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Politically Incorrect: Social Protest, Competition Advocacy, and Political Economy in Israel

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I. INTRODUCTION

In the summer of 2011, “Social Justice” became a rallying point for over 400,000 people in one of the largest protests seen in Israel. The movement began with a small group of friends in Tel Aviv who found housing prices way too high and were outraged by the government’s (un)social agenda. The movement spread quickly, and soon there were protests in every major city. Activists took to the streets in a non-violent and non-political demonstration of frustration, setting up tent cities in all the major streets and parks. Their demands were many and varied. Some focused on costs-of-living in Israel; others on fair employment conditions and on social inequality. Because the movement was truly spontaneous, the actual demands of the protesters, other than the somewhat vague notion of “social justice,” were unclear and amorphous.

In response to this massive protest movement, the government commissioned the Committee for Economic and Social Change, otherwise known as the “Trajtenberg Committee,” in order to uncover the major concerns behind the protests and suggest ways to address them.

This paper will describe the work and findings of the “Competition and Cost-of-living” team of the Committee. The first section delineates changes in the cost-of-living in Israel over the last decade. In the second section, the probable direct causes of those changes are discussed. Lastly, the paper suggests a clear link between those findings and a political-regulatory failure; in particular, that regulatory systems in Israel had mostly failed to protect public welfare in the face of special interest groups and big businesses. The main conclusion of the sub-committee is that intense competition advocacy, together with stronger consumer organizations, are the best tools to “level the playing field” and serve the public interest.

II. GETTING THE FACTS: COST-OF-LIVING IN ISRAEL

Over the last decade, the Consumer Price Index (“CPI”) rose 25 percent while the average income increased by 47 percent. At first glance, it would seem that consumers were better off. In order to further investigate changes in the cost-of-living, we examine the composition of household expenditure. First, we describe product categories that account for the bulk of consumption, and then we separate the changes in expenditure into their two components—changes in product price and changes in derived quantity.

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Table 1

	Share of Expenditure	% Nominal Change 1999-2010
Total Expenditure	100%	44.4%
Health	5%	81.2%
Housing	24%	68.9%
Household Maintenance	9%	50.4%
Transportation and Communication	20%	45.7%
Education, Culture, and Entertainment	13%	40.1%
Food, excluding fruits and vegetables	14%	32.9%
Fruits and Vegetables	3%	25.8%
Apparel	3%	2.5%
Furniture and Household appliances	4%	-7.8%

Source: Household Expenditure Surveys, Central Bureau of Statistics

From Table 1 we note that:

- A. Expenditures on health services display the largest increase in spending. The main components of health service costs are medications, services, HMO insurance, and general insurance.
- B. Expenditure for housing accounts for about 25 percent of total household expenditures in 2010. It has increased by 70 percent over the period examined. Rightfully so, housing prices have been one of the main causes of the social protest.
- C. Expenditure on food increased by 33 percent. Justifiably, food prices have also received public attention in the protest movement.

The next analysis utilizes changes in prices and changes in derived quantities for 109 product subgroups over the period 2010 - 1999. We divide household consumption changes into the following categories: a) products for which both prices and quantity demanded have increased; b) products for which prices have increased and quantity demanded have decreased; and c) products for which prices have decreased while quantities demanded have increased. Data show no products experienced a decrease in both prices and quantities.

In general, we see that for most products significant price increases were accompanied by significant declines in quantity, as one may expect. However there are important variations depending on the type of product. Below are the items that experienced an increase in prices, but a decrease in derived quantity over the defined period:

Table 2

	Group	Percent Change in Price 1999-2010	Percent Change of Quantity 1999-2010
Gas	Household Maintenance	127.4	-21.7
Water	Household Maintenance	107.4	-22.0
Dentistry Care	Healthcare	34.4	-8.1
Flour	Food	125.6	-24.1
Bread	Food	96.6	-31.8
Margarine	Food	89.2	-60.4
Sugar	Food	76.6	-38.0
Yogurt	Food	53.8	-13.0
Cheese	Food	50.6	-4.2
Cooking Oil	Food	49.2	-0.8
Poultry	Food	37.9	-2.7
Milk	Food	36.9	-17.8
Pastries	Food	36.3	-11.4
Eggs	Food	33.8	-8.3
Tea	Food	32.7	-22.0
Chocolate and Candy	Food	30.7	-56.8
Cream	Food	24.8	-1.1
Cakes	Food	24.2	-14.5
Cocoa	Food	24.0	-9.5
Ice cream	Food	17.8	-21.3
Coffee	Food	13.2	-2.8
Bus Transportation	Transportation and Communications	25.4	-43.0

This pattern of price-quantity relationship is consistent with monopolistic power, i.e. with supply reductions that drove prices up. This product category, as can be seen in the table above, is primarily comprised of food items, including some of the most basic items, such as flour, bread, margarine, sugar, cheese, poultry, meat, fish, milk, and eggs. These items are produced domestically, and producers enjoy tight government protection—that translates to market power.

