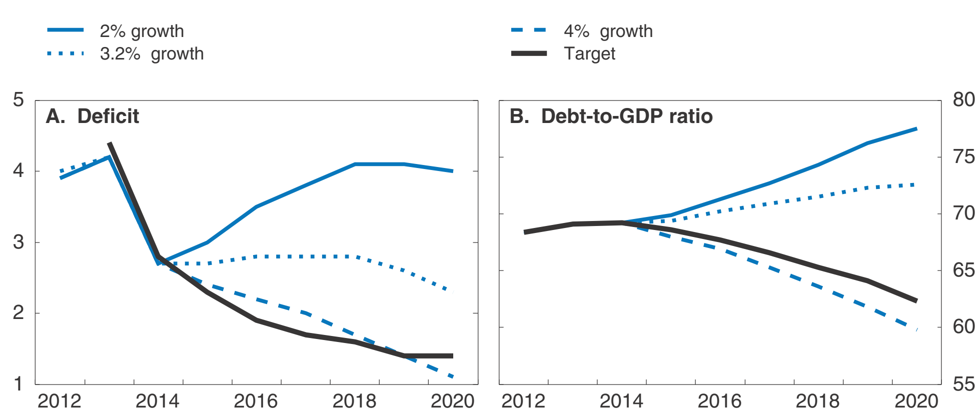
Figure 10. **Fiscal scenarios beyond 2014**[1]

As a share of GDP



1. The scenarios incorporate the budgetary measures in the 2013-14 budget but assume that there are no further measures and that expenditure increases according to the ceiling. The original estimates by the Bank of Israel have been adjusted by a constant coefficient to reflect the 2013 revision of national accounts.

Source: Bank of Israel and *OECD Economic Outlook 94 Database*.

StatLink http://dx.doi.org/10.1787/888932964262

revenue-raising measures or expenditure cuts that would result in undershooting the ceiling. Specifically, growth would have to average around 4% per year for the official targets to be achieved, which is a good deal above estimated potential rates. Parenthetically, the revision of GDP (Box 1 above) should not be viewed as creating room for spending simply because the deficit as a share of GDP has fallen. However, as GDP revisions have cut the gross debt-to-GDP ratio at end-2012 from 73% to 68%, it would be an appropriate moment to consider lowering the government's debt-to-GDP objective from the current 60%. The advantages of a smaller debt ratio include lower debt service (which is higher in Israel than the average elsewhere in the OECD) and greater flexibility in dealing with unexpected economic and geo-political shocks.

If further revenue-raising measures are needed, what form should they take?

Assuming that trend growth in the coming years does not reach the aforementioned 4% rate, further fiscal consolidation will be required. In that case the rule should be to first seek to eliminate any inefficient spending items. A general principle thereafter would be to favour seeking revenues through efforts to counter evasion and aggressive avoidance strategies and broadening of tax bases rather than raising rates. If needed, revenue-raising efforts should first exploit win-win measures, and environmental taxation is fertile ground in this respect. This *Survey's* in-depth assessment of taxes and transfers (Chapter 1) recommends several options: increasing the existing excise tax on primary fuels to levels consistent with GHG-emissions externalities; further use of environmental levies, such as those currently imposed on landfill waste; and heavier taxation of vehicle use, such as urban congestion charging and pruning the favourable tax treatment of company cars (the excise taxes on gasoline and diesel in Israel are already similar to the high levels found in many other OECD countries).

Ramping up campaigns against evasion and aggressive tax avoidance should also receive high priority. Public disquiet about fairness in the tax system at least partially arises from a perception (justified or not) that high-income or wealthy individuals and businesses pay little or no tax and that tax expenditures accrue mainly to the top decile and even the top few percentiles. Thus, the recent intensification of measures to counter evasion and aggressive avoidance has been useful; these efforts should continue.

In addition, further exploitation of "immobile" tax bases should be considered, as these can raise revenues with relatively small economic distortion. In this context the reform of the tax-royalty regime for hydrocarbon resources, implemented in the face of vigorous opposition by industry, has been welcome. Tax and royalty settings for other natural resources have also come under scrutiny with the recent establishment of another expert committee. Israel already collects substantial revenues (in relation to GDP) in recurrent real estate taxes compared with many countries, but problems of weak collection in some municipalities should be resolved.

Revenues should also be raised by more tightly focussing tax expenditures on core policy issues. In particular, it should be borne in mind that many Israeli personal tax expenditures essentially benefit only middle and upper income earners, because income falls below basic tax exemptions for a large share of the population. Thus, many tax expenditures in personal-income tax are not directly combating the problem of high levels of poverty. In the light of this, the tax treatment of pensions should come under scrutiny, including tax relief on compulsory pension saving and the tax preferences on income from pension annuities. The tax support for medium-term saving via the so-called "advanced training funds" (*Kranot Hishtalmut*) should also be reconsidered (OECD, 2011a). As regards business taxation, tax expenditure (in combination with subsidies) can cumulate to significant levels in the case of large firms, generously advantaged through the Law for the Encouragement of Capital Investment, for example. However, the benefits resulting from this law have already been moderated in 2010 and again in 2013.

Even if all of these revenue sources are fully exploited, and as demonstrated in the 2013-14 budget, it may be difficult to avoid recourse to the core tax bases of VAT, PIT and CIT. Indeed, the budget programmed increases in all the rates in these bases. Looking forward, however, maintaining an attractive tax profile for investors suggests limits to increases in CIT rates and a good deal of caution should be exercised in further raising PIT rates. Increasing VAT is probably the least harmful in terms of its impact on the business environment and growth (even if the revenue yield from further increases might slip below historical experience as the current revenue structure is already heavily weighted towards VAT), and there are ways of offsetting the associated problem of regressivity. This offset should not be met through more exemptions or preferential rates, as this is hugely inefficient in terms of redistribution because the well-off receive much of the benefit. Such complications are largely, and admirably, absent in Israel's VAT system, except, notably in the form of exceptions on fruit and vegetables and goods and services bought in the resort town of Eilat, which should anyway be cancelled. It would be better to offset this regressivity by strengthening the social safety net by, for example, increasing targeted welfare spending.

Clearly, even reforms that involve revenue losses should be preserved if they mark a substantial structural improvement by removing distortions or enhancing work incentives. In this context the lower customs duties on food and consumer durables that were prompted by the tent protests were particularly helpful and were fortunately not sacrificed as part of the austerity measures. Similarly, consideration should also be given to lowering the very high baseline purchase tax on cars, as this unduly distorts households' consumption/saving decisions. The authorities should ensure the earned-income tax credit (EITC) is used by all those eligible and examine the relative merits of its further enrichment as a way of lowering in-work poverty (see below).

Spending discipline need to be reinforced

Israel's particular spending rule in combination with deficit targets works satisfactorily but requires the backing of stronger medium-term budgeting mechanisms to combat a problem of additional spending commitments. For example, deals with teachers brought useful reforms but also involved several years' of sizeable wage increases and pay accords with health professionals improved supply but involved multi-year hikes in compensation (Chapter 2). New spending commitments were also prompted by the tent protests, notably increased funding for infant care and a rollout of universal access to free early childhood education. While such reforms should not be discouraged *per se*, their budgetary implications must have more prominence. A system recording such additional expenditures as they are proposed and estimating their current and future budgetary implications may well be sufficient. However, medium-term budgeting could go further, for instance by requiring explicit commitments on how additional spending items are to be accommodated. As discussed in the 2011 *Survey*, two-year budget cycles as implemented in Israel in recent years do not substitute for such medium-term budgeting. In any case it would appear that the current government does not intend to maintain the previous two-year budgeting system.

As regards wider efforts to achieve public spending cuts:

- Across-the-board cuts are inefficient. Instead, savings ought to be focussed where inefficiencies are greatest or where the impact of cuts in service levels is least damaging. Admittedly, identifying these areas can be tough, even more so in the absence of comprehensive accounts and output indicators. In this context constructive measures have been taken to increase transparency in defence spending, which is invariably a bone of contention in budget discussions.

- As in taxation, public welfare spending should focus on the core issues of reducing poverty and related socio-economic divides. In this context previous *Surveys* have questioned whether the raft of additional support for recent immigrants is efficient: for example, the lack of means testing stands in sharp contrast to the terms facing the resident population. Similarly, past *Surveys* have also queried whether the host of additional welfare benefits and advantageous conditions for those who have served in the army is the best way of motivating and rewarding military service, given that these privileges have the negative side-effect of perpetuating socio-economic divisions between the mainstream Jewish population, and the Haredi and Arab communities (there were heretofore special rules that effectively meant the Haredi could avoid conscription, while Arab-Israelis are not required to serve).

Box 3. **Recommendations on fiscal policy**

- Strongly prioritise reaching the current deficit targets unless growth falls substantially below assumed rates to avoid further deterioration in fiscal policy credibility.
- Be ready to raise taxes further, preferably by base broadening and further reducing avoidance and evasion. Prioritise environmental taxes, exploit immobile tax bases, and prune tax expenditures. If needs be, raise the rate of VAT rather than income-tax rates, and tackle the resulting poverty and distributional issues through the social welfare system.
- Strengthen spending discipline. Bolster the medium-term budgeting framework by monitoring the multi-year budgetary impact of new policy measures.

Social policy, education and health care still face difficulties

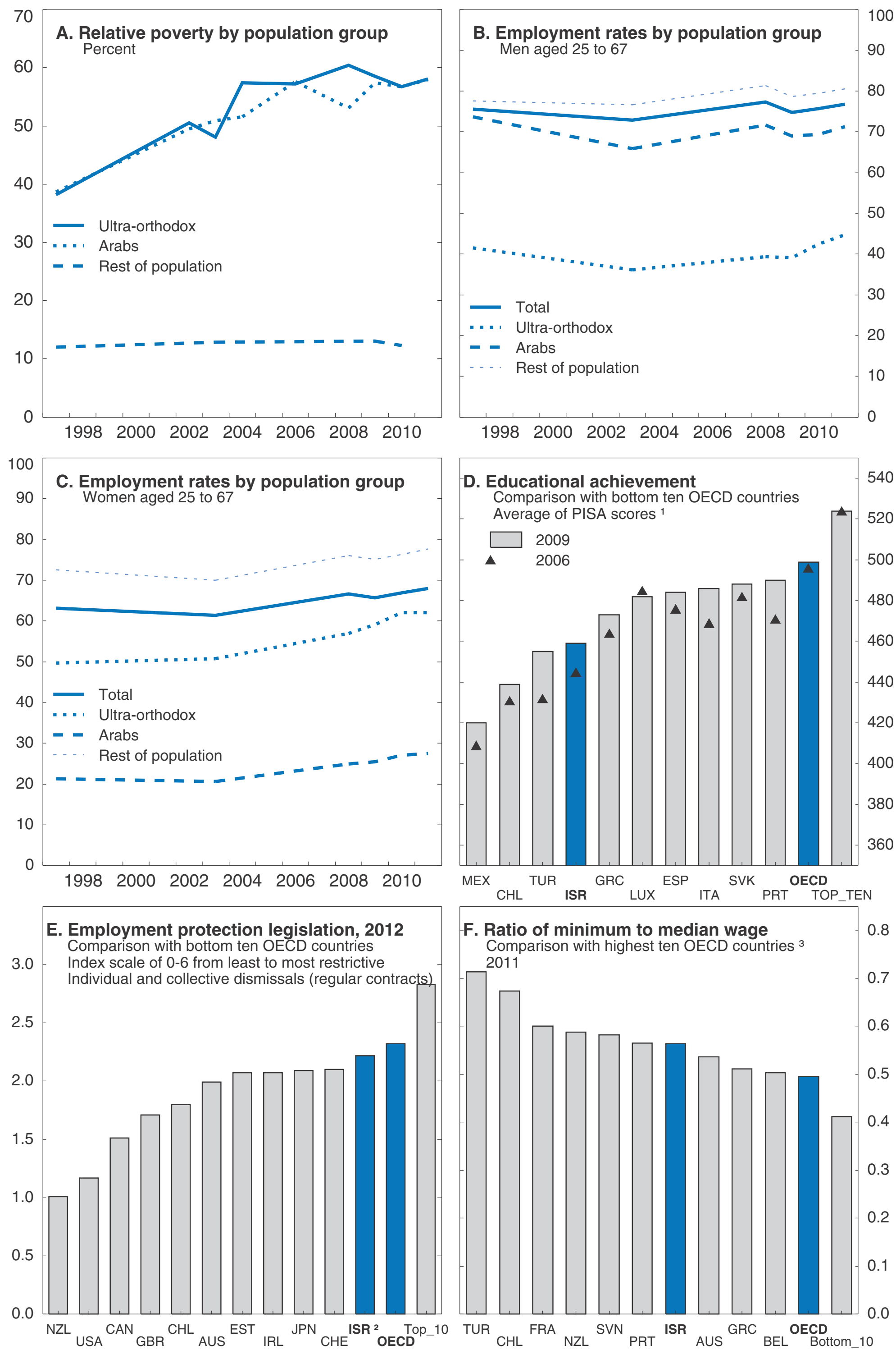
Despite positive developments in terms of falling unemployment and rising labour-force participation, Israel's challenges in social policy and education remain profound. Still high relative poverty and weak labour-force attachment in Arab-Israeli and Ultra-orthodox communities along with low earnings capacity and problems in the education system all play a role (Figure 11, Panels A-D). While these communities require special attention, many of those below the poverty line belong to other segments of the population. Therefore policy should be focussed on general measures that reduce poverty across all groups, with actions targeting specific communities taking an ancillary role. Despite the authorities' admirable goals to raise labour-force participation for vulnerable groups, introducing quantitative targets in poverty reduction should also be considered as a means of sustaining momentum and marking progress.

The examination of health care in Chapter 2 shows that Israel's socio-economic divisions are to some extent echoed in health outcomes. This is probably more due to lifestyle influences than inequalities in access to good-quality health care, which is satisfactory for the population at large. However, problems have been brewing: in particular, shortages of some health-care professionals, hospital overcrowding and tensions between the provision of public and private care.

In education a tougher line on enforcing the core curriculum is planned

In recent years deals with the teaching unions have combined major pay increases with commitments to work longer hours and adopt new teaching methods, most notably more time spent in small-group teaching. Also, the tent protests prompted a government

Figure 11. **Poverty, labour-market and education indicators**



1. Reading, mathematics and science.
2. Israel has the fourteenth rank over 34 OECD countries.
3. Data for only 24 countries are available.

Source: Bank of Israel (2013), *Annual Report 2012*; OECD, *Labour Database*; OECD (2010), *PISA 2009 results: What students know and can do – Student Performance in Reading, Mathematics and Science* (Volume 1).

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commitment to make free kindergarten universally available. This decision will have long-term benefits for student outcomes and is likely to have its greatest impact on lower middle-class households, as kindergarten is already free for poorer families and many better-off households already pay for kindergarten. The government appropriately intends to make state funding for the education of older children more clearly conditional on whether schools teach the core curriculum, with a view to encouraging more Haredi schools to shift away from exclusively religious subjects and include mathematics, science and foreign languages.

Employment and social policies are advancing only slowly, as spending remains small-scale

Israeli employment and social policies take a "welfare-to-work" approach to tackling poverty, but progress has often been slow and public spending meagre. For instance, the EITC was introduced on a pilot basis in 2007 but not rolled out countrywide until 2011, and, despite increasing in 2012, its value would need to be bigger still to significantly reduce in-work poverty (Chapter 1). As regards other dimensions of the tax-benefit system, the current government has cut the value of child allowances and means test their availability, thereby ending universality. This change is justifiable in terms of spending efficiency, although the savings from means testing will be small and it implies substantial reductions in the incomes of large poor families. By itself the cut in child allowances is regressive, but once combined with other budgetary changes hitting high income earners as well as increases in public education funding and extra efforts to bring more of the poor into jobs the overall impact on income distribution and poverty is less.

Reforms are also afoot outside the tax-benefit system. In particular, the government intends to re-introduce a system of private placement agencies; the previous programme was terminated in 2010 while still in its pilot phase. As regards labour-market flexibility, employment protection rules remain reasonably unconstraining (Figure 11, Panel E). And, in line with past recommendations (for example, OECD, 2013), the enforcement of labour law has been strengthened through new legislation that, *inter alia*, has increased the powers of the labour inspectorate, and many more inspectors have been hired. However, the authorities and some of the public continue mistakenly to view the minimum wage as an efficient instrument to tackle in-work poverty, and, accordingly, its level in relation to the median wage remains high in international comparison, potentially reducing demand for young and/or unskilled workers (Figure 11, Panel F). A past recommendation to combine strengthened enforcement with gradual erosion in the value of the minimum wage relative to the median still holds (OECD, 2011a), especially if the EITC is increased as suggested above.

To date Haredi men have essentially been absolved from military service via rules granting exemptions if they remain in full-time (religious) education. Landmark legislation is in the pipeline that will see a major reduction in the scope of these exemptions and, by consequence, will reveal the extent to which exemption from army service has been a driving factor behind their extended periods in religious institutions (*yeshiva* or *kollel*) and low labour-force participation. The Ministry of Economy intends to follow this legislation with a substantial programme of active measures directed at Haredi men to join the labour force. These changes may well be decisive in prompting a sea change in that community's attitude to education and to combining work with religious devotion.

Some pension settings need reform

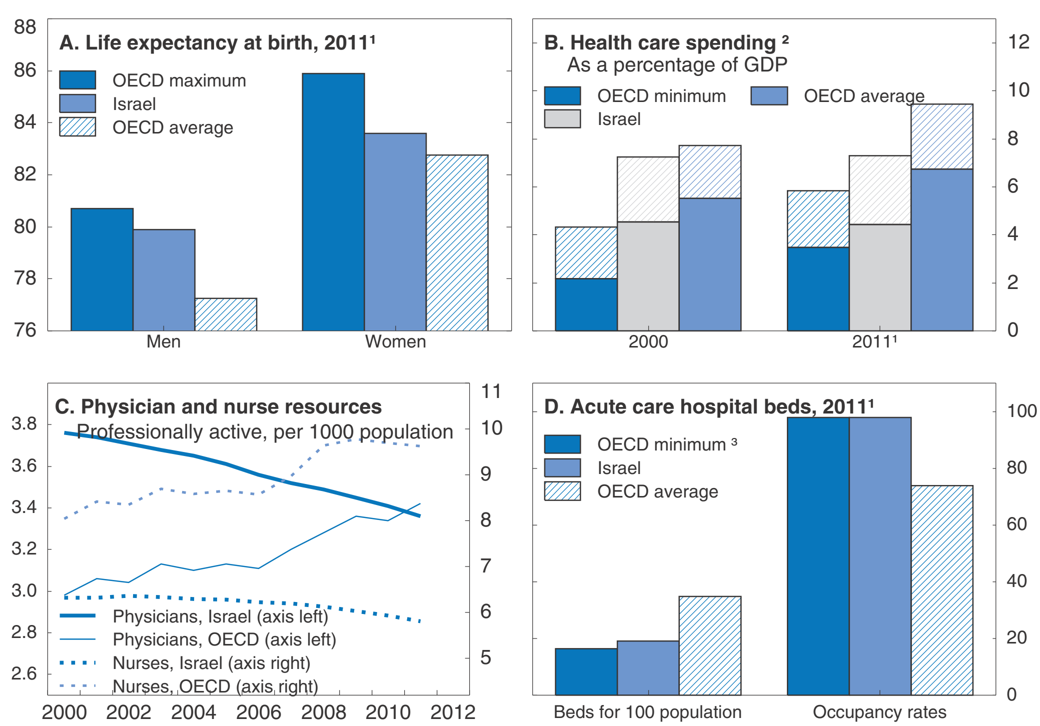
Projected demographic pressures from ageing are relatively light in Israel compared with many other OECD countries, but the authorities nevertheless need to prepare for increases in the size of the elderly population. State pension provisions in combination with supplementary welfare support (the system's first pillar) do a reasonable job in ensuring seniors a minimum living standard. However, while the eligibility age for men has been raised to 67, that for women was increased only to 62 and needs to be gradually adjusted upwards (Chapter 1).

Introduction of mandatory contributions in 2008 (i.e. a "second-pillar" pension) have helped limit public spending commitments but have effectively hiked the tax wedge on labour, adding another reason for caution in raising income taxes. There are plans to improve the tax treatment of the second pillar and to introduce life-cycle risk adjustments.

A good health-care system, but not without challenges

Israel's life expectancy compares favourably with other OECD countries (Figure 12, Panel A), and its population is relatively young. The health-care system is centred on four competing health funds, which provide a publicly funded basket of universal services at reasonable cost (Panel B) while financing a share of the market for private care (largely via voluntary health insurance (VHI)). Maintaining a reasonable balance between public and private provision and financing is a core issue that has been amplified by intensified

Figure 12. **Healthcare indicators**



1. Or latest available year.
2. The shaded bars correspond to the public expenditure; the slashed bars correspond to the private expenditure.
3. OECD maximum for occupancy rates.

Source: *OECD Health Database* and *OECD Economic Outlook 94 Database.*

StatLink http://dx.doi.org/10.1787/888932964300

competition over human resources due to shortages of nurses and some types of specialist physicians and from expanding technological possibilities. However, the overall ratio of doctors to the population remains higher than the OECD average (Panel C), and the age structure of Israel's population is more youthful than that of most other OECD countries, lessening the optimal share of medical professionals in the population.

Significant expansion of medical schools and nurse training is underway to counter the retirement of large numbers of health-care professionals, which lies at the heart of the staff shortages (Figure 12, Panel C). This should be backed by further enhancing motivation and efficiency in the existing workforce, for example through exploiting opportunities for shifting tasks from physicians to nurses and extending the effective age of retirement for medical professionals. Efforts to encourage the return of Israelis studying medicine abroad should be stepped up. Also, greater use of the international market for health-care professionals could be considered, but the role of this channel would have to remain auxiliary (in part because of language barriers) and to follow the World Health Organisation's code of practice in this regard. Reducing the supply shortages should in particular aim to reduce the difficulties in retaining some types of specialists for the public sector in the presence of lucrative private-sector earnings opportunities, for instance by combining expanded specialist training with incentives to work more in the public sector.

Universal health care needs to remain at the core of the system, and the establishment of the German Committee to take stock of the relationship between public and private health care is therefore particularly welcome. Governance would be improved if the status of government-run hospitals were altered so that they were no longer directly managed by the Ministry of Health, thereby eliminating the conflict of interest with its regulatory role. The pros and cons of the various solutions to this issue, such as putting these hospitals under the authority of the health funds or converting them to trusts along the lines of those operating in the Jerusalem area, are finely balanced. In any case, efforts should be made to retain the advantages of the current set-up.

Competition among the four funds should be encouraged, but not if it prompts undesirable practices, such as cream-skimming. Ensuring that the public can make well-informed insurance purchases is an important element in encouraging effective competition. To this end, increasing transparency in insurance products and ensuring good co-ordination regarding the supervision of insurance offered by the health funds and that offered by commercial companies can help.

Funding mechanisms need to provide appropriate incentives for the key stakeholders. In this regard, more socio-economic variables should be included in the formula that governs how much state financing the funds receive and greater use of output-based formulae in the funds' transfers to hospitals. Patient co-payments for public health-care services are easily affordable for most households; however, exemptions and discounts for the needy are limited in scope.

The search for further efficiency improvements needs to run in parallel with attention to service quality. The quality of primary care is generally exemplary, in large measure thanks to a preponderance of clinic-based services, which have greater capacity for providing sophisticated round-the-clock services than individual practices. However, the quality of hospital care, although good, does have some shortfalls (OECD, 2012). Instances of overcrowding are widely reported, and the combination of a very low number of acute beds per capita with extremely high occupancy rates (Figure 12, Panel D) suggests the system may have gone beyond efficient to over-stretched in this dimension. The government intends to add 7% more beds in the years 2011-16. Further investigation is required as to whether this will suffice. Also, while indicators in the primary care sector are comprehensive and well done, there is room to improve data on hospital care quality, which are below average.

Issues beyond primary and hospital treatment also require attention. Long-term care could be simplified by developing more straightforward and co-ordinated access to the various forms of support, for instance by paring back duplication in applications. Also, measures to encourage more local employment in the long-term-care sector should continue, for example by dissuading immigration from far afield by limiting intermediaries' opportunities to profit from processing foreigners' job applications. Finally, the government needs to play an increasingly active role in promoting healthy lifestyles, especially among the Israeli Arab minority, as well as increasing awareness of health conditions and health-care services. In the Israeli context it is important that information be multi-lingual and culturally sensitive, that the heath funds be encouraged to participate in health promotion and that this be well co-ordinated with government-run services.

Box 4. **Recommendations on social policy, education and health care**

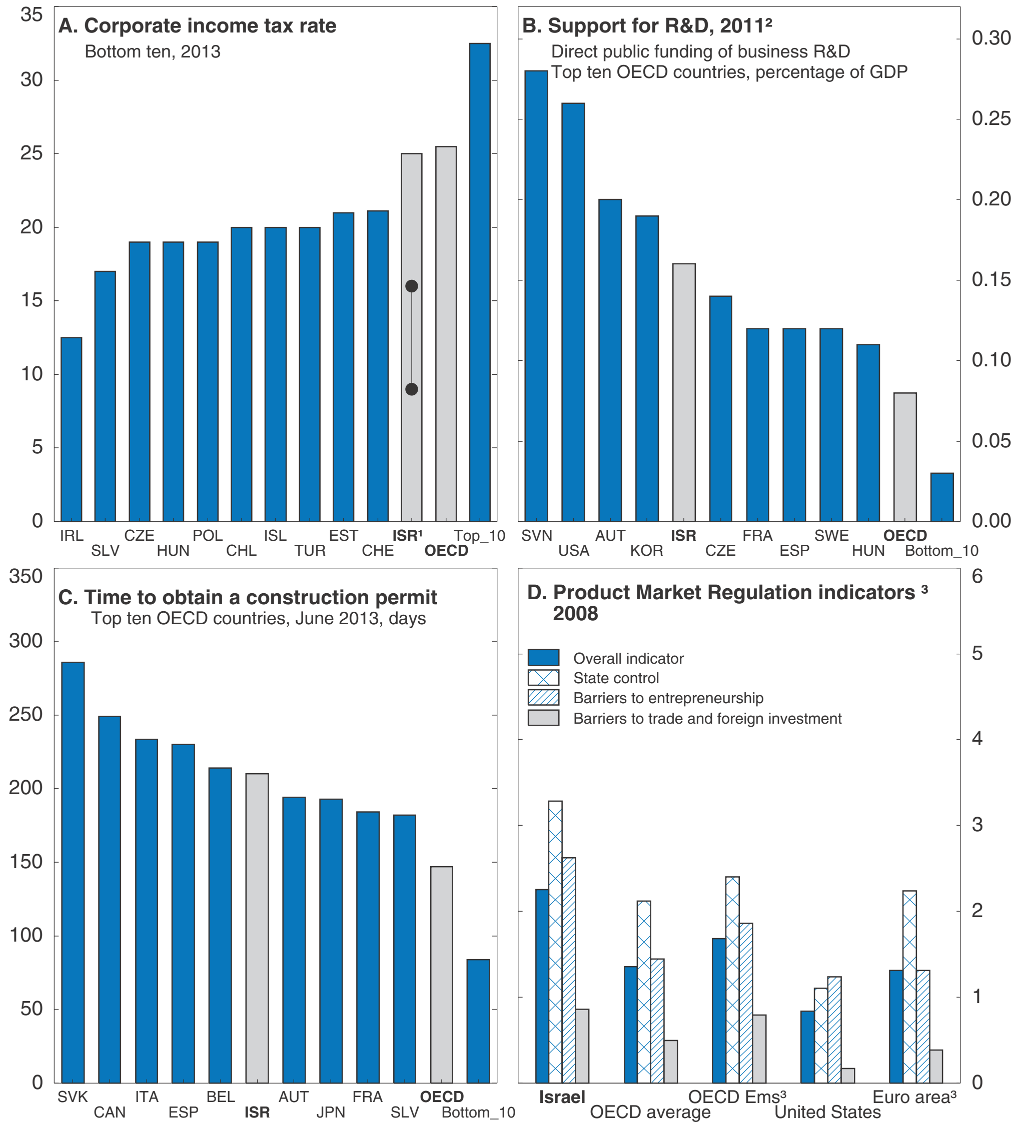
- Raise education standards. Ensure full implementation of the reforms to primary and secondary education, as agreed with the teaching unions, and implement targeted policies, particularly those to improve education for Arab-Israelis. Encourage more forcefully the teaching of core secular subjects in Haredi schools.
- Make work pay. Move quickly to introduce a nationwide welfare-to-work programme, reform disability benefits, and ensure better take-up of the earned-income tax credit. Continue to strengthen enforcement of labour regulation, while allowing gradual erosion of the minimum wage relative to the median.
- Keep public care at the core of the health-care system. Ensure public funds are adequate. Pursue the expansion of medical schools and nurse training, and improve the utilisation of the existing workforce. Extend the scope of discounts on co-payments, if possible within the system's current resources. Change the status of government-run hospitals. Adjust funding mechanisms throughout the system. Encourage vigorous competition among the health funds. Investigate hospital overcrowding.
- Ensure health and pension systems are able to cope with aging. Pursue reforms to the tax treatment of pensions, and increase women's retirement age. Simplify procedures for accessing long term care

There has been reasonable progress in improving the business environment

Maintaining an attractive profile of business taxation and effective business support remains crucial

Damage to Israel's international competitiveness from the cancellation of statutory CIT cuts and subsequent hikes has probably not been great so far, especially as preferential rates are available to a fairly broad range of firms (Figure 13, Panel A). Indeed, the criteria may still be too generous; it is likely that many eligible firms are essentially domestic in nature and not exposed to international competition. Nevertheless, the headline rate is one of a large number of indicators of the attractiveness of a country's tax system, and further increases beyond what is proposed in the 2013-14 budget should be avoided.

Figure 13. **Indicators of business policy**



1. Israel has the 18th rank. The line in the Israeli bar is the range of preferential rates available under the Law for the Encouragement of Capital Investments that will apply as of 2014.
2. Or latest available year.
3. The reference year is 2008 for all countries. The PMR indicator and its components for Israel is 2013 and is preliminary, and for purposes of comparability is calculated on the basis of the 2008 methodology. For more details, see the document prepared for discussions at the October 2013 meeting of the Working Party No. 1 of the Economic Policy Committee [ECO/CPE/WP1(2013)14]. The document also provides the 2013 indicators with a revised methodology. OECD emerging markets economies: the Czech Republic, Hungary, Korea, Mexico, Poland, the Slovak Republic, Turkey; euro area: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain.

Source: World Bank, *Doing business 2013*, *Dealing with Construction Permits Database*; OECD (2011), *OECD Science, Technology and Industry Scoreboard 2011*; OECD, *PMR Database*; OECD, *The 2013 Update of the OECD Product Market Regulation Indicators: Policy Insights for OECD and non-OECD Countries* [ECO/CPE/WP1(2013)14]; and *OECD Economic Outlook 94 Database*.

