ISRAEL COUNTRY PROFILE

Femise Coordinators

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INTRODUCTION: PREPARING FOR GLOBALIZATION

Israel’s economy has rapidly transformed itself in the last decade from being a semi-open industrially-based economy, highly intervened and regulated by the state to an open service- and high-tech based economy driven by market forces. It remains, though, that the impressive deregulatory and privatisation processes initiated since the end of the 1990s are not complete and cannot be completed as long as the size of public expenditure as a proportion of GDP will not be reduced to typical OECD countries’ proportions. This in turn will depend on the State’s ability to reduce defence outlays and the size of the Army, something that obviously hinges on finding a lasting solution to the Israeli-Palestinian conflict.

The present report is not about and will not deal with it. However as with other dimensions of Israeli day-to-day life, it will be in the background. It is a fact that Israel’s economic establishment (both at the public and at the business levels) has tried since long and continues to try to operate as if the conflict did not exist or as if it was a minor annoyance with which one must live with. Unfortunately, this view could be maintained all the time that global levels of economic interdependence were those preceding the technological communications revolution of the 1990s. As is well known, the latter has transformed financial, insurance and information markets, with the concomitant effect of drawing together all developed and emerging economies, of which Israel is part. This means also that whereas until the mid-1990s the only overseas institution peeping occasionally with a lamp torch into the Israeli economy was the International Monetary Fund¹, many foreigners (and maybe more significantly non-Jews) working for investing houses, pension funds, banks, multinational companies and credit-rating agencies are scanning nowadays Israel’s economic performance on a daily basis. This has meant among others that the Israeli Finance Minister is very much alert to changes in Israel’s political risk ratings, competitiveness rankings and so on. In other words, the economic establishment, which sees by and large the economic advantages of globalization for Israel, is by now very much aware of the importance of rapidly resolving the conflict, and if this is not possible, at least confining it to such a dimension as to reduce the focus of the international media on it.

¹ Since Israel was since long not a client of the World Bank, neither a member of the OECD nor the
The reason for this sensitivity is obvious: Israel is a small economy by international standards made-up of less than 7 million people and a couple of very specific primary resources (i.e. basically phosphates), located in the distant periphery of the EU’s economic core. Lying by the Mediterranean Sea and being still economically boycotted, whether *de facto* (e.g. by Egypt) or *de jure* (e.g. Saudi Arabia or Syria), by most of the Arab world including its poor neighbours (but for the exception of Jordan), it functions by and large as an island. Some would say more pessimistically it is still a backwater, an end-destination. Logistically its daily existence very much depends on one airport (i.e. Ben Gurion) and three deep-sea water ports (Haifa, Ashdod and Eilat). Obviously the whole Israeli economy would be transformed the moment land- and pipeline transport to and from Israel and across Asia and Europe would become a daily occurrence. Clearly the conflict plays the role of a spoiler. Honour must be made in this respect to the foresight of different Israeli governments in pushing forward the project partially implemented already of constructing a 4-lane North-South road cutting across Israel (the so-called Trans-Israel Highway number 6), which in time should be linked to the Egyptian, Syrian and Lebanese road networks.

Both geography and history, combined with location make of Israel an ideal place for the development of tourism services, particularly in view of its proximity to Europe. But, here again, the conflict, whenever it flares, as was the case from 2000 to 2003, can act as a paralyzing factor, to the dismay of tourist operators (although to the benefit of international media).²

In theory, the physical and economic distance from the European industrial core (i.e. Northern Italy, France, Germany, the Benelux and the UK) could have made of Israel in the 1980s and 1990s an ideal partner for the development of outsourcing and the internationalization of production. However the dependence of EU countries on Arab oil and their lack of tough anti-boycott legislations have resulted in European-based firms refraining from initiating such ventures. Thus it is not astonishing that in spite of the conclusion of a full-fledged free-trade agreement between Israel and the EU in 1975, Israeli exports of manufactured products to thru EU have not developed over the years as expected, particularly in view of the very restrictive rules of origin annexed to it. On the other hand and particularly since the conclusion of a similar agreement in 1985 with the US, the establishment of a flourishing intra-industry trade with US firms in the electronic

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² The number of journalists in the region per square kilometre whenever there is an acute crisis is said to be the highest in the world, partly due to excellent Israeli media facilities and easiness of...
and telecommunications industries has led to the consolidation of high-tech activities. These were initially very much based on the intimate defence relations between the two countries developed since the Yom Kippur War in 1973.

Turning to Israel’s neighbours, it goes without saying that the development of intra-industry trade with them has been precluded by the primary boycott applied by the Arab League until a Peace Treaty was signed with Jordan in 1995 and the latter country was offered by the US the possibility of benefiting from the above-mentioned 1985 US-Israel FTA by extending it to so-called QIZ, i.e. Qualified Industrial Zones, lying on Jordanian territory adjacent to Israel’s borders. The latter have been a tremendous success, allowing for the organized delocalization of Israel’s textile industry to Jordan, to the benefit of both countries. A sign of it has been that Egypt, which for political reasons had refrained from entering the fray, has had a change of minds and concluded a QIZ agreement with the US and Israel in 2004, probably driven by the fear of being shut out from developed markets after the phasing out of the MFA in January 2005.

That the integration of Israel into the world economy would be facilitated by a resolution of the conflict seems almost a tautology. The first thing that comes to mind is of course direct trade with the neighbours. Different estimates of this potential have shown it is fairly limited by Israel’s standards. Not a single one is predicting direct trade having a share of more than 10 percent of total trade. This is to be compared with shares of between 30 to 40 percent for the EU and the US. It basically reflects the fact that Israel’s neighbours are small markets. On the other hand trade in goods and services, as well as capital movements, between Israel and Gulf countries could be much more significant.

But using a magnifying glass, what is more important to note is that location-wise, Israel is ideally suited to operate as a logistical base for processing goods and servicing trade transiting between Europe on the one hand and Southern and Eastern Asia on the other. Plans are being made for the construction of a “land-bridge” between Eilat-Akaba, lying on the Red Sea at the Southern end of Israel, and Ashdod, on the Mediterranean Sea to compete with the Suez Canal. With the improvement of transport links and appropriate trade agreements, it is conceivable to envisage an intense intra-industry trade in high tech products between Israel and India. The same supply-side considerations apply to Israel’s links with Eastern European countries, be they current or future members of the EU (such as Hungary, the Czech Republic, Slovakia, but also Romania and access.
Bulgaria). In relation to the Arab world, QIZ is the line to be followed, to make capital of abundant semi-qualified Arab labour and geographic proximity. Light, labour-intensive industries should be favored (e.g. travel and leather goods, textiles and agro-food industries). Of course, with the expected economic development of all the afore-mentioned countries, they will become markets for Israeli goods and services on their own. In times of peace, Israel can make capital of its high-quality, education and research services, drawing thousands of Indian, Arab and Eastern European students to its universities and research centres and patients to its hospitals and medical facilities.

This is a long term perspective. In the meantime, Israel must deepen its institutional trade relations both with the EU and the US, its currently principal markets and suppliers. The reason is that it is better to be tail of lion rather than head of fox. Best practices, benchmarks, norms and standards are being imposed by these two economic powerhouses. From the beginning, a particular dilemma must be confronted. Is it better to deepen intimately the relationship with one of the two (e.g. by asking for membership in the EU) to the detriment of the link with the other (e.g. the US) or keep an equal economic distance. Here again the conflict with the neighbours interferes. For many years after formal peace is reached, Israel will be strategically dependent for its security on the US. Whereas from an economic viewpoint it might make sense to see Europe as the “natural trading partner”, using Paul Krugman’s terminology, this is not so in security terms. This is why membership in the European Economic Area or a status akin to Switzerland in relation to the EU could deliver to Israel most of what is needed in terms of economic integration, and allow her simultaneously to deepen the 1985 FTA with the US to NAFTA-type levels. In the relatively short run, Israel should strive to get acceptance in the OECD as a full member, as in practice it does comply with almost all OECD standards, including its tough money-laundering rules. In fact there is no reason, other than purely political, for Israel not being yet a member of this august institution. Membership would do Israel very good, as it would get accustomed to peer reviewing and stop thinking about itself as being a special case.

Domestically both the short term and long term perspectives presented here imply to prepare the public for the change. For instance it means that English becomes (in practice) the working language of Israeli universities, hospitals, financial institutions and other service industries. It also means to make the Israeli worker and student aware of the fact that they are going to be competing with European and American workers and students, and not only as now with
their fellow citizens. There will certainly be much opposition to be expected to this perspective from several quarters, not only from the usual suspects (i.e. import-competing goods and service industries). Nationalist and religious milieus will point to the risks of such economic strategies for national identity. Israel is after all 57 years-old and Hebrew is being spoken on a daily basis since less than a century, after a 2000 parenthesis. This contrasts with the situation in most of the OECD, where similar perspectives are nowadays confronted by national leaders (illustrated by the negative outcome regarding the ratification of the EU Constitution in France and in the Netherlands in the spring of 2005).

However, it must be reminded that Zionism was one of the many national movements emerging in Europe in the late 19th century and fighting for national, linguistic and religious emancipation. Some of them led to the creation of modern sovereign states (including Zionism): Poland, Czechoslovakia, Hungary, Yugoslavia, Romania and so on. Other national movements were then less successful (e.g. the Catalans, the Irish or the Basques). It appears that all of them have been able for the moment to combine economic integration into a supranational body while maintaining national cohesion and identity.

To sum up, given Israel’s geographic location, its relative distance to the economic power centres of the world and geopolitical realities, Israel must strive to be a part of as many economic networks as possible. In that respect, regional integration in the Middle East does not seem to be a rational option to follow, not only for obvious political reasons, but more intimately linked to this report, for purely economic ones. Domestically, it is of the first order of importance for Israel not to lose the present technological edge in relation to other peripheral OECD-type economies (e.g. Spain, Portugal, Greece, Hungary, the Czech Republic, Poland, Korea and Mexico but even Finland). This can be obtained by investing massively in the education system and by making Israeli daily life sufficiently attractive for its educated people to prevent a brain drain.

From all the above, it seems logical to start this report first with issues directly related with integration in world markets. This is why trade issues are dealt with first, in Chapter I. Domestically, supply-side reforms are well engaged (privatization, welfare payments reforms, pension funds reforms, tax reduction) and will be completed soon if the Israeli Finance Ministry prevails, as it has always been in the recent past. This will allow to keep the budget deficit under check and facilitate a reduction in coming years of the public debt, provided the
conflict does not flare up again as was the case during the recent second Intifada. This is treated in Chapter II, dealing with fiscal issues. But in an open economy, such as Israel’s, expenditure policies are intimately linked to the management of monetary and exchange rate policies. This is why the authors of this report have chosen to deal with monetary issues in the third place (Chapter III). Not that inflation is a problem anymore. It is remarkable that in spite of the rebellion in the territories, inflation has not raised its ugly face. Neither has the exchange rate varied significantly in relation to the US $, the reference currency until now for the Israeli economy. Therefore the classical macroeconomic tasks of the monetary authorities are not at stake at present. The Bank of Israel should put more focus in the future in something else if Israel wants to benefit from integrated financial markets, namely the former’s prudential role. It must be beefed up so as to raise the competitiveness of the banking sector, very much protected until now. Whereas the accountability and credibility of the monetary authorities is not at all an issue, this is not yet the case for other public sector activities, as the State’s Controller Annual Report illustrates regularly. This is the emphasis laid in the governance chapter that follows (Chapter IV). Finally, coming back to the long-term perspective, it seems obvious that Israel’s real economic productivity, compared to similar OECD economies, is very much linked to the quality of its human resources and that this quality must not only be preserved at all costs, but must be constantly improved. This is the leitmotiv of the final chapter dealing with human resource issues (Chapter V).
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I. Trends in trade, relations with the WTO and regional integration

Israel is one of the most open economies in the world and in the Middle Eastern region, compensating by means of trade its complex location and lack of natural resources. An increasingly liberal and open trade regime has contributed to Israel’s economic development and at the same time the industrial and service sectors became the leading growth engines. These factors made it possible for the Israeli economy to recover from the global recession in two years, despite an ongoing near-war situation with the Palestinian Authority.

In 2005 the Israeli economy is expected to grow at a rapid pace of 4 percent, with foreign trade responsible for more than 80 percent of the GDP (Haaretz, 27.06.05).

Figure 1:

![Openness Indicators](image)

Source: Data from Central Bureau of Statistics, (own elaboration)

This pace is a significant improvement as compared to the lack of growth in 2001-2002 and it almost returns Israel to the average annual growth of 5 percent that was reached in the period between 1990 and 1999. However, there is still a long way back to its record growth of 5.7 percent, as in the first four years of the 1990s (WTO, 1999).
During the last decade Israel’s trade policy has been dedicated to opening the economy to imports and foreign competition and becoming a central player in the world global economy. The trade policy emphasises free trade as a means of increasing competition within the local market, improving resource allocation and augmenting the efficiency of local industries.

In order to achieve this goal Israeli policy makers determined, and State institutes implemented, vast reforms in trade policy, starting with unilateral liberalisation by reducing tariff rates on almost all industrial products, signing MFN and free trade area agreements with most of the developed and developing countries. Until recently Israel enjoyed the unique position of being the only economy in the world to have free trade agreements with both the United States and the European Union, but several more countries as Chile, Mexico and Jordan now enjoy the same position.

The second principle of Israeli foreign trade policy is based on exploring and leveraging its dominant competitive advantage – human capital, which contributes mainly to development of the high-tech and service sectors. These sectors become increasingly important in the global economic arena, where they provide Israel with an opportunity to compete fully despite its small size and complex geo-political situation. Technology replaces the traditional labour-intensive sectors in the export basket and puts Israel on a par with the most developed and advanced large economies, at the same time improving the quality of life of the labour force.

The third pillar of Israeli trade policy is the privatisation process, as fostered by the former Minister of Finance Benjamin Netanyahu. For the last two years
the privatisation policy impacted on all the main sectors of the economy, including finance, telecommunication, aviation and ports. As a result, the economy opened up to high profile foreign direct investment (FDI), due to the fact that foreign firms can now participate in government bids for the central companies of the State with almost no limitations or restrictions.

Israel enjoys a positive balance of payments and in 2004 exports of goods reached US$36.2 billion and imports of goods US$38.6 billion. Services yielded 28% of total exports in 2004 and high-tech industry contributed US$10.5 billion to exports in 2004. The share of information communication technology as a percentage of service exports amounts to more than 30 percent today and is second only to Japan. Industrial exports represent 90 percent of the total exports of goods. Imports of goods were US$28.4 billion with services representing 27 percent of total imports.