The next set of items is characterized by an increase in both price and quantity:

Table 3

	Group	Percent Change in Price 1999-2010	Percent Change of Quantity 1999-2010
Medicine and Medical Needs	Healthcare	47.6	89.4
Health Insurance Services	Healthcare	46.1	110.1
Private Health Services	Healthcare	36.5	0.2
Opportunity Cost of House Ownership	Housing	28.7	36.0
Housing Rent	Housing	16.0	40.0
Preschool Tuition	Education, Culture, and Entertainment (“ECE”)	37.2	40.0
Primary School Tuition	ECE	36.2	35.2
Post-Secondary Studies	ECE	24.5	104.4
Secondary School Tuition	ECE	16.3	34.0

It is reasonable to assume that products in this category have experienced an increase in demand—as both quantity and price have increased. In Israel, health and education services are mostly provided by the public sector. The data suggests that as the government began withdrawing from providing these services (e.g. due to budget cuts) households have increased their demand for privately supplied education and health. As a result, we observe price increases in preschool fees, hospice care, pharmaceutical and medical care, primary school tuition, health insurance funds, and general insurance, *vis-a-vis* an increase in the quantity purchased.

Government policy also explains the increase in the housing prices, which was a major source of complaint in the social protest movement. As will be shown later, the government, who directly controls the vast majority of land available for development, did not supply the public with enough housing units to catch up with the increase in population over the past 20 years.

It is noteworthy that rises in prices for food products have a significant regressive impact on socio-economic inequality. Poorer households, defined as those in the bottom quintiles of the distribution, consume a higher proportion of their income, and “basic” goods account for a large share of total consumption. Therefore, they are affected more than wealthier households, in terms of disposable income, from rising prices in this context. Also, when certain education and health products are no longer provided by the public sector, poorer households are effectively denied access to them. This affects inequality both in the short- and long- run, as it reduces the probability of next generations escaping poverty.

The final table contains products and services for which prices have decreased and quantities have increased over the examined period. This pattern is consistent with an expansion of supply with effective competition in the marketplace.

Table 4

	Group	Percent Change in Price 1999-2010	Percent Change of Quantity 1999-2010
Men's Clothing	Apparel	-21.4	17.2
Men's Footwear	Apparel	-38.0	106.4
Children's Footwear	Apparel	-39.8	92.9
Women's Clothing	Apparel	-40.1	90.2
Children's Clothing	Apparel	-41.0	80.5
Women's Footwear	Apparel	-48.0	224.9
Entertainment Appliances, multi-channel television	ECE	-14.3	22.9
Toys	ECE	-35.9	91.5
Sofas, Beds, Mattresses	Furniture and Household Items ("FHI")	-2.7	9.2
Outside Furniture	FHI	-7.7	79.0
Baby Furniture	FHI	-12.9	15.4
Dinnerware	FHI	-18.2	36.6
Other Electrical Equipment	FHI	-28.7	8.4
Large Electrical Equipment	FHI	-30.6	10.2
Air Conditioning and Heating Equipment	FHI	-31.7	48.7
Bedding and Towels	FHI	-53.2	71.8
Bathing and Cosmetics	Other	-7.2	21.8

During the 1990s, Israel dramatically altered its customs laws and allowed the markets for certain goods, mainly those in the categories listed above, to be opened to international trade. As a result, prices dramatically decreased, product variety increased, and consumer purchasing power rose.

Based on the above, the Committee recognized the following:

- A. Government policy with respect to health and education had increased cost-of-living as well as social inequality.
- B. Exposing certain markets to international trade in the 1990s dramatically increased supply and reduced prices.
- C. Remaining markets are concentrated and suffer from lack of competition, largely due to barriers to international trade.

- D. The government failed to recognize that competition and cost-of-living concerns are major components in the regulatory “objective function.”