StatLink http://dx.doi.org/10.1787/888932964319

Other business support comprises a similar menu of schemes to that offered in many other OECD countries, with the encouragement of innovation and regional development as core themes. Monitoring the cost effectiveness of these schemes, minimising inertia when it comes to scrapping ineffective programmes or ramping up successful ones, and ensuring measures are coherent and co-ordinated are all crucial to success. Israel's support for innovation is substantial (Figure 13, Panel B), though this is not the only factor driving its impressive scorecard in research and development (R&D) activity.

As regards "red tape", indicators continue to confirm room to improve administrative processes in granting planning approvals for property development (Figure 13, Panel C). In taxation there also appear to be avenues for reducing compliance costs, with indicators showing that Israeli businesses spend 235 hours on average filling in tax forms each year, which is more than elsewhere (Chapter 1). To their credit, the authorities are moving to deal with these burdens, including by deepening regulatory impact assessments, which will bring a welcome increase in attention to the problem of excessive or poorly designed regulation.

Good progress in strengthening competition

Increased public awareness of competition issues arising from the 2011 tent protests gave birth to several government committees whose recommendations have to varying degrees been followed up by legislation. Curtailing the commercial powers of large business groups has been the most far reaching reform. As mentioned above new rules preventing these groups from controlling a financial institution alongside non-financial business interests are imminent, as is legislation to severely limit the use of pyramidal ownership structures, which have been the main vehicle for levering control and channelling profit. Companies will be given deadlines to re-shape their businesses so that there are no more than two layers in the ownership structure. While these corporate governance reforms are welcome, their impact must be closely monitored, given the uncertainties in the effects of this type of measure.

Campaigns to strengthen competition (with a view to lowering prices or bringing better value for money for consumers) in specific sectors continue, notably in retail supply chains for vehicles and food products. However, in both cases, even if supply-chain competition can be strengthened retail prices will remain high due, respectively, to the heavy car purchase tax and guaranteed producer prices in agriculture. The telecoms market is now intensely competitive, following a government reform campaign, and progress is being made in reducing the monopoly powers of the ports. Efforts to engender stronger retail banking competition continue, with the latest investigation delivering recommendations in 2012 to widen the scope of non-bank credit and increase transparency in retail banking (Bank of Israel, 2013a).

The government has made encouraging statements of intent to resolve the longstanding deadlock in reforming the electricity sector. Although the role of new private generators is expanding, the state-owned Israel Electric Corporation remains the core producer and sole distributor and retailer, a situation which is now rare among OECD economies. Indeed, the lack of reform in this sector is one reason why Israel scores poorly in the OECD's indicator of product-market regulation (Figure 13, Panel D). Competition concerns in the gas sector also remain. They were amplified by the termination of gas imports from Egypt in May 2012 following numerous breakdowns in supply due to attacks on the pipeline. Facilities for importing liquefied natural gas have been built as an energy-security measure and to reduce the market power of existing suppliers.

Government plans announced in June 2013 allow exports of natural gas, while ensuring at least 29 years' gas supply by ring fencing 540 billion cubic metres of offshore reserves for domestic use. This finely balanced decision takes into account the need to ensure energy security, as well as preserving economic incentives to develop existing gas reserves and to explore for new fields. It also aims to maximise the economy's long-term benefits. Nevertheless, the rules may well ultimately be a vehicle for heavy and unwarranted domestic gas subsidies.

Box 5. **Recommendations on the business environment**

- Strengthen competition. Closely monitor the new legislation aimed at improving the governance of business groups. Persevere with investigating and strengthening competition in retail supply chains.
- Press on with network industry reform. Follow through on the intended reform of the electricity sector. For gas, remain vigilant on competition and the risk that policies end up providing implicit fuel subsidies.

Environmental concerns need greater attention

Energy and transport policies could be greener

Israeli policy on GHG emissions is centred on a plan formulated in 2010 for a 20% reduction from estimated baseline emissions by 2020. The rise in the baseline implies that emissions would increase even if the target were reached. Progress has been made in implementing specific measures, with ongoing expansion in installed renewables capacity and in energy-efficiency programmes with regard to buildings, electrical appliances and transport. For instance, in August 2012 a second round of competitively awarded subsidies to GHG-reduction projects began. This target-setting exercise represents an admirable step forward and, in line with suggestions made in the OECD's *Environmental Performance Review* of Israel (OECD, 2011b), a monitoring system is being established. Economy-wide instruments should figure more prominently in future plans; as mentioned in the discussion on taxation, for example, the existing excise tax on primary fossil-based fuels could be ramped up to reflect externalities. Although perhaps a distant prospect, greater participation in international emissions trading should remain a strategic goal, so as to further deepen the role of market mechanisms in GHG-emissions reduction.

Reducing transport-related externalities requires both discouraging private-vehicle use (especially that involving highly polluting vehicles) and enhancing the availability of alternatives. The first of these fronts is reasonably well developed. But the tax treatment of company cars should be less generous. And, as regards the car purchase tax, the green-credit system is welcome, though the baseline rate is overly distorting, and policy efforts should focus more on taxing car use, which is the source of emissions (Chapter 1). Improving alternatives to trips by private car remains sluggish. Public transport largely involves state-subsidised buses; progress in expanding the rail network has been slow. A light rail network in Jerusalem was completed much later than planned, and the construction of a similar network in Tel Aviv is also suffering from extensive delays. In 2011 a major plan for inter-city rail and road development was approved by the central government. However, implementation will inevitably decelerate somewhat due to budget cuts as part of the consolidation programme. In any case an effort should be made to redirect some of the programme's resources to better confront Israel's major transportation challenges in urban areas.

Issues in water and waste management, and biodiversity

Israel has substantial expertise in efficient use of water resources: for instance, over 80% of wastewater is re-cycled. Natural water sources have been replenished by relatively high rainfall in recent years, and expansion in desalination capacity has reduced extraction from freshwater sources. This, in turn, has allowed a greater allocation of water to environmental purposes such as enlarging the flow of water through the lower part of the Jordan River, which, *inter alia*, will support biodiversity. Some dimensions of the economics of water management are also improving. All water consumption is metered, the use of "smart metering" is growing, and full-cost recovery in water pricing has been achieved. Industrial water tariffs are now compatible with those for domestic users, and those for agriculture are scheduled to increase to bring them much closer to household rates, even if some cross-subsidisation will remain. In terms of water pollution, a new system requiring polluters to report discharges has recently been implemented. However, there are concerns that the presence of about 50 municipality-based water companies providing end-user fresh water supplies and wastewater treatment may not be efficient in terms of economies of scale.

There have been a number of developments regarding waste management. In particular, producer responsibility has been extended. For example, legislation was passed in 2012 regarding electronics, battery waste and packaging which obliges "producers" (these may be importers or retailers) to fund and organise the processing/recycling of a certain volume of discarded items (the volume being linked to sales and intended to broadly reflect the rate at which households discard the items). This strengthening of producer responsibility is useful, though resources will have to be devoted to checking compliance.

Finally, Israel's location at the interface of Africa, Asia and Europe means it is not only home to a wide range of domestic species but also a major migratory route for birds and marine life. A biodiversity monitoring programme is well under way, which, for instance, includes the use of surveillance cameras and remote sensing tools. There has also been an encouraging development of economic instruments in biodiversity policy: an assessment of ecosystems has just begun, which *inter alia* aims to quantify their value with a view to adoption in policy settings. This should be pursued vigorously, and opportunities for private-sector participation in biodiversity protection (e.g. eco-tourism) should be exploited.

Box 6. **Recommendations on environmental policies**

- Make transport policy even greener. Continue to invest in economically efficient public transport, with a focus on urban areas. Enhance the role of efficiency considerations in project selection. Raise taxes influencing vehicle use, rather than ownership, and prune tax breaks for company cars.
- Develop economic instruments further and use targets to drive policy forward. *Inter alia*, increase involvement in international emissions trading; consider using existing duties imposed on primary fuels as a basis for a "carbon tax".

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ANNEX

Progress with structural reforms

This annex reviews the measures taken in response to the recommendations from previous *OECD Economic Surveys*. The recommendations that are new to the present *OECD Economic Survey* are contained in the corresponding chapters.

Recommendations	Measures taken
Financial sector regulation and macro-prudential policy	
Structure of supervision and macro-prudential oversight	
• Remove the supervisory duties currently carried out by CMISD from the Ministry of Finance as part of a broader assessment of financial-market supervision.	• No concrete intentions for such reform.
• Further strengthen communication and co-ordination in oversight.	• A macro-prudential working group has been established, and the authorities intend to establish a financial stability board.
• Focus in particular on regulatory reform and supervision of the non-banking financial sector.	• Committees have been established to examine debt restructuring proceedings (May 2013) and direct financing between institutional lenders and business. The Goldschmidt Committee reported in summer 2013.
• Build in strong safeguards in the plans to permit wider securitisation.	• The draft legislation is still being prepared.
• Strengthen mechanisms for dealing with banks in difficulty, for instance by augmenting the powers of the Bank of Israel for early intervention.	• No action taken.
Housing market (2011 Survey)	
• Pursue plans to decentralise planning through permanent reforms to the ILA and planning processes.	• The current government intends a lighter reform than the failed reform of the previous administration.
• Prune exemptions from capital gains taxation on property sales and rental income received by private households.	• Exemptions on capital-gains tax on second homes and investment properties have been completely removed.
• Consider making greater use of property taxation (Arnona).	• No action taken.
• As regards housing support aim for a simpler and more transparent system of housing support. In addition:	
❖ Consider raising rent subsidies while scaling back support for home purchase.	❖ The current government has concrete plans to re-focus support towards rental accommodation.
❖ Make eligibility for social housing more uniform across households. Do not grant points for siblings in the points system.	❖ No substantial progress.
❖ Introduce modest minimum criteria in rental contracts.	❖ No such reform has yet been contemplated.
Education (2010 Survey)	
Primary and secondary education: General reforms	
• Pursue the proposed deals with teaching unions that combine pay increases with reforms to working hours and teaching methods.	• Implementation of the deal (Ofek Hadash or "New Horizon") applying to teachers in kindergarten, primary and lower-secondary schools and its counterpart for those in upper-secondary education ("Courage to Change") are progressing as planned.
• Take further measures to reduce the share of teachers who teach as a lifetime career. Introduce an individual bonus for teachers linked to student performance.	• Programmes aiming to attract those in other professions to teaching (such as the Academics for Teaching programme) continue to be developed. "Courage to Change" includes bonuses for outstanding schools and teachers.
• As regards teaching methods and time spent in school: continue the extension of compulsory education, press on with the shift away from rote learning, and implement caps on class sizes.	• The extension of compulsory education to Grades 11 and 12 continues, and access to free kindergarten is being expanded. • Implementation of a class size reduction programme continues.

Recommendations	Measures taken
Primary and secondary education: Equity considerations and policy towards minorities	
• In Ultra-orthodox education, make all forms of state funding more strongly conditional on the extent to which schools teach core subjects. Consider core curricula for all schools, i.e. universal curriculum requirements.	• The current government is committed to more strongly linking access to state funding to school curriculum design.
• Make more strenuous efforts in affirmative action, particularly as regards Arab-Israeli students.	• The five-year programme in the Arab-Israeli sector has become more targeted, focussing on three areas: Arabic language, mathematics and sciences. The government believes further steps are required.
• Ensure general reforms also work towards reducing inequalities in education.	• Several programmes are being implemented in such a way as to reduce inequalities. For example, in the programme to cap class size the budget is being allocated disproportionately to the non-Jewish sector.
Tertiary education	
• Reforms should include giving providers greater leeway in setting fees, while ensuring access through student loans and grants. Make staff pay and progression more transparent and flexible.	• A six-year reform plan has been developed that notably reforms the system of state transfers to tertiary education providers. However, the reform does not propose reform of student-fee setting.
Labour-market, social and welfare policy (2010 Survey)	
Tax breaks and benefit levels	
• Make more use of the earned income tax credit (EITC), and consider further increases in the credit rate and greater differentiation according to the number of children.	• The EITC is now available nationwide and has been increased for some claimants.
• Increase Income Support, and bring in new levels of benefit for those with more than two children. Refrain from further increases in universal child allowances.	• No significant reform of Income Support payouts. Child allowances have been cut significantly.
• Reform other tax credits. For instance, consider reducing the regular (i.e. wasteable) tax credits, (especially if combined with an increase in EITC). On the grounds of equal treatment, credits should be the same for men and women.	• Child tax allowance can now be claimed by fathers (previously only mothers could claim), but only for children aged up to three years.
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.	• Ownership of a car no longer precludes access to Income Support (though the value of a car still features in the asset test for eligibility). Among various minor adjustments, the definition of a child for benefit purposes has been increased from below 22 to up to 24 years for those who have not yet completed army service. This may be of particular significance to Ultra-orthodox and Arab families.
• 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.	• The "Light for Employment" programme was cancelled in Spring 2010. Legislation for a new nationwide programme was approved by the government and is currently before parliament.
• The moves to ease employment rules for disability-benefit recipients should be followed by removal of those allowing labour-market conditions to have a bearing on eligibility and a general review of the eligibility-determination procedure. Also, a shift in the approach of medical assessment from general disability to capacity for work should be considered.	• No significant progress. Take up of an alternative benefit option to regular disability benefit (the "Incentive to Work benefit") has been disappointing.
Childcare services	
• Support for childcare services for Arab-Israeli children warrant particular attention.	• Roll out of free childcare continues.
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 median earnings.	• Intensified enforcement of labour regulation continues, including the hiring of many more inspectors. No sea change in minimum wage policy.
• In sectors dominated by foreign workers, increased enforcement of labour regulation should be accompanied by measures to limit rent-seeking in the permit system.	• Enforcement has been ramped up to counter rent-seeking in work permits. Reductions in quota numbers for temporary workers are planned, but as in the past may be only partially implemented.
Pensions	
• For first-pillar pensions, as with regular Income Support, eligibility rules for the Income Supplement should be reviewed with a view to widening coverage.	• No significant reform.
• Increase the age at which women become eligible for state pensions to the same level as men (67 years).	• Current legislation only envisages an increase in women's pension eligibility age to 64 years.
• 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.	• As regards those on low incomes, non-wasteable credits have not been introduced but a reform of the tax treatment of pensions is being developed.

Recommendations	Measures taken
• Pursue plans to reform the tax treatment of pensions and for life-cycle portfolio adjustment and carry forward of tax credits on pension contributions. Phase out tax breaks on savings in the "advanced training funds".	• No implementation of reforms to portfolio rules and tax-treatment of contributions as yet. • Attempts to remove the tax break on the so-called advanced training funds have so far failed.
• Simplify the characteristics and range of pension products.	• No action.
Policies affecting business (2011 Survey)	
Business support	
• In general, ensure there are good processes for pruning, modifying and innovating within the various menus of support measures.	• Core legislation governing business support (the Law for the Encouragement of Capital Investment, LECI) has been revised, and includes some simplification of processes.
• Consider paring back targeted business support in exchange for significant reductions in the rate of corporate income tax.	• Preferential corporate income tax rates available via the LECI are to be raised.
• Reduce support for agriculture, and make it less distorting.	• The reduction in customs duties on a wide selection of imported foodstuffs is welcome but could go further.
Competition policy and corporate governance	
• As regards the Israel Antitrust Authority (IAA), consider authorising civil penalties, increasing the budget to deal with staff-retention problems and making the IAA's advocacy and regulatory roles more explicit.	
• Implement the proposals of the Concentration Committee.	• Legislation limiting pyramidal structures and forcing a separation between financial and non-financial entities has been passed. Further legislation is in the pipeline.
Sectoral issues	
• **Electricity sector (2011 Survey).** Make stronger policy commitment on the direction and timeline of reform, which should be based on a competitive model.	• The government has emphasised its intention for reform, but no concrete measures have been taken as yet.
• **Gas sector (2011 Survey).** Channel the proceeds from natural gas into an independently managed sovereign wealth fund (SWF). Do not subsidise downstream investment to facilitate exports or increased demand for natural gas.	• Legislation establishing an SWF is being debated in the Knesset. The Tzemach Committee charged with examining the export of natural gas published its final recommendations in 2013, which include guaranteeing 29 years of domestic supply. Domestic pricing policy and the role of the state in providing infrastructure remains unclear.
• In **telecommunications**, follow through on plans to introduce an independent regulator, and continue to push for market opening, notably through unbundling the local loop.	• A host of regulatory adjustments mostly implemented in 2011 have strengthened telecoms competition. These include: regulation to force reduction in the cost of international cell-phone calls and reduction of termination charges.
• Press on with efforts to privatise and introduce or strengthen competition for services in **post, sea ports and water**.	• Privatisation of the existing ports and the construction of a new port edges forward.
• Continue campaigns to increase competition in the **retail supply chains**, notably food, and retail banking services.	• Provisions have been adopted that allow the direct import of cars from foreign dealers and the export of used cars to Arab countries.
Environmental and transport policy (2011 Survey)	
Energy and the environment	
• Follow up the one-off GHG-targeting exercise with monitoring and a system of rolling targets that looks beyond 2020.	• No action.
• Consider an economy-wide carbon tax by modifying the existing excise tax on primary fuels, and aim for greater participation in international emissions trading.	• Considered in the past, but not currently on the policy agenda.
• Expand plans for energy efficiency in buildings. Introduce mandatory green standards alongside the current voluntary system and mandatory energy-efficiency certification.	• Spending on the energy efficiency programme has been halted until 2016 as part of fiscal savings.
Transport	
• Pursue a two-pronged strategy that ensures the cost of private-vehicle use fully reflects externalities while widening the options for alternative forms of transport.	• Expansion of public transport is underway, but only slowly; in part due to cutbacks in infrastructure spending.
• Fully implement the plans to extend rail services.	• Some implementation of transport infrastructure investment is progressing slowly.
• Improve taxes and charges relating to vehicle use:	
❖ Maintain the green credit system, but reduce the basic rate of purchase tax (currently 83%).	❖ The green credits have been adjusted, but a higher basic rate of purchase tax has been introduced for vehicles costing more than NIS 300 000.
❖ Make greater use of taxes and charges on car use.	❖ A second toll-based extra highway fast lane is planned for another of the main routes into Tel Aviv.
❖ Adjust the tax treatment of company cars such that employees face positive marginal costs when driving them for private use.	❖ Individuals' tax liability on company cars has been increased.

Chapter 1

How to improve taxes and transfers

Ensuring tax and transfer systems bring sufficient revenue to reach macroeconomic fiscal targets, address societal goals in re-distribution and social welfare, recognise the influence taxation has on businesses' competitiveness and adequately address environmental externalities is a tough challenge, arguably more so in Israel than in many other OECD countries. High interest payments and large defence spending make deficit and debt reduction more difficult, socio-economic divides remain wide and as a small-open economy Israel is highly exposed to mobile international capital and competition over international investment. And, as elsewhere, the incorporation of environmental issues into the tax system remains only partial. This review examines ways forward for policy on several fronts: indirect taxation; household income tax and social benefits; taxes on property and wealth; business taxation; and evasion, avoidance and administration issues.

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.

Taxes and transfers are an important tool for reaching economic, social and environmental objectives, including achieving deficit and debt targets, creating a competitive business environment and assisting low-income households. Given the multiple facets of tax and transfer policies, making the most of "win-win" opportunities and having a good gauge of the trade-offs where these occur are key to good policymaking. In Israel, past and renewed efforts to reduce public indebtedness, while making the tax system more conducive to growth in an environment of high interest payments, large defence-spending commitments and significant socio-economic divides mean the authorities have long been keenly aware of the challenges. This chapter evaluates current policies and plans for the future and concludes with a series of recommendations.

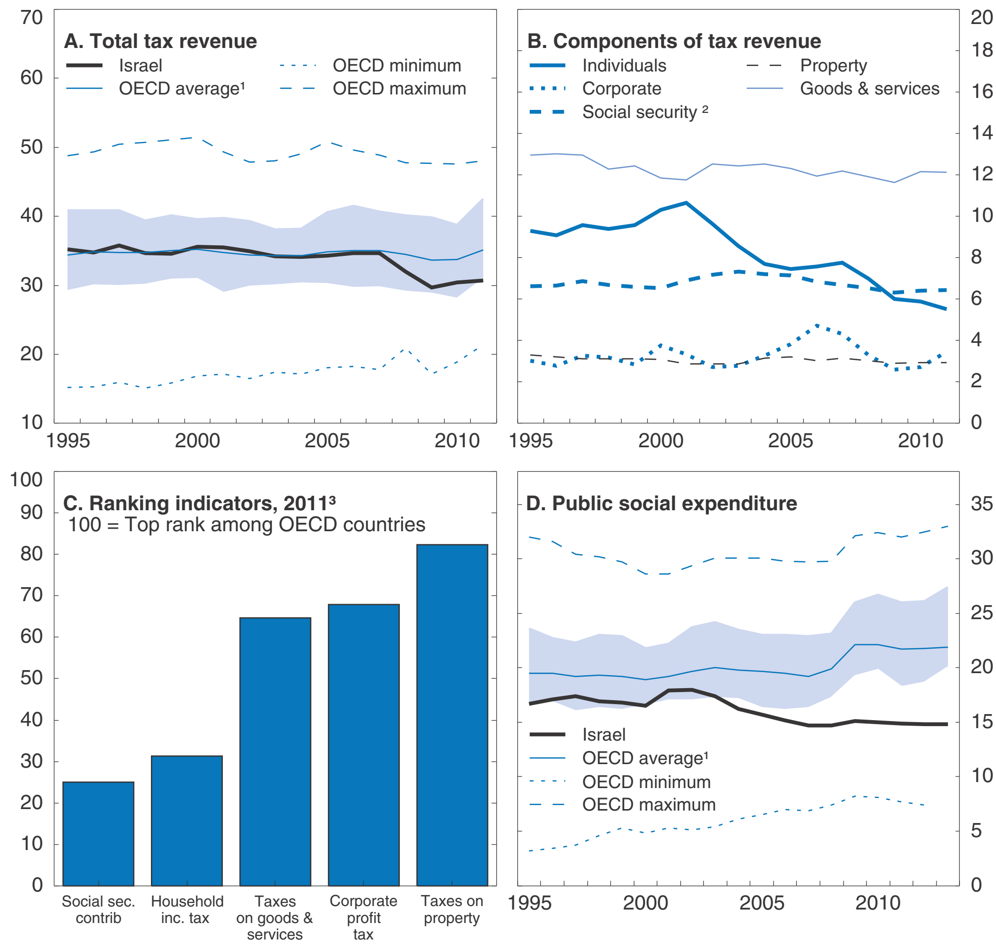
Notable features of the system

Israeli policymakers have pushed tax and transfer reforms a long way in some dimensions, most notably away from direct taxation and towards both indirect taxation and parsimonious social welfare payments:

- Until 2011 the authorities had been cutting statutory rates of direct taxation on households and businesses as part of a strategy of containing the "size" of government and making the tax environment more business friendly. Up to 2007, total tax revenues as a share of GDP had been close to the OECD average, but they have since dropped markedly, reflecting, in part, the effects of reductions in personal-income tax (PIT) and corporate-income tax (CIT) (Figure 1.1, Panels A and B). However, this created difficulties of squaring goals in public-debt reduction with spending commitments, and the 2011 "tent protests" saw increased political opposition; as a result, the scheduled cuts in the CIT and upper rates of PIT were halted. Since then, rates in both these tax bases have been increased as part of efforts to contain fiscal deficits, but also in response to perceived injustices in the burden of taxation raised by the protests.
- Indirect and property tax revenues are high as a share of GDP in international comparison (Figure 1.1, Panel C). Value-added tax (VAT) accounts for the lion's share of indirect tax revenues, and a municipally administered tax on housing and commercial buildings accounts for the vast majority of property tax. Alongside the usual "sin taxes" on tobacco and alcohol, there are specific customs duties or purchase taxes on many consumer durables and food items. The tent protests prompted cancellations or reductions in many of these. However, some substantial specific indirect taxes remain, including a heavy purchase tax on cars (though this has been given an environmental dimension in recent years), and new taxes on some luxury items have recently been introduced.
- As for civilian public spending as a whole, spending on welfare transfers to households is low in international comparison. This is partly explained by Israel's somewhat faster economic growth and lower unemployment rate than in many other OECD countries, particularly in recent years. But the low level of spending also reflects broader efforts to limit the scale of total public spending in the context of high debt-service costs and

Figure 1.1. **Tax revenue and social spending indicators**

As a percentage of GDP



1. The shaded area is the 25th to 75th percentile range of available OECD countries.
2. And payroll taxes.
3. Or latest available year, except for corporate tax which is based on the average of the previous seven years to reduce the influence of cyclical variation. The rankings are based on the shares of revenue in GDP.

Source: *OECD Tax Revenue Database* and *OECD Social Expenditure Database* and *OECD Economic Outlook 94 Database*.

StatLink http://dx.doi.org/10.1787/888932964338

defence spending. Arguably, the level of public spending also reflects a "supply side" policy view by successive governments, in particular a wariness of cash benefits because of their potential to create welfare traps that discourage employment. The low level of social spending can be seen both in the share of social spending in GDP (Figure 1.1, Panel D) and in comparisons of the tax-benefit positions of different sorts of households. The tent protests nevertheless led to more generous tax breaks for households with children and commitments to provide free childcare and early education services.

- For businesses the landscape is a familiar one. The statutory corporate-tax rate is combined with various allowances (for instance, on R&D outlays and capital depreciation), plus targeted tax breaks and other support aimed at larger businesses and a menu of programmes supporting small- and medium-sized enterprises (SMEs). The centrepiece of support is legislation that includes substantially lower corporate tax rates for internationally competitive businesses. As elsewhere, tax revenues from corporate profits are modest compared with those on labour and on goods and services and fluctuate considerably over the business cycle. However, based on an average of the past seven years, CIT revenues as a share of GDP compare favourably with elsewhere (Figure 1.1, Panel C), suggesting that the effective rate is perhaps somewhat higher.

Key challenges

The challenges for tax and transfer policy can be seen as having four inter-related components:

- Identifying the best (or rather least damaging) revenue-raising measures and cutbacks in public spending to achieve targets in deficit and debt reduction. A package of measures as part of the recent 2013-14 budget was the latest initiative to this end.
- Enhancing the role played by the tax and transfer system in achieving a socially acceptable distribution of income and, in particular, in relieving Israel's chronic problems of poverty and weak labour-force attachment in certain communities. High poverty rates and low employment rates, particularly in the rapidly growing Haredi community and the Arab-Israeli sector, remain a concern, not only from a social perspective but also in terms of long-term growth prospects.
- Maintaining a growth-friendly tax structure. Even though Israel already has a reasonably pro-growth tax structure, further improvement on this front, particularly in the context of competition with other countries for international investment, needs to remain a policy priority.
- Improving the environmental features of the tax system. Despite progress in "greening" some existing tax bases and the introduction of dedicated environmental taxes, as in most countries there is room for further action on this front.

The following sections first summarise the recent history of tax and benefit reforms and then discuss how policy has addressed the above issues and the best way forward under five headings: indirect taxation; household income tax and social benefits; taxes on property and wealth; business taxation; and evasion, avoidance and administration issues.

Background: The recent history of tax and transfer measures

There have been three recent packages of tax and spending measures. The first followed up the recommendations of the Trajtenberg Committee that was set up in 2011 in response to the tent protests and aimed to be fiscally neutral. PIT progressivity was notched up, capital was taxed more heavily, and customs duties were rationalised on consumer durables and food with a view to lowering retail prices (Table 1.1). Second, by mid-2012 it had become clear that fiscal balances were going seriously off target, prompting revenue-raising measures that included a rise in the standard rate of VAT and further increases in top-end PIT rates. This was followed in the 2013-14 budget by further measures as part of the significant consolidation to bring the deficit back on target. This latest round of changes includes many revenue measures and transfer savings, including additional hikes in the VAT, CIT and PIT rates and cuts in child allowances.

Table 1.1. **Key tax and benefit measures since the tent-protests of 2011**

Response to the tent protests 2011-12	Mid-2012 drive to rein in the fiscal deficit	Spring-summer 2013 revenue measures decided on for 2013-14 budget
Indirect tax		
Reductions and cancellations in customs duties on consumer durables and food items set in train.	VAT rate increased from 16 to 17% (effective September 2012).	VAT rate increase from 17 to 18% (effective June 2013). New purchase taxes on selected luxury items (e.g. planes, yachts).
Cancellation of a scheduled increase in excise on retail vehicle fuels.	Increased purchase tax on beer and cigarettes.	Increased purchase tax on alcohol (July 2013) and cigarettes (May 2013).
	Reduced green-credit discounts in the car-purchase tax.	Increase in the basic rate of car purchase tax for vehicles costing over NIS 300 000.
Household income tax and benefits		
PIT rates: suspension of scheduled cuts, increase in top rate (from 44 to 48%), reduction in some lower rates.	PIT rates: increase in the three upper rates and cancellation of threshold updating for these brackets (effective January 2013).	PIT rates: increases of between 1 and 2 percentage points in rates (effective January 2014). Automatic indexation of brackets cancelled for 2014.
Child tax credit made available to fathers.	Surtax of 2% on income exceeding NIS 800 000 per year.	
Cancelled increase in ceiling on national insurance contributions.		Reduction in child allowances and introduction of an income ceiling on eligibility (NIS 800 000 per year).
Corporate income tax and employer social contributions		
Cancellation of scheduled cuts and increase in rate from 24 to 25%.	A 0.6 percentage point increase in the employers' national insurance contribution brought forward from 2014 to 2013. Further increases are scheduled for 2014 and 2015.	Increase in CIT rate from 25 to 26.5% (effective January 2014). Preferential rates under the Law for the Encouragement of Capital Investment to be increased.
Other		
Increase in tax on interest, dividends, capital gains and "land betterment" from 20 to 25%.	Extension of an elevated rate of purchase tax rate on second homes to the end of 2013.	Acquisition tax for second homes and investment properties raised from 5 to 6%, exemptions on capital gains on property tax reduced.
Estimated net budgetary impact		
NIS -0.6 billion for 2012.	NIS +9.2 billion for 2013.	NIS +14 billion over 2013 and 2014, of which about NIS 11.8 billion in 2014.

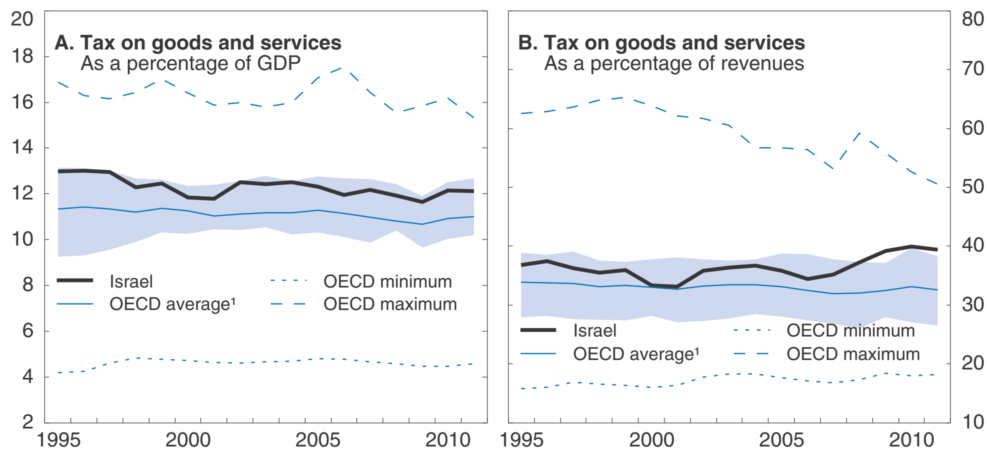
Source: Bank of Israel (2012, 2013); and OECD.