**Figure 3:**

<table>
<thead>
<tr>
<th>Year</th>
<th>Services</th>
<th>Goods</th>
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<tbody>
<tr>
<td>2000</td>
<td>31.2</td>
<td>12.5</td>
</tr>
<tr>
<td>2001</td>
<td>28</td>
<td>11.8</td>
</tr>
<tr>
<td>2002</td>
<td>27.5</td>
<td>11.0</td>
</tr>
<tr>
<td>2003</td>
<td>30.1</td>
<td>12.0</td>
</tr>
</tbody>
</table>

*Source: Bank of Israel*

**Figure 4:**

<table>
<thead>
<tr>
<th>Year</th>
<th>Services</th>
<th>Goods</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>31.2</td>
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<td>2001</td>
<td>28</td>
<td>11.8</td>
</tr>
<tr>
<td>2002</td>
<td>27.5</td>
<td>11.0</td>
</tr>
<tr>
<td>2003</td>
<td>30.1</td>
<td>12.3</td>
</tr>
</tbody>
</table>

*Source: Bank of Israel*
FDI reached US$3.9 billion in 2003, an expansion of more than 100 percent in comparison to 2002 (Bank of Israel). For the first half of 2005 the influx of FDI continued to improve and is expected to reach a high point of US$5 billion by the end of the year (Maariv, 28.06.05).

The year 2004 marked a turning point for the economy when the improvement in the world economy, which has a far-reaching effect on Israel’s foreign trade, was accompanied by an improvement of the leading indicators in the local economy, such as those related to private consumption and foreign direct investment. In the first quarter of 2005 exports of goods reached US$9.5 billion, an increase of 8 percent compared to the parallel quarter of the previous year. Imports were US$8.7 billion, up 14 percent compared to the first quarter of 2004 (Federation of Israeli Chambers of Commerce (FICC), 2004).

Israel has continued to liberalise its economy in order to achieve greater integration in the world economy. The past few years have been dedicated to further reduction of tariffs, attracting foreign investment and eliminating the remaining non-tariff barriers, such as import licenses, quotas and technical requirements. Acceleration of the privatisation process aims to add a further boost to removal of trade barriers and distortions to global trade.

A. Israel and the WTO

Israel has been a full member of the WTO since its inception in 1995. Prior to that Israel was a full member of GATT as of 1962 and has demonstrated its commitment to the multilateral trading system through active participation in that organisation. Since the completion of the Uruguay Round in 1994, Israel has amended legislation in areas such as customs valuation and standards in order to comply with its commitments. Israel is a party to the 1997 Agreement on Telecommunication Services, the Information Technology Agreement and the Financial Services Agreement. Israel is also one of the only 28 countries signatory to the Government Procurement Agreement (GPA), which allows foreign firms to participate in government tenders. As of the beginning of 2005 Israel reduced “off-set” provisions from up to 35 percent of the contract to 20 percent.
B. Regional Integration

In spite of the Israeli economy’s high degree of openness to trade, regional trade remains quite a challenging issue. The long period of the Arab Boycott and the long standing conflict with the neighbouring countries restricted regional trade, which remains low until today.

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</thead>
<tbody>
<tr>
<td>Egypt</td>
<td>0.42</td>
<td>0.49</td>
<td>0.63</td>
<td>0.56</td>
<td>0.67</td>
<td>0.41</td>
</tr>
<tr>
<td>Israel</td>
<td>0.12</td>
<td>0.25</td>
<td>0.23</td>
<td>0.1</td>
<td>0.14</td>
<td>0.04</td>
</tr>
<tr>
<td>Jordan</td>
<td>0.47</td>
<td>0.45</td>
<td>0.18</td>
<td>0.3</td>
<td>0.2</td>
<td>0.36</td>
</tr>
<tr>
<td>Lebanon</td>
<td>0.33</td>
<td>0.25</td>
<td>0.33</td>
<td>0.31</td>
<td>0.25</td>
<td>0.24</td>
</tr>
<tr>
<td>Syria</td>
<td>0.18</td>
<td>0.15</td>
<td>0.11</td>
<td>0.20</td>
<td>0.15</td>
<td>0.11</td>
</tr>
</tbody>
</table>

Source: Tovias et al. (2004)

Israel belongs to the Mashreq region, which is characterised by three remarkable facts: 1. integration of the Mashreq economies into international trade is limited; 2. intra-regional trade is at very low levels, especially when compared to other regions; 3. exports are concentrated in oil-related products and labour-intensive goods (Bavly, 2001). The chief reason for these characteristics is the fragile political situation in the region and in particular the Israeli-Arab conflict. The Mashreq countries do not fit popular trade models as the gravity model and this is especially true for Israel, which is significantly different from countries surrounding it, like Egypt, Lebanon or Syria. For example, Mashreq’s share in world exports was almost 1 percent in 1999, but only 0.2 percent if Israel is not included. Over the last two decades the Mashreq countries lost half of the share in world trade while Israel increased it by 50 percent. In Mashreq countries the share of exports in GDP amounts to 13 percent, but in Israel it is over 30 percent, as in most developing countries (Bavly, 2001). Compared to the broader region of MENA countries Israel is also better-positioned, but here the disparities are less striking, especially in comparison to more developed countries like Tunisia.
Until 1994 all Arab countries, with the exception of Egypt, banned all commerce with Israel (Kleiman, 1998). However, improvement in relations with Egypt and Jordan over the past decade had a positive effect on trade, though it is still far from the numbers to be expected if one implements the Hecksher-Ohlin or the Gravity models.

Israel recently signed QIZ (Qualified Industrial Zones) agreements with Egypt and Jordan. The agreement with Jordan, which also includes the United States, was signed in 1997 and a similar agreement was signed with Egypt in 2004. The QIZ agreements are one of the key developments in regional trade, which
was almost non-existent in past decades, notwithstanding the peace treaties signed between the parties.

The QIZ agreements aim to reduce tariffs on certain products and eventually to create a free trade area between the countries, with abolition of all tariffs and barriers. The secondary goal of the QIZ agreements is to enhance cooperation between Jordan and Israel and Egypt and Israel in order to promote regional stabilisation and peace (Ben Yehonathan, 2003).

At the first stage Jordan and Egypt have access to the Israeli FTA with the US, and the three countries can manufacture certain products in joint industrial zones. Such products are entitled to diagonal cumulation and are therefore free of tariffs and duties when they enter the US.

The impact of the QIZ agreement on trade is easily discernible in the figure below, which illustrates the Jordanian case. It is important to mention that even during the peak of the Intifada in 2001-2002, the volume of trade between the two countries increased. In 2002 Jordan signed a Free Trade Area agreement with the US, which partly neutralises the benefits of the QIZ agreement. However, there has been no decline in trade with Israel hitherto, and the common assumption is that Jordan will continue its interest in the agreement, since the FTA agreement with the US is a gradual one and only after 10 years all tariffs will be abolished (Ben Yehonathan, 2003).

Figure 6:

![Graph showing Israel-Jordan Trade since the QIZ Agreement](image)

Source: Central Bureau of Statistics

The agreement with Egypt was ratified by the Israeli government only at the beginning of 2005, therefore it is too early to examine its implications. In 2004 trade between Israel and Egypt reached $60 million, of which 40 percent is in
exports from Israel. Both Egypt and Jordan have a trade deficit vis-à-vis Israel; in the Jordanian case the gap between its imports from Israel and exports has been deepening in recent years (Ben Yehonathan, 2003). Israeli exports to Jordan grew by 55 percent to US$134 million in 2004 (Haaretz, 8.2.05).

Over the years there have been many speculations on “secret” (i.e. indirect) Arab-Israeli trade, which Forbes magazine estimated in one of its articles at US$500 million in 1984 and later at US$1 billion. These calculations were made on the basis of figures provided by an Israeli business consultant, who in turn based his report on Israel’s export statistics to unidentified destinations. According to the official data of Israel’s Ministry of Industry Trade and Labour, total indirect exports to Arab countries reached US$12 million in 2004 and imports grew by 20 percent to US$82 million (Haaretz, 8.2.2005).

Israel and the PLO

In 1994 Israel and the PLO signed a protocol providing for free movement of goods between Israel and the areas under economic jurisdiction of the Palestinian Authority, as well as a customs and standards union between the parties. In the period 2001-2004, in spite of the Intifada, trade (goods and services) between Israel and the Palestinian Authority grew by 37 percent to US$1.9 billion in 2004. Most of the trade was Israeli exports to the PLO (US$1.6 billion) and only US$300 million related to imports from the Authority, which nevertheless represents a sharp increase of 30 percent from 2001. Imports from the Palestinian Authority represent only 0.8 percent of Israel’s total imports and the current numbers are still 35 percent down from the 1999 peak, prior to the onset of the Intifada (Haaretz, 28.4.05).

II. Quantitative Indicators of Trade Patterns

Today the lion’s share of trade is done under cover of free trade area agreements, i.e. mostly with the US and the EU. The share of Europe (EU and non-EU countries) in total trade declined during the last decade from 42 percent in 1990 to 33 percent in 2003. However, in absolute terms trade doubled from US$5 billion in 1990 to US$10.4 billion in 2003. The share of the EU in total trade with Europe was 81 percent in 2003. Within the EU the major partners are Germany (21 percent of exports), the UK (18 percent), Italy and the Netherlands, accounting for 11 percent each, and France 10 percent.
In imports, Europe takes the lead with a share of 54 percent in 2003, but down from 62 percent in 1990. Most of the difference is due to a sharp increase in imports from Asia, from a low of US$1 billion in 1990 to US$ 5.4 billion in 2003. Asia’s share in total imports was 16 percent in 2003, up from 7 percent in 1990 and it clearly reflects the shift in global production that has taken place over the past ten years. The EU is the main source of the trade deficit, accounting for 85 percent of it at US$1.2 billion in the first half of 2005, while Asia accounted for 15 percent or US$725 million (Ministry of Finance).
Figure 9:

Top Five Import Sources of Israel (2003)

Source: HSBC

The share of the US in total trade grew from 28 percent in 1990 to 38% in 2003, and in absolute terms grew from US$3.4 billion to US$12 billion in 2003 (FICC, 2004). The US share of imports has been declining and reached 16 percent in 2003, down from 18 percent in 1990. Total imports came to US$5 billion, up from US$2.7 billion in 1990. The trade balance with the US is positive and reached $480 million in the first half of 2005 (FICC, 2004).

Figure 10:

Evolution of Imports by Origin ($ billion)

Source: FICC, (own elaboration)

Israel also has Free Trade Agreements with EFTA, Canada, Mexico, Turkey, Romania and Bulgaria. The new EU member countries contributed 5 percent of total exports in 2003 and their share is growing steadily, especially since the expansion and adoption by the latter of the Association agreement between the EU and Israel.
Recently, Israel has focused greater attention on developing trade with Asia. Over the decade, trade with Asia did not grow significantly and it currently represents only 18 percent of the total numbers, with almost no change from 1990. Nonetheless, in real terms the change is more perceivable since the numbers rose from US$1.9 billion to US$5.6 billion in 2003 (FICC, 2004).

A. Exports

Israel’s major exports are manufactured goods and software, which accounted for 97% of total exports (excluding diamonds, ships and aircraft) in 2002.

**Figure 11:**

![Major Exports by Product (2003)](image)

*Source: HSBC*

The manufacturing sector is mainly high-tech oriented and major manufactured goods include communication, medical and scientific equipment, electronic components and computers. Israel’s central role in the global high-tech arena is also reflected by RCA indicators, as seen in the table below.

Between 1995 and 2002 exports in the fields of both telecommunications and medical and scientific equipment grew by an average of 21 percent per year. The slowdown in the US economy and the sharp decline in global IT investment had a profound effect on Israel’s high-tech exports, which fell by 9 percent in 2002, but the turnaround that began in mid-2003 resulted in an 8.1 percent increase in Israel’s total exports and a 2.2 percent in high-tech exports (HSBC, 2004).
The high-tech industry accounts for much of the rapid increase in Israel’s trade, but other sectors also account for a large part of exports, though they are less dynamic. The primary example is diamonds, representing 30 percent of total exports, making Israel the largest diamond exporter in the world with 70 percent of the world’s cut diamonds (WTO, 1999). Israel’s leading position in this sector is clearly seen in the Revealed Comparative Advantage table below. In 2003 exports of polished and rough diamonds reached US$7.9 billion, as compared to US$6.9 in 2002. At the same time Israel is also the largest consumer of gem-quality rough diamonds, buying 50 percent of the world’s annual manufactured output.

<table>
<thead>
<tr>
<th>Table 2: Evolution of Revealed Comparative Advantage</th>
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<tbody>
<tr>
<td>Series name</td>
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<tr>
<td></td>
</tr>
<tr>
<td>Jewellery</td>
</tr>
<tr>
<td>Fertilisers</td>
</tr>
<tr>
<td>Telecommunications equipment</td>
</tr>
<tr>
<td>Basic organic chemicals</td>
</tr>
<tr>
<td>Precision instruments</td>
</tr>
<tr>
<td>Basic inorganic chemicals</td>
</tr>
<tr>
<td>Electronic components</td>
</tr>
<tr>
<td>Miscellaneous hardware</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
</tr>
<tr>
<td>Knitwear</td>
</tr>
</tbody>
</table>

Source: CHELEM (own elaboration)

B. Imports

Manufacturing accounts for 80 percent of merchandise imports, of which machinery and transport equipment and other semi-manufactures (i.e. diamonds) are the most important items. Fuel is one of the most important import items, with its share growing from 8 percent in 1997 to 11 percent in 2003 (WTO, 1999). The structure of imports by function has remained broadly the same over the past two decades, and intermediate goods such as diamonds and fuel continue to dominate merchandise imports, accounting to 70 percent, while investment goods account for 16 percent (WTO, 1999).
C. Intra-Industry Trade

Intra-industry trade has been growing continuously over the past decade, suggesting that the Israeli economy is becoming more open. Today it accounts for more than 60 percent of Israel’s total merchandise trade, up from 41 percent in 1985 and 55 percent in 1994. Intra-industry trade with the US comprises 16 percent of total merchandise trade and 33 percent of trade with the EU. While intra-industry trade between Israel and the EU covers different groups of products, intra-industry trade between the US and Israel is concentrated in high-tech only (Tovias et al, 2004).

Over the last decade high-tech exports have played a more central role than before, expanding intra-industry trade even further. Intra-industry trade with the world concentrated mostly in high-tech products, aircraft and also some chemical products. Israel’s intra-industry trade index is significantly higher than for its neighbours, such as Egypt or Jordan, where intra-industry trade does not exceed the 20 percent mark.