The next section provides an overview of the direct forces behind the changes in cost-of-living described above and provides several real-life examples.

III. MAIN DRIVERS BEHIND THE INCREASING COST-OF-LIVING

A. Regulation

1. Regulation and Competition

Regulatory bodies, with their rules and guidelines, have a substantial impact on equilibrium results in many markets. However, regulators have no legal obligation to consider the implications their decisions may present for competition or for cost-of-living. The regulatory “objective function” is almost never defined in terms of competition or lower prices; rather, it is often about safety, stability, health, and simplicity of enforcement. In order to allow for this change, three recommendations were made.

The first recommendation was that the government should institutionalize regulatory theory practices to ensure that regulation will not vary unnecessarily in quality, objectives, and methods. It was also recommended that the government requires all regulators to consider competition and market concentration concerns when making decisions. Finally, it was recommended that the government takes a proactive approach to advocating competition. This process has already begun with the establishment of the Competition Research Division of the Israel Antitrust Authority. This division will monitor and analyze trends in various markets, as well as proactively test and diagnose failures in competition and advocate changes when needed.

2. Regulation and Special Interest Groups

When regulators have to deal with special interest groups and other unregulated entities, results may be biased against the interests of the public. This is not due to malice or wrongful intentions, but instead because the public is an amorphous and undefined entity that lacks the ability (or finds it costly) to petition regulators. In most cases, the public is not included in the regulatory proceedings and may not even know which proceedings take place or that they may have a substantial effect on consumers. A regulated entity, however, has a strong interest in the outcomes of regulatory decisions, and thus is familiar with both the procedures and the people involved in the process. The Committee believes that interest groups cause an imbalance between the interests of the public and the narrow interests of an industry. Because of this imbalance, the interests of the public are not always best represented.

The public transportation industry provides a good case study for problems special interest groups may cause for market regulation. The structure of the public transportation industry evolved over many years of mergers and acquisitions. By 2000, 95 percent of the market was controlled by two companies—Egged and Dan. During this period, quality of service has declined, while prices were on the rise. In 1999, the government decided to open 100 percent of the industry to competition, as market outcomes were to the detriment of consumers. Nevertheless, today Egged and Dan still control 70 percent of the public transportation in Israel. In addition, to keep the costs for consumers low, government subsidies to Dan and Egged are 25

percent higher than subsidies for competitive public transportation companies. Overall, this costs taxpayers an extra 720 million NIS (\$190 million) each year.

To deal with special interest groups, the Committee recommended the following actions:

1. Increase the quality, expertise, and skills of the regulators;
2. Place harsher restrictions on commercial lobbying; and
3. Strengthen consumer influence on decision making by mandating regulators meet with consumers to get information and opinions.

3. Ex-Post Regulation of Non-Competitive Markets

Ex-post monitoring of non-competitive markets and industries allows governments to prevent dominant firms from engaging in anticompetitive behavior. The government may further instate price controls for their products. However, in both cases, there is a great need for improving and strengthening the supervision. Based on surveys of international competition law, Israel's regulatory mechanisms are not significantly different from those found in other jurisdictions. However, that does not mean that the desired effects are always attainable.

For example, according to the Director General of the Antitrust Authority, "Elite Ltd," a major chocolate and candy producer in Israel controlling well over 70 percent of the market, successfully prevented the entry of Cadbury Chocolate into the market. Currently, antitrust laws in Israel mandate that the dominant firm agrees to pay a fine for any non-criminal breach of the law. The fine Elite had agreed to pay, 5 million NIS (about \$1.3 million), was in no way significant or meaningful given the size of the market for chocolate in Israel.

Therefore, the Committee recommended expanding the tools available to the Antitrust Authority in order to achieve ex-post changes to monopoly business practices by:

1. Providing the Authority with the power to impose non-criminal financial sanctions to enable fast and efficient handling of violations; and
2. Authorizing the Director General of the Israel Antitrust Authority to impose structural changes, promoting competition in concentrated markets.

4. Governing Powerful Economic and Political Entities

In order to illustrate the limited ability of the government to intervene and impose its goals on powerful bodies, it is useful to examine the housing market. Land policy in Israel is set by the Ministry of the Interior and carried out by the Israel Land Administration. The performance of the housing sector was characterized by two failures:

1. Supply shortage, which contributed to a continuous rise in residential land prices for over three decades; and
2. Insufficient development of urban centers, which resulted in accelerated suburbanization processes.