Indirect tax

Indirect taxes have some attractive features. Theory and evidence suggests they are preferable to direct taxes in terms of economic growth (for instance, Arnold, 2008), as they favour saving and investment and have a smaller impact on business costs and profits. Also, for those goods and services where there is inelastic consumer demand (or producer supply), there are opportunities for reliable revenues with comparatively low deadweight losses in economic welfare. Indirect taxes can also "internalise" externalities, in particular those connected with the environment and public health. Of course there are potential downsides: they can be a vehicle for protectionism, distort household consumption and saving behaviour and can be regressive.

Israel has long made heavy use of indirect taxation. Indeed, at least since the mid-1990s revenues from taxes on goods and services have been among the highest in the OECD area both as a share of GDP and of overall revenues (Figure 1.2). In revenue terms, VAT is by far the largest single item. Other indirect taxes are by no means insignificant, however, representing about 37% of all indirect tax and nearly 4% of GDP in 2011 (Table 1.2). They are practically all targeted on specific goods and services in one way or another and comprise various sales taxes, customs duties, excises and fees. Excise on fuels is the largest component, accounting for about 45% of this class of revenues.

Figure 1.2. **Tax on goods and services**



1. The shaded area is the 25th to 75th percentile range of available OECD countries.

Source: *OECD Tax Revenue Database* and *OECD Economic Outlook 94 Database*.

StatLink http://dx.doi.org/10.1787/888932964357

Table 1.2. **Key features of Israeli indirect tax, 2011**

Type of indirect tax	Comment	Share of indirect taxation	Share of total revenues	Share of GDP
Value added tax	Single rate but fruit and vegetables and goods and services bought in the tourist resort of Eilat are exempt	62.6	24.7	7.6
Sales taxes, excise taxes customs and excise duties	Aside from excise on fuels (below), this category includes a substantial car purchase tax, and tax on tobacco, alcohol, various foodstuffs and some consumer durables	30.5	12.0	3.7
of which: Excises on fuels	Chiefly excise on retail motor-vehicle fuels, there is also an excise on wholesale primary fuels	13.5	5.3	1.6
Recurrent taxes	Mainly licence fees, also includes a landfill tax	6.9	2.7	0.8
Total		**100.0**	**39.5**	**12.1**

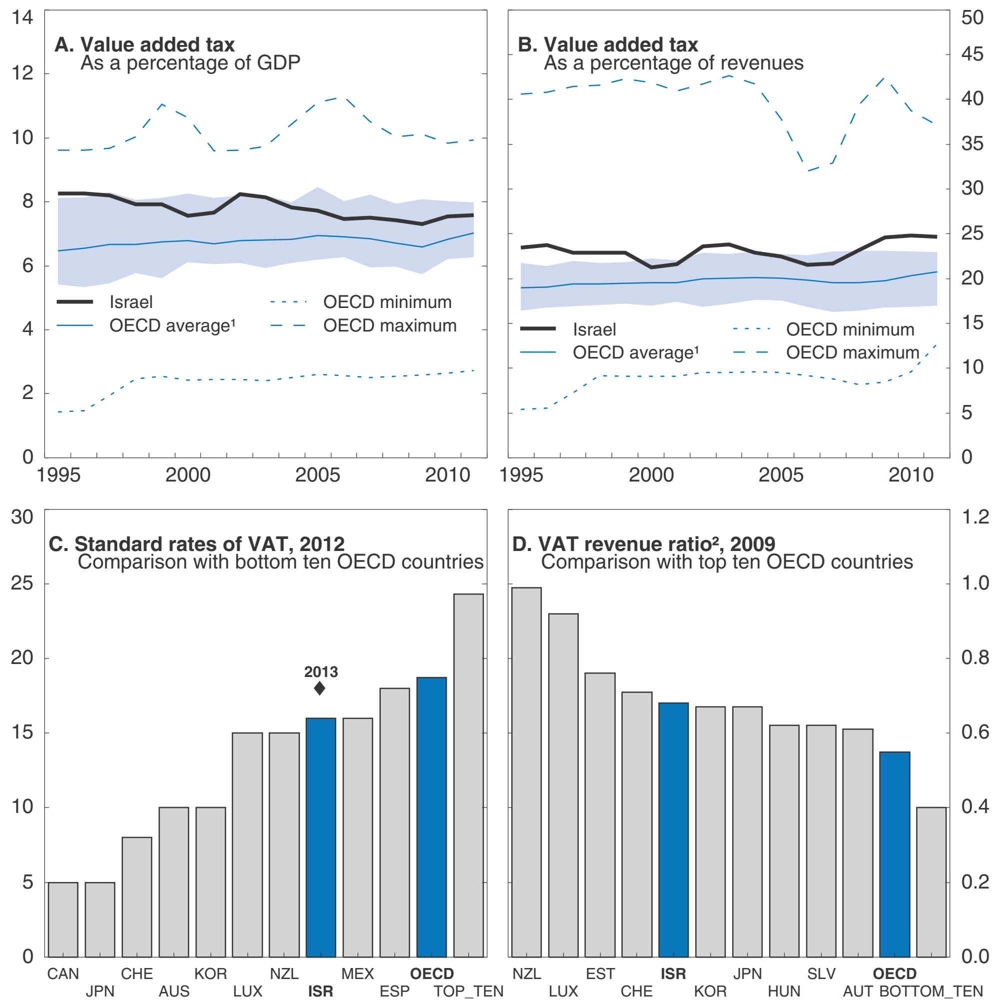
Source: *OECD Revenue Statistics*.

A good system of VAT

Israel's VAT system is admirable in that there is a single rate with few exemptions. As a result, revenues (both as a share of GDP and of total revenues) have been consistently above the OECD average, despite the comparatively modest standard rate (Figure 1.3); thus, the VAT Revenue Ratio is high (this ratio is derived by dividing actual revenues by the revenues implied by applying the standard VAT rate to total household consumption).

Multiple rates of VAT (with "preferential" rates alongside the standard rate) and more widespread exemptions should be avoided. In contrast to the Israeli case, many OECD countries' VAT systems have become complicated because of such provisions. In principle, preferential rates and exemptions can be used to address equity issues and correct for externalities. However, as pointed out in the OECD's *Consumption Tax Trends* (OECD, 2012a), in general they are not the best tools for the job. As means of addressing income inequality and poverty inefficiency arises because exemptions and preferential rates benefit all households, including the affluent. Similarly, targeting environmental externalities via VAT can be a blunt instrument as it may not accurately impact the source of the externality; for instance,

Figure 1.3. **Value added tax**



1. The shaded area is the 25th to 75th percentile range of available OECD countries.
2. The VAT revenue ratio is derived by dividing actual revenues by the revenues implied by applying the standard VAT rate to the total value of household consumption spending.

Source: *OECD Tax Revenue Database*, *OECD Economic Outlook 94 Database* and OECD (2012), *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administration Issues*, OECD Publishing.

StatLink http://dx.doi.org/10.1787/888932964376

reduced rates on energy-saving appliances may boost demand and stimulate use, thus denting the intended curbing of energy consumption. In addition, despite possibly good intentions, creating a subset of items benefitting from preferential rates or exemptions almost inevitably gives rise to anomalies, complications, additional administrative costs and the attention of lobby groups. It is worth noting that while there is only a single VAT rate in Israel, the retail prices of quite a number of basic food items are regulated, so there is some official attention to affordability issues, although price regulation is not the best solution.

Indeed, the authorities should consider making VAT coverage even wider by removing the remaining exemptions; fruit and vegetables along with services in the tourist centre of Eilat. Although they are hard to justify on economic grounds, they remain fully VAT exempt, despite several proposals to eliminate them, including during the development of the fiscal budget for 2013-14.

Raising the rate of VAT is in many respects a logical choice for increasing revenues. Indeed, it was raised from 16 to 17% in 2012 and to 18% in 2013. As mentioned, VAT is more growth friendly than other taxes, and relatively modest rate increases can yield sizeable additional revenues. For instance, a 1 percentage-point increase is reckoned to add around NIS 4 billion (i.e. around 0.4 percentage point of GDP). Should substantial additional revenues be required to reach the fiscal targets, then further increases in VAT may well be among the best options. However, such a move would no doubt raise concerns about the impact on the cost of living of low-income households. As underscored above, addressing this through exemptions or preferential rates of VAT would be a poor strategy. Instead, consideration could be given to providing offsetting measures in welfare policy.

Welcome reductions in the taxation of specific consumer durables and food items

Israel has historically made heavy use of supplementary forms of indirect taxation (purchase taxes, customs and excise duties). Limited trade with neighbouring economies, tightly controlled points of entry to the country and a low risk of retaliation from trading partners due to the economy's relatively small size have made these attractive tax bases for the treasury and a vehicle for protecting domestic production.

Over time, the number of these supplementary taxes has been reduced, and the rates of tax or duty have been lowered on those that remain. Complaints about the cost of living that were a key issue in the tent protests of 2011 have prompted the government to undertake further rationalisation:

- Customs duties on consumer durables have been completely abolished. Previously, consumer durable items under 21 tariff codes, ranging from microwave ovens to hairdryers, were subject to customs duties typically at a rate of either 10 or 12%.
- Customs duties on food products where there is significant local production are undergoing scheduled cuts that are typically due to be completed in 2015. These were very high on some items and for many will remain significant, even when the reductions are fully implemented. For example, duty on beef products was previously 190% but will only drop to 90%; similarly, the duty on lamb will drop from 50 to 30% and on sausages from 50 to 22%. Clearly,and unfortunately, there is reluctance to remove this dimension of agricultural support entirely.
- Reductions in customs duties on food items that the authorities have classified as having limited local production have already been completed. The rates on these items vary widely such as fish (cut from 5 to 3 shekels per kg) and dried fruit (reduced from 25 to 8%).
- Customs duties on processed food are also undergoing scheduled reductions.

This is an encouraging development. Taxing imported consumer goods may be perceived as preferable to taxing domestic production, but this point can be overstated as bringing imported goods to customers often involves a sizeable domestic supply chain. Also, such taxes distort consumption patterns, unless the price elasticity of demand for the products is zero. The customs duties on food are one of several elements in Israel's substantial and costly support for domestic agriculture (OECD, 2013a) (see below).

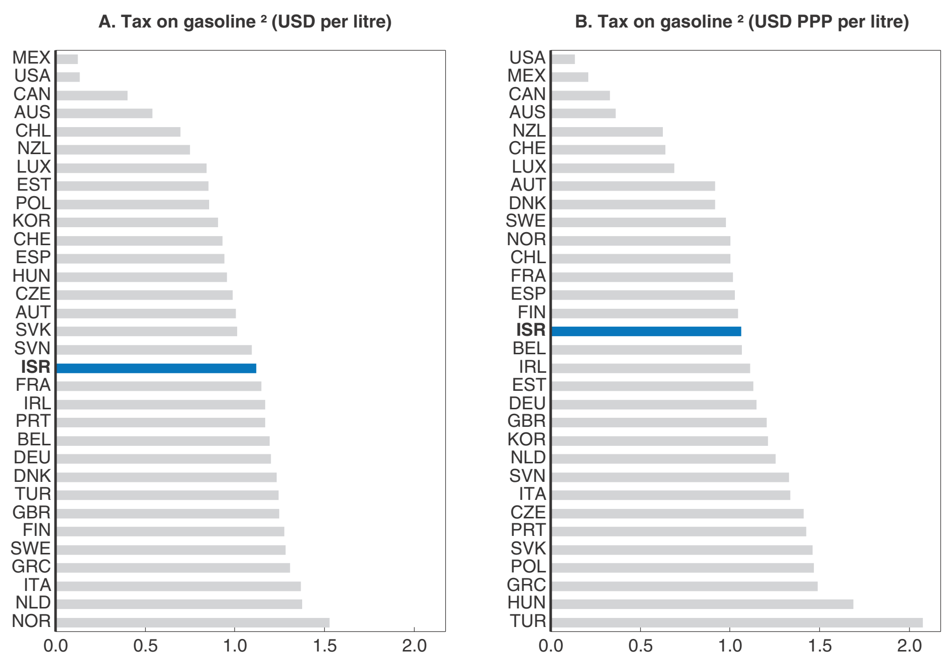
This said the 2013-14 budget introduced new purchase taxes of 15 to 20% on several high-end, luxury consumer goods, specifically airplanes, fur clothing, yachts and jet skis. Also, the car purchase tax has been increased for high-end vehicles. This somewhat arbitrary selection of items for additional taxation represents a largely symbolic gesture at taxing the rich; it is unlikely to raise much revenue or have anything but a marginal impact on the progressivity of the tax system.

Vehicle taxation: There is room for a better balanced system

Israel's vehicle taxation is among the heaviest in the OECD. Excise plus VAT on gasoline and diesel is similar to the levels in many European countries (Figure 1.4). But, what really distinguishes Israel is the hefty purchase tax imposed on cars, second only to that in Denmark. The high cost of purchasing and running cars for private individuals plus generous tax treatment of company cars has led to a disproportionate number of company cars, though recent reforms have seen some downward adjustment (see below).

Figure 1.4. **Taxes on gasoline**

Q1 2013[1]



1. Or latest available period.
2. Unleaded premium 95 RON; Taxes comprise both excises and VAT.

Source: OECD Energy Database.

StatLink http://dx.doi.org/10.1787/888932964395

Echoing previous OECD advice (for example, in both the 2010 and 2011 *OECD Economic Surveys*), the differentiation of the car purchase tax according to environmental criteria is welcome, but arguably the range of rates should be shifted down. For decades a single, and very high, rate of purchase tax was imposed on private vehicles, and then in 2009 a system was introduced that maintained a high "basic" purchase tax but with discounts calculated from a "green credit" based on the vehicle's emissions characteristics. The credit is a weighted average using emission levels and shadow-price estimates for a range of pollutants, and this is used to classify vehicles into categories that determine the discounts from the baseline purchase tax. The discounts do not exactly equate with shadow costs, thus departing from pure environmental taxation. Indeed, following substantial behavioural responses in terms of car purchase, the authorities have been lowering the discounts, one official justification being that this helps push consumers (and importers) towards cleaner cars. However, it is clear that the authorities also have revenues very much in mind. For instance, a round of adjustments was made as part of fiscal consolidation measures in 2012, and another one features in the 2013-14 budget. The bottom line is that the purchase tax, net of discounts, remains high. Generally, effective tax rates range between 30 and 83%, averaging about 60% (hybrid cars are taxed at a 30% flat rate, plug-in hybrids 20% and fully electrical cars 8%). Aside from being a source of revenue there is little merit to such heavy taxation: the distortion in relative prices is substantial, and on environmental grounds it makes more sense to target car use rather than ownership. The authorities have moved somewhat in the opposite direction on this front with the introduction of the higher basic rate of purchase tax on high-end vehicles (applying to vehicles with a pre-tax price of more than NIS 300 000).

One way of increasing the focus of taxation on vehicle use is via the tax on retail gasoline and diesel. Benchmarking Israeli levels of retail gasoline and diesel tax against those elsewhere suggests there is some headroom to raise them further while remaining within the range of international experience (Figure 1.4). However, as illustrated in the 2011 *OECD Economic Surveys* (OECD, 2011a), justifying middle-to-high tax burdens on retail gasoline and diesel on purely environmental grounds either requires an assumption of a very high implied price of carbon or taking on board additional externalities (and it may be difficult to argue that fuel-based tax is the best way to internalise some of them). In short, pushing up excise on fuels is certainly a feasible means of raising fiscal revenue, but the environmental case for doing so in Israel (and some other countries) is not strong. Whatever strategy is chosen for fuel excise, pressures to lower it when world oil prices are high should be resisted, as that discourages desirable demand and supply adjustments. In recent years the authorities have occasionally succumbed to such pressures, causing some problems for the treasury.

There is also room to improve the relationship between diesel and gasoline taxation. In Israel the tax per litre of diesel is similar to that on gasoline, which is more than can be said for many OECD countries. This lowers demand for diesel-engine versions of private cars. However, as underscored in OECD calculations (for instance, OECD, 2013b), the effective tax rate in terms of energy use or carbon emissions is nevertheless lower than that that for gasoline. Thus, the authorities should in principle tax diesel more than gasoline.

There is also scope to develop other use-based vehicle taxes. To date most road pricing is in the form of tolls on sections of road that have been built under build-operate-transfer (BOT) contracts with the private sector and is therefore not really designed to manage traffic flows and congestion or contain local pollution. One exception is a reserved-lane system operating on the main highway into Tel Aviv from the south-east where public transport and some other vehicles (for instance, those with at least three passengers) can use the lane for free, while others are charged a fee (which varies according to the current volume of traffic). There is considerable scope to develop user charges further, for example, through more reserved-lane systems, an urban congestion charge or GPS-based road charging. Progress is being made on these fronts. In January 2013 the authorities announced the development of a reserved-lane system on another of the main highways into Tel Aviv. Also, the tax authority is currently conducting a feasibility study for an urban congestion charge. A recent OECD review of Belgian transport infrastructure (OECD, 2013c), which has a similarly high population density to that of Israel, illustrates the challenges and possibilities for policy on this front.

There has been welcome reduction in the generosity of the tax treatment of company cars (typically provided via leasing companies) but further adjustments are needed. For companies, all expenses (leasing costs, maintenance and fuel) are tax deductible with no cap. As regards employees, since 2008 a use-value (or in-kind income) has been added to taxable income, which varies with the car's characteristics (including emissions) and has been substantially increased since its introduction. And, the tax treatment was altered further in 2010 with a switch from seven in-kind income categories to a formula calculating the in-kind income as a percentage of the showroom price. Data suggest there has indeed been a behavioural response to these reforms. According to the Israeli tax authorities, the share of corporate sales in total car purchases fell from 60% in 2006 to 40% in 2012, and it is likely that the tightened legislation drove at least part of this trend. Nonetheless, the provision of company cars still remains common. A core problem is that the marginal cost to driving a company car for private purposes remains practically zero, as the associated recurrent expenses are often covered by the employer. Thus, the advantageous tax treatment, aside from implying revenue losses, is also not ideal from an environmental perspective (OECD, 2013d). According to the Israeli tax authorities, in the face of higher fuel costs more employers have been voluntarily endeavouring to limit their support by, for instance, charging employees for car use beyond a certain mileage. However, this should not be viewed as a substitute for further improving the tax treatment of company cars. As suggested in the 2011 *OECD Economic Surveys*, one solution is to introduce a cap on corporate tax deductibility for fuel expenses, the level of which could be perhaps varied to accommodate occupations where mileages covered for work purposes are high (such as delivery staff).

The fine-tuning of vehicle taxation needs to be accompanied by improvements to alternative transport options. Most notably, as previous *Surveys* have underscored, public transport has to be sufficiently developed to provide feasible alternatives to car use. Rail transport in Israel is particularly underdeveloped; progress in building intra-urban rail systems has been slow, and the inter-city network remains limited. Without further infrastructure development, ramping up vehicle taxation might fail to elicit a significant reduction in the number of car journeys and associated emissions, and could prompt significant opposition from the public.

Excise duty on wholesale fuel: A potential "universal" carbon tax

Israel possesses a ready-made instrument for a carbon tax via the excise that is already charged on wholesale primary fuels (heavy oil, natural gas and coal). Practically all domestic GHG emissions originate from these fuels (which apart from natural gas are entirely imported) as they are used to generate all electricity and provide refined hydrocarbon fuels (such as gasoline and diesel for vehicles). Thus, the excise on primary fuels is, in effect, already a carbon tax. However, the excise rates remain well below the levels concomitant with prices of carbon that are typically assumed in policymaking, as illustrated in the 2011 *OECD Economic Surveys* (OECD, 2011a, p. 113). Proposals to raise the excise to reflect environmental externalities were made in 2006, although they were never implemented. Ramping up the excise to reflect the shadow price of CO_2 would imply this particular externality is internalised throughout the supply chain. Thus, for instance, in the presence of such a tax it would no longer be valid to include the shadow price of carbon when performing an environmental account of excise on retail vehicle fuels. Similarly, justifying guaranteed feed-in tariffs for renewable energy production on the basis of the shadow price of CO_2 would no longer be appropriate. In any case feed-in tariffs are typically much higher than those suggested by the shadow price of CO_2, and other arguments are used to justify them, such as a need to support demand on the basis that this promotes technological development that might lead to greater economic viability for renewables.

Other issues in environmental taxation

Outside the energy sector, taxation can play an important role alongside regulatory and other measures in ensuring environmental externalities are incorporated into household and business decision-making. Environmental tax reform outside the realm of energy does not tend to involve adjustment to established bases (where revenues can be fiscally important), but rather the introduction of new taxes specifically designed to deal with environmental issues.

A landfill levy has been one of Israel's flagship initiatives of recent years, aiming to reflect the external costs of this form of waste disposal and make other forms of treatment more competitive. The levy varies according to the type of waste; for instance, the highest levy is imposed on the disposal of "sludge" and the lowest on construction and demolition waste; the low rate on the latter partly reflects a widespread problem of illegal disposal. The proceeds are earmarked to finance waste-related developments. For example, they have been used to help local authorities set up municipal waste-collection points, run education and information systems and build recycling infrastructure. As is almost always the case with earmarked funding, there are no strong grounds for believing that the revenues collected will equate with the optimal amount of spending, and policymakers therefore need to remain aware of the risk of excessive or insufficient funding.

The landfill levies have been increased substantially since the scheme was first introduced in 2007, and legislated increases are continuing for some forms of waste. Concerns about concentration in the waste sector have been voiced and there is the possibility that the price of processing landfill waste may be capped to curtail profit margins for landfill operators. This could perhaps be combined with a hike in the levy so as to further limit margins and preserve a gap between the cost of landfill and more environmentally friendly alternatives.

Environmental levies also apply to water extraction, quarrying and shipping. Similar to the landfill levy, the latter two are linked to dedicated funds (for the restoration of quarries and marine pollution prevention, respectively) (OECD, 2011b). As regards air pollution some progress has also been made in increasing the role of economic instruments; the Clean Air Act (2008) introduced compulsory emission fees and permits for plants with high pollution potential.

Household income tax and benefits

Household income taxes and benefits account for a significant share of fiscal revenues and expenditures, and are an important tool of social policy. The architecture of the Israeli system is similar to that in many other OECD countries. Households face progressive PIT plus social-security contributions on the one hand, and are potentially eligible for a range of transfer programmes on the other hand, including unemployment benefit, general social welfare, child allowances and child support (Tables 1.3 and 1.4). In addition, recent years has seen the introduction of an earned income tax credit (EITC) for low-income households. In terms of budgeting, most welfare benefits are administered by the National

Table 1.3. **Personal income tax and social security contributions**

Dimension	Notable features
Scope of the tax base	Levied on an individual basis. Income from employment, some welfare benefits and pensions as well as interest income are included in the base.
Rates and thresholds	As of January 2014, six rates ranging from 11% to 50%, the first threshold is at NIS 62 400 and the last at NIS 501 960. In addition, a 2% "surtax" applies to annual incomes above NIS 800 000. Tax on interest is subject to a ceiling of 25% (i.e. individuals pay their marginal rate of tax on interest income, but only up to a rate of 25%). The ceiling is 15% for interest on non-indexed shekel deposits, and rules differ if the interest is accrued by a "substantial owner" of an asset. Thresholds automatically updated to compensate for inflation every year (except for a few years when the threshold update has been cancelled as a one-off fiscal measure).
Wasteable tax credits	Credit points system with a universal component and an additional credit per-child (for fathers the credit applies only for children up to the age of three, unless 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 any personal income tax.
Earned-income tax credit (EITC) (non-wasteable)	Applies to households with one or more children and those aged 55 and over. Maximum monthly credit NIS 330 for those with one or two children (NIS 495 for mothers and single fathers) and NIS 480 for those with three of more children (NIS 720 for mothers and single fathers).
National insurance: standard rates	Up to 60% of the average wage: employee contribution 3.5%, employer contribution 3.45%. Above 60% of the average wage: employee contribution 12%, employer contribution 6.5% (the latter is due to increase to 7.5% in 2014).
Special conditions	Special contribution rates apply to non-working persons: the unemployed, disabled pensioners and so on.
Other considerations	Compulsory minimum contributions to second-pillar pensions on earnings up to the average wage (Table 1.5).

Table 1.4. **Key unemployment and welfare benefits**

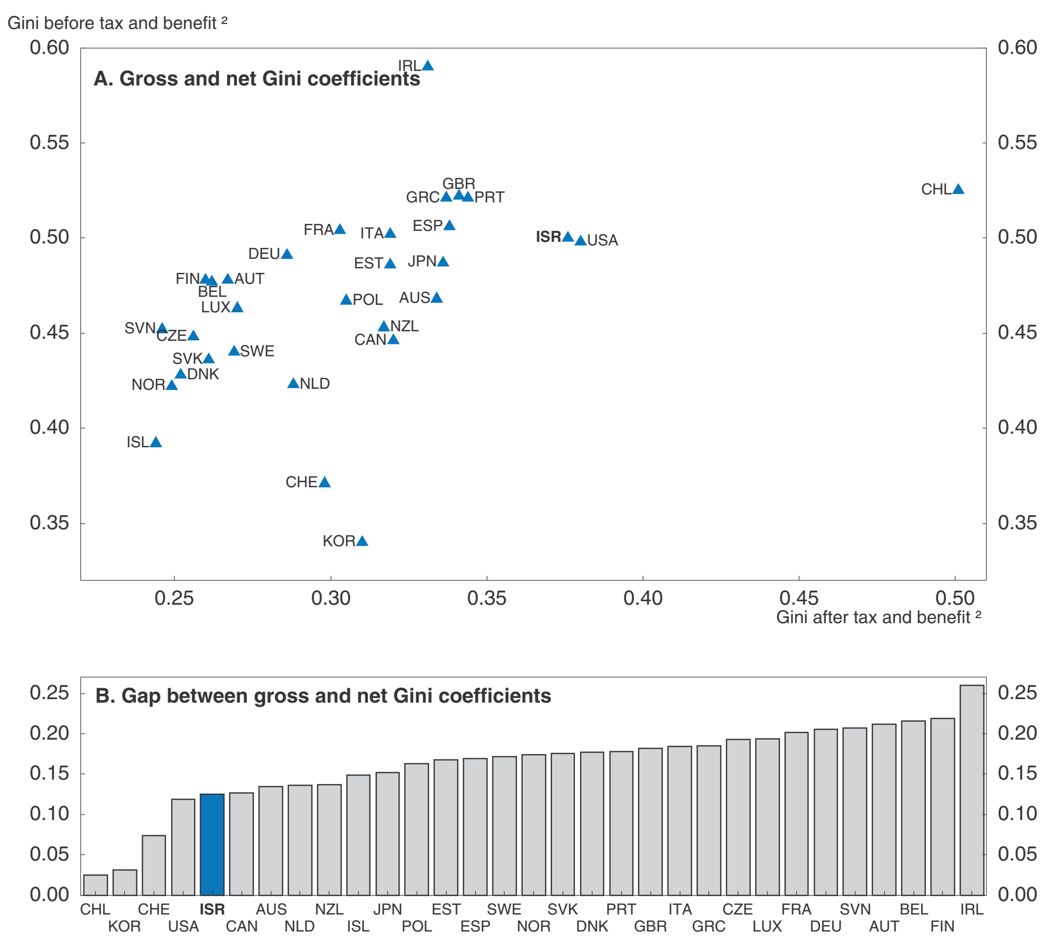
Item	Notable features
Unemployment insurance benefit	Pay-out ranges from 45 to 80% of previous earnings (35 to 60% for those aged under 28), accompanied by benefit ceilings. Maximum duration ranges from 50 to 175 days according to age and number of dependents. Subject to regular income tax, but a low National Insurance Institute (NII) contribution rate is applied. Those taking up "unsuitable work" can receive UI as an in-work benefit.
Income support	Eligibility is means and employment tested. Ownership of a car no longer precludes eligibility, but vehicles are included in the assessment of assets. For instance, monthly support is NIS 2 843 for a couple with two or more children. Support increases with household size, but not beyond two children. Support can be given when the family has income from other sources (including earnings). There are modest earnings disregards. For earnings above these levels, benefits are withdrawn at rates ranging from 62.5 to 70%.
Paid maternity leave and birth grants	Conditional on NII contributions for 10 of the last 14 months (or 15 out of preceding 22) preceding due date. Those on Income Support would normally be eligible for hospitalisation grants as they pay a health-care contribution. A maternity allowance pays 100% of previous earnings for up to 14 weeks. In addition, there are one-off birth grants, which decline with the number of children, hospitalisation grants and benefit for precautionary rest taken during pregnancy. Leave (and payment) can be switched to the father for up to six weeks.
Universal child allowances	More generous allowances can apply to children born before May 2003, depending on birth order. Monthly allowances were cut in the 2013-14 budget. Those on Income Support receive additional allowances equal to 70% of regular child benefit for both the third and fourth children. The allowances are paid until the child reaches age 18.
Study grants	Eligible groups notably include lone parents and families on Income Support with at least four children. Annual payments of NIS 1 528 per child aged 6 to 12 and NIS 849 per child aged 12 to 14.
Rental support	In general, eligibility is determined by a means test, one notable exception being recent immigrants who are all eligible for rent subsidies (OECD, 2011a, Table 1.5).

Insurance Institute (NII), which also receives the social-security contributions directly. Shortfalls in the NII's budget between contributions and spending are made up by central government revenues. Therefore, the contributions are, for all intents and purposes, taxation in another name. Compared with other systems, social contributions are light, and the welfare pay-outs are not hugely generous, reflecting the parsimony in overall civilian public spending.

Israel's light tax-benefit system in terms of spending means it is not strongly redistributive. This can be seen in comparing Gini coefficients for gross income and for income after adjusting for taxes and transfers (net income), where the country has the third-largest degree of overall income inequality in net terms but only the ninth largest in gross terms and is close to the United States on both counts (Figure 1.5). In terms of relative poverty, the pre-tax rate is similarly close to that of the United States, but the post-tax incidence of relative poverty

Figure 1.5. **Gross and net income inequality, 2010**[1]

Total population



1. Or latest available year.
2. The Gini coefficient takes values between 0 for maximum equity (all households receive the same income) to 1 for maximum inequality (one household receives all income).

Source: OECD Income and Poverty Distribution Databases.