III. Privatisation and FDI

One of the most important junctures in the globalisation process of the Israeli economy was the liberalisation of foreign exchange controls in the second half of the 1980s. The liberalisation was implemented gradually, and the process lasted over ten years. The first stage of the programme included cancellation of restrictions on long-term capital, and subsequently restrictions on short-term capital imports were also lifted (Friedman and Goldstein 2004, p.54).
Starting from 1992 restrictions on capital exports were likewise abolished. The liberalisation, together with the peace process that was underway in the 1990s and the receipt of loan guarantees from the US government, led to a significant improvement in Israel’s credit rating and encouraged foreign direct investment (Friedman and Goldstein 2004). The Arab boycott still affects the issue of foreign investment in Israel to a certain extent, but an increasing number of foreign companies have recognised the importance of the Israeli market and of advanced technology developed in Israel.

During the second half of the 1990s and the global high-tech boom, many Israeli companies were acquired by foreign firms and several issued their stock on Wall Street. In terms of the number of foreign companies traded on NASDAQ, Israel is the third country of origin after the US and Canada.

An additional factor to support investment (mostly portfolio investment) in Israel was an interest shown by Western investors in emerging markets. This trend started during the second half of the 1990s and continues today. Due to relatively high credit rating and sophisticated financial system and capital market, Israel enjoys a comparative advantage among countries defined as "Emerging Markets".

**Figure 13:**

<table>
<thead>
<tr>
<th>Year</th>
<th>FDI in EM ($ billion)</th>
<th>Share of Israel</th>
</tr>
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<tbody>
<tr>
<td>91</td>
<td>0.00%</td>
<td></td>
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<tr>
<td>92</td>
<td>0.00%</td>
<td></td>
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<tr>
<td>93</td>
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</tbody>
</table>

**Source:** *Israeli Economic Review*

From 1995-2000, FDI represented 44 percent of the total US$33.2 billion invested in Israel, a yearly average of US$2.3 billion. Until recently most of the FDI came from the US and Canada, but over the last five years this trend has altered and European firms have also been showing interest in the Israeli economy. However the US remains the principal investing country in Israel,
accounting for almost half of total investment, while Europe accounts for 30 percent. European firms tend to concentrate their FDI in Eastern and Central European countries with which Israel competes, especially in light of the enlargement process.

The primary sectors attracting FDI are high-tech companies specialising in Internet, telecom and medical devices, as well as the banking sector and some insurance activities. Over the past decade the business environment in Israel continued to develop into a modern and more open arena for foreign investment. Apart from the enactment of a new Companies Law in 1999, legal frameworks in other areas that affect conditions for operating a business have also been reformed (OECD, 2002).

Today there are almost no restrictions on entry of foreign companies, excluding situations involving State-controlled companies and acquisition of rights for land use. In such cases the foreign investor must apply for a special permit, whose primary purpose is prevention of money-laundering risks; in most cases this is a simple formality. The defence industry is still closed to foreign investors for reasons of national security and there are some restrictions in tourism.

In 2000 the foreign investment influx peaked at US$9 billion and accounted for 9 percent of GDP. Portfolio investment accounted for 53.2 percent of the total foreign influx and 46.4 percent of total foreign outflows (OECD, 2002). FDI reached a record level of US$4.4 billion in the same year.
During the global economic crisis in 2001, FDI proved to be more resilient to the downward trend than portfolio investment, exceeding the level of investment of 1999.

In 2005 the numbers might climb even higher and according to a Bank of Israel forecast total foreign investment is expected to reach US$15 billion, reflecting a 2.5 fold rise compared to 2004 (Maariv, 28.6.05). The Israeli Ministry of Industry Trade and Labour is somewhat more sceptical and expects FDI to reach only US$6 billion by the end of 2005. However these data do not include portfolio investment, which also reached a new peak of US$3.3 billion during the first half of 2005, following the positive trend in the local stock market (HSBC, 2004). According to the Ministry of Industry Trade and Labour, Israel received US$2.1 billion in FDI during the first quarter of 2005.

Direct investments support the Israeli economy’s integration in world trade by improving its competitiveness, contributing to increased efficiency and helping to market export goods abroad. At the same time foreign investments promote market recognition abroad by using international brand names and the marketing networks of companies that invest in Israel. The growing share of portfolio investments, which include investment in stocks and bonds, reflects the globalisation process since they require investors to learn and deepen their understanding of the local economy more than in the case of simply granting
In order to continue enhancing the attractiveness of the Israeli economy, the government develops different programs, ranging from corporate tax reduction from 36 percent to 25 percent to assisting (financially and legally) the expansion of R&D centres in Israel. Israel’s overall aim regarding FDI is to become “the next Ireland,” even if the process implies additional cost to the local population.

One crucial step on the path to becoming “the next Ireland” is to reduce government involvement in the economy by privatisation. The Israeli government began its privatisation activities in the 1970s, but the process only began to gather momentum from the mid-80s. The reason for this was the 1985 Economic Stabilisation Programme, which aimed to transform Israel into a competitive, market-based economy, led by the private sector. Privatisation levels peaked in 1997 and 1998 when government assets worth US$2.4 billion and US$1.7 billion respectively were sold to the public. Of the 160 government–owned companies that were in operation in 1985, less than 100 remained in 2003 (HSBC, 2004).

Since the 1990s the privatisation process has intensified. In 2003 the government sold a 13 percent share of El Al, the national airline, and a 5.25 percent stake in Bezeq, the Israel Telecommunication Corporation. In January 2004, the government sold its share of Zim Israel Navigation Company. During the first half of 2005 government assets worth US$1.5 billion were sold to the public, exceeding the original target of US$900 million for the whole year. This time the assets were sold mainly to foreign investors, emphasising the greater openness of the economy.

At the beginning of the year a controlling share of Israel Discount Bank, the country’s third largest bank, was sold to Matthew Bronfman and a 6.5 percent share of Bank Leumi Le-Israel, the second largest bank, was sold through the stock market, mostly to foreign investors. Later this year the government is expected to sell its 29 percent remaining share in Bank Leumi. The highlight of the privatisation programme to date was the agreement to sell a 30 percent stake in Bezeq, signed with former Israeli businessman Haim Saban for US$1 billion.

The next planned sales include more of the country’s largest service providers,
such as Bazan Israel Oil Refineries, Israel Aircraft Industries, the Mekorot Water Company and Israel Electric Corporation. At the same time the government is introducing reforms in the electricity sector and other utilities with the aim of promoting competition and lowering pricing.³

IV. Market Developments

A. Trade Policy: Agriculture and Manufacturing

1. Tariffs and Tariff-like Charges

For the last decade Israel has continued to move slowly but steadily towards a more open trade regime. Endeavours in this direction include, among others, increased transparency of its tariff system. The bulk of Israel’s trade is conducted within the framework of free-trade agreements with the EU and the US, as well as a long list of preferential trade agreements with countries in Central and Eastern Europe, Central America and more recently also with the Far East.

MFN (Most Favoured Nation) tariffs were lowered from an average of 8.3 percent in 1993 to 4.5 percent today, significantly below the commitment taken by the unilateral liberalisation programme announced in 1991. The plan required a gradual reduction of tariffs to a range of 8-10 percent over a period of six years, when as a first step tariffs replaced NTBs (Non-Tariff Barriers) like licenses and quotas. The reduction process was postponed to 2000 for the textile industry, but market forces proved to be very strong, so that beginning in 2000 most of Israel’s textile plants closed down and moved their production to neighbouring countries such as Jordan and Egypt.

Due to the low tariffs, tariff escalation almost does not exist, with a higher range, close to 8 percent for final and semi-processed products and a lower range for unprocessed products. This system usually provides states a greater degree of protection for the local manufacturing sector, but in recent years tariff escalation has not been maintained in all stages of processing. Overall, the current tariffs represent negative escalation for raw materials and intermediate goods, implying lower effective protection for every stage of processing than was indicated by nominal rates.

³ For more information on the Privatisation programme refer to “Fiscal Policy Issues” in chapter II.
Coverage of an additional tariff called the “safeguard levy” has also been substantially reduced from the equivalent of 2.7 percent of the tariff lines in 1992 to 0.8 percent in 1999. The main difference between MFN tariffs and the safeguard levy is that any change in the former requires approval by the Knesset (the Israeli Parliament), while the levy does not. This fact introduces a certain element of uncertainty to tariff protection. Another aspect of uncertainty for importers results from the fact that Israel has bound rates on just half of its tariff lines. The bound rates are often above the applied MFN rates, giving Israel the possibility to unilaterally raise its applied tariffs. This issue might be solved by narrowing the gap between bound and applied rates, as well as by increasing the coverage of tariff bindings.

In recent years Israel has introduced seasonal tariffs and MFN and preferential quotas, but at the same time the concession rate is higher than the applied MFN, thus making the new quotas ineffective.

Notwithstanding all that is stated above, it is important to mention that in practice most importers do not pay the MFN applied tariff, since only about a quarter of Israel’s total imports take place under the MFN agreements. The EU and the US export their goods within the ambit of their respective free trade agreements and receive duty-free status.

Under the auspices of the WTO Israel participated in the ITA initiative to eliminate tariffs on telecommunications equipment, computers and related equipment on an MFN basis, and it is currently taking part in the Doha Round Development Agenda (WTO, 1999). However the implementation of the GPA agreement is still far from perfect. For example, although some Israeli government entities notify the US government on tenders valued at over US$50,000, many do not. Notifications are often received shortly before deadlines and only in Hebrew. Complex technical specifications and kosher certification requirements discourage foreign participation in government tenders for food (US Department of State, 2002). Israeli law provides for a 15% cost preference to domestic suppliers in many public procurement purchases and the cost preference can reach as high as 30 percent for firms located in Israel’s priority development areas.
2. **Non-Tariff Barriers**

As an integral part of its strategy to become an open economy, Israel abolished many non-tariff barriers that used to exist decades ago. The trade agreement between the EU and Israel, for example, prohibits import restrictions except under strict conditions for safeguard or balance-of-payment reasons. However, NTBs such as import licenses, standards and quality controls still exist.

The oldest non-tariff trade barrier in Israel is the kosher certificate requirement. The Jewish religion, which in Israel is not separated from the State, demands that almost every product entering the country must be kosher. Over the last decade, with the massive influx of immigrants from Russia, who brought with them a new and more liberal culture and also began to import non-kosher products, the restriction became less rigorous. However, any overseas exporter who aims to reach maximal market access and share in Israel must comply with the kosher requirements and therefore bear the additional cost of carrying out the “kosher process”.

One of the main NTBs in the Israeli economy originates from its centralistic structure regarding imports. While in most countries of the world, especially those with open economies, many firms may import identical products, in Israel only one firm is allowed to import a certain label. For example, a study conducted in Israel in 1988 discovered that three main importers hold more than half of the import market in 75 percent of the imported products (Brezis, 1999). Since the study was carried out the situation has improved dramatically, but the issue of the high concentration in imports has not been resolved altogether.

Two main setbacks continue to characterise the structure of the import market: an importer imports a certain label exclusively and usually imports a number of labels from the same sector, i.e. cars, alcohol or perfumes. There are almost no parallel imports, leading to a situation in which foreign producers who did not sign agreements with the “exclusive importer” in Israel are denied access to the market. While the phenomenon might be acceptable in heterogeneous products, in homogeneous products like cement, for example, it is not.

The reason for a lack of parallel imports is mostly historical and goes back to
the period when Israel had low foreign exchange reserves. Due to that fact the
government tried to restrict imports by restricting the number of authorised
importers (Brezis, 1999, p.7). Until 1991, Israeli importers received a license
only if they had the ability to cover imports with their private foreign exchange
reserves or via barter deals. This policy became one of the main NTBs and
created a large number of import monopolies, which exist even today. The
best examples are vehicle importers (Karasso, Lubinsky, Meir) as well as
importers of wheat (Zanziper) and some cosmetic products (Shastovich).

The Israeli government is trying to improve this situation and some recent
publications reveal that it might approve parallel imports in the vehicles sector
shortly. Currently, all import licensing covers 8.5 percent of tariff lines, down
from 19.2 percent of tariff lines in 1992. Most of the remaining licenses relate
to safety and security concerns (WTO, 1999). Additionally, in 1998 the Ministry
of Industry Trade and Labour changed the law regarding import licenses for
products with spare parts to allow parallel imports (Brezis, 1999). This type of
products previously also fell under restrictions forbidding parallel imports.

Special licensing regimes exist for countries that do not have an MFN
agreement with Israel, such as Albania, Indonesia, Cambodia, etc. All imports
from these countries are subject to licensing.

Another NTB is standardisation and quality controls. All products entering
Israel must comply with local standards, as determined by the Standards
Institution of Israel and the Ministry of Industry Trade and Labour. A first type
of standard, called “Israeli Standard”, relates to quality of the product, but is
not binding. A second type, called “Official Israeli Standard” is mandatory and
products cannot enter the local market without this official mark given by the
Ministry of Industry and Trade.

While standardisation is customary in many Western countries in order to
protect local customers from low-quality products, in Israel its origin is quite
different. In the past standards were set in such a way as to protect local
producers and prevent imports of competing products. For the last few years
the Ministry of Industry Trade and Labour revoked many official standards
aimed at preventing imports according to the new Standards Law of 1998.
Some 250 of 540 official standards were dropped, among them marks for the
length of simple matches and a standard to determine a minimal number of
ventilator speeds (Brezis, 1999).
More generally, the Israeli government has been moving over time in the direction of bringing its standards into line with international ones and completely abolishing some anachronistic local standards. Currently, one quarter of the mandatory standards emulate international standards.

It is important to note that the process of striving towards uniformity at the same time helps to increase exports. One of the main issues Israel faced recently is the question of which international standards it should comply with: American or European. Both the US and the EU are major trading partners with Israel, thereby creating a complex dilemma.

Concerning other types of NTBs available for use, Israel is among the most progressive countries. It has not been an active user of its anti-dumping legislation, nor did it take any safeguard or counter measures during the 1990s.

3. Export Subsidies

Israel has eliminated virtually all of its export subsidy programs in the past ten years. It still retains a mechanism to extend long-term export credits, but the volumes involved are small (roughly US$250 million) (US Department of State, 2002). Israel has been a member of the WTO Subsidies code since 1985. Within the framework of the Encouragement of Marketing Fund Programme, it provides certain subsidies to exporters. The subsidy covers exporters from all sectors, which intend to expand their marketing infrastructure abroad and have prepared a plan to that end. In this case the State provides 33 percent financing of approved infrastructural marketing expenditure up to US$400 thousand. However, this kind of grant is less and less frequent since many companies turn to venture capital distributed by the Investment Centre of the Ministry of Industry Trade and Labour for this purpose.

The most significant sector, which is still subject to governmental subsidies, is agriculture. Government involvement includes direct subsidies to farmers and direct transfer payments. However, subsidies have been declining constantly over the last decade, except in the sub-sector of cut flowers.
4. Anti-Export Bias

The small size of the Israeli economy has created a situation in which Israel’s GDP growth is highly dependent on increasing exports. Therefore an anti-export bias barely exists. Anyone interested in becoming an exporter must apply for a license to the Ministry of Industry Trade and Labour with certain minimum requirements, such as proven experience and a financial statement.