Housing prices rose sharply over the past 20 years, far beyond increases in construction input prices. The price rise began with the mass immigration from the former Soviet Union during the 1990s, and prices have not significantly decreased since then. The government, anticipating an increase in demand, had decided to accelerate the construction of housing all across Israel. This decision was never implemented by the Israel Land Administration (see Table

5 below). The consequence was a sharp rise in housing prices. Finally, the economic crisis of 2008 resulted in interest rates decreasing to near-zero levels, driving demand for housing significantly, which resulted in another price increase.

This illustrates the usual problems associated with state control over a major share of available land, as well as the government's inability to impose its decisions on powerful economic bodies, even if they are ostensibly under its direct control.

Table 5

Period	Additional Apartments (thousands of units) (1)	Additional Households (thousands) (2)	Ratio of Construction to Households (1)/(2)	Rate of Change-Residential Construction Inputs	Rate of Change-Housing Prices	Ratio of Rates of Change-Housing/Inputs
1987-1996	383.9	450.6	0.85	204%	544%	2.67
1997-2007	450.8	493.8	0.91	51%	-3%	-
2008-2010	96.0	105.3	0.91	2%	14%	5.62

Another contribution to the cost-of-living in Israel is the government's inability to promote structural changes to promote competition, especially in cases where government monopolies are involved. This is mainly a result of excess power held by labor unions in essential infrastructure that protect the interest of a small group at the expense of the public. An individual level wage regression using pooled data for the period 1996-2010 indicates excess wages paid in five government monopolies (water ports, airports, water utility, railway and electric utility) sum up to 1 Bn. NIS per year (about \$250 million).

The Committee recommended that action should be taken to balance the interests of the general public and those of employees in government monopolies. More importantly, it is necessary to balance the interests of the public with the monopolistic practices of state-controlled entities, which directly affect the cost-of-living and the quality of services the public receives.

The above section focused on regulatory problems in the Israeli economy, one of the main contributing factors to the increased cost-of-living, as identified by the Committee. The other major contributor was the lack of trade liberalization policies in several important markets. A brief overview of these issues continues in the next section.

B. Import Barriers

Trade liberalization is often the driving force behind price reductions, new product offerings, and intense competition. In the 1990s, Israel made vast changes to its trade policies by opening specific markets to international competition. This change reduced prices for households, either through direct importation of products or due to adaptations made by domestic manufacturers in order to compete with international products.

However, Israel's current foreign trade policy still displays significant barriers to imports in certain markets. Some of these barriers have been upheld by the government, without a clear

estimate of the economic costs associated with lessened competition. The Committee found that government policy protecting domestic markets, regardless of changes over time to their structure, concentration, and level of competition, was ill-guided.

While there may well be cases with real benefits to protecting certain industries, import barriers constitute a burden to competition and often inflate local prices without justification. The Committee found that government policy protecting private interests resulted in many of these import barriers. These policies are a detriment to the entire economy.

1. Anti-dumping and Trade Levies

The Trade Levies Law, established in 1991, authorized the government to impose levies to protect local manufacturers. In practice, the Committee found that the use of this tool does not reflect a reasonable balance between consumers' interests and manufacturers' interests. According to data received from the Commissioner of Trade Levies, these protectionist policies have a direct cost on the economy of over 600 million NIS (about \$150 million) a year. Those include costs associated with preventing competition and bureaucracy.

The Committee recommended a substantial reduction in the use of trade levies that protect local monopolistic or concentrated industries. In particular, levies should not be imposed where there are less than three domestic manufacturers of the relevant product or whenever a non-negligible share of local production is, in fact, exported. Last, it is recommended that anti-dumping levies may only remain in place for 5 years for each specific product.

2. Standards

Regulatory barriers to imports may disguise as safety and quality standards. Israel's regulatory system often has had different requirements from those of its trade partners. This has had an adverse effect on trade, as would be expected. However, since 2007, there have been reforms to accept international standards in Israeli markets, but these reforms have yet to be extended to a vast majority of products. The Committee therefore recommended an immediate removal of all Non-Tariff Barriers.

3. Customs

Another way to protect domestic products from import competition is through customs. As mentioned above, Israel had taken significant steps to reduce customs duties on specific products in the past. However, large parts of the economy are yet to be exposed to foreign trade. While the Committee attached great importance to promoting Israel's foreign trade, including through new trade agreements, it strongly disapproved of taxing households in order to bring about this goal. Therefore it was recommended that Israel should consider lesser duties for agricultural and food products.