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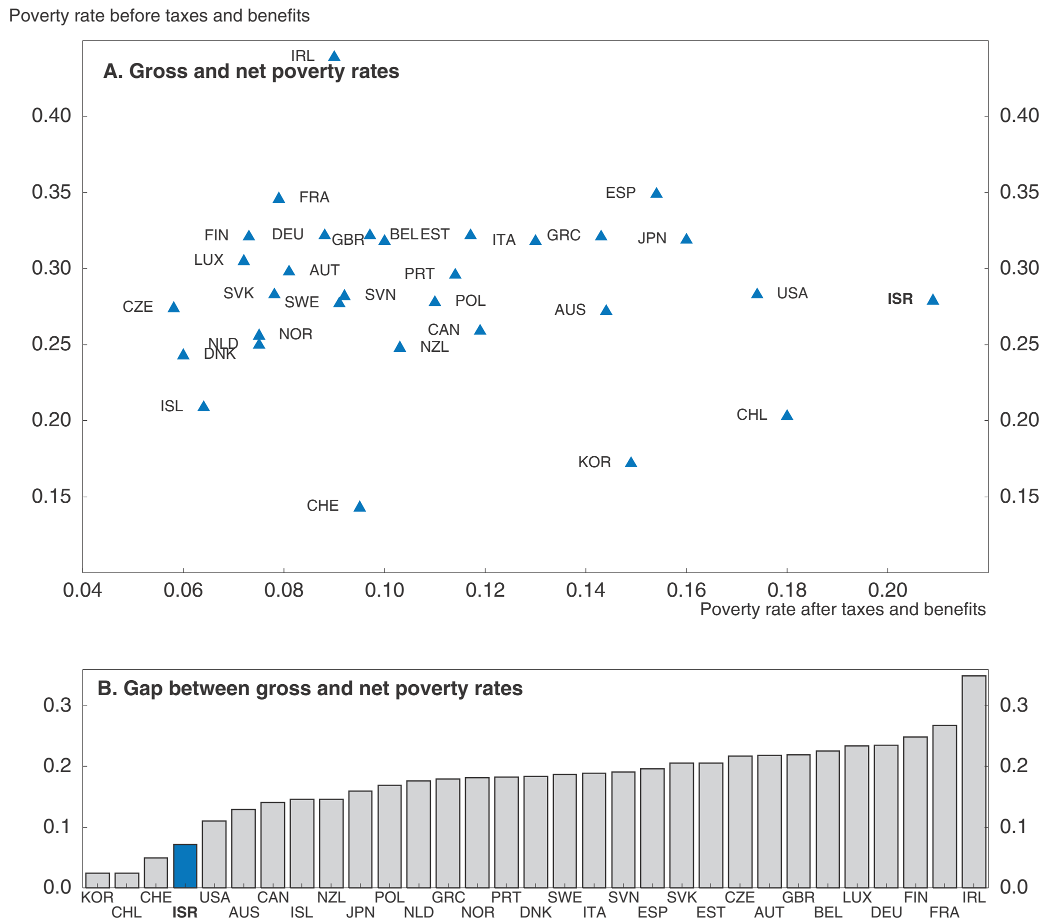
Figure 1.6. **The incidence of relative poverty based on gross and net income**[1]

2010,[2] total population



1. The incidence of relative poverty measures the share of households whose equivalised income is less than 50% of the median income.
2. Or latest available year.

Source: *OECD Income and Poverty Distribution Databases.*

StatLink *http://dx.doi.org/10.1787/888932964433*

is substantially higher and indeed is the highest in the OECD area (Figure 1.6), echoing the low spending on social welfare. The bottom line is that any substantial reduction in Israel's rate of relative poverty is likely to involve more public spending.

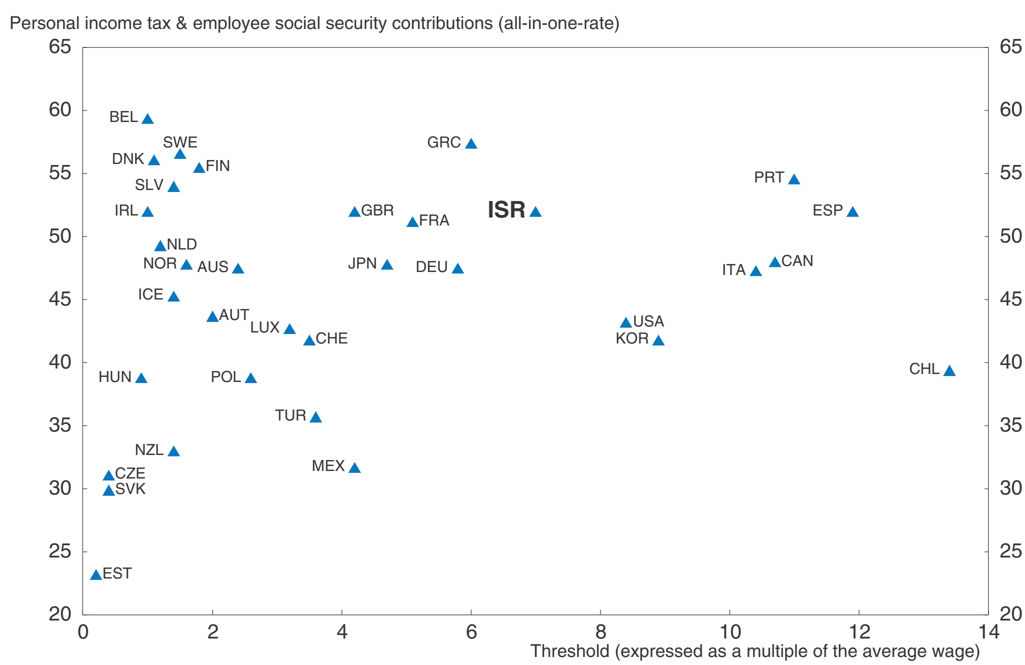
The government's strategy on personal income tax

The cancellation of scheduled cuts in PIT rates and the subsequent increases mark a change of direction that Israel's policymakers would probably not have made, were it not for the fiscal difficulties and the political pressures from the tent protests. The planned cuts in PIT, as well as those in CIT, reflected a belief that these generate sizeable positive second-round effects in terms of investment and growth. As previous *Surveys* have argued, lowering top-end PIT rates probably delivered healthy marginal returns initially in terms of attracting investment and incentivising labour, but these diminished over time with the immediate fiscal consequences of cutting tax rates becoming progressively more prominent.

While the cancellation of the rate cuts was, on balance, a good move from a fiscal point of view, the subsequent increases do pose risks for the country's reputation regarding the business friendliness of the tax environment. There have now been three rounds of PIT rate increases: the Trajtenberg reform saw an increase in the top rate of tax; the mid-2012 fiscal package brought increases in other high-end rates and a freeze on threshold updating, plus a 2% surtax on very high incomes (Table 1.1); and finally, all PIT rates are scheduled to rise as part of the 2013-14 budget. Policymakers need to remain mindful that the top statutory rate (including social-security contributions) is now quite high in international comparison at 52% (the ceiling on the employees social security contribution coincides with threshold for the top tax rate of personal income tax and so does not add to the marginal tax rate on earnings in this bracket). This said, the income threshold of the top rate of tax (in relation to the average wage) is good deal greater than in many countries with high top marginal rates, such as Belgium, Sweden, Denmark and Finland (Figure 1.7). The recent increases in all PIT rates imply Israel's position in international comparison has become slightly less flattering across a wide range of skill levels.

Figure 1.7. **Top marginal rates of personal income tax and corresponding thresholds**[1]

2012



1. Data comprise the top statutory personal rate plus additional deductions (such as social security contributions) that apply at the threshold where the top statutory PIT rate first applies.

Source: OECD, *Tax Database* and Israeli authorities for Israel.

StatLink http://dx.doi.org/10.1787/888932964452

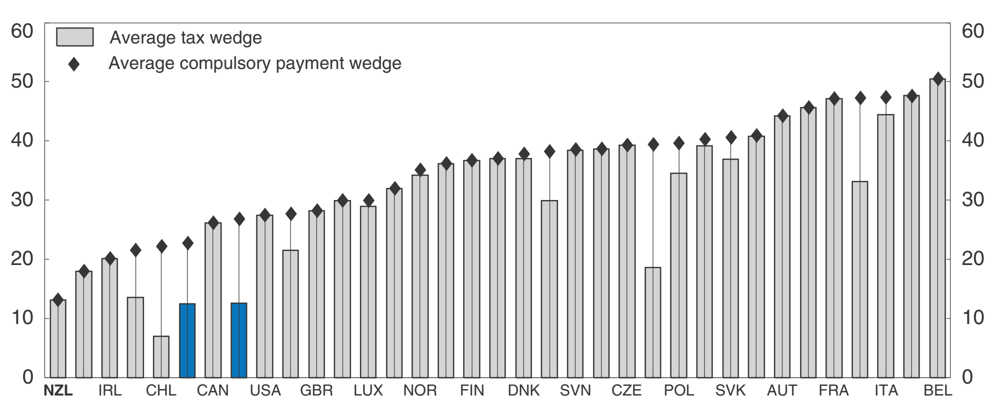
Encouraging employment and combating poverty

Income tax, particularly those aspects applying to people with low earnings capacity, in combination with the generosity, accessibility and qualifying conditions of welfare benefits, govern poorer households' disposable incomes and influence their incentives to engage in the labour market. Ensuring that the system of taxes and transfers is well designed is particularly important for Israel, given the large number of poor households concentrated in the rapidly growing Haredi community and in the Arab-Israeli sector. The issue is regularly assessed, for instance in the National Insurance Institute's *Annual Surveys* and the Bank of Israel's *Annual Reports* and has been discussed in several OECD reports (the latest being a follow-up review on social policy: OECD, 2013e). Of course the tax-benefit system is not the only area requiring attention in order to make progress on reducing poverty. As described by the recent OECD review, the authorities have, for example, been endeavouring to improve the enforcement of labour legislation by, for instance, increasing the number of labour inspectors.

Over the past few years the tax wedge on labour has shifted away from being among the very lowest in the OECD distribution, although this is not due to the tax-benefit system *per se*. Indeed, personal income tax and total social security contributions on low-wage earners remain very light. Tax credits plus a low bottom rate of tax (for 2013 the rate is 10% for the first NIS 63 360) mean that individuals earning up to the average wage (approximately NIS 110 000) pay little or no income tax. Social security contributions are also modest; the combined employee and employer contribution rate is only 6.95% up to 60% of the average wage and 18.5% on earnings above this amount. Thus, the aggregate tax wedge based on standard taxation and social contributions is among the least burdensome in the OECD. Even with the imminent increases in tax rates, this wedge will still be low. However, mandatory pension contributions to private-sector pension funds ("second pillar" pensions) were introduced in 2008 with contribution rates increasing annually according to a schedule that ends in 2014 (when the total contribution will reach 17.5%). OECD simulations show that as of 2012 the tax wedge for a single person earning two-thirds of the average wage with no children was only 13% of total labour costs, but 23% once the second-pillar pension contribution is included (the "compulsory payment wedge", Figure 1.8). Moreover, the latter figure is estimated to reach 27% in 2014 due to the further increase in mandated pension contributions. True, the pension-contribution component of the wedge probably elicits milder behavioural responses than the taxation

Figure 1.8. **Tax and compulsory payment wedges for a single person at two-thirds average wage, no children**

2012



Note: "ISR2014" incorporates the higher mandatory pension contribution that will apply in 2014, while leaving other settings used for the calculation at the 2012 values.

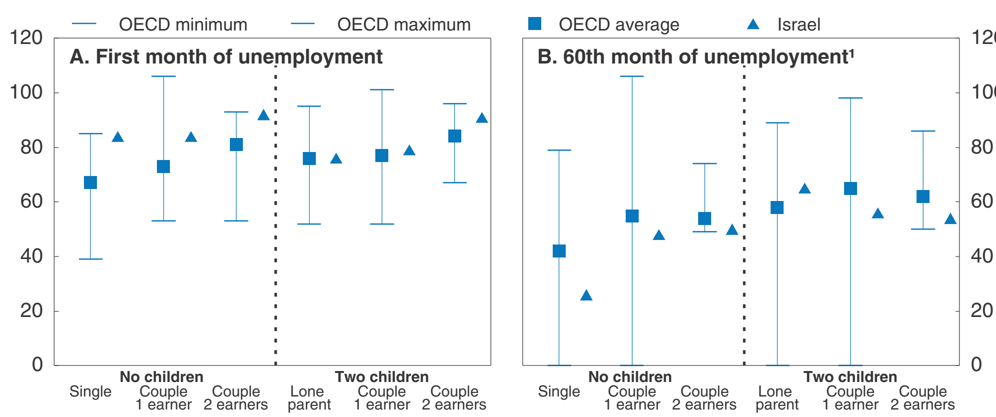
Source: OECD, *Taxing Wages Database*.

StatLink http://dx.doi.org/10.1787/888932964471

component, to the extent that individuals view it as a redistribution of their own income over time. Also, a tax wedge of this magnitude is still well short of the largest in the OECD area. Nevertheless the negative effects of further increases on the demand for and supply of labour and more generally the business environment should be a consideration in assessing the pros and cons of further recourse to PIT or social contributions as a means of raising revenues.

In other respects the tax-benefit system has some positive qualities in terms of work incentives. Unemployment insurance benefit duration is not excessive, ranging from 1½ to 6 months, depending on the applicant's age and family circumstances. Also, the main welfare benefit – Income Support Benefit – is not only means tested but also requires an employment test (OECD, 2010). As shown in Figure 1.9, among the various standard household types modelled by the OECD, the replacement rates in the first month of unemployment are typically close to the OECD average, while, at the end of five years some replacement rates are well below the OECD average, especially for single childless people. Note that these calculations do not incorporate Israel's mandatory pension contributions. Additional calculations for a subset of the household types shown in Figure 1.8 confirm that including such contributions does push the replacement rate higher (as the contribution is only made when earning) but not to levels that would discourage job-search efforts.

Figure 1.9. **The unemployment benefit replacement rate at two-thirds average wage, 2011**



1. The micro simulations 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 60th 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*.

StatLink http://dx.doi.org/10.1787/888932964490

The fact that a significant proportion of Israel's poor households are very large affects the policy issues and complicates any assessment of the tax-benefit system. First, the universal child allowances often account for a significant share of income for large households and, consequently, are often at the forefront of debate about welfare benefits. The Haredi community's interest in maintaining generous child allowances has, at least in the past, been intense and often influential. Not only are their families typically large, but the Income Support Benefit is of limited relevance because most Haredi men study full time and are thus ineligible based on the benefit's employment test. Large cuts were made to the child allowances in the early 2000s, but this was followed by some programmed increases. However, the governing coalition has reduced child allowances and moved away from universal provision: they were eliminated for those with incomes of more than NIS 800 000 per year (i.e. around USD 225 000 or seven times the average wage). Abandoning universality is justifiable in terms of spending efficiency in a difficult fiscal situation, but with such a high threshold the savings will likely prove small. The reform to the value of the child allowances is of some concern. The allowance has been cut to NIS 140 per month for each child, previously it was either NIS 175 or NIS 263 (the latter applying to the second, third and fourth child) the higher benefits were granted to children born before 2003. The cut in the allowance in itself implies significant percentage reductions in the incomes of poor families with many children. However, the cut has been made alongside a raft of measures providing positive encouragements to labour force participation and skills development, such as the widening of free childcare, plans to revive private-sector job placement and the increase in the value of the earned-income tax credit (EITC).

The presence of a significant number of large families has also to be borne in mind in considering the extent and significance of poverty and the capacity of the tax-benefit system to bring these households above the standard poverty thresholds. Relative poverty thresholds are commonly calculated as half of "standardised" median income (the poverty rate is then the share of households below the threshold). The standardisation procedure divides household income by an adjusted figure that gives progressively less weight to each additional family member (conceptually this is intended to reflect economies of scale as households increase in size). OECD relative poverty statistics, for example, use a standardisation weight based on the square root of family size, i.e. the marginal weights for each family member are 1, 0.41, 0.32, 0.27, etc. (Israel's National Insurance Institute uses a different weighting system in which the marginal weights are typically higher). One practical implication is that, for instance, the poverty threshold for a couple with six children is 41% higher than that of one with two children under the OECD's square root approach; keeping large households above the poverty line implies a need for generous welfare provisions.

There is a need to press ahead more vigorously on some fronts, the EITC in particular. The EITC is available to workers with children and/or those aged 55 or over and is a non-wasteable credit: in other words, households can receive a payment from the tax authorities if the credit exceeds the value of tax otherwise owed. In its pilot phase the credit was twinned with a programme introducing government-funded private-sector placement services, which was later cancelled. The EITC has operated nation-wide since 2011 and the credit for mothers and single fathers was increased by 50% in 2012. During the pilot phase (between 2007 and 2010) the scheme is estimated to have boosted recipients' annual income by 7% and to have reduced their incidence of poverty by about 4.5% (Bank of Israel, 2013). Its subsequent extension to the whole country plus the increases in credit amounts will have boosted its impact, but its scale remains small. Further increases in the take-up, and possibly also the generosity, of the credit are required to have an appreciable impact on in-work poverty and incentives to enter the labour force (or to increase hours worked among those already employed). Public spending on the credit was only 0.02% of GDP in 2011. This figure will have increased since then due to increased take-up and hikes in the credit but probably not to the level spent on similar schemes for instance in the United States and United Kingdom where the credit costs 0.4 to 0.5% of GDP.

Little progress has been made in reforming the disability benefit system, with disappointing take-up of a new scheme aiming to encourage employment. As in a number of other OECD countries there are concerns that there are fairly significant numbers of disability-benefit recipients who have some capacity to work, but that the system neither encourages nor makes it easy for them to so. Gauged by the total number of recipients, the problem in Israel has not swelled to the levels seen in some countries but nevertheless needs to be tackled. To their credit the authorities have at least been trying to bring about concrete change. Reforms in 2009, *inter alia*, brought a new classification of disability-benefit recipients and the introduction of an earnings top-up payment (the Incentive to Work benefit) as an alternative to regular disability benefit. The Incentive to Work Benefit includes guarantees permitting a return to full-time disability benefit (if, for instance, the individual decides to quit their job) and is, in principle, financially attractive. However, take-up has been extremely low – only 3 490 people entered the scheme in 2011 out of the approximately 215 000 persons on disability pensions. Seemingly, mistrust of the guarantees attached to the scheme and complicated procedures are key reasons for low take-up (OECD, 2013e). Such efforts to engage with those already on disability benefits should not be abandoned. Also, there should be a focus on new claimants, where reforms are often easier to implement and more effective, and on policies encouraging employers' demand for disabled workers. In that vein, new support centres to advise and assist employers with disabled workers are planned.

In addition, tax-benefit policy needs to focus more tightly on the core socio-economic problem: that of poor and often large households with weak labour-force attachment. Since the tent protests of 2011, middle-class concerns have gained in prominence, and there is a risk that these overly divert policy attention and resources away from solving the problems of poverty and wide socio-economic divides. In the Israeli context some measures might, *prima facie*, help both low- and middle-income households but in reality largely benefit the latter (and possibly high-income households too). In particular, reductions in income-tax rates or social-security contributions, as well as expanding wasteable tax credits, are unlikely to relieve poverty or raise work incentives among poor households to any great degree, because a significant proportion already pay little or no income tax, whether working or not. For example, the decision to allow men to claim child allowance when children are aged up to three years was a good move towards equal treatment (though the treatment remains asymmetric as for mothers the allowance applies to older children too), but also fiscally costly and largely benefiting middle- and upper-income households. Accompanying the extension of the allowance with a reduction in its size would arguably have been a better move.

Of course, adjustments to taxes and benefits are only one element in the range of possible policies to tackle socio-economic problems. For instance, the government is committed to widening access to free daycare for infants and to early childhood education, which should help households combine work and family life. And, with a view to providing longer-term improvement in living standards for poorer communities, policymakers are endeavouring to improve education for Arab-Israeli students and to encourage Haredi schools to pay more attention to core subjects, such as maths and languages.

Pension reform

Israel's pension system combines a modest publicly funded pay-as-you go pension (the first pillar of the system) with favourable tax treatment of pension savings and

Table 1.5. **Key features of the pension system**

First pillar (state pension and related benefits)	
Retirement age	Men's retirement age reached 67 years in 2009. For women the retirement age is currently 62 years; a schedule bringing it to 64 years is due to begin in 2017. There are limits on earnings while in receipt of a public 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 pay-out.
Coverage	Practically universal. Exceptions include immigrants who arrived when over the age of 60 who are covered by a special arrangement.
Pay-out	Pay-outs vary according to household composition and age. For example, as of January 2013 for those under 80 years old the pension for a single person was NIS 1 502 per month and for a couple NIS 2 257 (the pensions are slightly higher for those over 80). A seniority increment increases the pension by 2% for each year of full contributions after the first 10 years of contributions (with a ceiling on the total increment of 50% of the pension). Thus, for instance, including the maximum possible increment, the total pension for a single person (aged under 80) is NIS 2 253 and for a couple NIS 3 386. The "survivors" pension pay-out is similar that of the regular pension.
Income supplement	The income-support system guarantees minimum income levels subject to means testing. As of 2013, for example, single persons aged 70 to 80 are guaranteed NIS 2 833 and couples NIS 4 204.
Deductions	A deduction for medical insurance is made on the basic pension (which is lower if the individual is eligible for the Income Supplement).
Second and third pillars (compulsory or voluntary contributions to pension funds or similar)	
Contributions	Mandatory minimum contributions to the new pension funds (introduced in 2008) apply to employees' earnings up to the average gross wage. The contribution rate has been undergoing stepped increases and will reach 17.5% (7.5% from employees and 10% from employers) by 2014. Five percentage points of the employers' contribution also serves as severance insurance.
Tax treatment	Tax treatment not only applies to "regular" pension products but also to saving via life-insurance and provident-fund products. Employer contributions are not counted in employees' taxable income (with a ceiling). Employee contributions are subject to a 35% (wasteable) tax credit (with a ceiling). Returns on pension saving are not taxed. Pay-outs (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 tax credit if one's spouse does not work and has no pension.
Other dimensions	Tax incentives generally guide the retirement age (or equivalent) set 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 pay-out. 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.e. about 60% of the average wage). There are portability provisions for switching between savings products (introduced in 2008).

pay-outs. As mentioned above, since 2008 for (almost all) employees there are minimum compulsory contribution rates to private-sector pension plans (the system's second pillar, see Table 1.5). Thus, in broad terms, the authorities have avoided significant fiscal commitment. This, combined with favourable demographics, means that public spending on pensions has remained relatively low. And, even though population ageing will increase spending in the future, public pension spending under current policy settings will remain among the lowest in the OECD area.

The first pillar of the pension system ensures reasonably adequate support for retirees when benchmarked against standard poverty thresholds. However, this is not entirely thanks to the state pension. Indeed, as calculations for the 2010 *OECD Economic Surveys* show (p. 128), even with the inclusion of seniority payments (Table 1.5), pension income *per se* probably falls somewhat short of the poverty threshold for many retiree households. However, retirees can be eligible for top-up payments referred to as the Income Supplement (similar to the Income Support benefit discussed above), and calculations suggest these typically ensure retiree incomes are above poverty thresholds (though not by much).

However, the first-pillar pension is not devoid of problems, most notably a singular failure to reach political agreement to bring women's eligibility age for the state pension up to men's. Commendably the retirement age for men has already been increased to 67 years (this was achieved in 2009). However, increases in women's retirement age have stalled, remaining at 62 since 2009, and a series of increases that would bring it to 64 is due to start only in 2017. Among OECD countries it is now extremely rare for women's retirement age to be below that of men and even where this is the case for there to be no concrete plans to close that gap.

While the second pillar of the pension system does not involve direct state funding, there are implications for taxes and benefits and related issues. As pointed out above, the introduction of compulsory pension saving involving both employee and employer contributions is similar in some respects to a hike in the tax wedge on labour as regards employees' and employers' incentives. Israel's tax treatment of pension saving (or similar forms of saving) comprises partial exemption at the contribution phase, full exemption in the accumulation phase, and imposition of PIT (though with some special breaks) at the pay-out phase (so-called EET tax treatment). Previous OECD assessment (most recently in OECD, 2013e) has suggested the tax treatment should be reviewed. One issue is that introduction of the mandatory pension contributions was not accompanied by a revision to tax treatment, with tax relief continuing to apply to the compulsory component which is in a sense wasteful tax expenditure. Also, the tax benefit on pension income is in the form of a universal tax credit and is therefore not hugely efficient as a means of combatting pension poverty. A further issue is that the returns to the mandated pension saving for low-income households are dented, since the income from second-pillar pensions can mean reduced income-support payments as pension income is counted in the means test. Adjustments aiming to further encourage pension saving are being planned alongside proposals to introduce default portfolios in which investment risk declines as the employee ages (the so-called life-cycle approach).

Parenthetically, scrapping the tax credit for medium-term saving in so-called "advanced training funds" (Kranot Hishtalmut) was for a while included in proposed measures for the 2013-14 budget, but unfortunately did not make the final budget. The funds have to be held for three years if the savings are spent on training or education but if held for at least six years they can be spent on a wide range of goods and services, for instance the purchase of cars. As previous *Surveys* have pointed out there is practically no economic justification for maintaining this particular tax expenditure.

Property and capital gains taxation

Israel is one of several OECD countries that have no taxes on the value of property in the form of wealth tax or on transfers of property through inheritance or gift taxes. Interest income, dividends and capital gains are subject to various flat rates of tax. The basic rate of capital gains tax is the same as that for corporate income tax, but there are variations depending on the purchase date and the nature of the asset. And, as in most other OECD countries, the tax treatment of housing (and real estate in general) differs from that on other assets, which has an important influence on rates of home ownership and property markets and therefore the focus of this section.

Taxation relating to housing

In a welcome move the 2013-14 budget pruned exemptions on capital gains from the sale of property. The in-depth review of the housing sector in the 2011 *Survey* was critical of the scope of these exemptions, and the budget law has narrowed them considerably: exemptions on capital gains from second homes or investment properties have been scrapped entirely (previously there was exemption as long as the owner held onto the property for a minimum number of years); and a limit has been placed on the exemption from capital gains tax for principal residences.

In other respects the tax treatment of owner-occupied housing takes a practical approach. In theory, owner-occupiers should be taxed on imputed rental income but allowed to deduct mortgage interest payments. However, due to the practical difficulties of establishing imputed rents, the treatment is similar to that in some other countries: neither imputed rents nor mortgage interest are taken into account (the assumption being that their values are roughly equivalent, although this is not the case once the mortgage is paid off). More serious is that up to certain limits private taxpayers renting out properties do not have to declare rental income. In addition, the authorities should consider raising the Land Betterment Tax (Hetel Hashbacha), which is imposed when the property sold has benefitted from favourable re-zoning; the tax is currently 20% of the estimated value of the betterment accrued. Such a move would improve the state's share in the windfall profits from re-zoning and reduce the incentives for property developers to try to influence local planning decisions.

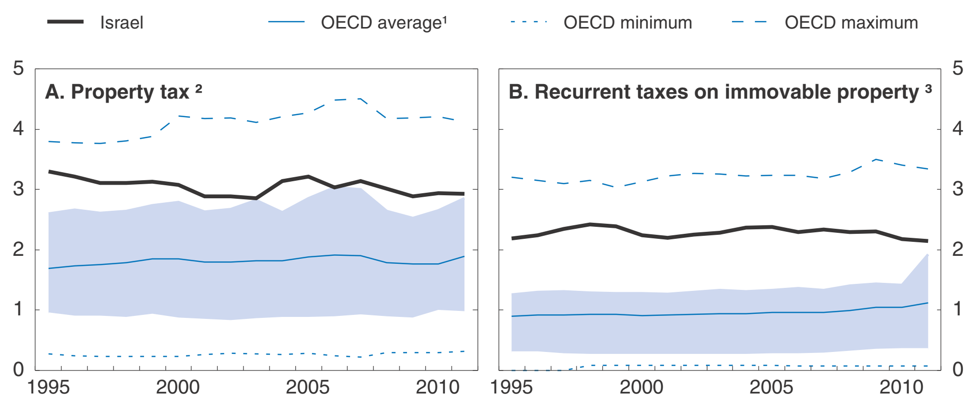
Transaction costs on purchasing a house have become somewhat heavier: the tax has been increased when purchasing investment property or second homes, and a supplementary tax has been introduced for high-end property. Given the very wide search for additional revenues in the 2013-14 budget and the continued concerns about the strength of house-price rises, these moves are understandable. Although these particular measures are very unlikely to have dissuaded household mobility to any great extent, the authorities should remain aware of this issue should further hikes in transactions taxes be considered. Also, as a measure to cool the property market, the government has been considering a penalty tax on property developers if the time between receiving the approval for construction and the sale of all properties in the project exceeds three years.

Revenues from recurrent taxes on immovable property (i.e. housing or other buildings) are among the highest in the OECD area (Figure 1.10, Panel B), representing about 2.25% of GDP and account for the majority of property tax (including that on financial assets) (Figure 1.10, Panel A). Israeli property tax (the Arnona) is based on the surface area and type of property and is a significant source of municipal revenues. The exploitation of the tax base on immovable property is broadly welcome, given its textbook advantages, in particular the low risk of evasion and less distortionary effects on economic behaviour compared with other tax bases.

New regulations are in train that, if fully implemented, will double the Arnona on vacant apartments. The move is part of wider efforts to increase the supply of housing; in this instance the intention is to dissuade property owners from leaving apartments vacant for prolonged periods, which is quite common in some localities, especially Jerusalem, where there are substantial numbers of foreign property owners. According to the regulation, municipalities will use water-meter data to determine whether the apartments are "vacant" and therefore subject to the higher Arnona rate. While this move is perhaps

Figure 1.10. **Tax on property**

As a percentage of GDP



1. The shaded area are the 25th to 75th percentile range of available OECD countries.
2. This heading covers recurrent and non-recurrent taxes on the use, ownership or transfer of property. These include taxes on immovable property or net wealth, taxes on the change of ownership of property through inheritance or gift and taxes on financial and capital transactions.
3. This sub-heading covers taxes levied regularly in respect of the use or ownership of immovable property. These taxes are levied on land and buildings.

Source: *OECD Tax Revenue Database* and *OECD Economic Outlook 94 Database.*

StatLink http://dx.doi.org/10.1787/888932964509

well intentioned, *prima facie* it seems possible that the absent owners may find an easy way around regulation by arranging for someone to occasionally run the water for them or by just leaving the tap on a little. Also, those who are content with leaving apartments unrented are probably not that price sensitive and so the extra levy may not substantially reduce the number of so-called "ghost apartments", although then it would be an efficient revenue-raising base.

Company taxes and business subsidies

Israeli policy on corporate tax and business subsidies appears to be guided by several objectives: *i)* making the profile of taxes and subsidies attractive to investors, especially foreign investors; *ii)* encouraging scientific R&D and other forms of innovation; *iii)* promoting regional development; and *iv)* providing targeted support for the agricultural sector. Any one element of tax or subsidy often reflects more than one of these goals. Various factors shape how far each is pursued, most notably the strength of revenue pressures and the balance of tax burdens between households and firms. The latter not only reflecting subjective societal choices but also practical considerations, such as co-ordinating policy on the statutory CIT rate with that on PIT to prevent tax avoidance through incorporation by high earners.