There are limitations and restrictions on weapons exports, especially to Arab countries (sometimes arranged through intermediaries). Live animals, strategic goods and materials as well as certain types of know-how developed with the aid of government funding are also subject to export restrictions (HSBC, 2004).

5. Agriculture

Since the inception of the State the agricultural sector has been defined as one of the vital parts of the economy and the first Zionist settlers at the beginning of the previous century dedicated themselves to its development, despite the fact that climatic conditions in Israel are not welcoming to most crops. However, to counter this, there are significant advantages of topography conditions – from 400 meters below sea level to 1,000 meters above sea level – and a wide variety of soils – from sand dunes to river-watered types. Israel specialises in vegetables, citrus fruits and flowers. Over the last five years more profitable niche markets such as herbs, goat’s milk and organic products have been targeted.

For the last few decades the economy’s focus has switched from agriculture to other areas of expertise, mostly high-tech, as mentioned above; today agriculture represents only 1.6 percent of the GDP, down from 2.5 percent in 2001 (HSBC, 2004). However, in absolute terms agricultural output has grown almost without interruption since 1948 and reached US$3.3 billion in 2000.
Agriculture today accounts for less than 3 percent of exports, a sharp drop compared to a 30 percent share during the 1960s. The bulk of exports (75 percent) are destined for the EU, mostly due to geographic proximity, which facilitates the supply of fresh produce. At the same time Israeli exports to the EU are very sensitive to market expansion by Spain, Portugal, Greece and lately also Eastern and Central European countries.

The main reason for the decline is reduced profitability of the sector due to global developments in competition, as well as scarcity in vital resources such as water. For example, between 1998 and 2000 the price of inputs rose 10 percent to US$2.2 billion (USDA, 2005). Above half of the cultivated area in Israel needs to be irrigated. Water scarcity pushed local scientists to develop revolutionary methods of water recycling, hothouse farming and computerised irrigation, but the costs of crop raising are still relatively high. Extensive research and the invention of unique technologies play an important role in agricultural exports.

Today Israel’s agricultural sector supplies most of the country’s food needs and around 20 percent of the yearly production designated for export (Tovias,
The only exception to agricultural self-sufficiency is feed grains such as wheat and soybeans, where Israel is a net importer. The United States supplies nearly 45 percent of imported grains and the former Soviet Union supplies 25 percent. Israeli grain imports from the US were valued at US$158 million in 2003, split almost evenly between wheat and corn.

At the same time, and similarly to the rest of the world, the agricultural sector is still highly protected, especially in comparison to industrial goods. Despite the general process of lowering MFN tariffs on most exports, MFN tariffs on agricultural products have risen more than 2.5 times from 1993 to 1999 (WTO, 1999).

Some NTBs still exist, such as quotas on agricultural production as set by the Israeli Ministry of Agriculture and Rural Development (see Appendix), mostly in dairy products and cereals (Tovias, 2003). Tariff rate quotas (TRQ) are also applied on chickpeas and potatoes.

In 1996 Israel and the US signed an agricultural trade accord aimed at including the remaining goods not covered by the 1985 FTA agreement. Accordingly, imports from the USA are entitled to a preference of 10 percent (USDA, 2005).

Another protection measure for agriculture is variable import levies applied to imports of basic products like sugar, pasta, sunflower seeds, jams, fruits, wine, cheese and frozen fish (WTO, 1999). The rate of the levy is the difference between world prices and local prices. Israel does not apply these levies in its trade with MFN countries, but it does apply them with the EU and the US.

B. Trade infrastructure and Transaction Costs

Israeli import and export procedures conform in general to international practice. Import controls are minimal, pertaining mainly to those products that require licenses or need to comply with local regulations in the public interest, i.e. health or environment. The infrastructure for international trade has been developing rapidly, especially since 1990, in order to improve the process of conveying cargos inside Israel to and from its ports and to leverage its strategic location between Asia and Europe.
1. Railways and Roads

Until the 1990s transportation was based chiefly on roads while railway infrastructure was out of date and with limited deployment. This has changed over the last decade as railway investment grew to 28-38 percent of total inter-urban transport investment at 2003. The main reason for the change is that the government realised that the best way to solve traffic congestion, as well as accelerating the transportation of cargos, is by developing the railway system rather than by building new roads. Accordingly, since 1996 railway budgets have doubled annually. One of the most ambitious projects plans is to connect the port of Eilat by means of a single railway line with the centre of the country. This would not only provide for fast movement of cargos in and out of Israel, but also create a “land bridge” between all Red Sea ports and Mediterranean ports, thus facilitating the transport of cargos from East Asia through Israel to Europe and vice versa. There is also attractive potential for regional cooperation with Jordan for the transport of cargos from the port of Aqaba to Ashdod, opening up the Mediterranean for Jordan. In addition to reducing Israel’s sensitive dependence on the Suez Canal, the new railway line will also benefit promotion of trade between Israel and the Far East. Currently, the most southerly point on Israel's railway network is Dimona, some 250 kilometres north of Eilat, beyond which connection by trucks is much slower.

Highways are the most developed infrastructure in Israel, since until recently all traffic relied on roads. During the past decade Israel invested around US$10 billion in improving highway infrastructure, especially for commercial traffic, and today it meets European standards for kilometre/square kilometre ratio (Haaretz, 21.8.01). However, investment is still relatively low by Western standards and does not exceed 1 percent of the GDP.

Israel has thousands of kilometres of highways, all of them free for use, with the exception of the country’s first toll road, the new Trans-Israel Highway 6 project. Today the central 90-kilometer section of this highway connects Gedera in the south with Hadera in the north, but the plan is to extend it to cover the full length of the country. The new highway significantly cuts travel time from the south to the north, therefore improving efficiency of transportation while also reducing freight costs.
2. **Ports**

Some 97 percent of Israel’s trade passes through sea ports, mainly Haifa and Ashdod. All three Israeli ports – Eilat, Ashdod and Haifa – are owned by the Israel Ports and Railways Authority and as a result operate very inefficiently. The average layover time per ship is estimated at 4 hours in Haifa and 18.4 hours in Ashdod, as compared to only minutes in Europe and one day in Greece (The Ports and Railways Authority of Israel, Annual Report, 2001).

However, the main problem of Israeli ports is not the long layover time, but frequent strikes. Port workers are highly unionised and prolonged strikes are very common, resulting in a blockage of the country’s international trade. However, one of the current government’s principal reforms is the reform of ports, with an aim to increase their efficiency and prevent strikes. The reform aims to create a more competitive environment between the three ports and make them more responsive to their customers.

Pursuant to legislation enacted in July 2004, the organisational reform of the Israeli port system came into effect at the beginning of 2005. As the first step the Ports and Railways Authority ceased its operations and was replaced by four government owned companies. Each of these companies will be responsible for development and maintenance of the breakwaters, port access channel and water depths within the port basin. The second step was the signing of agreements with all the unions, ensuring that over the next five year period there will be no strikes. During this period the government intends to sell up to 15 percent of its shares in the operating companies and over the next 10 years it plans an additional sale of up to 49 percent of its current stake.

3. **Airports**

In 2004 Israel completed one of its most ambitious projects: the construction and opening of the new Terminal 3 at Ben Gurion International Airport, the only airport relevant to exports and imports. The new, modern infrastructure helped increase the volume of cargo, which reached 332,000 tons in 2004, an 8% rise in comparison to 2003 (Ministry of Transport). Two Israeli airlines, 40 foreign airlines and a further 50 foreign charter companies operate in the market.
Internal flights are operated by two local companies, Arkia and Israir, but they are designated for passengers only and do not convey goods.

C. **Network Industries and Services**

Services have been the most dynamic sector of the Israeli economy, with the economy making a gradual shift over the last 15 years away from agriculture and manufacturing and towards services. The overall growth of the sector was underpinned by the rapid expansion of activities in the area of personal, finance and business services. Improvement in the geo-political situation also facilitated the development of the tourism sector.

**Figure 16:**

![Chart: Foreign Trade In Services ($ billion)](image)

*Source: Central Bureau of Statistics (Balance of Payments)*

Developments in the service sector mainly reflect the successful privatisation process, which has improved the private sector environment and, along with the high level of Israel’s human capital, made it friendlier to foreign investors. The second cause of the shift from agriculture and manufacturing to services is a lack of natural resources and scarcity of water and land (Herman, 2005).

Barriers preventing foreign firms from entering the local service market are largely being removed, especially in the telecom and finance sectors. Israel’s commitments in its GATS schedule, which covers a wide range of services, provide legal security for market access in the form of assurances not to increase the level of restrictions covered by the Schedule (WTO, 1999).

Today services account for over 70 percent of Israeli GDP and over 70 percent
of the labour force is employed in various service-related sectors, such as information, telecom, tourism and financial services. Israel’s foreign trade in services represents almost 1 percent of total world trade in services (Herman, 2005).

Figure 17:

![Distribution of Services Labour Force (2003)](image)

Source: FICC

1. **Telecom**

Israel’s telecommunications sector is one of its major export sectors. In many segments of the telecommunications market, Israeli products and services rank among the most advanced in the world. Telecom is also one of the main growth engines of the Israeli economy – between 1998 and 2002 telecom exports grew by 83 percent to US$2.93 billion (Israel Export Institute).

This very advanced sector attracts one-third of total FDI in Israel, with leading multinationals like BellSouth, France Telecom and Hutchison Hong Kong already having invested in the local market. At present there are four cellular service providers, six international call service providers and 75 Internet and broadband service providers.

However, the telecom market was not always as advanced and open to competition as it is today. The new reality is mainly due to a vast reform of the telecom services market, which is still ongoing.

The reform began in 1984 with a separation of regulatory and operational functions. All telecom facilities were transferred to the newly established Bezeq, which was granted a monopoly for the provision of telecom services.
Bezeq operates 3.1 million direct exchange lines. While it is not the largest of its kind in the Middle East, the infrastructure is the most superior (Ministry of Communication). Israel has a 100% digital network with most of its equipment supplied by local vendors. The penetration rate is over 95 percent and the home-pass exceeds 99 percent.

The second phase began in 1994, when Bezeq was required to establish subsidiary companies in order to provide services in additional market sectors, such as international (Bezeq International) and cellular (Pelephone) calls. By the end of 1994 the cellular market became the first competitive telecom market after Cellcom, another operator, received its license. By the end of 2001, after Partner and Mirs also entered the cellular communications field it became an extremely competitive one, which today is characterised by very low prices allowing high penetration. Israel bypassed even Finland in terms of the penetration rate. It ranks first in the world with a penetration rate higher than 100 percent, meaning that some people have more than one subscription. Another factor for high penetration is introduction of calling party pay methods: in contrast to most countries only the calling party pays, and not the receiving one. At the beginning of 2005 3G services were launched.

**Figure 18:**

![Annual growth in cellular telephone subscribers in Israel](image)

Source: Ministry of Communication (own elaboration)

Competition is growing equally fast in the international calls segment too. It first started in 1997 when Barak and Golden Lines were licensed by the Ministry of Communication to begin operation. During 2004 the Ministry awarded three more international telephony licenses to Internet Zahav,
Netvision and Xphone. As a result prices fell sharply from more than 1 shekel per minute during the 1990s, to about 0.2-0.4 shekel per minute in 2005, among the lowest in the world.

Figure 19:

**Decrease in Consumer Prices of Long Distance Calls ($)**

- USA: 0.98 → 0.17
- Japan: 1.2 → 0.24
- Western Europe AVG.: 0.87 → 0.2

*Source: Ministry of Communication*

Another aspect of the reform was the licensing in 1997 of a DBS satellite TV service provider to compete with the existing cable corporations in the multi-channel broadcasting market. The DBS service provider commenced operations in 2000 and today also competes with cable companies in the broadband Internet. Moreover, since the beginning of 2005 cable companies may also provide voice telephony services (Ministry of Communication).

The broadband service in Israel, via Cable Modem or ADSL, has a home-pass rate of 99 percent, and penetration rate of 43 percent of households, one of the highest in the world. Internet services are provided by five major and 70 smaller companies, which serve more than two million users, including 55 percent of households and 75 percent of businesses (Ministry of Communication). Broadband penetration is relatively high with 600,000 ADSL subscribers and 320,000 cable modem subscribers as of October 2004. The growth rate is high and reached 50 percent through 2004.

The highlight of the reform was completed in May 2005 with the full privatisation of Bezeq. The remaining 30 percent stake belonging to the State was sold to a private company controlled by former Israeli Haim Saban, and
Bezeq is expected to undergo a process of increasing efficiency with prices for local calls ultimately being slashed.

Israel fully participated in the WTO telecommunications services negotiations and has committed itself to an open, competitive and transparent telecom industry. Israel has signed bilateral agreements with 24 countries and an additional six are currently in various stages of negotiations.

2. **Financial Services**

Historically financial services have been highly concentrated, but since the 1980s significant reforms have been implemented by the government in order to render the Israeli financial sector more open and competitive. The balance of the financial sector (banks, insurance, provident funds and pension funds) was US$1.25 trillion by the end of 2003, 2.5 times higher than the GDP. The financial sector includes 200 institutions, but the bulk of activity is concentrated in five banking groups and five insurance groups and pension funds, which until recently were government owned (Haaretz, 1.7.2004).

The government reformed the pension funds system during 2003, moving them away from union control to temporary management by the Ministry of Finance.

After the pension funds reform, the most challenging task in the financial services sector is reforming the banking system. This system may be characterised as an oligopolistic one, in which the two largest banks (Hapoalim and Leumi) control 60.4 percent of total banking assets and the three largest banking groups hold 76.6 percent of the assets (Banks Supervision, 2000). Comparative research shows that the concentration in the Israeli banking system is among the highest in the world.