IV. POLITICAL ECONOMY AND SOCIAL PROTEST

All systems of economic regulation transfer wealth between sectors of the population. When government grants exclusive rights to manufacture a certain product, a monopoly is created, and wealth flows from customers to the monopolist. Conversely, opening a monopolistic market to competition will shift wealth back from the monopolist to its customers. The use of high customs tariffs, mandatory standards, and other non-tariff barriers protects local manufacturers from international competition and may enhance their market power. In this

context, governmental powers are virtually unlimited, and the costs associated with such policies will always be paid by the citizens—who, more often than not, would not be able to figure out exactly why and how much surcharge they pay.

There are many powerful organizations and interest groups that are aware of the government's power and of the benefits that the state can provide them. Thus, there exists a constant struggle to gain funds or protection through extra subsidies or beneficial legislation. It is usually the case that the interests of households and citizens are contrary to those of businesses. Thus, government officials and regulators are charged with striking an appropriate balance between these opposing forces. It is the Committee's view that the political-regulatory system in Israel has failed doing so in many cases.

Interest groups are not always members of the private sector. Employees in strong workers' unions in government monopolies, such as those of airports, seaports, and electric utilities, receive benefits from the government through high wages. The state needs to regain control over these powerful entities, including those that have previously seemed beyond the government's reach, such as the Israel Land Administration. Otherwise, these groups will continue to facilitate wealth transfers from the public to a limited group of stakeholders.

The public's voice is barely heard in this context, due to a number of reasons. Primarily, citizens often lack the ability and motivation to collect all relevant information about the variety of decisions made daily by the government. Even if they manage to collect the data, they still must process it, and then formulate an opinion about how it would affect their interests. Even if some citizens could do all that efficiently, the payoff for each of them is not very high. Regulatory decisions may have a major impact on the economy as a whole, but may make a small difference—a few cents per day—per citizen. On the other hand, if a single firm could collect those few cents a day from every citizen through tax shields, it would benefit enormously. The economic benefit for that one firm would be more than enough to cover the costs associated with gathering the necessary information, processing it, and hiring the best specialists and lobbyists to defend the company's interests. Therefore, in any discussion with regulators or with the legislature, we would expect to find many more businesses and stakeholders involved than ordinary consumers.

Business interests who are vying for government protection are often those in monopolistic or oligopolistic markets. This is because markets with intense competition expect to earn less from imposing high customs. In fact, the Committee finds that many industries that seek protection are those with only a single or a few local manufacturers.

However, even large firms sometimes find lobbying individually to be unprofitable. Organizations such as the Manufacturers Association, the Association of Contractors and Builders, the Chamber of Commerce, and large unions play a central role in aggregating and promoting the interests of their members. The activities of these organizations are extremely important in many situations, as they are representative of the major forces in the economy. It is equally important to note, however, that consumers in Israel currently have no similar institutions to help make their voices heard.

The need to countervail the power of interest groups is not unique to Israel, but rather it is manifested worldwide. In addition, this is not a problem of personal dishonesty, bribery, or

corruption. Instead, it stems from a market failure very similar to that of public goods. In Israel, however, it was almost always the case that only businesses have had the incentive to petition the government, often to the detriment of the public. Creating strong institutions to advocate on behalf of the public will help to rebalance the interests of corporations and special interest groups against those of the public.

V. MOVING FORWARD

Since the Committee for Economic and Social Change first published its report, much progress has been made. An examination of regulatory bodies is already underway, legislation has been passed to limit customs duties, and changes have been made to the antitrust law such that administrative fines can be issued by the General Director of the Antitrust Authority. Specialized government teams to investigate industries with little competition such as cement, banking, food, and automobiles have been formed. A review of the anti-dumping legislation and other trade policies is due to begin in the near future. In addition, the Israel Antitrust Authority has already started capacity building in order to establish a Competition Research Division.

More importantly, the commissioning of the Trajtenberg report and the subsequent adoption of its recommendations may indicate a shift in economic regulation practices. Israel's regulatory regime should become more pro-consumer and pro-competition, instead of serving mainly the interests of businesses. The protests of the summer of 2011 initiated this change by showing decision-makers that the public has a say in such matters, and that they must be heard. Now, it is the role of the government to act and make the necessary changes in order to protect consumers and rein in cost-of-living for its constituents.