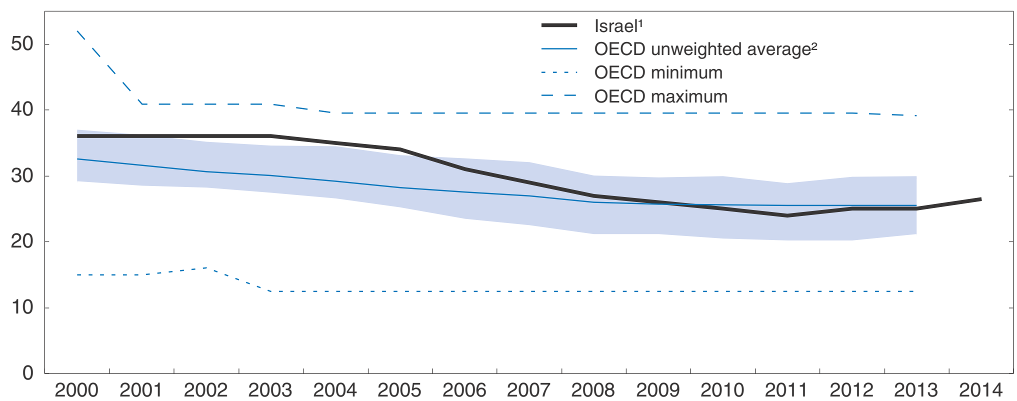
Making the profile of taxes more attractive for business

In small open economies such as Israel's the tension between keeping business tax light in the interests of investment while accommodating revenue needs and tax-fairness considerations is particularly acute because of their intense exposure to capital mobility. As elsewhere, corporate-income taxation involves a range of tax breaks (and subsidies), many of which are, in effect, differentiating between different degrees of capital mobility, thus helping ease policy tensions by targeting special treatment only where it is most required to attract investment. However, the tools for achieving that differentiation are not that precise and can result in a complex system that can be hard to communicate and entail high administrative costs. As an alternative, some OECD countries have focused on imposing a low statutory CIT rate with few base-narrowing rules, tax breaks or subsidies.

Until 2011 Israeli policy was also heading towards a low statutory CIT rate. It had been on a downward track for some years and by 2011 had reached 24%, with further cuts programmed that would have brought it to 18% in 2016. As mentioned, revenue concerns and political opposition arising from the tent protests saw the schedules of cuts abandoned and followed by an increase from 24 to 25% in 2012, with an increase to 26.5% scheduled for January 2014. At that point the rate will probably be once again slightly above the (unweighted) OECD average (Figure 1.11).

Figure 1.11. **Statutory rates of corporate income tax**

Per cent



1. The rate for 2014 (26.5%) is scheduled in measures in the 2013-14 budget.
2. The shaded area is the 25th to 75th percentile range of available OECD countries.

Source: OECD Tax Database.

StatLink http://dx.doi.org/10.1787/888932964528

The negative impact of these developments on the perceived "competitiveness" of the tax system has probably not been very large so far. The headline rate has not been increased substantially, and, in any case, the attractiveness of the system also depends on the various factors in calculating the CIT base, as well as tax breaks and subsidy programmes. The Law for the Encouragement of Capital Investments (LECI), the flagship programme on this front, offers CIT rates well below the statutory rate plus other support (Table 1.6). Previously this legislation explicitly focused on attracting foreign investment; in its current version the eligibility rules assess the firm's export orientation (whether foreign-owned or domestic), a key criterion being that export revenues must account for at least one quarter of turnover. Aside from taking into account the details of the tax system, investors also value responsible macroeconomic policy. Given that the change in Israeli policy on the statutory rate reflects efforts to bring fiscal balances back on track, the investment community has probably taken a less dim view of it than might otherwise have been the case.

Table 1.6. **Targeted programmes providing tax breaks and subsidies**

Law for the Encouragement of Capital Investments (LECI)	
General scheme	• Eligibility, *inter alia*, requires the firm to be "internationally competitive", defined by the industrial sector of the firm or by the geographic diversity of its sales or by having substantial sales to at least one large foreign market. • As of 2014 the CIT rate will be 9% in "priority areas", 16% elsewhere. Dividend tax 20%. (There is no time limit to these tax rates.) • Investment grants up to 20% of approved investment available.
Special benefits for large companies	• Eligibility criteria include minimum annual turnover in Israel of NIS 1.5 billion, a combined balance sheet of at least NIS 20 billion, plus either: *a)* productive equipment with a value of at least NIS 400 million in priority areas (NIS 800 million elsewhere); *b)* R&D investment of at least NIS 100 million NIS per year in priority areas (NIS 150 million elsewhere); or *c)* employment in Israel of at least 250 new employees in priority areas or 500 elsewhere. • CIT rate 5% in priority areas, 8% elsewhere.
R&D incentives (managed by the Office of the Chief Scientist)	
R&D fund	• Competitively awarded grants up to 50% of R&D spending with obligation for repayment in instalments if the project is commercially successful. This is the main form of R&D support.
Targets of specialised programmes providing some form of financial support for R&D	• Individual investors and nascent start-ups (Tnufa programme). • Entrepreneurs that are accepted to one of Israel's business incubators. The incubators themselves are privately owned and also partially fund the entrepreneurs. • Academic research particularly in biotechnology and nanotechnology (Magneton and Nofar programmes). • Consortia of firms and academic institutions for joint R&D projects (Magnet programme). • Joint ventures by Israeli and US companies ("BIRD" programme). • Co-operation between Israeli companies and foreign multinational companies. • Centres for R&D in the finance sector. • R&D centres of foreign companies.
Employment grants	
Standard programme	• Available for the establishment or expansion of business premises (involving a least five employees) in certain areas (the priority areas as defined in the LECI, northern and southern areas and selected towns which are dominated by minority populations. • 2½ years of support, declining over time, initially ranging between 10 and 35% of the gross wage bill of the employees concerned, depending on the area of the country and the size of the enterprise (smaller businesses receive more). There is a cap on support per worker of NIS 135 000 over 30 months (i.e. 4 500 per month).
Employment Grant Program for High Salaries (R&D centres)	• Available for the establishment or expansion businesses (involving at least 15 employees) only in northern (Galillee) and southern (Negev) regions of the country. The salary of all new employees must be at least 2.5 times the national average. • Five years of support initially ranging between 35 and 45% of the wage bill. A company that recruits 130 or more employees is entitled to a flat grant of 40% of the wage bill for four years.
Employment Grant Program for large Enterprises ("Anchor")	• Same regional coverage as the "high salary" programme, minimum number of employees 100, average cost of new salaries must be at least 1.5 times the national average. • Four years of support initially ranging between 35 and 45% of salary costs.
Other schemes	
"Angels Law" (2011)	• For the years 2011-15, individuals (foreigners or nationals) investing in "target" companies can deduct the amount invested from their overall taxable income from all sources (up to NIS 5 million per targeted company). • "Target" companies must be R&D-oriented (there are various specific qualification rules in this regard).
"Film Law" (2008)	• Provisions allowing foreign and co-produced filmmakers to withhold tax payments ranging from 9 to 17% of certain production expenses without transferring the amount to the tax authorities.

Strong revenue pressures and greater public attention to the distribution of the tax burden between corporations and households have increased the challenges in presenting a business-friendly tax profile. Looking ahead:

- Further hikes in the CIT rate beyond 2014 could be damaging. Even if the direct impact may not be significant, further rises may create the impression that the rate is on an upward trend and prompt fears that economic policy in general is becoming less business-friendly. Rate cuts should certainly not be dismissed entirely from the policy agenda, even though it may be some time before fiscal conditions (and perhaps the political climate too) allow them to resume.

- There may be avenues for improving the efficiency of some CIT features. For example, the LECI's international competitiveness eligibility rule could perhaps be raised so as to provide savings and better focus the preferential rates on businesses that are heavily exposed to international competition.
- There may also be opportunities to develop taxation more fully where activities are inherently tied to location, in particular resource extraction. The authorities have already demonstrated a capacity for reform in this area with the new tax-royalty regime for natural gas and oil resources in 2011 (Box 1.1). Also as from 2011, businesses engaged in natural resource extraction have been precluded from the benefits under the LECI. And, 2013 saw the launch of a committee to re-examine tax-royalty regimes for natural resources outside the sphere of natural gas and oil (dubbed the Sheshinski II Committee, after its chair).
- International comparison suggests there is room to reduce tax compliance costs for business. According to the World Bank's *Doing Business* database Israeli businesses have to deal with a comparatively large number of separate payments; 33 in total. According to the Israeli authorities 27 of these tax payments can be made online. However, the World Bank data suggest taxpayers are nevertheless devoting a considerable number of hours to making these payments (235 hours, on average). In contrast, for example, for Ireland eight payments are reported with an average time to comply of 80 hours (see later sections). Recognising the need for further progress, the authorities aim for only 17 separate payments by end-2015, and ministries have been required to make proposals for cutting red tape in the interface between government and business.

Box 1.1. **The 2011 reform of the tax-royalty regime for natural gas and oil resources**

The discovery of substantial offshore hydrocarbon resources (mainly in the form of natural gas) prompted positive reform of the tax-royalty regime in 2011 and commitment to establishing a sovereign wealth fund (SWF). The reform left the royalty rate itself unchanged but made numerous adjustments and added new features to taxation (OECD, 2011a). In particular, a special profit levy is now imposed once the ratio of accumulated revenues over costs of a particular gas (and/or oil) field reach a certain level (the levy is often referred to as the Sheshinski tax after the person who headed the committee established to recommend reforms to the regime). The plan is to channel the Sheshinski tax revenues, which will not become substantial for some years hence, into an SWF. Preparations for this are well advanced; as of September 2013 the legislation had completed the parliamentary process. The establishment of the fund reflects a welcome effort to ring-fence the public's share of the hydrocarbon resources and spread the returns across generations through a drawdown mechanism. The fund will also be designed to reduce the risk of so-called "Dutch disease" by skewing the fund's portfolio towards foreign-currency assets (the authorities have already started combating Dutch-disease effects with the Bank of Israel's foreign-currency purchase mechanism).

Encouraging innovation

As elsewhere, R&D activity and innovation in general are encouraged through favourable tax treatment and a host of targeted programmes providing grants and other forms of support. Economic justification for favouring innovative activity lies in externalities arising from gaps between public and private returns to innovation and knowledge spillovers. However, while there is little doubt as to the existence of such phenomena, their scale is uncertain, and the underlying processes generating them are complex. Therefore, developing effective support programmes (either in the form of tax exemptions or grants) requires good systems for monitoring and assessing programme impact and low policymaking inertia when it comes to dropping poorly performing schemes or ramping up those that prove successful.

R&D support programmes in Israel are managed by the Office of the Chief Scientist, which is supervised by the Ministry of Economics and Trade. The main programme comprises a system of competitively awarded grants. Its design is interesting in that, if the supported R&D project generates commercial revenues, then recipients must repay the grant via a deduction comprising a small percentage of annual sales. These repayments are an important source of revenues for the Office and therefore the system is more akin to high-risk loans than a pure "grant" programme.

A number of additional programmes provide tailored support for small-scale start-ups, academic research (especially when in conjunction with business) and co-operation between domestic and foreign multinationals (Table 1.6). Also, subsidy schemes endeavour to attract companies to base scientific R&D centres and R&D in the finance sector in Israel. There is support for business parks for start-ups (so-called business incubators) as well. A large number of state-owned incubators were established in the 1990s, the vast majority of which were subsequently privatised (of the 24 currently operating only two remain in state hands). Government continues to play a significant role, as it partially funds the financial (and other) support provided to the entrepreneurs taken on by the incubators.

Given the Israeli economy's impressive scoring on indicators of R&D and high-tech activity (for instance, OECD, 2012b), questions naturally arise regarding policy lessons for other countries on R&D tax breaks and subsidies. At face value the menu of support on offer in Israel does not differ radically from elsewhere, but there may be important differences in detail. Also, there are other forces at work. Training with sophisticated technologies during military service, a large pool of researchers in the Jewish diaspora, and the engineering and science skills brought by the mass immigration from the former Soviet Union in the early 1990s are commonly cited as the key drivers of the economy's success on this front. Digging deeper into this issue requires an in-depth examination of Israel's innovation performance and policy.

Regional development

Israel's tax-subsidy system has fairly strong elements of regional development in that some support is either available, or is more generous, only in certain areas of the country (or specific towns). The preferential CIT rates provided by the LECI, for instance, are lower in certain regions. And, there is a system of employment grants that is available only in some places. As for the other regional incentives (such as those provided for housing), there are some sound socio-economic arguments to justify them; for instance, promoting the development of poor peripheral areas and as a means of combatting the externalities of urban congestion in the centre of the country. However, this is almost certainly not the sole motivation for such regional incentives, given Israel's geopolitical situation.

Support for the agriculture sector

As mentioned in the context of customs duties above, support for the agricultural sector is significant: as of 2012 producer support was estimated at 12% of farm receipts (OECD, 2013a). In addition to the tariff-based border protection, agriculture is supported through a number of other channels including: implicit subsidies through low rents of state-owned land (almost all land is state-owned), favourable charges for water compared to other users, guaranteed prices and sales volumes for producers, direct income support, capital grants and subsidised insurance schemes. Such heavy support brings higher consumer prices, imposes additional fiscal burdens, curbs structural adjustment toward higher-productivity sectors and implies spillovers on foreign trading partners, especially poor countries with plentiful arable land. As detailed in a recent OECD assessment (OECD, 2013a), reform initiatives have typically headed in the right direction (i.e. lowering support), but implementation is frequently slow. For example, reductions in the guaranteed price paid to dairy farmers for raw milk along the lines recommended by the Kedmi Committee in 2012 have yet to be implemented.

A need for more integrated assessment of targeted business support

Viewed as a whole, Israel's corporate tax and business support is generous, particularly to internationally competitive, high tech operations. The principle of support can only be welcomed, particularly that aiming to overcome informational barriers and asymmetries between private and public returns in innovation. However, it is also important to recognise that, especially when stacked together, tax breaks and other forms of support can be *overly* generous, subsidising much non-incremental activity. The preceding paragraphs suggest this could be the case for Israel. For instance, it seems possible that some firms can simultaneously benefit from the LECI, the R&D fund and employment subsidies and probably enjoy a hefty net subsidy as a result. In light of this, the recent establishment of an inter-ministerial committee to examine the costs and benefits of business subsidies is certainly welcome.

Evasion, avoidance and administration issues

If additional revenues can be raised via enhanced compliance, for instance through more effectively tackling tax evasion and aggressive avoidance, this would create room for manoeuvre in tax strategy and help fiscal balances in general. The increased attention, both domestically and world-wide, to tax evasion and avoidance is providing a political opportunity for renewed policy vigour on this front.

As in other countries the attention of policymakers, the press and the public has homed in on the seemingly low levels of tax paid by some well-known business operations. Particular attention is often drawn to companies' "tax optimisation" strategies that erode the corporate tax base by shifting profits between tax jurisdictions (base erosion and profit shifting, or BEPS), which has become a focus of OECD analysis (OECD, 2013f). Governments, including Israel's, wish to create attractive environments for business on their own terms, through targeted tax incentives and subsidy programmes such as those described above, not through companies exploiting unintended loopholes. BEPS may not only imply losses in CIT revenue but also put multinational enterprises (MNEs) in an advantageous position over domestic firms and distort investment. Also, the perceived unfairness of BEPS risks damaging trust and compliance elsewhere in the tax system. However, making progress in addressing these issues can be tough, especially when this runs counter to MNEs' vested interests. Recent experience in the taxation of profits (or dividends) when transferred out of the country illustrates that resolving these issues is often a bargaining outcome, rather than one driven only by economic principles (Box 1.2). This underscores the importance of Israeli policymakers working together with other governments on the BEPS Action Plan to achieve international consensus on actions to deal with weaknesses in the international tax system.

Box 1.2. **The issue of "trapped profits"**

Big business often has a degree of bargaining power regarding tax treatment, and Israel is no exception. This has been exemplified by the issue of so-called "trapped profits", which has become prominent. In a previous version of the LECI foreign transfer of dividends or profits was subject to capital taxation. As a result, some large companies held back from such transfers, accumulating large reserves of assets in Israel. A new version of the law, which came into force in 2011, removed this condition, but not retrospectively. The regime for "trapped profits" was offered to companies as a non-obligatory complementary measure following the transition from the former version to the current LECI. Following consultation with business, an amendment to the LECI was passed in November 2012 under which companies that accumulated profits under the former version of the LECI will pay between 40 and 70% of what would have been owed under the previous rules when transferring dividends or profits. This non-obligatory measure stipulates that the amount of saved tax in increasing the plant in Israel by purchasing more machinery and equipment, R&D expenditures or hiring new employees. According to press reports, as of November 2013 the amendment had brought NIS 4.4 billion in revenues.

The authorities' efforts to tackle the "trapped profits" issue is part of a wider campaign to increase revenues and to tackle evasion and aggressive avoidance. Concrete steps on several fronts have being taken or are underway, including: media campaigns, increased numbers of staff (an additional 400 relative to a total of around 6 000), further development and implementation of e-reporting, computerised systems for fraud detection, and strengthening collaboration with other government bodies (for instance, the police) and with other countries and international organisations. In addition, a host of technical adjustments to legislation and regulation are in train (Box 1.3). Continued efforts along these lines can only be encouraged.

The authorities should also contemplate reforms to the institutional and organisational framework of revenue collection:

- There has been a shift internationally towards establishing more autonomous tax authorities, and Israel remains among a handful of countries in which the tax authority (ITA) remains a directorate within the Ministry of Finance (or equivalent) (OECD, 2013g). The arrangement echoes that of the Capital Market Savings and Insurance Division, a supervisory body that is also part of the Ministry of Finance. The establishment of a body that is more independent and genuinely outside of the Ministry should be considered, or, if not, there should be some reflection as to whether the ITA's relation with the rest of the Ministry requires adjustment.

Box 1.3. **Recent alterations to legislation and regulation aiming to reduce tax evasion and aggressive avoidance**

Recent measures taken by the Israeli authorities to close legal loopholes have targeted the following:

- Financial trusts: contributions from a foreign trust "settlor" (i.e. the person who creates the trust, the donor) no longer produce tax-free income for Israeli beneficiaries.
- "Family" companies. Exploitative switching by enterprises in their status for tax purposes between "family run" and regular businesses has been stopped. The amendment also explicitly defines the profits eligible to be distributed to the shareholder free of tax.
- Revaluation gains. Enterprises can no longer avoid two-tiered taxation via revaluation gains. Revaluation gains are surpluses "generated" by an increase in the value of assets and were previously subject only to dividend tax.
- Real estate taxation. Legal changes include a narrowing of tax exemptions when property is transferred in the form of a gift.
- Vehicle leasing companies. Unintended tax benefits have been removed and a depreciation rule made less generous.

In addition, the campaign to counter evasion includes greater penalties for failing to report items legally requiring disclosure, and, aiming specifically at money laundering, reporting requirements for foreign currency dealers have been ramped up.

Future plans aim to increase the power of the money laundering law, bring in new rules for controlled foreign corporations, improve tax debt collection when activities are "rolled over" into a new company and establish a new expert analyst unit.

- In Israel, social security revenues are administered separately from the ITA's administration of the tax system. While this approach to revenue collection is also seen elsewhere, a growing number of governments have, over the past two decades, integrated the collection of tax and social security contributions to improve efficiency and effectiveness and to reduce the compliance burden on businesses (OECD, 2013g). Reform along these lines should be considered in Israel as part of efforts to reduce the perceived significant revenue leakage arising from underground economic activities where incomes go unreported (e.g. cash-in-hand payments to casual employees and incomes of self-employed taxpayers) in order to escape both taxation and social security contribution liabilities.
- Increasingly, tax authorities in OECD countries are organising their operations on a "functional" basis, *inter alia* featuring a dedicated division to administer the tax affairs of their largest taxpayers. In addition, many have downsized office networks given reduced needs for "face-to-face" services arising increasing use of modern electronic services. The potential for further reforms in these areas should also be considered.

Other avenues for improving the effectiveness and efficiency of tax administration should continue to be pursued. These include embedding risk-management approaches for improving compliance across all segments of taxpayers and enhancing the quality of services provided. Policy efforts regarding the latter should focus on further developing and encouraging use of electronic services, especially web information and systems for the electronic filing and payment of taxes, and to encourage their use.

Box 1.4. **Recommendations on taxes and transfers**

Indirect tax

- Should the regressivity of VAT require a policy response, use existing social welfare mechanisms rather than recourse to multiple VAT rates. Renew efforts to remove the existing exemptions on fruit and vegetables and services in Eilat.
- Press on with the scheduled reductions in customs duties on consumer goods and food items, and maintain a strategic goal for further liberalisation.
- Keep the "green credits" but cut the basic rate of purchase tax on vehicles. Shift instead to taxing vehicle use, such as by fee-based reserved lane systems and urban congestion charging. Further tighten the tax treatment of company cars. Accompany these moves by expanding alternatives to car use.
- Consider an economy-wide carbon tax by increasing the existing excise tax on primary fuels to levels concomitant with the estimated GHG-emissions externalities.
- Continue to develop environmental levies. Remain aware of the risk of under- or over-funding from earmarking the revenues from such levies for particular areas of spending.

Household income tax and benefits

- Broad strategy on PIT rates: avoid further hikes in PIT rates beyond what is in the pipeline.
- Employment and relative poverty:
  - Avoid further increases in the tax wedge on low-wage labour.
  - Invest more in active social policies. Ensure better take up of the earned income tax credit as part of wider welfare-to-work measures, such as reforms to employment services.
  - Further pare back universal support, and reduce tax credits that largely benefit middle and upper income earners.
  - Consider increases in means-tested income support, but ensure these do not create welfare traps.
- Pension issues: bring the age of eligibility for the state pension for women to that for men (67 years). Pursue intended reforms of the tax treatment of pensions.

Property taxation

- Make capital assets deemed to be realised at death for capital gains tax purposes.

Company taxes and transfers

- Refrain from further raising the statutory CIT rate, and consider signalling that reductions will be resumed once budgetary conditions allow it.
- As planned, review the net subsidies granted to firms, taking all tax breaks and support schemes into account. Consider narrowing eligibility for the benefits provided by the Law for the Encouragement of Capital Investment.
- Ensure taxation is adequate in immobile sectors (such as resource extraction).
- Pursue plans to reduce tax compliance costs for business by simplifying the tax code such that the number of payments paid is lower.
- Reform agricultural support to improve the efficiency of the sector and its international competitiveness.

Box 1.4. **Recommendations on taxes and transfers** *(cont.)*

Evasion, avoidance and tax administration

- Press on with campaigns combatting tax evasion and aggressive avoidance. Evaluate the Israel Tax Authority's position within the Ministry of Finance with a view to either moving it outside the Ministry or to strengthening its independence by other means. Consider unifying the collection of tax and social security revenues, and adopting a "functional" approach to tax administration that, *inter alia*, includes a unit dealing with large taxpayers.
- Press on with the further development of electronic services in tax administration.

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Chapter 2

How to improve Israel's health-care system

Israelis enjoy higher life expectancy and have a much younger demographic profile than most OECD countries. However, the demand for health care is expanding rapidly due to population growth and ageing. Also, the country's wide socio-economic divides are reflected in differences in health outcomes. To date the health-care system, centred on four health funds, is widely acknowledged as providing a basket of universal services, with good quality primary and secondary care, while also accommodating demand for private health care. However, there are challenges and tensions in the system. Currently the authorities are having to rapidly expand the number of places in medical schools and nurse training because large cohorts of health-care professionals are heading for retirement. More broadly, there are concerns that the core notion of a universal basket of services is being eroded by co-payments and the increasing demand for the additional services and options provided by private insurance. Although the quality of care is generally good, in hospital care there is room to improve data and concern that overcrowding may become chronic.

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.

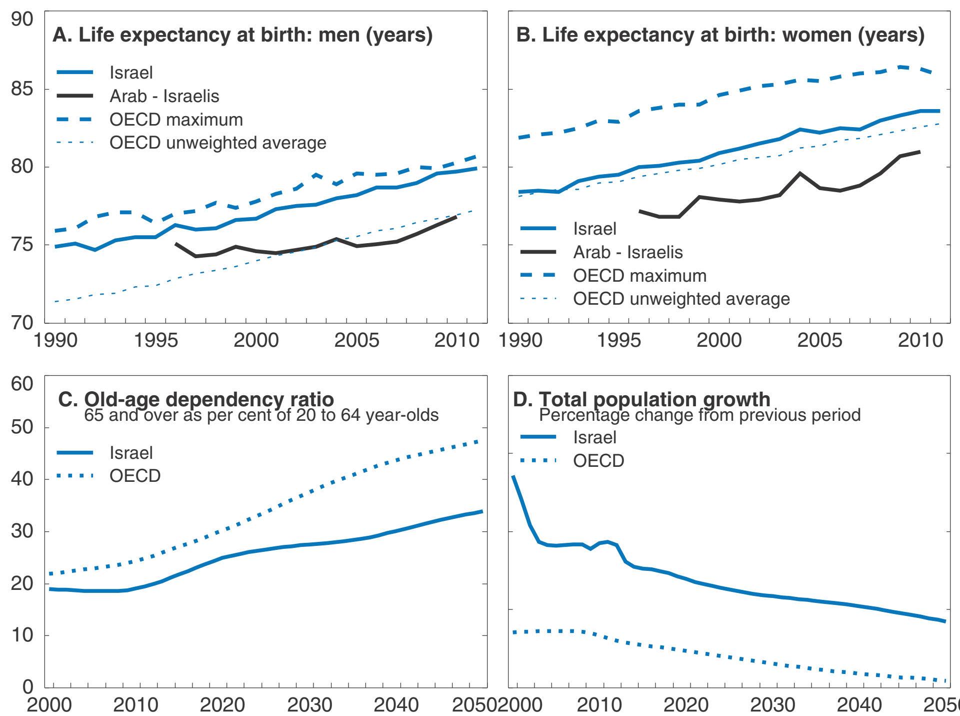
Health-care services absorb a substantial share of economic resources in all OECD countries; in Israel they account for around 8% of GDP, a little below the (unweighted) OECD-wide average of 10%, though this difference partly reflects relatively the country's youthful population. As in most developed countries the system guarantees universal access to a basket of services but also allows private provision. Many aspects of the Israeli system are in good shape, and indeed some are exemplary. However, there are challenges. As elsewhere, technological advances in pharmaceuticals and treatments bring both opportunities but also demands on resources while population aging is adding pressure on the system. Policymakers in Israel are also facing particularly significant difficulties in ensuring an adequate supply of health care professionals and in dealing with socio-economic divides in health outcomes.

Key features of health outcomes and the health-care system

Key aspects of health status and the health-care system are as follows:

- **The health status of the population overall generally ranks well.** Average life expectancy at birth among men is among the highest in the OECD, while that for women is a little less impressive but nevertheless above the OECD average (Figure 2.1, Panels A and B). Furthermore, Israel has a relatively young population; only around 10% of the population is aged over 65, one of the lowest shares in the OECD area (the OECD average is around 15%). This implies a lower proportion of health conditions (and health services) related to old age and a larger proportion related to childbirth, infants and children compared with many OECD countries.
- **Population growth is, however, relatively high and ageing is well underway.** Israel's comparatively rapid population growth contributes to baseline growth in the demand for health care, although the pace of increase is diminishing (Figure 2.1, Panel D). Also, the old-age dependency ratio is rising rapidly (Panel C). This implies a need for substantial and continuous adaptation in resources, treatments and care related to old age. Coping with this challenge will be helped somewhat by the fact that the old-age dependency ratio is projected to remain substantially below the OECD average.
- **There are significant socio-economic divides in health status.** Most notably the health status of Arab-Israelis is poorer than for the rest of the population, as exemplified by their lower average life expectancy (Figure 2.1, Panels A and B). This is in part due to non-medical issues: on average, Arab-Israeli men smoke far more than the rest of the population, and the incidence of obesity is relatively high among Arab-Israeli women (see below). Also, within the Arab population, the Bedouin community raises particular concerns, for instance, infant mortality remains very high (Chernichovsky, 2011). These gaps in health outcomes link to wider socio-economic issues. The Arab-Israelis, along with the Ultra-orthodox Jewish community (the Haredi) account for a significant share of the country's high rate of poverty. Furthermore, these communities are growing faster than the population at large: they account for about 30% of the total population but around half of children entering primary school.

Figure 2.1. **Life expectancy, ageing and population growth**

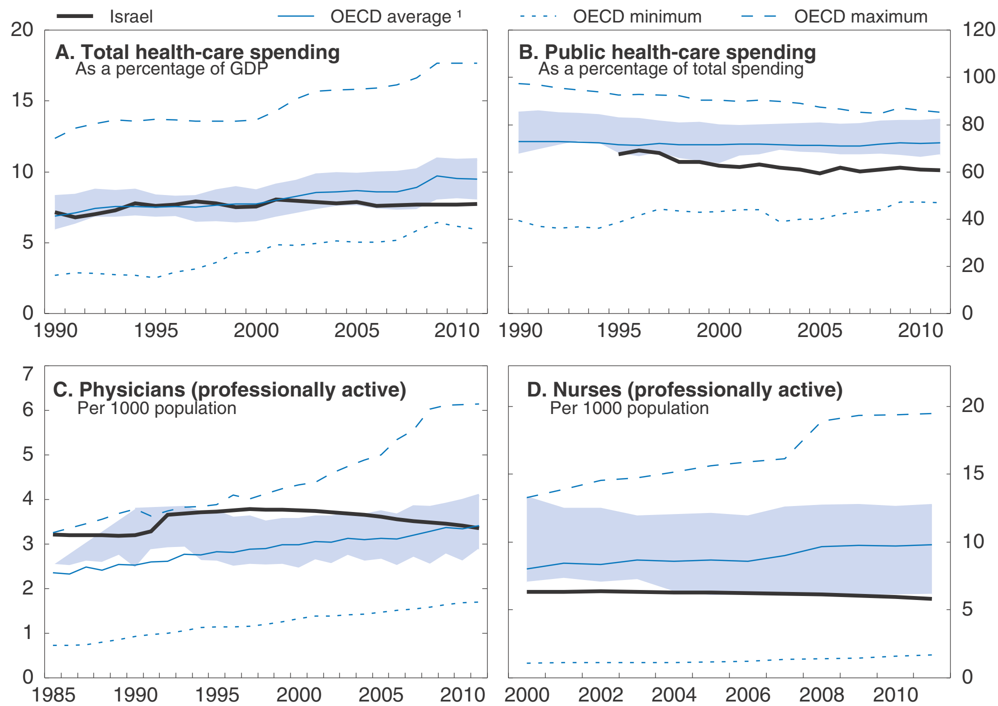


Source: CBS; *United Nations Database*; and *OECD Health Database*.