Table 3: Banking System Indicators

<table>
<thead>
<tr>
<th>Country</th>
<th>Population Per Bank (Thousands)</th>
<th>Concentration (Share of 3 Large Banks)</th>
<th>Private Credit by Deposit Money Banks to GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>140</td>
<td>0.75</td>
<td>0.98</td>
</tr>
<tr>
<td>Belgium</td>
<td>67</td>
<td>0.83</td>
<td>0.65</td>
</tr>
<tr>
<td>Denmark</td>
<td>46</td>
<td>0.75</td>
<td>0.31</td>
</tr>
<tr>
<td>Finland</td>
<td>361</td>
<td>0.98</td>
<td>0.55</td>
</tr>
<tr>
<td>Greece</td>
<td>252</td>
<td>0.83</td>
<td>0.22</td>
</tr>
<tr>
<td>Ireland</td>
<td>83</td>
<td>0.67</td>
<td>0.32</td>
</tr>
<tr>
<td>Israel</td>
<td>260</td>
<td>0.77</td>
<td>0.71</td>
</tr>
<tr>
<td>New Zealand</td>
<td>235</td>
<td>0.59</td>
<td>0.94</td>
</tr>
<tr>
<td>Portugal</td>
<td>235</td>
<td>0.50</td>
<td>0.63</td>
</tr>
<tr>
<td>Sweden</td>
<td>260</td>
<td>0.83</td>
<td>0.38</td>
</tr>
</tbody>
</table>

Source: Ber and Wachtel (2000)

One of the major characteristics distinguishing the Israeli banking system from other countries is the relatively small involvement of foreign banks. Another characteristic, which has been slowly changing over the last two years, is the lack of competition from non-bank financial intermediaries and capital markets. Competition among institutional investors, pension funds, insurance companies and others is less intense in Israel than in many developed countries (Ber and Wachtel, 2000).

The current situation is problematic for Israel, an emerging market, where banks are particularly important, and non-bank financial institutions are less well developed (Ber and Wachtel, 2000). However, it is important to take into account that small economies usually tend to have concentrated banking systems due to economies of scale. For many observers, the high concentration of the Israeli banking system is not “a problem” to be solved, but a necessity. At the same time a comparison with other small-economies like Belgium, Greece or Portugal shows that the Israeli banking system is twice as concentrated as in those three countries (Ministry of Finance).

However, the main development in the banking sector is the Bachar reform, aimed at resolving the issue of concentration in the credit market and lack of competition in the capital market. The key recommendation of the committee was to remove ownership of provident and mutual funds from the banks and
sell them to local and foreign private brokers and insurance companies. Over the next four years the reform should be implemented, allowing foreign investment firms to launch activities in Israel, as some of them are already doing currently in the wake of the reform.

The insurance sector is also concentrated within the two largest groups, Clal and Migdal, which together control half of the assets, and the five largest groups holding 84 percent of total assets. In life insurance the concentration is even higher and the five largest groups together hold 95 percent of the premiums (Haaretz, 1.7.2004). The planned Bachar reform addresses this issue by giving the banking system license to market insurance policies at branches. The planned sale of the provident and mutual funds together with the pension funds reform is already beginning to attract foreign firms to invest in the Israeli insurance sector. The only international firm to operate in the local insurance market hitherto was AIG.

3. **Electricity**

The electricity system in Israel is operated by the Israel Electric Corporation (IEC), a government owned company which supplies over 99 percent of electricity consumed nationwide. The company was established in 1923 during the British Mandate and was nationalised by the Israeli government in 1953. Presently the IEC operates under the Electricity Sector Law passed by the Knesset (the Israeli Parliament) in 1996, after the previous exclusive right for transmission, sale and distribution expired. The new law extended the IEC monopoly for a further 10 years, pushing back a long planned reform to 2006.

Today the IEC is one of the most inefficient electric companies in the Western world in terms of employees, return on capital and ratio of labour costs to revenues (Borochov, 1999).
Table 4: Comparison of Selected European Electric Companies

<table>
<thead>
<tr>
<th>State Type of control</th>
<th>Labour costs to total revenue ratio</th>
<th>Return on capital (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEZ Czech Republic</td>
<td>6.3</td>
<td>11.5</td>
</tr>
<tr>
<td>VERBUND Austria Public</td>
<td>27.3</td>
<td>26</td>
</tr>
<tr>
<td>ENDESA Spain Public</td>
<td>10.5</td>
<td>9.3</td>
</tr>
<tr>
<td>IEC Israel Government</td>
<td>24</td>
<td>0.23</td>
</tr>
<tr>
<td>N.POWER Britain Public</td>
<td>-</td>
<td>30</td>
</tr>
</tbody>
</table>

Source: Borochov

The total installed capacity of the generating system reached 10.1 MW by the end of 2003 and is forecast to rise to 13.4 MW by 2010 (Ministry of National Infrastructures). Total consumption during 2004 increased 4 percent to 9.5 MW, while over the past decade consumption doubled, mostly due to the growth in the household sector (Ministry of National Infrastructures). The sharp rise is due to the influx of nearly one million immigrants over the same period and an improvement in living standards.

Contrary to electricity companies in many countries, Israel's supply system is isolated from those of neighbouring countries. Israel has expressed an interest in the idea of a regional power network, a step aimed to save capital expenditure and enable individual power companies to take advantage of differences in peak demand periods. Recently, talks on the issue were held with Jordan, but the project was put on hold following political pressures (www.worldenergy.org). The IEC, protected by its local monopolistic status, never tried to compete for tenders in Eastern Europe, Asia and Africa, missing the opportunity to expand its activities.

For the past decade the Israeli government has been trying to make a move towards opening up the electricity market to competition; however such efforts are often blocked by powerful unions, which represent 10,000 IEC employees. The first move was made in 1995, when the government decided to open up electricity production to limited competition from private producers of up to 10 percent of IEC’s total production, and to the purchase of up to 10 percent from foreign producers such as Egypt (Borochov, 1999). Despite the decision, production of electricity by private bodies has not actually started and imports
have not progressed. The second step came in 1999 when the Inter-ministerial Committee for the Development of the Future Structure of the Electricity Market was established by the government. The new market structure should be implemented as of 2006, after consultation with international research companies.

The current plan, which has been passed under the “restructuring law” of 2003 is to separate the IEC into three subsidiary companies, each one to focus on different segments of the supply chain, i.e. generation, transmission and distribution. From 2006-2012 generation will be separated into 3-4 companies and privatised. At the same time distribution and supply will be split into 4-5 companies. The transmission division will remain under government control. Research conducted recently by the Bank of Israel indicates that the planned reform in general resembles reforms carried out in many other countries, although in this case the schedule is more cautious and slower (The Marker, 21.4.2005). By the end of 2012, IEC should control only 30 percent of the electricity system.

Once the reform has taken place, private producers will be allowed to build power plants and to sell electricity directly to end users and not to the IEC. Following the implementation of the reform it is reasonable to assume that foreign electricity companies will consider entering the Israeli market, especially regional ones.

4. Civil Aviation

The civil aviation market remains one the most problematic in terms of competition for local companies as well as for foreign ones. The leading company is El Al, which until 2004 was State-owned and defined as the “national carrier”. Two significantly smaller Israeli companies also operate – Arkia and Israir. The Israeli market is open to free operation of foreign airlines, but de facto there are many restrictions and limitations on their operation. All airlines carrying passengers to and from Israel must comply with regulations of the Israeli Civil Aviation Administration, which tends to protect the interests of El Al (Haaretz, 10.12.2003).

El Al enjoys a clear monopolistic status in the Israeli aviation market, with a growing market share of 40 percent in 2004, up from 38.4 percent in 2000. In
2003 the Israeli government completed El Al’s privatisation through an IPO of its shares in the Tel Aviv stock market. Although the IPO was considered a great success, it did not reach its main goal of diversifying control in the company. The Borovitch Group bought most of the shares and today holds 52 percent of El Al, which has 5,400 employees.

In spite of expectations that the privatisation would enhance competition in the market, El Al merely became a privately-owned monopoly instead of a State-owned one (Haaretz, 19.12.2004). Even as a private company El Al continues to enjoy “national carrier” status, in that all State employees are obliged to fly El Al. The Civil Aviation Administration continues to protect El Al from competition from foreign airlines. For example, when Lufthansa tried in 2004 to increase the number of seats on its flight from Tel Aviv to Frankfurt, it encountered heavy opposition by the CAA, which prevented this happening. After intervention by the Anti-Trust authorities the issue was resolved, but only temporarily. This was not the first case when the CAA tried to protect El Al from competition – the same happened with Air Canada in 2000 and again with Lufthansa in the 1990s.

During the 2003 El Al privatisation process the Israeli government retreated from its previous plan for an “open sky” policy, which allows any airline to compete freely in the market. The main reason for this, as frequently stated by Israeli officials, is the fragile geo-political situation. Contrary to most countries that enjoy as attractive a location as Israel, connecting Europe with Asia, Israel is as yet unable to become an international hub and this is the main reason given for protecting of the local market for El Al.

Such protection also harms the tourist influx to Israel since the newer, budget priced airlines like EasyJet and RyanAir have not entered the local market. However, in this case protection is not the only reason; the geo-political situation also plays a significant role. Both of those airlines place Israel in an inferior position in comparison to neighbours like Greece and Cyprus.

V. Trade and Competition Policy

A. Structure and Sustainability of the Current Account

Israel has a long history of large current account deficits, which peaked in
1996 with a deficit of US$5.4 billion (HSBC, 2004). By the end of 1998 the current account deficit was reduced to US$1.2 billion, due to a tightening of fiscal policy, a general economic slowdown and more favourable trade terms as a result of new Free Trade Area Agreements signed by Israel with third countries.

Because of the Israeli economy’s high degree of openness, the current account is very volatile and fluctuates with every shift in the global economy. For example, the year 2000 was one of the best for Israel’s economy due to the high demand for high-tech exports, in which Israel specialises, and the deficit contracted to US$671 million. In 2001, following the global recession, the current deficit widened sharply to US$1.8 billion. At the same time there are factors acting to reduce external vulnerability, such as, for instance, high national reserves that reached US$26 billion by the end of 2004, loan guarantees from the US and substantial holdings of foreign assets.

However, despite a long period of account deficits, Israel managed to switch to a surplus of US$0.5 billion in 2004. In the first quarter of 2005 the surplus grew to US$531 million, more than double the level of the previous year, as the trade gap narrowed (Bloomberg, 16.6.2005). The first three months of 2005 marked the sixth straight quarter of current account surpluses. The trade deficit in goods and services narrowed to US$28 million, down significantly from US$353 million in the first quarter of 2004 (Bank of Israel).

**Figure 20:**

![Current Account, 1993-2004](chart.png)

*Source: Bank of Israel*

Among the main reasons for the continuing surplus are the recovery in global demand for high-tech exports and a sharp improvement in service exports.
The improved security situation has led to a recovery in tourism with tourist arrivals rising 25 percent since the beginning of 2005.

Another important factor for the improvement of the current account is the depreciation of the shekel over the past four years. The depreciation, which peaked in winter 2002 with the dollar reaching a record of almost five shekels, improves the terms of competition for Israeli exporters in foreign markets. Due to that fact, the share of traded goods in the balance of payments expanded 18 percent during 2004, higher than in 2000 and faster than the growth of the services share in the balance of payments (Bank of Israel, 2004).

An additional factor is FDI and portfolio investment. For the past two years the Israeli stock market performed very well, mainly due to the vast economic reforms and privatisation. The reforms, as well as the improved geo-political situation, have attracted foreign investment and the strength of the stock and bonds markets (especially in comparison with other emerging markets) attracts portfolio investment. These factors have had a favourable effect on Israel’s current account since 1993, with the beginning of the peace process, but until 2004 the capital influx managed only to offset the deficit. In 2003 the financial account deficit narrowed by 93 percent to US$126 million and the trend continued with the influx of foreign capital reaching US$6.6 (Bank of Israel, 2004).

B. Terms of Trade Evolution and Exchange Regime Choice

The exchange rate system did not elude the wave of reforms in Israel and actually was one of the first to be reformed following the opening of the economy to imports in 1991. In 1993 Israel accepted the obligations of Article VII of the IMF’s Articles of Agreement, removing all remaining constraints on current account transactions. Within the framework of the liberalisation policy, at the end of the 1980s a process of gradually removing restrictions on capital flows was also set in motion, allowing the foreign exchange regime to become more flexible. The Israeli currency – the shekel – became close to being fully convertible in 1998 and since then the government has rarely intervened in foreign currency trading.

The currency rate is affected mostly by the political situation and security issues, as well as by capital inflows. Since the Bank of Israel ceased to
intervene in the foreign exchange market by buying or selling foreign currency, exporters feel less protected that they used to be during the 1990s, when the government adhered to their interests. However, despite the fact that the Bank of Israel committed itself officially to inflation rate targets, implying appreciation of the shekel, the Ministry of Finance seeks growth, implying depreciation of the shekel to increase exports. This sometimes causes policy clashes and it can be stated that today exporters act in a more uncertain environment than in the past.

C. Labour Costs, Management and the Determinants of Comparative Advantage

Over the past decade the Israeli economy has continued to shift away from agriculture and manufacturing towards services. This process is occurring mostly due to investment in education, with the purpose of nurturing highly skilled workers for the high-tech industry and service sector, contrary to the early 20th century Zionist ethos of working the land. About 40 percent of the Israeli population over the age of 15 has university qualifications or other advanced degrees. More than one quarter of the work force is composed of scientific, academic or other professionals or technical and related workforce, and 5% consist of administrative or managerial workers. Israel is in third place in the industrialised world behind the USA and the Netherlands for its percentage of degree holders.

The development of a vibrant high-tech industry originates in the complex geo-political situation in Israel and its location, which led to increased investment in army-related industries based on technologies developed by intelligence forces and the Air Force. The high-tech sector is one of the central engines behind the growth of hired worker numbers in Israel over the last 30 years and one fifth of the total growth between 1975 and 1999 (De Fontenay and Carmel, 2004). The total number of hired workers increased by 11.5 percent during that period, while in the high-tech sector the increase was much sharper and reached 41 percent. In comparison to other countries the leverage of Israel’s comparative advantage can be easily seen: 6.2 percent of total employed people worked in the high-tech industry, as compared to 3.5 percent in the US, 4.5 percent in Switzerland, 3.1 percent in Japan and 4.1 percent in Ireland.
Israel also enjoys the highest ratio of scientists and engineers in the world - 135 per 10,000 persons, as compared to 85 per 10,000 in the US in 2001.
Another factor is the influx of almost one million immigrants from the former
USSR at the beginning of the 1990s, most of them educated and highly skilled.
Such a large influx of immigrants provided additional flexibility in the labour
market, together with greater opportunities for investment.

Today the services sector employs 70 percent of the labour force, almost four
times more than manufacturing. The fastest growing sub-sectors are personal
services, business services and financial services, reflecting Israel's highly
educated workforce. Another factor affecting the services sector is the
privatisation and deregulation of the service sector, which has improved the
service environment and created new jobs.

The share of manufacturing in the economy has been declining since the
1970s, when it reached 24.4 percent, to 18.4 percent in 1999 and less than 15
percent today (De Fontenay and Carmel, 2004). Average manufacturing labour
costs in Israel are relatively high, especially when compared to its geographical
region, as illustrated in the table below, denying Israel any comparative
advantage in labour-intensive production.
Table 5: Average Manufacturing Labour Cost per Hour for Selected Countries

<table>
<thead>
<tr>
<th>(a) Country</th>
<th>(b) Labour cost per hour</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>US$16.69</td>
</tr>
<tr>
<td>Germany</td>
<td>US$16.68</td>
</tr>
<tr>
<td>USA</td>
<td>US$12.96</td>
</tr>
<tr>
<td>UK</td>
<td>US$9.5</td>
</tr>
<tr>
<td>Israel</td>
<td>US$8.44</td>
</tr>
<tr>
<td>France</td>
<td>US$6.91</td>
</tr>
<tr>
<td>Cyprus</td>
<td>US$4.59</td>
</tr>
<tr>
<td>Bahrain</td>
<td>US$1.40</td>
</tr>
<tr>
<td>Jordan</td>
<td>US$0.90</td>
</tr>
</tbody>
</table>

*Source: United States Bureau of Labour Statistics (2003)*

The manufacturing and agricultural sectors employ mostly foreign workers in order to reduce labour costs and to enable traditionally successful sub-sectors like flowers and exotic fruits to compete in the global market⁴.

D. Technological Content of Exports and Capacity to Respond to the International Demand Evolution

Since the establishment of the State of Israel, the local economy has been transformed from a largely agriculture based one to a high-tech powerhouse. While the traditionally predominant sector of exports, diamonds, remains strong, high-tech became the main source of exports, contributing a record 36 percent to GDP growth in 2000. Israel specialises mostly in the export of software, telecommunication equipment, Internet products and medical devices. Such diversity, which is considered relatively high as compared to other emerging information technology clusters as India, Taiwan and Ireland, makes Israel more resilient to international demand fluctuations.

⁴ For more information on the labour market refer to the “Labour and Human Resources Developments” chapter (V).
However, and contrary to more stable demand sectors as agriculture or diamonds, relying chiefly on high-tech exposes Israel to greater shocks. The high-tech sector is influenced by world demand, which tends to fluctuate depending upon the situation on Wall Street. When the world boom in finance and technology in the 1990s came to an end in 2001, the Israeli high-tech industry suffered a sharp slump. Some 500 technology firms were closed down and 11,000 employees were laid off (De Fontenay and Carmel, 2004). By 2002 the Israeli economy plunged into a strong recession, mainly due to the technology downturn, but also partly due to internal causes such as the outbreak of the second Intifada.

At the same time, heavy investment in research and development (R&D) by Israeli firms, supported also by the government Office of the Chief Scientist, enables a quick response to changes in international demand. Israel invests 5% of its GDP in R&D, the highest rate of R&D investment in the world (Ministry of Industry, Trade and Labour). The OCS, established in 1975, selects projects focused on development of new products and technologies and funds up to 50 percent of the budget (De Fontenay and Carmel, 2004).

Given Israel’s location, distance from most of its markets has driven the industry to specialise in more sophisticated products, which require relatively little support activity. Thus, in these markets Israeli firms can compete on more equal terms with local firms in the countries in question.
VI. Recommendations

The main recommendations are inspired by the strategy spelled out in the introductory chapter.

Economically, Israel must try to put an end as soon as possible to its status of a far-away island economy (a “backwater”). This will allow her to use land transport (road, rail and pipeline) to reach distant markets in Europe, Asia and Africa or to be supplied from there. Normalization of trade relations with the neighbours is a must, but even more rewarding would be normalization with Gulf countries. On the other hand, preferential trade agreements with the neighbours should be prevented from emerging, as this would imply discriminating in favour of Arab countries in the Israeli local market against other developing economies with the implied cost of trade diversion which the 1991 unilateral trade liberalization strategy was trying to prevent. On the other hand getting preferential access into Arab economies is not to be recommended because the political costs implied by such a move are not worthwhile the economic benefits of accessing to small markets. An indirect proof of the precedent is the animosity that such a trade regime has left in the Palestinian Authority.

Much more positive is to link some Israeli labour-intensive declining sectors to the corresponding sectors based in neighbouring economies via the use of the QIZ trade regime. This opens up very rewarding possibilities for Israel to otherwise condemned activities by shifting labour-intensive operations across the border and by making capital of duty-free market access into the US and hopefully very soon into the EU (which is exploring the feasibility of such schemes at present). The textile sector is only one example. Jordan and Egypt are already benefiting from the QIZ regime but Israel should keep in mind for when peace arrives countries such as Syria, Lebanon, the PA and even far-away ones, such as Tunisia or Yemen.

For a centrally-located country between Europe and Asia, an open-sky policy seems to be a must. Here the conflict is the excuse used now for not considering it seriously, as the continuous existence of a viable national carrier is considered vital by the defence establishment. And if Israel is going to play its logistical comparative advantage, the completion of the privatization of the three existing ports, leading to more competitive structures, is also of
critical importance.

Finally the transformation of Israel into a service-based economy requires from its authorities to deepen its trade agreements with the EU and the US to include not only goods but commercial services, including GATS- Mode 4 ones. This is realistic to contemplate, because contrary to other emerging economies, Israel is considered by the US and the EU as a high-wage economy. Therefore the syndrome of the “Polish plumber”, very much in vogue in France at present, should be muted in the case of Israel. In particular Israel should grab with both hands the offer being made since 2003 by the EU of “having a stake in the Internal Market” in the context of the new European Neighbourhood Policy (the so-called ENP) and even suggest membership in the European Economic Area. For Israel, the status contemplated for her a decade ago (November 1995) in the context of the Euro-Mediterranean Partnership (the EMP or the so-called Barcelona Process) is not suitable anymore.
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VIII. Appendix

Appendix 1: Israel’s Net of Bilateral Trade and Economic Agreements

<table>
<thead>
<tr>
<th>Free Trade Area Agreements</th>
<th>MFN Trade Agreements with non-WTO Countries</th>
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<th>Avoidance of Double Taxation</th>
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CHAPTER II : FISCAL POLICY ISSUES

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Table 6: Selected State Owned Companies
I. STRUCTURE OF INTERACTION BETWEEN THE DIFFERENT ENTITIES

The Ministry of Finance is the principal economic ministry of the Government of Israel. It is in charge of the preparation and execution of the government's overall economic policy. In consideration of this, the Ministry plans the draft State Budget and supervises implementation of the approved budget, manages State revenues and collects direct and indirect taxes, promotes foreign direct investment and conducts the government's economic relations with the government of the United States, amongst other countries, regulates the capital market, savings, and insurance, and maintains auxiliary units for government ministries in motor vehicles, computer services, printing and publications.

The head office also has three staff units: The Economic Research Division, The State Revenue Administration and The Legal Advisor’s Unit, and is responsible for the following areas of activity: personal compensation, persons disabled by Nazi persecution and persons disabled in war against the Nazis, retirement pensions, absentee properties, and international relations.

The units of the Ministry of Finance may be categorised by the three types of service they provide: government staff services, general economic staff services, and auxiliary services for government ministries.

Government staff services are departments that facilitate government units and operations: budgeting of government operations (Budget Department) and operations of the Accountant General, including supervising and auditing the individual ministers’ accountants.

Economic staff services are departments that act in matters pertaining to the economy at large: handling and attracting foreign direct investment (Investment Authority), regulation of the capital market, insurance and savings (Capital Market, Insurance, and Savings Department). The Income Tax and Property Tax Department implements the Income Tax and Property Tax ordinances; the Customs and Value Added Tax Department collects indirect taxes (those pertaining to imports, domestic manufacture and added value). The last two departments recently merged into a single entity.

Auxiliary services for government ministries include motor vehicle services (Government Vehicle Administration), computer services for the tax
departments (Computer Service), and printing (the Government Printer, a business enterprise owned by the Ministry of Finance).

II. TAX POLICY MEASURES

The following reviews the five basic principles of Israel’s tax policy and the way they were applied in 2003–2004.

A. Lowering Tax Rates

Lowering tax rates is a strong constraint in a global environment where countries compete for capital, know-how and high-quality human resources. The tax rates in Israel are high in relation to the standard in developed Western nations. An elevated tax rate on labour incomes serves to lower the incentive to seek gainful employment and is detrimental to the economy’s growth potential. In the past two years Israel reduced many tax rates—personal and corporate income tax, VAT, and purchase tax — and restored the ceiling on National Insurance contributions that was revoked in July 2002. It also enlarged the tax base on revenues from capital and revenues originating from abroad. The path created by the recent legislation will reduce taxes by NIS\(^5\) 10.8 billion in 2003–2007 in net terms, i.e. after the reduction of some tax expenditures and other tax increases. Most of the reduction will pertain to taxes on labour. Within the framework of the tax reform, the maximum tax rate on wages has been cut from 60 percent to 49 percent, and corporate tax will be gradually be cut from 36 percent to 30 percent.

B. Promoting Principles of Social Justice

The tax cuts are made in a manner that upholds principles of social justice. In 2004 several important steps toward this goal were taken. In particular, the ongoing personal income tax reform focused the entire tax cut (NIS 2.2 billion) on low and medium income earners. The reform raised the income tax threshold significantly, from taxable income of NIS 3,000 per month to NIS 4,000. This has made 300,000 workers who were previously liable to income tax fully exempt.

\(^5\) New Israeli Shekel, i.e. the local currency. In 2004, 4.53 NIS per 1US$. 

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C. **Broadening the Tax Base**

Tax benefits in 2005—according to the 2005 State budget proposal—are projected at NIS 24.3 billion, 15 percent State tax revenues and 4.4 percent of GDP. The benefits are distributed among various kinds of taxes—NIS 20.8 billion in income tax and real estate taxes, NIS 3.4 billion in customs and VAT, and NIS 0.1 billion in fees. The total tax benefits for 2005 are projected to be NIS 7 billion less than the 2002 level. NIS 4.1 billion of the decrease originates in measures taken in 2003–2004 to broaden the tax base; the rest comes from measures that the government included in the 2005 Economic Arrangements Law. The 2005 budget includes elimination of various tax exemptions (such as eliminating the VAT exemption in Eilat). If these measures are not applied, it will be necessary to find alternative sources in order to maintain the level of tax revenues intended. The IMF recommends this should be done by abolishing exemptions and not by raising tax rates. It is essential to continue broadening the tax base by eliminating exemptions in order to move ahead with the process of lowering tax rates and adjusting the Israeli tax system to the era of globalisation without infringing on the principles of social justice.

D. **Making the Tax System More Efficient**

In 2003-2004, actions to make the tax system more efficient were taken at two levels: legislative changes to reduce the variance in tax rates and a change in the tax administration that focused on merging the tax divisions into one administration. The tax reform had the effect of lowering marginal rates by up to 13 percentage points in some tax brackets, reducing the weighted marginal tax rate by nearly 6 percent and the average income tax rate by nearly 5 percent. This significant decrease is expected to have a positive effect on the incentive to labour. The elimination of tax discrimination against foreign securities relative to domestic ones, which went into effect at the beginning of 2005, will also make the tax system more neutral and efficient.

The Income and Property tax division and the Customs and VAT division were merged into the single Israel Tax Authority. This measure, a strategic structural change in the field of tax management, is designed to make the collection system more efficient and to intensify tax collection. The outcomes, in turn, will enable further reduction of tax rates.
E. Lowering the Tax Burden

The disparity in tax burden between Israel and the OECD countries has been narrowing perceptibly over the years—from 14 percent of GDP on average in 1970–1988 to half that level, only 7 percent of GDP, in 1989–2003. Israel’s tax burden in 2003 was 38.5 percent of GDP, 1 percent of GDP less than in 2002 and 1.6 percent less than the previous peak in 2000. The sharp decrease was caused by the economic recession that began in the last quarter of 2000 and lasted until the middle of 2003, which occurred even though the government took policy actions in 2002 to raise tax rates. According to estimates, the tax burden continued to decline in 2004, to 38.4 percent of GDP. This time, the decrease was due to tax cuts as mentioned previously.

Although the disparity between Israel’s tax burden and that of the OECD has narrowed, by international standards Israel still has a heavy tax burden. In 2003, the GDP-weighted tax burden in OECD countries was 31.5 percent, 7 percent of GDP lower than Israel’s. The tax burden in some OECD countries has fallen over the past three years, especially in the United States, where the decline was from 30 percent of GDP to 25.4 percent. Another noteworthy fact is the low tax burden in countries with which Israel competes to attract investments, such as Ireland and Singapore.

III. REDUCING THE TAX BURDEN

These findings lend backing to the current tax policy, which urges continued efforts to gradually lower the tax burden as a percent of GDP. Application of this policy will continue in 2005. By year’s end, the net effect of legislative changes will be a decrease of 0.4 percent of GDP in the central government tax burden. The current year marks the middle of a five-year period (2003–2007) during which legislative changes will lower the central government tax burden by 1.5 percent of GDP and the burden of National Insurance contributions by 0.6 percent of GDP (both in net cumulative terms), for a total of 2.1 percent of GDP.

Starting January 1, 2005, the maximum total tax rate in Israel, including income tax, health tax, and employee’s National Insurance contribution was estimated at 49 percent, as against 60 percent two years ago, due to implementation of the current phase of the Rabinovitch tax reform that began in 2003. When Benjamin Netanyahu became Minister of Finance, he stated that he had no intention of changing the Rabinovitch Committee
recommendations, which were formulated before he took office, or of impeding their implementation. In fact, he implemented them more quickly than had been planned. Netanyahu also said that if the state proved to have surplus revenues, he would pledge to tax cuts beyond those recommended by the Rabinovitch Committee. However, even after the significant lowering of tax rates the maximum tax rate is still too high relative to the countries presented in the table, which have sustained growth for years. He did so in 2004⁶, against the recommendations of the IMF.

**Table 1: Highest Income Tax Rate in Advanced Countries (percent, 2004):**

<table>
<thead>
<tr>
<th>Country</th>
<th>Tax rate (%)</th>
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<tr>
<td>Israel (2005)</td>
<td>49%</td>
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<tr>
<td>USA</td>
<td>42%</td>
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<tr>
<td>Ireland</td>
<td>42%</td>
</tr>
<tr>
<td>UK</td>
<td>40%</td>
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<tr>
<td>Singapore</td>
<td>22%</td>
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</table>

The above-mentioned reform spread the tax brackets and lowered the marginal rate at all income levels. For example, a person who earns NIS⁷ 20,000 per month paid 50 percent marginal tax two years ago and as from 2005 is paying 39 percent. One who earns NIS 12,000 will pay 37 percent marginal tax from the beginning of 2005, as against 45 percent two years ago. Those who earn NIS 4,000 paid 20 percent marginal tax two years ago and will fall below the tax threshold in 2005, meaning that they will pay no income tax whatsoever.