StatLink http://dx.doi.org/10.1787/888932964547

- **Universal provision ("national health insurance", NHI) via four health funds forms the core of the health-care system,** operating in tandem with private health care via voluntary health insurance (VHI) (insurance policies are offered by the funds and by insurance companies). As in many areas of Israeli policy the system reflects both European and US influences. The insurance format resembles that found in Germany and some other European countries, while the fund-based delivery structure has echoes of the US system (see Joumard et al., 2010). The NHI structure has many welcome features, including: choice of provider, checks on cream skimming and funding arrangements that incentivise efficiency. Take-up of VHI is extensive. About 75% of the population purchase supplementary insurance offered by the health funds, and about 40% hold policies offered by insurance companies (a sizeable minority hold both types of policy). In broad terms the system receives favourable reviews by experts. For instance, the OECD's review of the quality of Israeli health care (OECD, 2012) praised several aspects of the system and a biennial survey (run by the Myers-JDC-Brookdale Institute) reveals consistently high levels of satisfaction with health services, with only narrow gaps between members of each fund (Brammli-Greenburg et al., 2011).
- **The total resources devoted to health care as a share of GDP have remained relatively constant, in contrast to a rising trend in other OECD countries** (Figure 2.2, Panel A). Indeed, the resources devoted to health care in Israel are now relatively low compared with most OECD countries. Furthermore, the share of public spending has fallen from around 70% in the mid-1990s to around 60% today (Panel B). This shift reflects that fact that private care is playing a larger role; spending on private health insurance premiums has increased considerably. The relative merits of these developments are hotly debated.

Figure 2.2. **Health-care resources**



1. The shaded areas are the 25th to 75th percentile range of available OECD countries.

Source: CBS and *OECD Health Database* and *OECD Economic Outlook 94 Database.*

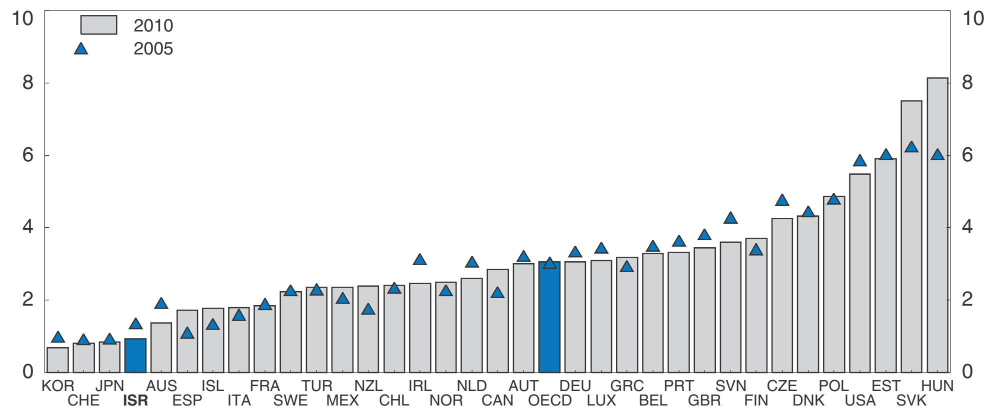
StatLink http://dx.doi.org/10.1787/888932964566

- **Large numbers of health-care professionals are heading for retirement, and this is posing a substantial challenge.** Israel's massive wave of immigration in the early 1990s included significant numbers of doctors and nurses, boosting the supply of professionals (Figure 2.2, Panel C). However, these cohorts are close to retirement. Declines in the numbers of physicians and nurses per capita have been underway for some time.
- **As regards the efficiency and quality of health-care services,** relatively high life expectancy combined with modest spending suggests the Israeli system is in general terms "efficient", and this is confirmed by favourable scores in measures based on data-envelopment analysis (Figure 2.3). As regards specific sectors, primary care is generally judged to be exemplary, but hospital care, although good, is seen as requiring some attention, with notable worries about overcrowding (OECD, 2012). In addition, there are concerns about whether the current system of long-term care is capable of dealing with the expansion in demand from population aging.

Thus, while the health-care system is in reasonable shape today, there are specific areas where improvements can be made and there are risks of general decline if the challenges outlined above are not properly dealt with. Training, recruitment and retention of professionals are among the most immediate issues. On other fronts, pressures for savings in public spending on health care are unlikely to lessen in the coming years, and neither will cost pressures from ageing and technological development. Making the best of the strengths of the health-fund system and addressing its weaknesses will be crucial if it is to offer the same scope and quality of universal care for the future and if there is to be

Figure 2.3. **Output efficiency**[1]

Potential gains in life expectancy



1. Data envelopment analysis (DEA) was performed with one output (life expectancy at birth for 2010 and 2005) and two inputs (a composite indicator of the socio-economic environment and lifestyle factors for 2010 or 2005 and healthcare spending). Averages over the periods 2006-10 and 2001-05 were used for expenditure to capture its effects on performance and smooth its developments. Potential gains are measured if efficiency in a country were to be raised to the level implied by the estimated efficiency frontier while holding inputs constant and under the assumption of non-increasing returns to scale.

Source: Hribernik, M. and R. Kierzenkowski (2013), "Assessing the Efficiency of Welfare Spending in Slovenia with Data Envelopment Analysis", *OECD Economics Department Working Papers*, No. 1058, OECD Publishing.

StatLink http://dx.doi.org/10.1787/888932964585

progress in narrowing gaps in health outcomes. Healthy competition should be encouraged, financing systems need to offer the right incentives, and better monitoring of the efficiency and quality of frontline services is required.

Background to the current health-care system

Major reform in the 1990s brought national health insurance

As in many areas of Israeli economic and social policy, today's health-care system is largely the product of reforms initiated in the 1980s and implemented in the 1990s. Prior to reform, health care had evolved in a largely ad hoc way that was mostly funded via a handful of health funds with provision by a mix of government-run, health-fund owned and independent providers. Reflecting the then dominant "corporatist" economic model that pervaded all areas of policy, most health care was provided by a single health fund, Clalit, which had strong links to the Labour Party and Histadrut (the main trade-union umbrella organisation). Some of the other health funds also had political affiliations. During the 1980s there was substantial labour unrest, the quality of care deteriorated, and problems of cream-skimming and "black-market" medical services (Rosen and Samuel, 2009).

In response to these problems the authorities did not abandon the health-fund system but instead re-shaped it, bringing universal health-care provision (for a specific basket of treatments and pharmaceuticals), while also encouraging consumer choice and competition among the funds. The reform largely followed the recommendations of the 1988 Netanyahu Commission, in particular with the passing of the National Health Insurance Law in 1995, which introduced the universal health coverage. Some issues raised by the Netanyahu Commission remain relevant today. For instance, it recommended making government-owned hospitals more independent by transforming them into hospital trusts, but to date all attempts to do so have failed.

Features of the current system

Today, four health funds are responsible for the majority of health care (Table 2.1). They are the sole providers of the universal basket of health services established in the 1995 reform (the NHI basket), and all (eligible) residents must join one of these funds.

Table 2.1. **Key features of the current health-care system**

The insurance system	
Health funds	Four health funds (market shares as of January 2013 in parentheses) – Clalit (52%), Maccabi (25%), Meuchedt (14%) and Leumit (9%) – provide all NHI services. Each fund offers two VHI packages (Shaban) standard and superior. Coverage and premiums in the Shaban are regulated but subject to change (i.e. they are not guaranteed). The Shaban are supervised by the Ministry of Health.
Commercial health insurance	Subject to insurance legislation and supervised by the Capital Markets, Savings and Insurance Division at the Ministry of Finance. "Individual" insurance must, unlike the Shaban, guarantee both the coverage and the premium for the entire life of the subscriber (though this does not apply to "group" insurance, which is more common). There are also fewer deductibles than with the Shaban.
Provision	
Primary care	A mixture of individual practitioners and clinics either operating under contract or paid (or run) directly by a health fund. About 80% of Clalit's membership (i.e. about 40% of the population) receive health care from Clalit-owned and operated clinics. The remainder of Clalit's primary-care services and much of that provided by the other three health funds are provided via contracts with independent clinics and individual physicians.
Secondary care	Government-owned and -run hospitals account for about half of acute-care beds. In the Jerusalem area there are NGO-based hospital providers, and some health funds own and operate hospitals.
Mental health care	Most mental health care is currently provided directly by government-run facilities. As of 2015 almost all areas of psychiatric care will be financed via the health funds (a large share of the front-line provision will continue to be provided in government-run facilities).
Dental care	Provided by individual operators or clinics (some with links to the health funds). Non-cosmetic dental care for children was shifted into the NHI basket in 2010; other dental care is covered by VHI.
Long-term care	Public support mostly takes the form of means-tested domestic help often provided by foreign workers.
Public health	Government public-health programmes are operated by a network of regional offices. The larger health funds also run public-health programmes.
Funding	
Government funding	A mixture of earmarked national insurance contributions and general tax revenues fund transfers to the health funds.
Health-fund transfers to providers	Health-care providers bill funds via various mechanisms: fee-for-service, per diem rates and diagnosis-related groups (DRGs).
Out-of-pocket expenses	Co-payments for NHI services (pharmaceuticals, consultations and treatments); voluntary insurance premiums and associated cost-sharing.

About 75% of the population buy health-fund VHI, which is called Shaban (each fund offers a "standard" and "superior" product, see Box 2.1). In addition, a sizeable minority purchase health insurance from commercial insurance companies, often in addition the Shaban. Probably the most highly valued elements of VHI are the options allowing choice of surgeon (the patient has no such choice under the NHI basket of services). The insurance packages also include a wide range of supplementary services (such as "comfort services" for hospital stays) but also complementary services, notably dental care for adults (which is not included in the NHI basket of services). Though more households are signed up for the Shaban than for the commercial insurance, the latter is a bigger business financially. For example, in 2011 household spending on premiums and deductibles was about NIS 3 billion for the Shaban but NIS 7 billion for commercial health insurance, though the latter figure includes spending on long-term care insurance, which does not feature in Shaban products.

Box 2.1. **Shaban insurance: An unusual feature of the health-care system**

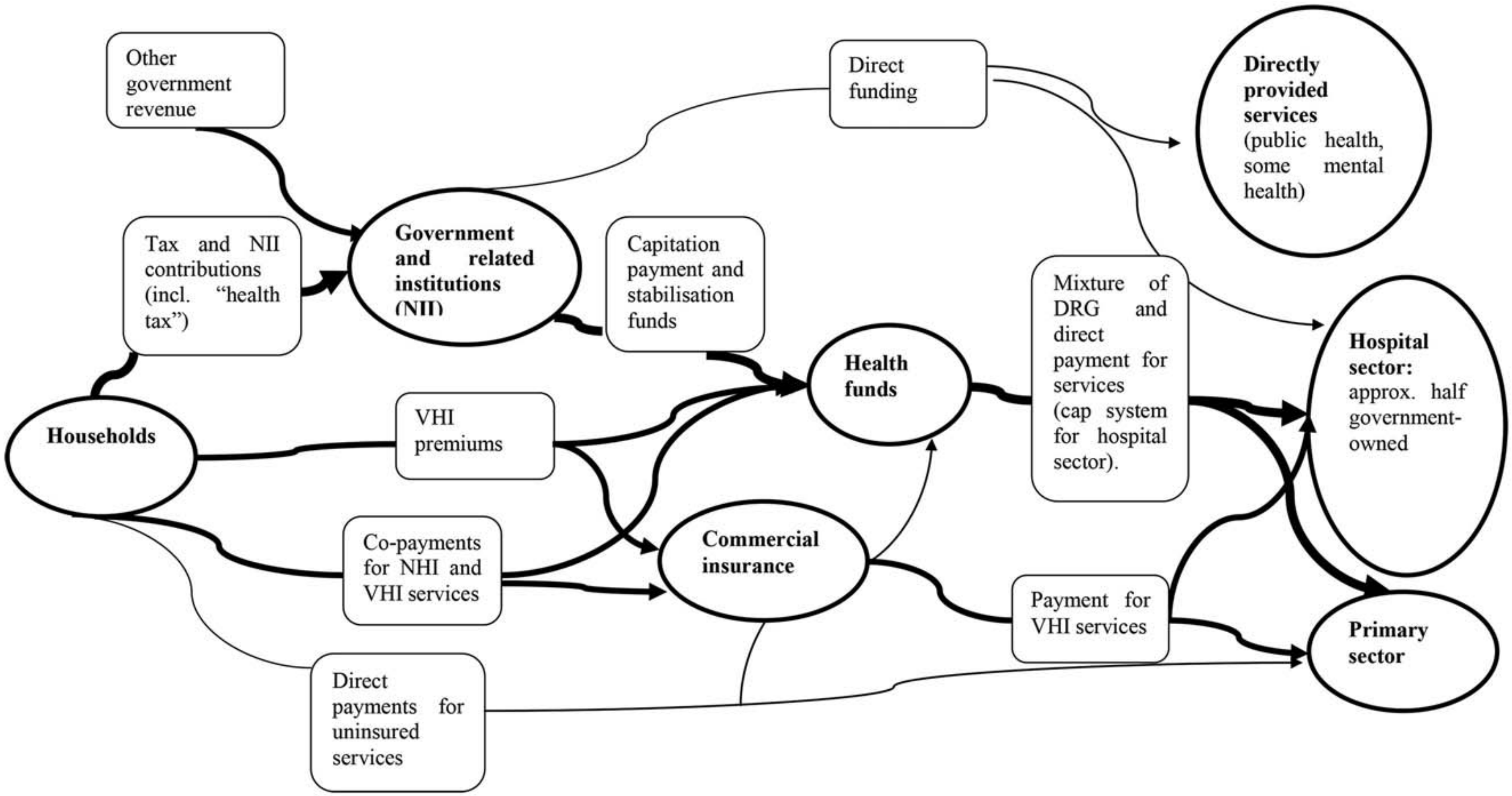
The Shaban is an atypical, indeed possibly unique, form of voluntary health insurance. Unlike commercial insurance the health funds, which are the sole providers of Shaban, cannot refuse applications (i.e. there is no underwriting). Indeed, the regulation and supervision is entirely separate from commercial insurance, being conducted by the Ministry of Health, rather than the office of the insurance supervisor, which is part of the Ministry of Finance. In addition, the Shaban are "tied" to NHI insurance (i.e. an individual cannot register with one fund for NHI insurance and purchase a Shaban policy with another). The absence of underwriting, plus government guarantees on health-fund financing (see main text), and a desire not to let the Shaban dissuade switching means there is a high degree of regulation. The Ministry of Health approves and regulates premium levels and tightly controls what services and pharmaceuticals are covered by the Shaban plans.

Frontline provision largely comprises facilities owned and operated by government or the health funds with, in addition, independent operators. In the hospital sector about half of all acute beds are in government-owned and -run hospitals (operating under contract with the health funds), and the remainder are in either hospitals owned by the health funds or independent hospitals with either non-profit or for-profit status. There are in effect two hospital systems in operation. In the Jerusalem area the hospital operators are non-governmental organisations (NGOs), and they provide both NHI treatment and private treatment. Elsewhere in the country NHI treatment is largely performed by government-owned hospitals, which under current regulation are not allowed to perform private treatment, so this is carried out in separate facilities. The merits of Jerusalem's "mixed" hospital system versus the "separated" system operating elsewhere is a key issue in the wider debate on the balance between public and private health care. In the primary sector, a large share of the population (about 40%) uses clinics run directly by Clalit, while the other funds rely more heavily on contracts with independent practitioners and clinics. Vertical integration also extends into the hospital sector: for example, Clalit owns and operates a number of facilities.

Most government funding for health care is channelled to providers via the health funds for the purposes of financing NHI services (Figure 2.4). The funding partly comes from an earmarked social insurance contribution, but this makes up only about one half of the total government contribution (the remainder is from general taxation) and does not drive funding overall. Households also fund health care directly; some NHI services involve cost-sharing via co-payments and, as mentioned above, many households buy VHI, access to which also typically involves some cost-sharing. Furthermore, in some areas of health care households may pay the full price for services, but this is chiefly in non-critical areas such as cosmetic surgery.

Overall, the government keeps a tight rein on the system. For a start, it provides a large share of the funding. Government also has significant regulatory powers at more or less every other point in the supply chain of services, such as the contents of the NHI basket, funding arrangements between health funds and providers, co-payments and the features of VHI packages. As regards labour relations (and costs) the government's main influence comes through its role as the largest employer in the hospital sector. As in many other policy areas in Israel, the government's role is highly centralised; local authorities have only a minor role as providers of services and do not own health-care facilities.

Figure 2.4. **Financial flows in the healthcare system**



The four health funds are hybrid bodies, lying somewhere between public service and commercial ventures. The government's tight rein on the system applies very much to them: almost all their activities and finances are regulated in some way. Furthermore, the funds have a particular non-profit status that means deficits are always covered by government. Indeed, the funds can take out only short-term bank loans. And, as they are largely publically funded bodies, under international accounting rules, they are included in the "general government" account. Despite all these factors, the funds are to some extent commercially driven. Competition over market share is particularly fierce. Management and employees are likely to have a vested interest in expanding market share and ensuring the fund has a good financial position, as this means greater employment security and better remuneration and working conditions. Other motivations may also play a role. For example, health-fund managers are probably motivated by reputational factors, successful management of a fund possibly leading to career advancement.

Main players in policymaking

Clearly the health funds and government play a central role in the health-care system. Within government, the Ministry of Health is both a supervisor and operator (Table 2.2), which is the subject of some debate. Also, as in other areas of Israeli policy, the Ministry of Finance's powerful position means that it plays a prominent role in reform and management. As in most countries, the professionals (particularly the doctors and nursing bodies) are relatively powerful. Among the other bodies, the parallel system under the Ministry of Defence is worth noting, as the armed forces are relatively large.

Table 2.2. **Bodies involved in health-care policies**

Body	Role
Core bodies	
Ministry of Health	Broad responsibilities of supervision and policy development for the sector. In particular the Ministry is both supervisor of the hospital sector and manager of government-owned hospitals. Supervision and regulation of the health funds includes the voluntary health insurance provided by health funds.
Ministry of Finance	Heavily involved in setting the parameters of funding and more generally influential in shaping policy. The Ministry's Capital Markets, Insurance and Savings Division is responsible for overseeing health insurance offered by commercial companies.
Health funds (Clalit, Maccabi, Meuhedet and Leumit)	Responsible for the majority of provision.
Israel Medical Association (IMA)	Representative body of the physicians.
Israel Nurses Association (INA)	Representative body of professional nurses. Note that this body does not represent most of those working in long-term care.
Other	
National Insurance Institute	The conduit for insurance contributions, including the health-care contribution; the latter is imposed only on employees.
Local authorities	Administer along with the health funds and the National Insurance Institute the main mechanism of public support for long-term care in the community (the Long-term Care Allowance).
Ministry of Defence	Funds (and typically also provides) health care for those in the Israeli Defence Force.
National Health Council	Advisory body to the Ministry of Health.

Ensuring human-resource challenges are addressed

The supply of health-care professionals is strongly controlled and regulated. As in many countries (Ono et al., 2013) the government determines the number of places available in medical and nursing schools and funds a sizeable share of the costs (students do pay fees, but these cover only part of the cost of training). Also, regulations on professional qualifications and standards, in combination with policy on foreign workers and immigration, mean inflows from outside the country are also tightly controlled. As a result, ensuring sufficient human resources is a highly centralised process.

The nature of the supply challenges

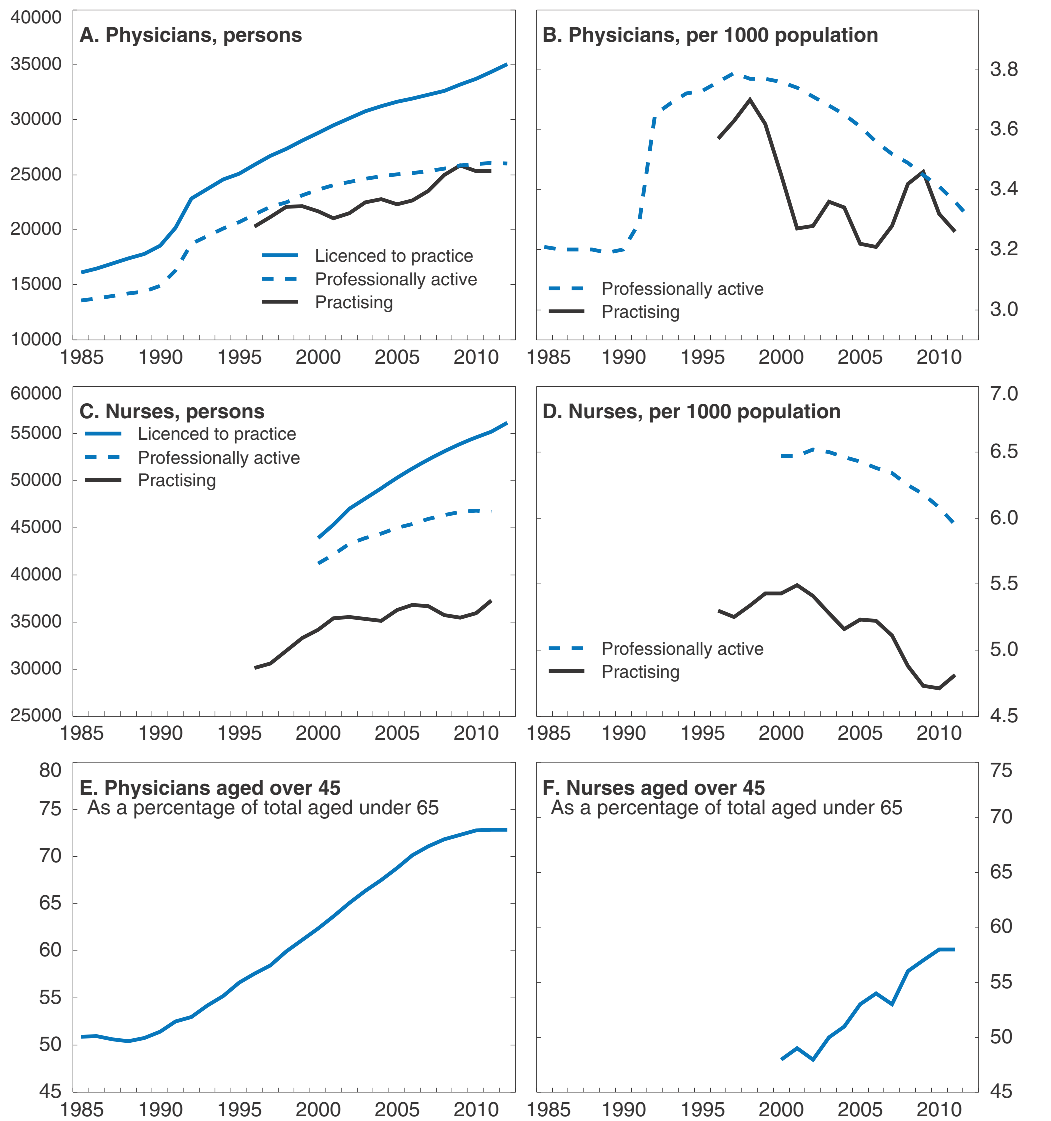
In large part, today's challenges are a consequence of the large wave of immigrants from the former Soviet Union in the early 1990s, many of whom were highly skilled professionals. As a result, from 1989 to 1992, the number of "professionally active" physicians (see Box 2.2) swelled from 14 400 to 18 700, an increase of nearly 30% (Figure 2.5, Panel A). To be sure, immigration also boosted the overall population (and therefore the demand for health care), but, proportionally not by as much. Hence, the number of licensed doctors per capita (aged under 65) also ramped up significantly (Panel B). The equivalent data for nurses do not stretch back as far in time but there was undoubtedly a similar boost in numbers. Raw international comparison, such as those shown in Panel C, suggests a relative abundance of physicians (in per capita terms) compared with other OECD countries even before the wave of immigration, although statistical issues complicate the comparison (Box 2.2).

Box 2.2. **Issues in Israeli data on health-care professionals**

Data on the number of health-care professionals in Israel can be derived either from administrative data on the number of licensed professionals or the labour force survey (LFS). In OECD databases, the administrative data are used as input for datasets on the number of "professionally active" workers, while the LFS data are used to indicate the number of "practising" professionals. In both cases there are important caveats:

- As for a number of other countries, the Israeli administrative data do not fully conform to the preferred OECD definition of "professionally active". The OECD definition excludes those working in jobs where the relevant qualifications are not required, and those that are unemployed, retired or working abroad. These groups cannot be properly filtered out of the Israeli data; as an approximation the "professionally active" data for Israel represent *all* those aged less than 65 years licenced to practice. For physicians, there is no renewal process in the licensing system, and so many indeed remain licensed when they have left the profession. According to notes in the OECD database, about 10% of Israeli licensed physicians had not been resident in Israel for at least 12 months. At the same time, selecting only those aged under 65 implies undercounting older active professionals; the standard retirement age for men is 67 years (although it remains 62 years for women), and many physicians work beyond that point.
- Conceptually, the LFS-based data accord reasonably closely with the OECD definition of "practising" health-care professionals, but variations due to the relatively small samples means considerable year-on-year change in the statistics. Clearly, this problem gets worse with further disaggregation of the data for instance, the number of professionals by specialty or age group.

Figure 2.5. **Physician and nurse resources**



Source: Ministry of Health and *OECD Health Database*.

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This "windfall" of human capital has been a boon for the health-care system. Without it, more resources (both public and private) would probably have had to be devoted to training, for instance. In addition, this influx of professionals almost certainly put the authorities in a stronger position in bargaining on pay and conditions than would otherwise have been the case.

However, the supply abundance is being steadily worked off as the population bulge works through. The number of professionals per capita has been declining for a number of years (Figure 2.5, Panels B and D). Indeed, there is a narrowing gap between the number of physicians aged under 65 (i.e. labelled professionally active), and the number inferred from the LFS ("practising"), suggesting a definite narrowing between supply and demand. A further consequence is that the medical professions have aged considerably, partly because the immigrant wave has aged but also because the boon in supply meant less need to train a new generation of physicians and nurses. Today, over 70% of licensed physicians and nearly 60% of nurses are aged over 45 (Panel E and F) as underscored in a number of papers (Israeli Medical Association, 2011; Nirel et al., 2010; Nissanholtz and Rosen, 2011; Toker et al., 2010).

Developments in remuneration and conditions

The tightening markets for health-care professionals have almost certainly been influencing industrial relations and wage agreements. As in many countries, collective agreements play a major role in setting pay and conditions for doctors and nurses, with the government often playing a key role (not least because it is a major employer).

As regards physicians, the benchmark wage agreement, which is that between the government and those physicians working in government-owned hospitals, has typically been negotiated once every nine-years. This agreement influences pay deals struck in other hospitals, and pay in the primary sector too (see Box 2.3). The latest agreement was finalised in August 2011 and covers the period mid-2010 to mid-2019. It includes an across-the-board increase in wages totalling 27% plus additional hikes for certain specialists and for those in the periphery. Also, there are substantial new grants (up to NIS 500 000) for physicians working in peripheral areas, which have reportedly prompted significant interest. Other gains on the employee side included agreement to create an additional 1 000 physician posts in hospitals. From the employer perspective, the government succeeded in getting agreement to a digital "punch card" time system that records when physicians arrive and leave the workplace. The pay rise is spread over the length of the agreement; thus providing considerable certainty on pay for some time to come. However, the wage negotiations have not always resulted in regular increments in wages. For instance, the agreement for the period 2002 to 2010 was subject to prolonged negotiation; the first instalment of the final agreement was not made until January 2008 and the last in January 2011, resulting in a sharp rise in pay in recent years (Figure 2.6). According to the latest edition of the OECD's *Health at a Glance* (OECD, 2013) general practitioners in Israel, as of 2011, earned around twice the average wage, a similar ratio to that in many other OECD countries. For specialists the ratio is around three times the

Box 2.3. **Wage setting and remuneration mechanisms in primary care**

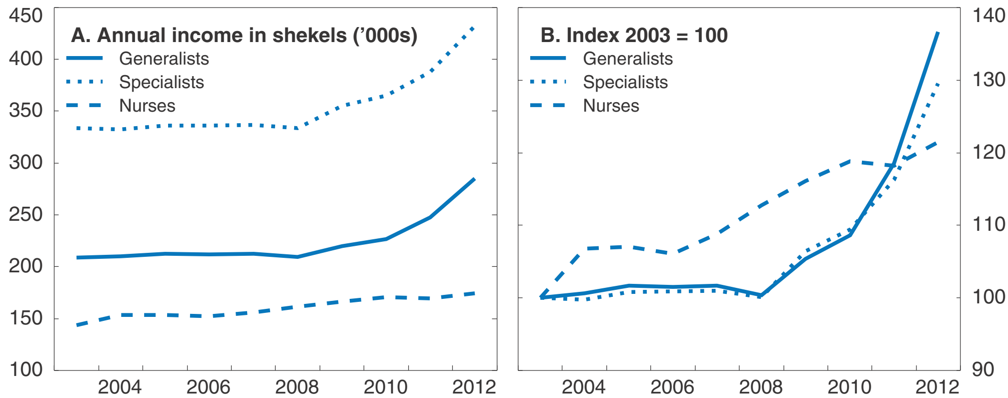
In primary care, government has rather less influence and control on wages and conditions, but collective bargaining still plays an important role.

As regards physicians working for the Clalit-owned clinics, there is a collective bargaining agreement that serves as a benchmark for pay increases elsewhere. The remuneration mechanism in these Clalit clinics includes a component related to the number of clients ("passive capitation"), but none relating to the number of consultations ("active capitation"). In independent clinics (i.e. those operating under contract with Clalit or the other health funds) there is a mix of "passive" and "active" capitation.

Nurses' pay in primary care in Clalit-owned clinics is set by collective agreement, while elsewhere it is set by individual contract. However, as for physicians, the collective agreement sets the benchmark throughout the sector. A variety of remuneration approaches apply to other professionals in the primary-care sector (community based specialists, dentists, pharmacists).

Figure 2.6. **Remuneration of health-care professionals**

Deflated by CPI (2010 = 100)



Source: *OECD Health Database.*

StatLink http://dx.doi.org/10.1787/888932964623

average wage, which appears to be somewhat higher than in many OECD countries. However, some caution is advisable in interpreting differences across countries in this instance; sources and methods in data collection differ widely.

Nurses' pay agreements run on a shorter cycle than those for doctors (3 or 4 years). Similar to physicians the benchmark agreement is that struck between the government and those professionals working in the public sector. Also similar to physicians, pay rises were relatively modest in the early 2000s but have ramped up in recent years. The latest deal was struck in December 2012 and comprises an across-the-board rise of NIS 1 300 per month (i.e. about USD 366 at an exchange rate of 3.55) for government-sector nurses spread over four and a half years. This increase is in addition to the general wage hikes agreed for the entire public sector (currently 1.5% per year). Interestingly, according to *Health at a Glance* as of 2011 hospital nurses' earnings are 140% of the average wage in Israel, which is one of the highest ratios among OECD countries. This of course does not necessarily imply nurses are "over paid" in Israel as there are wide differences in context between countries and different data sources and methods may also quite possibly be at play.