The Ministry of Finance stresses its belief in the importance of tax cuts in stimulating growth. To ensure sustainable growth in the future, the trend should continue primarily in lowering taxes on labour. A study by the State Revenues Administration shows that the tax cut operated in recent years had a perceptible upward effect on the share of low and medium income earners in tax benefits awarded pursuant to the reform. The tax cuts in the past two years have raised the income tax threshold steeply, from NIS 3,000 per month to NIS 4,000. The exemption is intended to encourage labour force

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⁶ In July 2004, the personal income tax rates applying to low and middle wage earners were reduced, resulting in an increase of NIS 540 – NIS 1,170 in net income for those earning NIS 4,000 – NIS 10,000 per month. People in this income bracket will receive twice this sum in 2005 and subsequent years.
participation and increase the disposable income of low wage workers. Additionally, indirect taxes on a series of basic goods (durables and basic consumption goods) were lowered at the beginning of 2004. The cuts included a 5-30 percent reduction in purchase tax, a 5-12 percent reduction in customs, and lowering of the VAT rate to 16.5 percent from 18 percent. The purpose was to focus the tax cuts on low and medium-income groups. The following tables show the changes in tax brackets and rates between 2003 and 2005 and add up the increases in net income that will result from these measures.

Table 2: Tax Brackets in Israel 2003-2005

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<td>50%</td>
<td>20,100</td>
<td>+</td>
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<tr>
<td>Credit point value</td>
<td>181</td>
<td>Credit point value</td>
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</table>
Table 3: Added net income
(gross income less income tax) due to reduction of income tax rates and adjustment of tax brackets in January 2005 (for taxpayer with 2.25 credit points):

<table>
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<tr>
<th></th>
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<tbody>
<tr>
<td>4,000</td>
<td>15</td>
<td>194</td>
<td>4.90%</td>
</tr>
<tr>
<td>5,000</td>
<td>57</td>
<td>273</td>
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<tr>
<td>6,000</td>
<td>77</td>
<td>343</td>
<td>5.70%</td>
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<tr>
<td>7,000</td>
<td>97</td>
<td>413</td>
<td>5.90%</td>
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<tr>
<td>8,000</td>
<td>80</td>
<td>431</td>
<td>5.40%</td>
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<tr>
<td>9,000</td>
<td>60</td>
<td>411</td>
<td>4.60%</td>
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<tr>
<td>10,000</td>
<td>40</td>
<td>391</td>
<td>3.90%</td>
</tr>
<tr>
<td>15,000</td>
<td>262</td>
<td>718</td>
<td>4.80%</td>
</tr>
<tr>
<td>20,000</td>
<td>565</td>
<td>1,129</td>
<td>5.60%</td>
</tr>
<tr>
<td>25,000</td>
<td>865</td>
<td>1,679</td>
<td>6.70%</td>
</tr>
<tr>
<td>35,000</td>
<td>1,445</td>
<td>2,725</td>
<td>7.80%</td>
</tr>
</tbody>
</table>

Furthermore, in 2004, some tariffs were cut and import licensing requirements were reduced. Tariffs remain for certain goods, e.g. electronics, wood and agricultural products, but the authorities plan to reduce them further. Most trade is already covered by bilateral free trade agreements, and additional free trade agreements with neighbouring countries are under consideration.

As the Israel Tax Authority, a branch of the Finance Ministry, announced, the State collected NIS 146.7 billion in taxes last year, 4.9 percent more than the NIS 139.8 billion collected in 2003 (Jerusalem Post, 2005). Taking into account differences in timing and NIS 5 billion worth of tax cuts, tax revenues rose 8
percent in real terms. The authority pointed out that figures from the second half of 2004 indicated that growth slowed down relative to 2003.

Last year's growth in tax revenues resulted primarily from 21 percent growth in corporate income tax revenues, a 37 percent surge in land taxes collected, and a 55 percent rise in capital market fees collected. Direct taxation revenues as a whole rose 5.1 percent to NIS 80.1 billion from NIS 76.2 billion in 2003. That reflected a real increase of 8.4 percent, led by the above categories, despite reductions in other fields.

Income taxes collected from the self-employed sector dropped 2.8 percent to NIS 6.8 billion and revenue from taxes on employee wages fell 4 percent to NIS 40.9 billion. The amount of collected taxes returned to the public rose 4.2 percent to NIS 7.4 billion in 2004.

It should be stressed that in the course of the year, income taxes were reduced, including an emphasis on lowering taxes among the lowest strata (those with a monthly income of NIS 4,000 to NIS 10,000). At the same time, corporate tax was lowered to 35 percent, as part of a multi-year procedure, which will be completed in 2007, bringing the corporate tax to 30 percent. The growth in revenue from income tax is due in part to growth in revenue by 22.5 percent from corporate tax.

Revenues from indirect taxation rose 14.6 percent in 2004 - 7.3 percent in real terms - to NIS 66.5 billion, led by taxes on imports: revenues from import VAT rose 15 percent; 17 percent more purchase tax on imports was collected; and 15 percent more in customs was collected.

Total direct taxation as a percentage of GDP remained stable in 2004, rising to roughly 15.2 percent from the 15.1 percent level of 2003. This follows a significant drop from 16.2 percent in 2002, roughly 18 percent in both 2001 and 2000, and 16.7 percent in 1999. The recent improvement was attributed to both tax cuts and the recovery of the economy.

A similar trend was seen in taxation as a percentage of wages, which dropped to 20.3 percent in 2004 from 21.8 percent in 2003; 24.8 percent in 2002; 25.2 percent in 2001; and 23.8 percent in 2000. Total wages rose as a result of an increase in the number of jobs and a rise in the average wage, totaling roughly 3 percent. Alongside this, tax collection from wages fell, both as a result of the composition of the jobs and an increase in part-time positions paying low
wages, and due to tax reductions.

**IV. BUDGETARY EQUILIBRIUM: FRAGILITIES AND PERSPECTIVES**

In 2001-2003, the Israeli economy experienced a severe slowdown of activity. As a result, government tax collection slumped and, although government expenditure did not exceed its original limit, a severe budget deficit resulted and this led to a deviation from the downward path of the budget deficit as stipulated by law.

In 2001-2003, government debt to GDP increased as the Israeli economy experienced a severe slowdown of activity. This was contrary to the long term trend of a constant decrease in debt, a trend that characterised the Israeli economy from the stabilisation plan of 1985 up to the year 2000. Indeed, when one examines the development in the government debt to GDP ratio in the period 1987-2000, a considerable and fairly rapid decrease of about 5.1 percentage points per annum (on average) is found. This decrease was mainly due to the growth of the Israeli economy, but also to State revenues from privatisation and from the fiscal discipline that was maintained in spite of the many pressures and constraints.

The 2004 Budget proposal, which was approved by the government in September 2003, set a deficit-decreasing path according to which the government deficit in 2004 was forecast to be 4 percent of GDP and will be not be greater than 3 percent of GDP in 2005-2010. The 2005 budget is the first that is subject to the multi-year targets set by the government - a deficit ceiling of 3 percent of GDP and a real growth in expenditure of 1 percent in each year. As part of the formulation of the economic policy for 2004, it was resolved approximately a year ago that the Deficit Reduction Law would be amended and that this policy would be implemented in the 2005 budget. The government has displayed a commitment to these targets. The budgetary commitments that were made during the coalition negotiations that preceded approval of the budget did not lead to a deviation from the target, but came at the expense of other budget cuts, especially lateral cuts in the budgets of government ministries. However, in order to finance the disengagement plan it was decided to raise the deficit target in 2005 to 3.4 percent of GDP. The budget deficit in 2004 amounted to 3.9 percent of GDP, which was slightly less than the deficit ceiling. Because of the delays in approving the budget, during the first three months of this year the government operated on the basis of the
One of the key assumptions is that the government’s economic policy will continue to meet the objectives of the economic plan that was formulated in 2003 and that the budgetary policy will meet the expenditure and deficit targets for 2005. Economic policy in the past year constituted one of the building blocks for the positive turnaround in the growth of the Israeli economy. The continued ability to meet these objectives is highly important in fully realising the growth potential of the economy.

A continued responsible and determined economic policy, within the framework of the 2005 budget, which was only approved at the end of March 2005, is expected to have a positive effect on the growth of the economy in 2005 and over the next several years, through several channels:

The recent continued lowering of the current government expenditure (as a percentage of GDP) will enable the lowering of tax rates on individuals, thereby increasing disposable income and private consumption, as well as the participation rate in the workforce (as a result of the lowering of transfer payments).

Stable fiscal policy supports price stability, an expansionary monetary policy and the lowering of the economy’s risk premium.

The resolution of the pension and allowances problem serves to remove future threats regarding long term government expenditure, increasing the probability of lower public expenditure in the future and indirectly resulting in improved capital market efficiency.

The continued trend of privatisation of government owned companies will make their future operation more efficient and will guarantee a more efficient allocation of resources in the economy.

The strengthening of the trend of investments in infrastructures and large scale national projects will serve as a basis for the continued business development of the economy.

In line with the assumption regarding the ability to continue to meet economic objectives, the calculation takes into account the preservation of the expense framework for 2005, as stipulated by the “expenditure target” law, that serves to limit the real term growth in government expenditures (excluding the planned expenditure exception of 0.4 percent of the deficit resulting from the plan to disengage from the Gaza strip) to 1 percent in relation to the volume of government expenditure in the preceding budget year.

There is an assumption that government resolutions regarding the reduction in
the number of foreign workers and raising the cost of their employment will not be amended. There is a further assumption that the number of Palestinians working in Israel will not increase. These assumptions are crucial in the context of the forecasts for the development of the Israeli labour market. (The unemployment rate was 10.4 percent on average in 2004). A policy that will fail to curb the number of non-Israeli workers (foreign or Palestinian) will jeopardise the continuing growth in the number of Israeli jobs and the projected decrease in the unemployment rate. Yet another assumption holds that the Israeli government’s economic policy will continue to adhere to the terms agreed upon with the US Administration and that Israel will receive the anticipated third batch of US guarantees in 2005.

The number of Israeli employed increased markedly in 2003-2004, by 100,000, reflecting, among other things, the successful implementation of government policies that aimed to downsize the population of foreign workers and reduce transfer payments. In 2004, business sector employment increased by 74,000 and general government employment declined by 3,000 (year-on-year averages). The decrease in general government employment in 2004, for the first time in many years, is a substantial achievement for the economic policy that set as a goal the reduction in the size of the general government sector.

Given the continuing contractionary fiscal policy and the expected decrease in the public debt over the next several years, in addition to the stability in the shekel exchange rate, the Bank of Israel is expected to maintain a real interest rate, compatible with the economic conditions and with prevailing real interest rates worldwide.

Continued fiscal consolidation is essential. The government faces a difficult task in adhering to the strategy of reducing government size and public debt. In order to pay down the debt faster, it should refrain from unplanned tax cuts should revenue over-perform. In the medium term the authorities need to strictly observe the deficit target of 3 percent of GDP and limit expenditure growth in real terms to no more than 1 percent a year.

V. BUDGETARY EXPENDITURE ON THE DISENGAGEMENT PLAN

The disengagement plan will impose a considerable burden on the State budget during the coming years and introduces some uncertainty as to its extent. The plan also raises issues of principle regarding the manner in which it is to be financed and its place in multi-year fiscal policy. These three aspects of the disengagement budget are discussed below (Bank of Israel, 2005).
A. Cost

The overall budgetary cost of the disengagement plan is estimated at around NIS 6.5-7 billion, as assessed by the Finance Ministry, and is due to be staggered over the years 2005-2007. The State budget for 2005 allocates NIS 2.2 billion (0.8 percent of the total budget) for financing the plan. The Disengagement Law permits a similar amount to be spent in 2006. The amount of spending for 2007 has yet to be determined. In 2005 half of the expenditures will be civilian and half will be security related. The civilian spending is mainly designated for compensating the settlers, business owners in the Erez industrial area and other entities. Although the military spending is intended primarily for the Ministry of Defence, the police and other branches of the security forces will also receive budgetary increments.

There is some degree of uncertainty regarding the total costs of the disengagement and their actual apportionment over the budget years. Firstly, the staggering of the compensation payments over the years is dependent on the pace at which agreements with the settlers are signed and implemented. In particular, payments may be delayed from 2005 to 2006 with the result that spending in 2005 will be less than NIS 2.2 billion and more than that in 2006. Secondly, total compensation payments may exceed the forecast. The size of the payments may well increase as the result of legal deliberations under the existing 'Evacuation-Compensation Law' or due to changes in the law. Thirdly the difference between the budgeted spending for 2005-2006 (NIS 4.4 billion) and the overall cost estimate (NIS 7 billion) should be noted. The difference implies that spending in 2007 may be expected to decrease considerably. Accordingly, if the present budget for 2005-2006 accurately reflects the actual expenditures that will be incurred, the total costs are likely to amount to less than NIS 7 billion. However, if total costs do not in fact reach NIS 7 billion, then expenditures in 2005 and 2006 are likely to exceed the currently budgeted amounts.

B. Finance

The government decided to increase the budget deficit for 2005 by 0.4 percent of GDP in order to finance the disengagement plan. This increase in expenditure will be included in the budget base for the purpose of calculating total government spending in 2006. The method of finance in 2007 has yet to be determined. The decision to increase the deficit has a number of
implications from the fiscal policy aspect:
Disengagement expenditures in 2005 will not be at the expense of other
government spending items in that year.
The government will not raise the tax burden in 2005 in order to finance
disengagement.
The public debt will increase.
In 2005 the government raised its expenditure related target (a growth of 1 percent a year) and the deficit target (3 percent of GDP), above the long term targets.

A number of considerations may be noted regarding the method chosen for financing the disengagement plan. From the budgetary aspect, the disengagement plan is a one-off and exceptional event. A large budgetary expenditure is therefore necessary during a short period for the purpose of financing the plan. Logically, such a one-off event, as distinct from a permanent increase in government spending, would be financed by creating debt. Without an increase in the deficit, a drastic cut in spending or a large rise in the tax burden during the current year would be necessary. Debt creation makes it possible to stagger over time the cut in expenditures or a tax hike at moderate rates. More than once, countries have chosen to finance exceptional events (wars as well as one-off civilian needs) by means of an immediate increase in debt and its repayment over time.
Increasing the deficit for the purpose of financing the disengagement also raises two issues. Firstly, the government will deviate from the multi-year expenditure and deficit targets that it set itself only recently. However, the amendment to the Disengagement Law stipulates that the increase in the deficit will be for the sole purpose of financing the disengagement. It is therefore important that the deviation in this case, which is clearly one-off in nature, will not create a precedent for deviating from the targets in normal circumstances. This is because the deviation could harm the government’s credibility with respect to its commitment to such targets. This is particularly relevant when it is considered that in recent years the government exceeded its deficit targets several times, or increased them when it realised that it would be difficult to adhere to them.
Secondly, any increase in the debt is problematic in view of the high debt/GDP ratio in Israel compared with the usual worldwide level. However, the one-off nature of the expenditure means that the increase in the debt is also one-off, and therefore does not create a long term trend of growth in debt (negative debt dynamics).
VI. GOVERNMENT EXPENDITURES

Government and public spending in Israel is one of the highest in the world. A consistent lowering of government spending would make it possible to lower the tax burden in the future, as well as the government debt, and would free capital market sources for the benefit of the business sector and result in a lowering of the long term interest rate, thereby encouraging investments and sustainable growth.