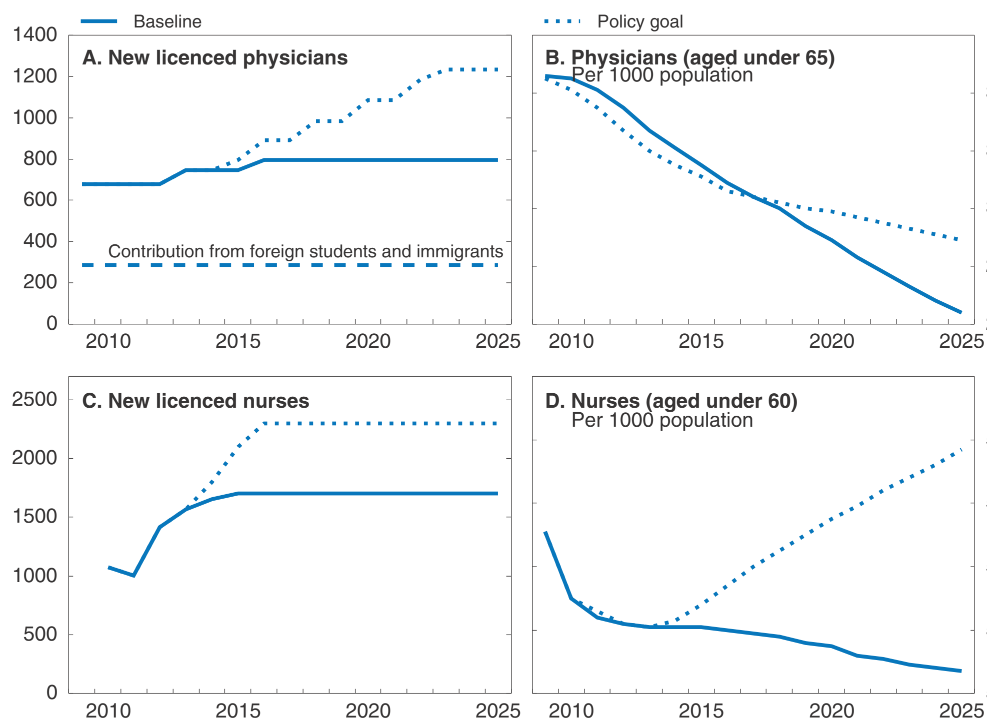
Specialists in high demand (for example, some types of surgeon) typically divide their time between NHI work and far more lucrative private-sector treatment. Indeed, the recently introduced punch-card system reflects the authorities' concerns that physicians are not always fulfilling their obligations for NHI practice. Interestingly, some government hospitals are using discretionary funds to offer specialist physicians significantly higher pay than the standard pay grades in exchange for full-time commitment to NHI work. This flexibility in being able to compete for specialists is welcome.

Significant expansion of physician and nurse training is underway

To their credit, the Israeli authorities have long recognised that challenges would emerge once the 1990s cohorts of health-care professionals started to retire. Various committees considered the supply problems in the 2000s and prompted some policy responses (for instance the Pazy Committee 2000, the Halevy and Bin Nun Committees in 2005). The most recent impetus has been provided by a committee set up by the Ministry of Health (the Planning Committee for Medical and Nursing Personnel), which reported in 2010.

The Planning Committee essentially concluded that the physician-to-population ratio could be allowed to fall a little further from the current level of around 3.3 physicians per 1 000 population but that a floor should be firmly established at around 2.9. For nurses the Committee recommended that the downward trend in the nurse-to-population ratio should be turned around, with an interim goal of 5.8 nurses per 1 000 by 2025 and 6.5 in the longer term. The Committee's baseline calculation and scenarios illustrating the rise in graduate physicians and nurses required to achieve these goals are shown in Figure 2.7. In international comparison the targets imply staffing levels (per capita) that are around the OECD average in the case of doctors but still below average for nurses (see Figure 2.2). However, this by no means implies the targets are inadequate, given the wide differences in demand for health care and in the structure of health-care services across countries. Israel's relatively youthful population plus the emphasis on primary care (which is less staff intensive than hospital care) in particular suggests that optimal staffing levels in Israel lie below those in many other OECD countries.

Figure 2.7. **Official projections of the number of health-care professionals**



Source: Ministry of Health.

StatLink http://dx.doi.org/10.1787/888932964642

Further growth in medical and nurse training formed the core of the Committee's recommendations. This was accompanied by a raft of auxiliary recommendations aimed at improving the recruitment and retention of staff in general and in those physician specialities with particularly acute current or potential supply problems.

As regards physicians, intakes to the four established medical schools are being boosted and a fifth medical school, located in the north of the country, began operating in 2011. In the mid-2000s the intake grew from around 300 to 400 students per year and another wave of expansion is currently underway. The latest committee recommended a total intake of about 700 students by 2012 and to plan a further phase of intake uplifts starting in 2014, so as to generate numbers of new licenced physicians along the lines shown in Figure 2.7. So far, action on the ground has largely echoed these proposals. By the 2012/13 academic year, the intake to the established medical schools was 760 students (of which 630 in the established medical schools and 130 in the new medical school).

The training of nurses is also being expanded substantially. As of 2014, the Ministry of Health estimates that there will be nearly 1 900 newly qualified registered nurses compared with fewer than 900 in 2011, which is in line with the timeline suggested by the Planning Committee's report. The report also recommended ensuring corresponding growth in nursing assistants, such that they represent 20% of combined nursing staff and greater training for this category of staff. This would appear to be an attempt to address the potential imbalances in the mix of nursing skills. Training courses for "associate nurses", which was a less advanced qualification compared to registered nurses, were terminated in 2007. This, along with the rapid expansion of training for registered nurses, does suggest a need to enhance the supply of "lower end" nursing skills.

Avenues for additional reform

While the expansion of medical schools and nurse training should do much to ensure an adequate supply of professionals, additional avenues should also be explored. Indeed, this has been recognised by the authorities, for instance in the Planning Committee's wide ranging recommendations. Despite on-going expansion of training, the system will have to cope with further declines in the numbers of professionals, especially doctors. Also, the health-care professions will remain dominated by older staff for a long time ahead as the expansion of training among younger cohorts will take some time to work through. Finally, events on the ground will inevitably not evolve exactly as projected, perhaps requiring capacities for short-term backstops in addition to long-term solutions to supply difficulties.

The recent pay deals for physicians and nurses will have bolstered recruitment and retention of staff. And specific issues were also addressed, for instance the useful additional pay increases for certain specialist physicians and for those in the periphery. Both for doctors and nurses, pay rises are now set for some years to come and in any case the deals largely reflect underlying market conditions. However, there are various areas outside the sphere of straightforward staff remuneration that could further help further with recruitment, retention and supply flexibility.

Putting professionals' skills to the best possible use

Improving the use of health-care professionals' time through shifts in tasks could help considerably, in particular:

- *Transfer of tasks from doctors to nurses,* possibly in combination with additional nurse training. Steps along these lines were suggested by the Planning Committee, and there has already been some follow through. Specialist training for nurses enabling them to take over some of physician tasks has already been established in palliative care. And, in December 2012 the Ministry of Health announced plans to extend this programme to chronic and diabetes care, with the intention to eventually include administering anaesthetics.

- *Transfer of tasks from skilled nurses to either lower-skilled nursing staff or hospital orderlies.* Reducing the time spent by registered nurses on tasks that could be performed by less qualified and less costly staff could similarly enhance efficiency. This would clearly be helped if the number of nursing assistants expands in line with registered nurses as recommended by the Planning Committee (which also recommended more formalisation through the creation of a "nursing assistant" occupation).
- *Transfer of administrative duties* from all health-care professionals to specialised administrative staff, where this is demonstrably more efficient.

Tapping into the international market for health-care professionals

More use could be made of the international market for health-care professionals. Compared with many developed countries, Israel has not tapped heavily into the international market for health-care professionals. There are relatively few foreign physicians practising in Israel, and it is understood that as regards nursing the authorities currently have a policy of employing only Israeli nationals. The Planning Committee recommended encouraging nationals studying or practising abroad to return (fairly substantial numbers of Israelis study medicine abroad, particularly in Italy, Hungary and Jordan), and encouraging the permanent immigration of non-Israeli health-care professionals. However, the latter may not have as much potential as it might appear. In Israel, permanent immigration is almost exclusively only open to Jews under the "right of return" law and a fairly large proportion of the diaspora live in countries where the incentives to migrate among health-care professionals in terms of earnings capacity and career opportunity are often working in the opposite direction (notably with regard to the United States).

To be sure, under the 2010 World Health Organisation (WHO) code of practice on the international recruitment of health-care personnel, countries (including Israel) are committed to avoiding active recruitment from developing countries that face critical shortages and to being broadly self-sufficient in terms of personnel (WHO, 2010). However, the WHO code certainly does not discourage all international migration of health-care professionals and indeed points out the potential for mutual advantage.

In sum, while respecting the WHO code, channels for foreign health-care workers could be widened so as to supplement the expansion of domestic training and in particular to deal with temporary supply difficulties. However, the size of such potential inflows would be limited by obvious language barriers. As regards physicians, the authorities have opened the door a little more. In January 2013, various changes to medical licensing were agreed, including replacing the present licensing exam with the international version of the United States Medical Licensing Examination, which is recognised in around 20 countries. However, as regards nursing, there is no sign of any change from the nationals-only policy. It should be noted that permit systems for temporary foreign workers in other sectors of the economy are well established and already provide a substantial share of workers in the long-term care sector (see below). Indeed, foreign nurses were employed (via temporary work permits) in the past, but this programme was abandoned. For instance, bringing in recently qualified doctors for, say, two-year residencies could be one way forward to address supply difficulties while giving them skills that have value for when they return to their home countries.

Ensure physicians remain fully operational and encourage retention

Various steps should be taken to encourage staff to remain professionally active and to update their skills and qualifications. In particular:

- Encourage older health-care professionals to remain active. Even with the growth in student intake, the medical profession will remain top-heavy with older physicians and nurses for many years to come. The Planning Committee, for instance, suggested adjusting pension rules to encourage older staff to continue working. Supply in the nursing profession would be helped in the longer run if agreement were reached to raise the standard retirement age for women in general.
- Reduce exits by younger professionals, for instance through greater flexibility in working hours and contractual arrangements so as to help staff combine work and family life. For example, the Planning Committee recommended establishing day-care facilities for children and more opportunities to combine continued clinical practice with management and research.
- Strengthen requirements on continuing professional development. Mandatory forms of quality assurance should be progressively introduced, for instance: peer-review activities, assessment of professional performance, and continuous medical education. Such mechanisms could be linked to the ending medical licences being awarded "for life" in favour of a system of licence renewal (as is typical in other countries).

Ensure good returns to subsidised medical training

As in many other OECD countries the public invests a considerable amount in training medical and nursing students, suggesting the following policy directions:

- Consider linking the public contribution to the cost of medical training to commitments from graduates to work in the NHI system. For example, medical school fees paid by students could be raised but then partially reimbursed for those who subsequently work in the NHI system or, similarly, a system of bonded scholarships could be established.
- Identify and exploit efficiency improvements in medical training. For example, Tel Aviv University is now offering a four-year medical programme for those with a BA degree in basic sciences. Also, the Planning Committee suggested looking into shortening training paths for specialist physicians.

Governance of the insurance system: 1) Ensuring universal health care remains central to the system

In many respects the health-care system works well; there is no need for a fundamental shift away from the present system that combines universal services (the NHI system) with options for parallel or additional services via VHI. However, given the erosion of the share of public spending that has already taken place, it is important to ensure that universal care indeed remains at the core of the system.

The system for updating the NHI basket is in reasonable shape

The health-care basket requires regular review, largely because new treatment options are continuously becoming available, and the authorities have to assess whether these should be covered by national insurance. In addition, society's views on minimum levels typically rise as living standards increase, and updating needs to take account of this too. Revising the universal health-care basket clearly involves trade-offs. If the basket is expanded slowly in relation to the flow of new developments in treatments and pharmaceuticals (and changing views on acceptable service levels in other dimensions), then, generally speaking, recourse to voluntary insurance (or direct payment for services) will increase, with implications for inequalities in access to health care and health outcomes. Conversely, keeping the basket very close to the technological frontier may imply prohibitively high costs.

Israel's approach to updating the NHI basket is admirably formal and transparent. Each year a specific amount from the central-government budget is allocated to taking on board new treatments and pharmaceuticals. This is then allocated according to the recommendations of a committee comprising representatives from the Ministry of Health, Ministry of Finance, the physicians and health funds as well as experts in health policy and public figures from outside the health system. The committee's recommendations are based on a list of candidates for inclusion in the basket drawn up by the Ministry of Health in consultation with key players (notably the health funds, pharmaceutical companies and the IMA). Changes to the system in recent years include for instance the adoption of a multi-year allocation in 2008 (three years instead of one). However, it should be underscored that even with a good process, the budget allocation still has to be set at the right level.

The scope of the NHI system is being widened

There has been a tendency for the scope of NHI services to widen in recent years. This has arisen partly from additions to the NHI basket. For example, in 2010 dental care for children was included in the basket; previously, as for other dental care, it was provided through VHI. In addition, NHI coverage has been expanded. As of 2015, almost all of the mental-health services, currently managed directly by government, will be put under the responsibility of the health funds, and there have been proposals for long-term care to be shifted into the NHI system too (this is discussed further below).

There is room for some adjustments regarding groups not covered by NHI. Foreign workers on temporary work visas are not covered by NHI and their employers are required to take out private medical insurance. However, the minimum requirements of this private insurance imply narrower coverage than NHI, which contrasts with prevailing practice in OECD countries (OECD, 2011a). Also, given growing numbers, the health-care provision for undocumented migrants needs attention. At present, undocumented migrants (including visa over-stayers) have rights to some kinds of treatment but otherwise rely on local government and non-profit initiatives. Personnel in the Israeli Defence Force (IDF) are also not covered by the NHI, the IDF's Medical Corps being responsible for all medical care. It achieves this via a mixture of own provision and outsourcing; for instance, it purchases all hospital services from the general (civilian) hospitals. Given the pressures for spending efficiency in the IDF, a review assessing the mix of own provision and outsourcing should be considered.

Policy on NHI co-payments

Co-payments for NHI services represent a kind of "privatisation" of public health care. They are welcome in that they reduce the fiscal burden and encourage the responsible use of health-care services But they are potentially unwelcome in equity terms, especially when they undermine the principle of universal care by dissuading patients from seeking care or placing heavy financial burdens on some households. Reforms in 1998 saw a substantial broadening in the range of co-payments health funds can impose for NHI treatment to include visits to general practitioners, specialist doctors and diagnostic centres in primary-care clinics. However, the authorities have maintained a tight rein on the system: for instance, all co-payments have to be approved by the Ministry of Health. The 1998 reform contributed to a significant increase in the role of co-payments in financing health care; indeed, the motivation for reform was partly budgetary. Key details of the current co-payments are shown in Table 2.3.

Table 2.3. **Co-payments: Rates, ceilings and exemptions in operation**

Visits to physicians and clinics	Co-payments: • First visit in a quarter to primary care provider: flat rate charge of NIS 0 to 8 (depending on the health plan). • First visit in a quarter to a secondary care provider: flat rate charge of NIS 23. • No charge for subsequent visits in the same quarter to the same centre/professional.
	Ceilings: • Quarterly ceiling per household of NIS 122-205 (depending on health plan). • When the ceiling is reached, patients continue to receive treatment without further charge. • For pensioners or households with recent immigrants the ceiling is halved.
	Full exemption from co-payments: • Pensioners in receipt of the income supplement (see OECD, 2010a). • Patients with end-stage renal disease, cancer, AIDS, Gaucher disease, thalassaemia or tuberculosis (only for their conditions).
Pharmaceuticals	Co-payments: • Generally 15% (10% for generics) of the purchase price, with a minimum of NIS 15.
	Ceilings and exemptions: • A ceiling on quarterly pharmaceutical charges for the chronically ill (NIS 870 per quarter, or NIS 290 per month). • This is halved for pensioners and those in receipt of the NII's Income Support programme (see OECD, 2010a).

Source: Based on Rosen and Samuel (2009); the values have been updated to 2013 figures.

While the standard co-payment rates appear reasonable, wider reductions and exemptions should be considered – if possible within the current resources of the health-care system – in the interests of adequate access to health care for low-income groups. For most households the NHI co-payments are probably easily affordable. For instance, visits to primary care providers are free in three of the health funds and only NIS 8 (about USD 2.25) in the fund that does charge. However, for low-income households with relatively heavy health-care needs such costs can accumulate. Research using a household expenditure survey (Navon and Chernichovsky, 2012) estimated about 68 000 households spend at least one-third of their disposable income (excluding spending on food) on health care. There has already been some widening of exemptions in recent years, including reduced co-payments for mother and child care and for the elderly. Nevertheless, more may be needed to provide a good enough safety net. One possible weak point is that there is a ceiling only on charges for the chronically ill. Widening this ceiling to the population at large would potentially reduce the risk of low-income households (particularly large ones) from being dissuaded from accessing the health-care system. Finally, co-payments for NHI services should not be the sole focus as direct payments linked to either Shaban or commercial insurance may well also be significant for those households who spend a substantial share of their incomes on health-care services.

In order to expand discounts it would be necessary to decide how to target those households that are vulnerable. One approach is to base eligibility on whether individuals (or households) receive the National Insurance Institute's (NII's) Income Support benefit (or the Income Supplement in the case of pensioners). Indeed, these criteria already feature in the discounts and exemptions for the co-payments (see Table 2.3). However, the eligibility criteria for this support are so stringent that a significant share of low-income households does not receive these benefits. Clearly access to health care would be strengthened if access to them was itself widened, as has been suggested in other OECD analysis (OECD, 2010a, 2010b and 2011b).

Finally, the special dispensations for recent immigrants seem unlikely to represent good value for money and should be reconsidered. As in many areas of Israeli social and welfare policy, recent immigrants (typically defined as those who have been in Israel for less than five years) receive special dispensation in the form of a 50% lower ceiling on quarterly co-payments for visits to physicians and clinics. As with many of the other special allowances for immigrants, this is unlikely to have a significant impact on decisions to settle in Israel (a process referred to as *aliya*). Furthermore, its universal application to all immigrants means that it is "wasteful" in that even well-to-do immigrants benefit from the lower ceiling.

Managing the scope of the VHI sector

The VHI sector widens consumer choice and provides an additional conduit for competition among health funds. However, there is a risk that it "crowds out" NHI care in undesirable ways, creating an excessively two-tiered health system. For instance, parallel treatment under VHI can mean longer waiting times in NHI treatment because, in the short run at least, the supply of specialist physicians is practically fixed. Also, as with health care anywhere, there is a risk of supplier-induced demand. The combination of commercial interests with the asymmetries in information inherent to health care and the importance individuals attach to good health can lead to overprovision and inflated health-insurance premiums. Reflecting the concern about the relative roles and importance of public and private care, a committee has been established headed by the Minister of Health (Yael German). The committee's examination of the division between public and private healthcare includes analysis of private insurance and assessment of the pros and cons of allowing the further development of medical tourism services.

The risk of "crowding out" underscores the need to ensure a wider and more flexible supply of health-care professionals as detailed previously. Especially given the supply problems of recent years, it is likely that the demand for medical (and non-medical) services encouraged by VHI has been drawing resources away from NHI treatment. Recent efforts to expand the supply of professionals should significantly reduce this problem and the authorities should take account of likely growth in demand for services via health insurance products in future planning for the training of professionals. It is worth underscoring that the "crowding out" issue as regards professionals is probably rather more complex than might at first appear. For example, without the additional income that some specialists earn from private work, the "brain drain" to other countries might be more significant.

In the public part of the health-care system ministerial oversight generally provides significant checks against supplier-induced demand. There is tight regulatory control over the price and content of VHI products (particularly the complementary insurance provided by the health funds, the Shaban) implies providers have to convince the authorities, as well as patients and insurers (or health funds) of the case for particular procedures or drugs. Also, the authorities have regulatory powers than enable them to control the number of beds in private hospitals.

Improving oversight: What to do about government-run hospitals

The health-care system would be improved if the government-run hospitals were not managed directly by the Ministry of Health, for instance by changing them to hospital trusts. As mentioned in previous sections, the government-run hospitals are a hugely important component of provision, accounting for about half of all acute-care beds. However, their status as public-sector entities means there is a fundamental weakness in the governance of hospital care: the Ministry of Health is both a provider and regulator. This conflict of interest can potentially lead to a number of difficulties, such as a tendency to focus on the hospital sector in policymaking and the potential for internal tensions within the Ministry when there are reforms that run counter to the interests of government-run hospitals. Furthermore, as government-owned and government-run entities, these hospitals are subject to civil-service regulations and procurement procedures, which in some cases are not suitable in the context of health care.

Attempts at changing government hospitals' status go back a long way. Proposals have included conversion to "trusts" (non-governmental entities governed by boards of directors) or transfer of ownership and operation to the health funds. However, to date such initiatives have not progressed far, often successfully headed off by the health-care unions, which are concerned, *inter alia*, about the implications of loss of status and rights as government employees. The authorities have, however, succeeded in taking smaller steps. For instance, the hospitals have been encouraged to establish "trust funds" comprising receipts from NHI services that have been scheduled outside normal working hours (Rosen and Samuel, 2009). Hospitals have considerable freedom in using these funds, and they account for about 10% of their activity. However, this progress should not be viewed as a substitute for more radical change.

The issue of government ownership and management in the hospital sector is tied to the debate on the relative merits of the Jerusalem "mixed" system where the NGO-based hospitals perform both NHI and private treatment and the "separated" system operating in most of the rest of the country, where public and private care is conducted in separate facilities. As yet there is no consensus among stakeholders and policymakers within Israel on this issue. And, international experience does not provide definitive evidence that one approach is superior to another. In Israel, proponents of the wider adoption of the Jerusalem system point to practical advantages, for instance from specialists remaining on site, and that having private-care alongside public care may help support universal provision. Conversely, the chief argument made against the Jerusalem system is that allowing more hospitals to perform private care will expand the gap in health-care provision between different socio-economic groups, lead to treatment of patients according to their wealth instead of their medical conditions and prompt greater supplier-induced demand in private health care, which will increase private expenditure on health care, further threatening the public system. As regards alternatives to adopting the Jerusalem system, some argue the government-hospital system should remain unchanged, while, for instance, some propose putting these hospitals under the management and control of the health funds. The current set-up does have merit in some dimensions, and reform should endeavour to retain these advantages.

Governance of the insurance system: 2) Ensuring healthy competition

The combination of health funds, universal provision and VHI insurance options in principle allows for a healthy degree of competition, i.e. one which brings efficient provision of the NHI basket but also a range of consumer choice for additional services. As described above, despite this non-profit status and government support in paying off deficits, the funds nevertheless do compete for market share.

The rate of switching is low, but market shares are changing

Under the NHI system individuals can switch between funds on six specific dates each year but can switch only twice a year. Given that a large majority of the population purchase Shaban, then for many the choice of fund is likely to be governed by a general assessment of the quality of care, in combination with judgement as to which Shaban package offers the most attractive deal. Efforts have been made to ensure there are no barriers to switching in the Shaban regulations, for instance a problem with waiting periods has been resolved (Box 2.4). In this context the Shaban system is probably superior to allowing the health funds to market regular commercial insurance, which can usually be designed to lock clients in and effectively dissuade them from considering whether to switch funds.

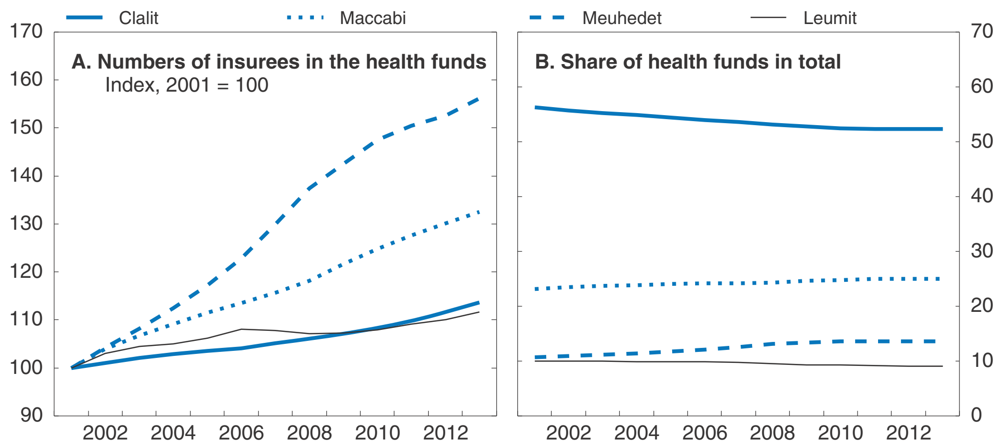
Box 2.4. **Waiting periods in the health funds' complementary insurance (Shaban)**

Given that there is no underwriting, as a protection against clients signing up to policies when they are aware of medical problems (moral hazard), the Shaban have "waiting periods" for certain treatments (generally 6 to 24 months). In other words the individual is not initially covered for certain treatments when they sign up to a health plan. Prior to 2008 the waiting periods applied to clients who were switching funds as well as first-time clients. This was very likely dissuading some from switching funds as it implied spending time without coverage for VHI insurance for some treatments. In 2008 new rules were introduced, such that the client's waiting times are now "carried over" (e.g. if the client had passed all the waiting times under their old fund (which will typically be the case), then no waiting times apply to the new fund), and so this aspect of the Shaban is no longer a consideration for switching funds.

Despite what appear to be minimal barriers, the incidence of switching is low. In the three years following the 1995 reform, about 4% of the population were switching funds each year, but this subsequently dropped to about 1% and has remained at about this level since then. As in other countries with fund choice, switching declines with age. As of 2013, the overall switching rate was 1.6%, but the rate was 2.0% among 15 to 24 year-olds, and only 0.3% among those aged 65 and over. In addition, switching is more prevalent among low-income households; the same study found that the average income of those switching accounts was some 20% below that of those who did not.

However, a low incidence of client switching does not necessarily mean an absence of competition. Indeed, it is interesting that, according to one survey (Gross et al., 2007), 20% of respondents indicated that they had considered changing health funds in the previous year. This suggests that a reasonable proportion of the population is at least paying some

Figure 2.8. **Trends in health-fund market shares**



Source: National Insurance Institute.

StatLink http://dx.doi.org/10.1787/888932964661

attention to their choice of health-care plan. Also, since the introduction of the NHI system, Clalit's dominant position in terms of market share has been eroded (Figure 2.8), which is perhaps a sign that there are adequate long-term market forces at work.

Combatting unhealthy forms of competition

While the Israeli health-care system does not seem to suffer from endemic cream-skimming, the authorities should nevertheless remain vigilant. Some (for instance Shmueli et al., 2007) suspect the higher rate of switching among poorer households at least in part reflects "risk exporting", i.e. where funds use various strategies to encourage clients who are high risk in terms of medical care, or in some other sense financially unattractive, to move to another fund. For example, funds might purposefully limit the scope and quality of primary-care facilities in poorer areas and have ways of manipulating waiting lists for treatments; though it is not believed that these techniques are widely used. However, funds undoubtedly target their advertising campaigns to preferred audiences.

In addition, the transparency of insurance products is a cause for concern. There is overlapping coverage between complementary insurance provided by the funds (Shaban) and commercial insurance. In an effort to reduce this, since 2007 the commercial insurers have been required include in their range of health-insurance products insurance plans that are strictly complementary to the Shaban (i.e. they only contain services over and above those in the Shaban). This complementary coverage, for instance, compensates the insured for the difference between actual expenses and the expenses covered by the Shaban plans. However, the commercial insurance funds probably make greater profits out of the more comprehensive plans and are therefore perhaps not making huge efforts to market these complementary products. This underscores the importance of the government's continued efforts to increase product transparency and promote financial awareness in the general population.

The separate supervision of the VHI provided by the health funds and that provided by the insurance companies is an understandable division, but good co-ordination is required. VHI provided by the health funds is supervised by the Ministry of Health, while the health insurance offered by commercial insurance companies is supervised by the body overseeing insurance in general, the Capital Market Insurance and Savings Division, CSMID, a unit within the Ministry of Finance. Supervision of the Shaban within the Ministry of Health makes sense in that it means supervision of all health-fund activities is within one body. Meanwhile, commercial health insurance is more appropriately supervised by CSMID, as it is subject to insurance legislation. However, there does have to be a good deal of co-ordination to ensure the system remains balanced and harmonised.

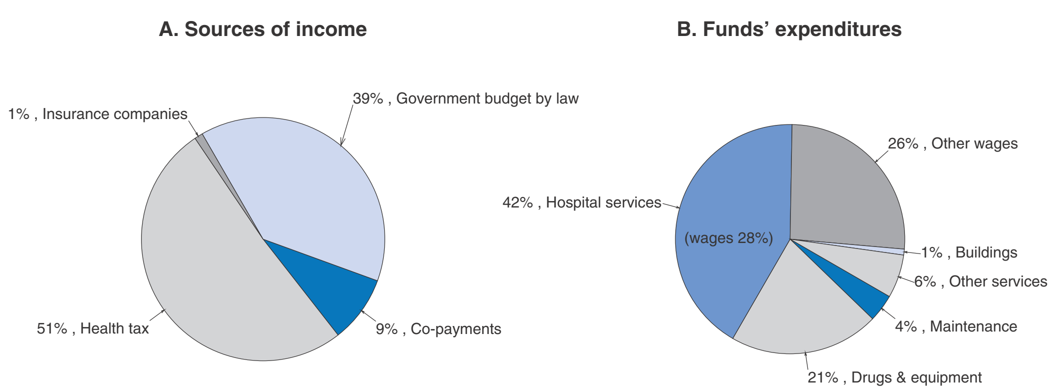
There is room to improve funding mechanisms

The NHI funding system

The core of health-care funding comprises transfers from government to the health funds and reimbursement systems governing transfers from the funds to the providers (Figure 2.4 above). About 90% of health funds' income for providing NHI services comes from government (Figure 2.9), about half of which comes from an earmarked component of national insurance contributions (often referred to as the "health tax"), the rest from general taxation. Almost all of the government-to-fund transfer is through a capitation payment based on the age and sex profile of each fund's client base and a "remoteness" variable (which was added in 2010 and is discussed further below). In contrast, transfers between the funds and the providers are based on health services provided (or approximations thereof). Hence, in principle, one of the key strengths of the system is that the health funds have incentives to ensure the efficient provision of services and to engage in preventive measures – a healthy client base means fewer costs through the reimbursement system.

Figure 2.9. **Health-care funds' income and expenditure (relating to NHI services)**[1]

2011



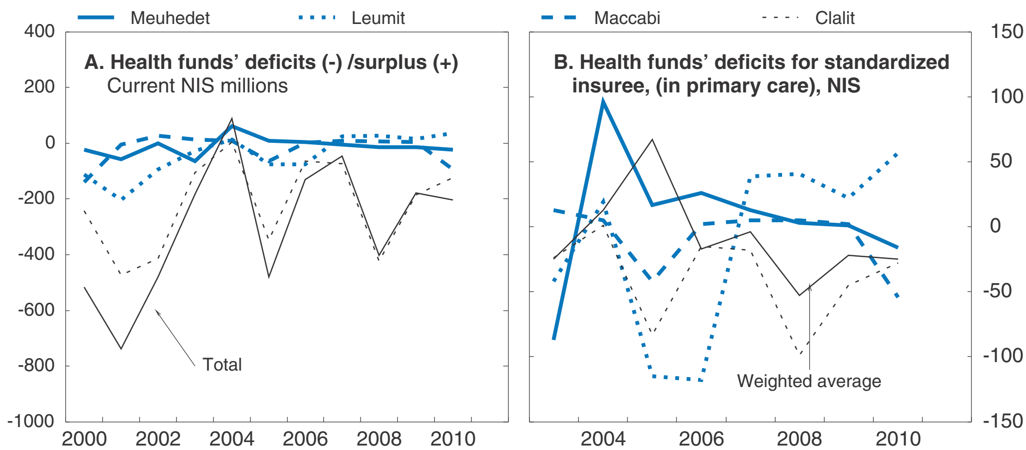
1. The figures shown do not include income and expenditure relating to other activities, notably VHI insurance. In the health funds' accounts these activities are recorded separately.

Source: Ministry of Health.

StatLink http://dx.doi.org/10.1787/888932964680

Both the health funds and providers are often in deficit. At least in recent years, Clalit has been in deficit more often and more deeply than the other three funds, both in absolute and per capita terms (Figure 2.10). Indeed, Clalit's budget balance invariably drives the balance of the funds overall. However, the government responded to health-fund deficits by increasing their financial budgetary resources by NIS 200 million per year starting in 2014. It should be mentioned, that the health providers, such as hospitals, are also often in

Figure 2.10. **Budget balances of the health funds**



Source: Bank of Israel.

StatLink http://dx.doi.org/10.1787/888932964699

financial deficit, but these have remained stable over the last five years. This appears to reflect a tacit strategy by the government of keeping the public part of the health-care system on a tight budgetary leash in the belief that this encourages efficiency, while responding to unforeseen changes in demand to safeguard it.

Although the lion's share of funding is public, most health services involve some form of out-of-pocket expense. As discussed above, co-payments are required for many services and drugs in the NHI basket. Also, many items in the VHI baskets require some form co-payment (the benefits are commonly advertised as "discounts" on the price of the service).

Additional variables should be considered for inclusion in the government's capitation payment

There has long been concern that the capitation formula is not sophisticated enough, failing to take adequate account of links between households' socio-economic characteristics and demands on health-care services. The simplicity of the formula has probably contributed to the funds' incentives to cream skim (although of course this can be done only through various back-door approaches, as discussed above). Also, Clalit has long argued that it is in a disadvantageous financial position as it has a greater proportion of low-income and disadvantaged clients compared with its rivals.

Addition of the "remoteness" variable to the capitation formula in 2010 aimed to address this issue. Using an index constructed by the Central Bureau of Statistics in 2004, the health funds receive more money for clients living in some municipalities. This approach potentially helps funds target disadvantaged communities, which are indeed an issue in Israel, given the strong geographic segregation along socio-economic and cultural lines. Clalit has benefitted most from this change in the formula and the capitation system is in some sense "fairer" than its predecessor. However, the funds are under no obligation to direct the additional funds from the remoteness variable to deprived areas, so the remoteness variable's impact in this dimension is a little uncertain. Furthermore, the variable is obviously only at best a partial control for differences in socio-economic characteristics. Given this, the impact of the remoteness variable on health-care funding should be closely monitored and consideration given to adding direct, country-wide socio-economic variables to the capitation formula.

Issues in reimbursements to hospitals for NHI services

Hospitals receive payments for services based on a mixture of diagnosis-related group (DRG) funding and per diem mechanisms. Thus, in broad terms therefore these are inclined to accentuate the price and volume of services provided. Of course there are various checks in the system aimed at preventing the providers from taking advantage of the system in this way. There are tight controls on prices in the reimbursement mechanisms, for instance. In addition, a cap system operates on NHI hospital services.

The cap system provides government-set limits on the amount each hospital can receive in compensation for the provision of NHI services. It has been subject to a number of reforms, which illustrate some of the difficulties involved. At one point the health funds were fully exempt from paying any hospital charges above the caps. Subsequently, the system was made more lenient (from the hospitals' perspective); the funds were required to pay half of the hospital charges above the caps (i.e. there was a 50% "discount" on the additional bill). However, experience with this reform suggested incentives had swung too far in favour of the hospitals. As a result, the discount to the health funds was increased to 70% for hospital charges up to 113% of the cap (and 50% thereafter). As of 2012 some hospital services are subject to a straightforward 80% discount, thus strongly discouraging provision beyond the spending caps.

In addition to the capping system the health funds can, and do, negotiate additional discounts on service costs. In principle, this negotiation process adds a useful market-based element to the health-care system. However, this is somewhat compromised by the limited number of "market players" on both sides, especially since Clalit's vertical integration means it does not really participate in this process. Alongside the caps which limit the bills presented to the health funds, some "protection" for hospital financing has been introduced; the capping system for 2014-16 includes a purchase floor equalling 95% of the services provided by the hospital to the health fund in 2012 and keeps the discount rates at their 2012 level.

In general terms, there should be further shift away from input-based charging (such as *per diem* charging for hospital care) and towards, for instance, DRGs so as to reduce the incentives for hospital-induced over provision. Negotiation processes between the health funds and providers should be closely monitored to avoid the risk of collusion on both sides given the small number of players.

Indexing needs to be kept on an even keel

Various indexing mechanisms are used to annually update the financial flows and parameters in the funding system. For instance, separate indexing methods are used for capitation payment, the prices hospitals charge the funds for providing health care (fees for service, DRGs, and *per diems*), and the caps in the capping system. Ensuring this indexing appropriately reflects costs and is coherent helps prevent imbalances in the relations between health funds and providers, for example through the erosion of financial balances of one side in favour of the other.

A recent debate between the Ministries of Health and Finance on indexing of the capitation payment illustrates the issues that can arise. The Ministry of Health's "health-input prices index" had risen considerably faster than the index used to update the capitation payment, suggesting a need for revision of the latter to avoid a financial squeeze on the health funds. However, the Ministry of Finance argued that the health-input prices index did not accurately represent the health funds' cost inflation and that it would be better to maintain a more conservative indexing of the capitation payment. An agreement between the Ministries on this issue was reached in mid-2013 that will ease the tensions in the health fund budgets by taking greater account of wage increases and population growth in the indexing calculation.

Earmarked funding should remain partial

The funding of NHI care comes partly from earmarked national insurance contributions that are deducted from employees' gross salary at source (prior to 1997 there was also an employer contribution). The employee contribution (often referred to as the "health tax") is earmarked, in that the revenues go towards paying the government's contribution to services as described in previous sections. As for other insurance contributions, the funds are managed by the NII.

Budgeting works such that, in effect, there is no actual connection between the value of the NII health-care contributions and total public spending on health care. As described above, the total government contribution is driven largely by the capitation formula, and as the NII contributions cover only about half of this amount, the difference is made up from general-government revenues. This weak connection between earmarked revenues and spending is welcome. A strong connection could risk unwanted variation in health-care funding over the business cycle and misallocation of resources over the longer term. This should be borne in mind in assessing calls for a significant hike in the health tax (which has sometimes been suggested by Israeli policymakers as a means of funding reforms). The health tax should never be allowed to drive the amount of public health-care funding. Raising the health tax would also prompt other considerations. Such a move is possibly more marketable politically than many alternatives as politicians and the public are perhaps more willing to accept a hike in a tax with a "health" label than, say, an increase in more general taxation. But, a hike in the health tax does not score well from a growth perspective, as it raises direct tax on labour. Also, from an equity perspective, while the Israeli NII contributions do have a progressive element (Table 2.4), it is not as strong as that of personal-tax rates.

Debate about the relative merits of the "health tax" aside, it should be noted that the exemption of housewives (Table 2.4) from contributions is unusual for a modern welfare system; typically such an exemption would apply to either male or female non-earning partners (who would not necessarily have to be married). As is typical in many areas of Israel policy, there are special dispensations for recent immigrants. In this instance the exemption is sensibly limited to those on low incomes.

Table 2.4. **The earmarked health insurance contribution (the "health tax")**

General features of all NII contributions	A two rate system, the "reduced rate" applies to earnings below 60% of the average wage, the "regular" rate applies to earnings above this threshold. The contribution ceiling has changed a number of times in recent years. It is currently five times the average wage. Exemptions: ● Groups fully exempt notably include: wives (not in paid employment) married to insured persons; recent immigrants (for the first 12 months of residency) who are unemployed and/or on low incomes; those in the armed services (health care is provided by the IDF); foreign workers on temporary work contracts (they are not covered by NHI; their employer has to arrange private medical coverage). ● Where relevant (such as for health care), children are automatically insured and exempt from payment.
Specific features of the health insurance contribution	The health care contribution is managed in a separate account from other NII contributions. Contribution rates: ● Salaried employees and self employed: 3.1% (reduced rate), 5% (regular rate) (there is no employer contribution). ● Those not working but with income: 5% at all income levels. ● Those with no income and recipients of some types of benefit (notably income support) a flat rate of NIS 100 per month. ● Old age pensioners: flat rate contributions ranging from NIS 100 to NIS 273 (as of 2012) depending on circumstance.

Source: National Insurance Institute (Israel).

The quality of primary care and hospital services

As described above, there is considerable variation in the degree of vertical integration across health funds. Clalit operates its own network of primary providers and runs several hospitals, Maccabi has fairly substantial links with providers, while the two smallest funds have few ownership or control links with providers. Vertical integration certainly brings some advantages. For instance, it is easier to co-ordinate between primary and secondary care. Also, it provides greater opportunity for the funds to distinguish their services from others. For example, with vertical integration the funds have more ways of influencing non-medical aspects of health care (such as reception services for patients and so on). On the other hand, for instance, vertical integration further limits the already narrow market in the negotiation between funds and providers that are not vertically integrated. Also, some argue (for instance, Rosen and Samuel, 2009, p. 181) that separation between the funds and providers is mutually beneficial; independent providers help advance health care because they have incentives to develop and sell new services, while the cost-consciousness of the funds helps ensure this proceeds at a reasonable pace. In sum, the pros and cons of vertical integration do not suggest a clear case to force a shift away from the current mix of separate and integrated provision.

In broad terms, the health funds have gone a long way in exploiting efficiency gains by shifting away from hospital care towards primary care and preventive measures. In the large funds, vertical integration has helped promote the use of primary and preventive care. Also, the funding mechanisms encourage all the funds to look for more cost-effective approaches. Israel's relatively rapid population growth is likely to have helped the political economy of adjustment by reducing the need for hospital downsizing and closure. In other countries the latter is often a key sticking point in reform, particularly where there is rural depopulation and when local authorities own hospitals.

Primary care: An exemplary system in many respects

Israel's primary care is widely judged to be of a high standard and to be performing a good gatekeeping role, as underscored in the OECD's review of the quality of Israeli health care (OECD, 2012). Health funds have successfully promoted a shift away from independently operating general practitioners towards team-based care in clinics, and this has been a critical element in improving accessibility and the breadth and depth of services provided. Clalit, as direct operator of primary care services, shifted towards more clinic-based care more or less directly, while the other funds used a combination of dialogue and financial incentives to persuade independent operators to move to clinic-based systems. The economies of scale in clinic-based services have, for instance, facilitated round-the-clock accessibility and capacities for supporting patients with chronic diseases.

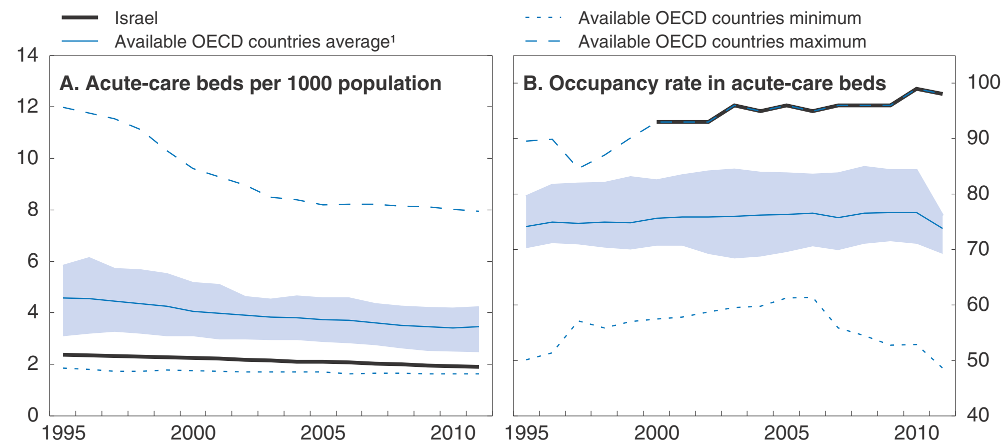
Furthermore, primary care benefits from extensive data collection and monitoring. Data on patients collected by primary care providers forms the basis for an electronic database (the Quality Indicators in Community Health Care, QICH, programme) that is one of the most comprehensive in the OECD area (OECD, 2012). The QICH data include basic patient demographics and more than 60 measures across six areas – asthma, cancer screening, immunisation for the elderly, children's health, cardiovascular health and diabetes. The data also flag risk factors and log treatments, drug utilisation and treatment outcomes. The database is not only used by the primary providers, but also by the funds to assess the clinics' performance. There is room for further development in the system. The OECD review recommended expanding the areas covered by the indicators and developing patient-focused measures that draw on multiple indicators (OECD, 2012).

Despite its first-rate credentials, the primary-care sector is not immune to difficulties. As for health care at large, the ageing workforce and related supply problems are a challenge. Furthermore, as in many countries, attracting health-care professionals to work in rural or peripheral areas has proved problematic. In this regard, the substantial grants for physicians to work in peripheral areas (see above) are no doubt having a positive impact, although it is hard to gauge the extent of deadweight loss, i.e. "wasted" spending in that some of the physicians would have worked in the periphery without the grant, or would have been induced to work there by a smaller grant. In nursing, the risk that up-skilling of the profession creates shortfalls in those undertaking basic caring tasks is possibly greater in primary than secondary care (OECD, 2012). This underscores the need to ramp up the training of nursing assistants, as discussed above.

Hospital care: Concerns about overcrowding, quality measurement and governance structure

Hospital care is also judged to be generally of high quality. But there are opportunities for improvement. Given the government's direct involvement in hospital care as owner and operator of about half the acute-care beds, the drive for efficiency gains in this sector is likely to have been strong at times of fiscal pressure. *Prima facie*, the fact that the average number of acute-care beds per capita is relatively low while the average occupancy rate in Israeli hospitals (98% in 2008) is among the highest in the OECD area suggests that the hospital sector is efficient in this dimension (Figure 2.11). However, the fact that the Australia, Ireland and the United Kingdom consider an occupancy rate of 85% as an appropriate limit is perhaps a sign that bed occupancy in Israel may have been pushed too far. In addition, press reports citing instances of overcrowding, such as patient beds being located in corridors, are fairly frequent. In response, the government began increasing the number of hospital beds in 2011 with a view to adding a total of 1 000 (an increase of roughly 7%) by 2016. While this move is undoubtedly helping to resolve this problem, further investigation of the nature and scale of overcrowding should be carried out, taking into account the earlier decision to boost the number of beds.

Figure 2.11. **Acute care hospital beds**



1. The shaded areas are the 25th to 75th percentile range of available OECD countries.

Source: OECD Health Database.

StatLink http://dx.doi.org/10.1787/888932964718

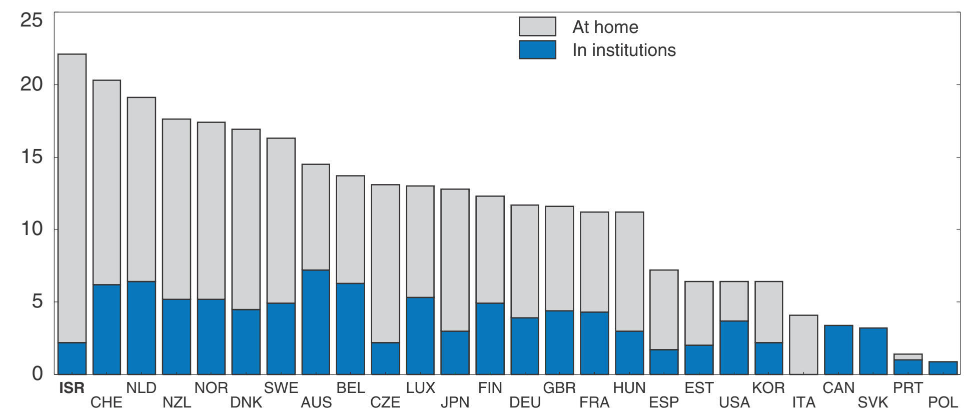
There is room to further develop the collection, processing and dissemination of information on the quality of care in the hospital sector. Monitoring and feedback mechanisms exist, but these have often been the result of individual initiatives in specific facilities. For example, to date the only system-wide and regular information on waiting times is from patients' responses to the Myers-JDC-Brookdale survey. This gives a general impression of the public's experience and perception of waiting times, but lacks the detail and depth that can be gleaned from administrative data. However, initiatives are underway. Under regulations introduced by the Ministry of Health, as of 2013 general hospitals have had to fully computerise applications and processing for elective procedures and, beginning in 2014, will have to submit reports on waiting times based on these data. Also, the health fund Clalit is developing a database of quality indicators for its hospitals. Since 2009 health funds and most general hospitals have been participating in a government initiative to develop sector-wide indicators of the quality of hospital care with an initial focus on general surgery and orthopaedics. The goal is to collect comprehensive data on patient characteristics, treatments and outcomes in all wards, three times per year. The quality indicators include, for instance, surgical site infection, re-hospitalisation, mortality and medical complications. While welcoming such initiatives the OECD's review of the quality of care in Israel (OECD, 2012) urged greater ambition and faster roll-out. The authorities have also been encouraging the adoption of an international hospital accreditation system (the "Joint Commission International", JCI, system), which can only be welcomed.

Delivery of long-term care should be simplified

Policy on long-term care for the elderly and disabled in Israel focuses strongly on providing assistance at home, a welcome approach that OECD countries are increasingly adopting. Indeed, Israeli policy has managed to go further than most in this regard, and the share of the population receiving long-term care at home is the highest in the OECD area (Figure 2.12). In particular, the state provides means-tested domestic help (provided as hours of help, and referred to as the long-term care allowance) and facilitates the

Figure 2.12. **Population aged 65 years and over receiving long-term care**

Percentage of total aged 65 years old and over, 2011[1]



1. Or latest available year.

Source: OECD Health Database.

StatLink http://dx.doi.org/10.1787/888932964737

employment of foreign workers as carers through temporary work permits. Households entitled to the in-kind support often top up the hours so that the carer is a full-time live-in helper. Also, many households take out long-term care insurance (these products are marketed by the health funds, but originate in the commercial insurance industry), which helps fund domestic help. These foreign workers typically come from far afield (many from the Philippines, for instance). Various other forms of community support are provided, some directly by the Ministry of Welfare and Social Services, others by the health funds, which have certain obligations under NHI. Institutional care is supervised by the Ministry of Health and provided by a mix of government-run institutions and facilities run by the health funds.

Substantial reforms of long-term care have been proposed but have yet to receive full government approval. In particular, under the previous government the Ministry of Health proposed a reform that included putting both institutional and domestic long-term care under the responsibility of the health funds, and increased subsidies to households, for example through widening the provision of "in-kind" hours of domestic support. Making the health funds responsible for long-term care certainly has some potential benefits; for instance, it could enhance attention to preventive care. Opponents of this move have claimed that the health funds would find it difficult to cope with the long-term care system and that that the cost of the reform would be more than estimated by the Ministry.

Whatever reforms are eventually implemented regarding the structure of long-term care support, simplification should be a central theme, including ensuring one-stop-shop universal medical assessment for long-term care needs. The wide range of care requirements among elderly populations means that there are inevitably a number of institutions and processes involved. However, even if some aspects are unavoidably complex, efforts can be made to pare back duplication in processing and to present a relatively straightforward "front end" to the public. There would appear to be room for improvement on this front. For a start, there is wide variation in the assessment of income in the various means tests. In assessing eligibility for domestic help, the NII takes into account only the income of the applicant and spouse, while assessment of assistance for hospitalisation expenses by the Ministry of Health also takes account of the incomes of children, and assessment for community services by the Ministry of Welfare and Social Services takes account of the incomes of the spouses of children too (Bank of Israel, 2012). Elsewhere in the OECD there has been a shift towards ensuring a one-stop-shop system of universal assessment of individuals' long-term-care needs (i.e. everyone has access to a medical assessment process that advises on the type of care required). This should also be pursued in Israel. Note that universal assessment does not mean universal support. In most systems public support continues to be selective (for instance, assessment of medical needs may recommend an individual receive 20 hours of domestic help per week but through means testing the government pays for only 15 hours of help).

Adjustments are needed regarding policy on long-term-care workers. The authorities have long been concerned that there are excessive biases in favour of employing live-in foreign care workers, such as Filipinos. The agencies providing such workers are able to profit by charging them quite significant fees. Though there are caps on these fees, they are widely thought to be disregarded. In addition, employment regulations differ. For instance, live-in carers are not covered by the overtime provisions of Israeli labour law. Preventing abusive exploitation of foreign workers (for instance via the fees and payment verification) should remain a priority and will also narrow the gap with Israeli workers and other workers from the region. In a purposeful effort to encourage the employment of locals, the authorities have been providing extra hours of domestic help if households choose an Israeli carer. However, this is thought to have had only a modest impact. Given that there remain substantial pockets of low-skill Israeli labour with hitherto weak attachment to the labour force and plenty of potential carers in neighbouring economies, the continuing heavy dependence on foreign workers from far afield does suggest that further re-balancing is required.

Greater use of health promotion and education is required

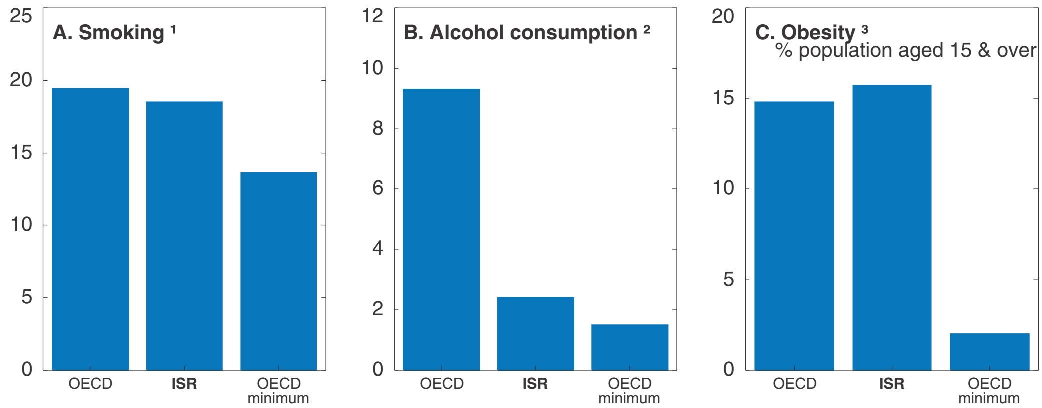
Israel's diverse ethnic and cultural mix and wide socio-economic divides means that targeting specific population groups and tailoring communication in health promotion and education is particularly important. Furthermore, health promotion and education has to play a key role in narrowing inequalities in health outcomes, as they are to some extent driven by differences in lifestyle, diet, awareness of medical issues and attitudes towards accessing medical services.

On the whole, the Israeli population scores reasonably in terms of healthy lifestyles. A smaller share of the population smoke regularly than in many OECD countries, average alcohol consumption is among the lowest in the OECD area, and the prevalence of obesity in the population has not reached the worrying levels seen in some OECD countries (Figure 2.13). But in certain segments of the population unhealthy lifestyles and diets are a significant issue. The most striking specific problems are in the Arab community. Men smoke relatively heavily, and among older Arab women obesity is a concern. And, at least according to a self-reporting survey, both Arab men and women do considerably less physical exercise compared with the rest of the population (Figure 2.14).

Socio-economic and cultural factors present other issues for health promotion and education. For example, the OECD's report on the quality of health care draws attention to low uptake of cancer screening among Arab and Ultra-orthodox Jewish women (OECD, 2012). This report also discusses the difficult issue of consanguineous marriages. As in many middle-eastern countries, rates of congenital anomalies and recessive disorders

Figure 2.13. **International comparison of non-medical determinants of health**

2010



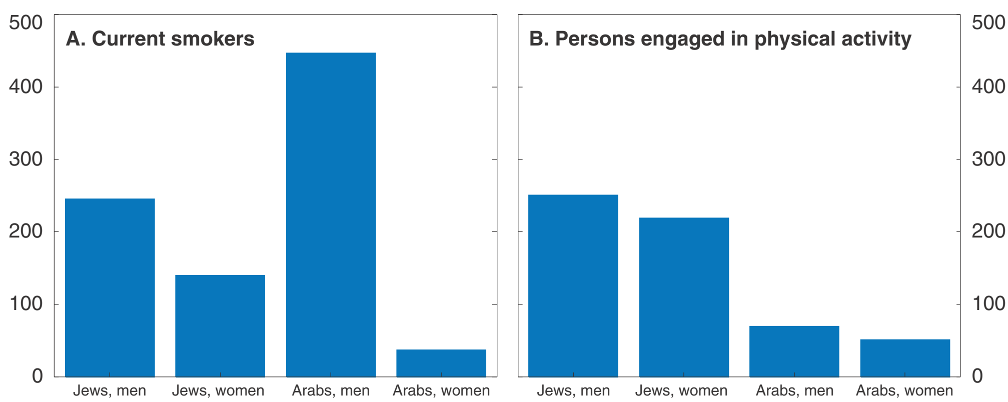
1. Percentage of population aged 15 and over who are daily smokers.
2. Litres per capita in population aged 15 and over; 2007 for Israel.
3. Overweight and obesity are defined as excessive weight presenting health risks because of the high proportion of body fat. The most frequently used measure is based on the body mass index (BMI), which is a single number that evaluates an individual's weight in relation to height (weight/height^2, with weight in kilograms and height in metres). Based on the WHO classification (WHO, 2000), adults with a BMI from 25 to 30 are defined as overweight, and those with a BMI of 30 or over as obese.

Source: *OECD Health Database*.

StatLink http://dx.doi.org/10.1787/888932964756

Figure 2.14. **Non-medical determinants of health by population group in Israel**

Rates per 1 000 residents, 2009



Source: CBS (2011), Health Care Survey 2009.

StatLink http://dx.doi.org/10.1787/888932964775

resulting from consanguinity are relatively high in the Arab-Israeli population and present particular problems in terms of health promotion and education (some countries offer pre-marital screening to help couples make informed decisions).

Health promotion and education have been key elements in the government's strategy for reducing inequalities in access to health care and health outcomes. Generally, such efforts can only be welcomed. For example, reducing morbidity from cultural and lifestyle differences is a key objective in a Ministry of Health mission statement outlining goals for the 2011-14 period. As regards specific initiatives, the authorities launched the National Program to Promote Active, Healthy Lifestyles in 2011, an inter-ministerial programme aiming to address obesity and its contribution to chronic disease (Kranzler et al., 2013). The programme includes quantitative targets (for instance, one goal is to reduce childhood and adolescent obesity by 20%), and a wide range of practical measures have been taken or are in the pipeline (for instance, legislation banning unhealthy foods in schools). It is worth stressing that, as discussed previously, the health funds have a vested interest in promoting good health in their client bases. This should be encouraged, alongside the further development of government-led initiatives in health promotion and education. A mix of government and health-fund initiatives can provide a rich source of information on which programmes work best (as long as programmes are monitored and there are opportunities to exchange information). However, getting such a system to work well requires good co-ordination, not only at the central level but also regionally and locally.

Box 2.5. **Recommendations for health care**

Policy towards health-care professionals

Alongside the significant expansion of medical schools and nurse training that is currently underway:

- Further exploit the potential for shifting tasks between professions, for instance from doctors to nurses, so as to make more economic use of capacities.
- While respecting the WHO code, widen channels for foreign professionals as a supplement to the expansion of domestic training.
- Encourage staff retention and skill development for instance by encouraging older professionals to continue working and by providing childcare facilities for staff.
- Strengthen requirements on continuing professional development; consider linking this reform to the introduction of licence-renewal systems.
- Ensure good returns (to the public) and efficiency in medical training: consider some additional commitments to work in the National Health Insurance (NHI) system for those that have benefitted from subsidised medical training; and, investigate avenues for shortening the time taken to acquire qualifications and specialisations.

Governance of the insurance system

- Ensure universal NHI services remain at the core of the system. The system for regularly updating the NHI basket is in good shape and more areas of care have been brought into the basket. However:
  - Widen the scope of reductions in co-payments to low-income households, if possible within the current resources of the health-care system, while reconsidering the special dispensations for recent immigrants.
  - Do not seek to ban or severely limit VHI activity, but nevertheless ensure sufficient checks against the crowding out of NHI-based treatment.
  - Alter the status of government-run hospitals so they are no longer directly managed by the Ministry of Health, for instance through conversion to independent hospital trusts or by putting them in the hands of the health funds. In the process of reform, endeavour to retain the advantages of the current set-up.

Box 2.5. **Recommendations for health care** *(cont.)*

- Ensure healthy competition. The fundamental structure of the health-care system lends itself to competition, and this should be encouraged, as long as it does not take undesirable forms:
  - Remain vigilant to back-door cream skimming strategies and to undesirable cross-subsidisation between NHI and VHI activities.
  - Take steps to ensure transparency in insurance products, for instance by ensuring consumers are aware that commercial insurers offer products that are fully complementary to the Shaban.
  - Ensure good co-ordination in the supervision of the Shaban and commercial insurance.

Funding mechanisms

- Consider adding further socio-economic variables to the capitation formula that determines government transfers to the health funds.
- Further shift payment mechanisms away from input-based measures (such as *per diem* charging for hospital care) and towards output based formulae, for instance, DRG mechanisms.
- Closely monitor negotiation processes between the health funds and providers, given the risk of collusion due to the small number of market players.

Quality of care in primary and hospital services

- Launch an in-depth study of hospital overcrowding.
- Further develop the collection, processing and dissemination of information on the quality of care in the hospital sector.
- Improve the quality of primary care by expanding the areas covered by the indicator system and developing patient-focused measures that draw on multiple indicators.

Long-term care

- Simplify the long-term care system, in particular as the application processes for public support schemes, and by ensuring one-stop-shop medical assessment for long-term care needs.
- Remove biases that encourage employing carers from far afield, including by further limiting intermediaries' opportunities to charge heavy fees in processing foreign-worker applications.

Health promotion and education

- Press on vigorously with health promotion and strongly focus on those groups with weak health outcomes. For instance, ensure the general campaigns of health promotion are multi-lingual and that specific campaigns are appropriately pitched.
- Encourage the health funds to develop programmes for health promotion, education and to reduce inequality in health outcomes. Ensure good co-ordination with the government-run health-promotion services.

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