A. Trends in the years 1995-2003

Between the years 1995-2000, government expenditures (excluding lending and government hospital expenditures) fell from 44.7 percent of GDP in 1995, to 39.8 percent of GDP in 2000. Following the severe economic recession in Israel, which began in October 2000 and originated primarily from the combination of several exogenous shocks, together with an overly contractionary monetary policy, the real GDP fell by 0.9 percent in 2001, by an additional 0.7 percent in 2002 and rose slightly by 1.3 percent in 2003. The recession, the defence expenses as a result of the conflict with the Palestinians, and the severe monetary contraction (in excess of the degree warranted in order to meet the inflation target), resulted in a significant rise in the government’s real expenditure in the years 2001 and 2002 (primarily in defence, wages and transfer payments). The lower GDP (in the denominator) and higher government expenditures (in the numerator) resulted in a significant increase in government expenditure in 2001-2002, from 39.8 percent of GDP in 2000 to 43 percent of GDP in 2002. In 2003, the government initiated measures to rein in government and public expenditure and government expenditure as a percentage of GDP fell slightly, to 42.7 percent of GDP.
Table 4: Israel: State Budget Expenditure (Economic Classification) 1999-2003

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current expenditure (In millions of new Israeli shekel)</td>
<td>161,761,167,870,179,448,186,057,190,442,198,524,205,737</td>
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<td></td>
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<td></td>
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<tr>
<td>Wages</td>
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<td>35,265</td>
<td>38,458</td>
<td>41,234</td>
<td>41,062</td>
<td>43,007</td>
<td>44,375</td>
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<td>Of which: defence</td>
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<td>13,287</td>
<td>14,746</td>
<td>18,113</td>
<td>14,894</td>
<td>15,628</td>
<td>16,540</td>
<td>16,358</td>
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<td>Goods and services</td>
<td>33,230</td>
<td>34,643</td>
<td>36,914</td>
<td>38,230</td>
<td>40,841</td>
<td>43,340</td>
<td>43,364</td>
<td>45,981</td>
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<tr>
<td>Of which: defence</td>
<td>21,072</td>
<td>22,422</td>
<td>22,782</td>
<td>24,738</td>
<td>26,172</td>
<td>29,031</td>
<td>27,980</td>
<td>29,567</td>
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<td>Interest</td>
<td>23,836</td>
<td>24,930</td>
<td>26,339</td>
<td>27,748</td>
<td>28,570</td>
<td>27,906</td>
<td>28,957</td>
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<td>Domestic</td>
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<td>21,824</td>
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<td>6,082</td>
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<td>Subsidies and transfers</td>
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<td>68,283</td>
<td>68,004</td>
<td>67,316</td>
<td>71,837</td>
<td>72,905</td>
<td>77,169</td>
<td>75,959</td>
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<td>Subsidies</td>
<td>5,544</td>
<td>5,910</td>
<td>5,741</td>
<td>5,016</td>
<td>5,253</td>
<td>4,829</td>
<td>5,379</td>
<td>5,567</td>
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<tr>
<td>Non-export</td>
<td>1,448</td>
<td>1,636</td>
<td>1,842</td>
<td>1,532</td>
<td>1,881</td>
<td>1,711</td>
<td>2,132</td>
<td>2,312</td>
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<td>Export</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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<td>Investment grants</td>
<td>4,096</td>
<td>4,274</td>
<td>3,899</td>
<td>3,484</td>
<td>3,372</td>
<td>3,118</td>
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<td>Transfers</td>
<td>60,468</td>
<td>62,373</td>
<td>62,263</td>
<td>62,299</td>
<td>66,583</td>
<td>68,077</td>
<td>71,790</td>
<td>70,392</td>
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<td>To local authorities</td>
<td>9,059</td>
<td>9,708</td>
<td>8,891</td>
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<td>9,752</td>
<td>10,645</td>
<td>10,096</td>
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<td>To National Insurance Institute</td>
<td>16,684</td>
<td>16,893</td>
<td>18,134</td>
<td>18,240</td>
<td>20,696</td>
<td>21,230</td>
<td>22,640</td>
<td>21,057</td>
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<td>To non-profit institutions</td>
<td>32,118</td>
<td>32,071</td>
<td>33,765</td>
<td>32,926</td>
<td>34,658</td>
<td>34,128</td>
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<td>37,404</td>
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<td>To defence</td>
<td>2,606</td>
<td>3,701</td>
<td>1,474</td>
<td>1,331</td>
<td>1,477</td>
<td>2,073</td>
<td>1,906</td>
<td>1,920</td>
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<td>Repayment to National Insurance Institute</td>
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<td>4,749</td>
<td>5,095</td>
<td>4,921</td>
<td>5,404</td>
<td>5,229</td>
<td>6,028</td>
<td>6,172</td>
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<td>Capital</td>
<td>9,164</td>
<td>7,145</td>
<td>9,743</td>
<td>7,770</td>
<td>10,353</td>
<td>8,268</td>
<td>10,579</td>
<td>10,693</td>
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expenditure
Of which:

housing

Reserve

Total expenditure

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<tr>
<th></th>
<th>2,076</th>
<th>1,777</th>
<th>2,367</th>
<th>1,726</th>
<th>2,465</th>
<th>1,825</th>
<th>2,246</th>
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<td>Reserve</td>
<td>7,131</td>
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<td>4,374</td>
<td>0</td>
<td>4,591</td>
<td>0</td>
<td>3,325</td>
<td>4,473</td>
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<tr>
<td>Total</td>
<td>178,056</td>
<td>175,016</td>
<td>188,927</td>
<td>187,218</td>
<td>201,001</td>
<td>198,710</td>
<td>212,428</td>
<td>220,903</td>
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Memorandum items:

Domestic expenditure

Foreign expenditure

(In percent of GDP)

<table>
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<tr>
<th>Current expenditure</th>
<th>37.9</th>
<th>36.1</th>
<th>37.6</th>
<th>38.2</th>
<th>39.6</th>
<th>39.4</th>
<th>41.1</th>
<th>42.6</th>
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<tbody>
<tr>
<td>Wages</td>
<td>8.0</td>
<td>7.6</td>
<td>8.3</td>
<td>8.8</td>
<td>8.4</td>
<td>8.5</td>
<td>8.9</td>
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<tr>
<td>Goods and services</td>
<td>7.8</td>
<td>7.5</td>
<td>7.9</td>
<td>8.1</td>
<td>8.7</td>
<td>9.0</td>
<td>9.0</td>
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<td>Interest</td>
<td>5.6</td>
<td>5.4</td>
<td>5.7</td>
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<td>6.1</td>
<td>5.8</td>
<td>6.0</td>
<td>6.9</td>
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<td>Domestic</td>
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<td>4.1</td>
<td>4.3</td>
<td>4.6</td>
<td>4.6</td>
<td>4.5</td>
<td>4.7</td>
<td>5.1</td>
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<td>Foreign</td>
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<td>1.2</td>
<td>1.4</td>
<td>1.3</td>
<td>1.5</td>
<td>1.3</td>
<td>1.3</td>
<td>1.8</td>
</tr>
<tr>
<td>Subsidies and transfers</td>
<td>15.5</td>
<td>14.7</td>
<td>14.6</td>
<td>14.3</td>
<td>15.3</td>
<td>15.1</td>
<td>16.0</td>
<td>15.7</td>
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<tr>
<td>Repayment to National Insurance Institute</td>
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<td>1.1</td>
<td>1.0</td>
<td>1.1</td>
<td>1.1</td>
<td>1.2</td>
<td>1.3</td>
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<tr>
<td>Capital expenditure</td>
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<td>Of which: housing</td>
<td>0.5</td>
<td>0.4</td>
<td>0.5</td>
<td>0.4</td>
<td>0.5</td>
<td>0.4</td>
<td>0.5</td>
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</tr>
<tr>
<td>Reserve</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
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Memorandum items:
### VII. GOVERNMENT REVENUES

The government’s ability to control its revenues in the short term is limited, since the revenues are influenced primarily by the level of activity in the economy, as well as by the level of prices and the wages in the business sector – those that are not controlled by the government. Additionally, government resolutions regarding the raising of taxes may lead to reduction in economic activity and may ultimately lower government tax revenues.

#### A. Trends in the years 1995-2003

Throughout the years 1995-2002, government revenues totalled approximately 40 percent of GDP, with domestic tax revenues equal to an average of approximately 30 percent of GDP. The continuing slowdown in 2003, in conjunction with a sharp drop in wages and private consumption, and a price level that was far lower than the level compatible with the inflation targets – all served to bring about a significant gap in revenues from taxes and other government revenues, relative to the planned revenues in the 2003 budget. Government revenues were equal to 37.1 percent of GDP, with tax revenues totalling 28.6 percent of GDP.

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Source: IMF Statistical Appendix (Data provided by Ministry of Finance)
### Table 5: Israel: State Budget Revenue, 1999-2003

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<td>Foreign revenue and grants</td>
<td>3.3</td>
<td>2.6</td>
<td>3.2</td>
<td>2.8</td>
<td>2.7</td>
<td>2.4</td>
<td>3.8</td>
<td>4.3</td>
<td></td>
</tr>
</tbody>
</table>

*Source: IMF statistical Appendix, (Data provided by Ministry of Finance)*
VIII. ROLE OF THE STATE IN THE ECONOMY AND INCREASING THE LEVEL OF COMPETITION

A. Role of the State in the Economy

Historically, the government has been involved in nearly all sectors of the Israeli economy, particularly in defence-related and monopolistic businesses. Before the privatisation process began, ownership of industry in Israel was divided between the government, the Histadrut (General Federation of Labour) and the private sector, with the government and the Histadrut owning prominent interests in several key industries. In recent years, the government has made significant progress towards the privatisation of State-owned enterprises. As part of this process, the government has implemented structural reforms aimed at enhancing competition in some essential monopolistic sectors, such as the communication sector and the seaports. In addition, the government has begun the process of introducing competition into additional sectors and industries, such as the electricity sector and refineries.

As of May 2005, there were 98 State-owned companies, 37 of which are business-oriented enterprises (Israeli’s Prospectus, 2004). The remainder of the State-owned companies, which includes funds established as vehicles for employee savings or educational institutes, are not business-oriented.

State-owned enterprises are divided by law into two categories: Government Companies and Mixed Companies. In addition to State-owned enterprises, the government is also involved in some sectors of the market through statutory authorities.

Government Companies (the category excludes State-owned banks acquired pursuant to the Bank Shares Arrangement, see “Privatisation” below), are those in which the government owns more than 50 percent of the voting shares and which are subject to the provisions of the Israeli Government Companies Law, 1975 and the regulations promulgated thereunder (the “GCL”), as well as the directives of the Government Companies Authority (see “Privatisation” below). The provisions of the GCL regulate the management and operations of Government Companies and the circumstances under and procedures by which the government may sell shares in or reorganise Government Companies.

Mixed Companies are companies in which the State owns 50 percent or less of the voting shares. Under the GCL, Mixed Companies are not subject to the same
degree of regulation as Government Companies. However, Mixed Companies do remain subject to certain limited provisions of the GCL, including appointment and qualification by the government of certain directors.

Government Companies play a significant role in the Israeli economy. In 2003, Government Companies accounted for 8.3 percent of total exports and 10.8 percent of investment in fixed assets, although they employed only 1.8 percent of the Israeli workforce. These companies include several public service monopolies and a number of companies that either engage in activities considered crucial to Israeli national security or provide important services to the government.

The government has initiated a number of regulatory arrangements with the major Government Companies; these are designed to increase competition in the markets in which these companies participate and thus prepare them for privatisation. Nevertheless, the pace of privatisation may be affected by the need for further regulatory and structural reforms and formulation of policies that will define the post-privatisation environment in which these companies will operate.

The development and implementation of some of these policies and reforms may take a considerable amount of time.

B. Privatisation

An essential element of the broader structural reforms initiated by the government over the past several years to promote the growth of the private sector and enhance competition is the government’s move towards privatising its business holdings. Privatisation efforts have included the full or partial sale of State-owned companies, banks and the transfer of activities which were previously performed by the government or statutory authorities to private entities. From 1986 through May 2005, 89 companies ceased to be Government Companies and the government’s proceeds from privatisation from 1986 through May 2005 were approximately $10.9 billion. In 2004, proceeds from privatisation totalled $189 million.

Privatisation of all State-owned enterprises, other than banks, is conducted by the Government Companies Authority. Pursuant to the Bank Shares Arrangement (as described below), the responsibility for privatisation of banks is in the hands of the Ministry of Finance through M.I. Holdings Ltd., a wholly-owned Government Company. M.I. Holdings Ltd. advises the Minister of Finance regarding bank privatisations and manages the process according to the Minister’s instructions.
The Ministerial Privatisation Committee, consisting of the Minister of Finance, as chairman, the Minister of Justice and one other minister (the “Privatisation Committee”), has the power to initiate the privatisation of any Government Company or Mixed Company without the consent of the minister directly responsible for such Government Company or Mixed Company, and to authorise preparatory measures necessary to effect such privatisation. The Government Companies Authority also has general authority relating to the supervision of Government Companies, including the right to convene board meetings and the authority to issue directives to Government Companies in relation to decisions of the Privatisation Committee.

In 1983, as a result of the collapse in the share prices of several large banking institutions on the TASE (Tel Aviv Stock Exchange), the government entered into an arrangement (the “Bank Shares Arrangement”) with shareholders of banking institutions. Under the Bank Shares Arrangement, the State purchased shares from the banks’ shareholders at the time of the crisis. As a result, the State gained a controlling stake in five of the six largest Israeli banks (although the State did not exercise any management control over these banks). The government’s ongoing privatisation programme is intended to result in the sale of the government’s controlling interest in these banks. Implementation of this program is ongoing as the government continues to reduce its bank holdings through a variety of public and private transactions.

Between 1993 and 2001, the government sold 27.7 percent of the total outstanding shares of Israel Discount Bank Ltd. In February 2005, the government sold the control of the bank (26 percent of the issued share capital of the bank) for a total of NIS 1.3 billion. This sale is still pending the approval of the Bank of Israel. Together with control of the bank, the buyer bought the option to purchase an additional stock package totalling 25 percent of the issued share capital of the bank. As of June 2005, the State still holds 57.1 percent of the shares in Israel Discount Bank. Once the Bank of Israel approves the deal, and if all options are to be exercised, State holdings in the bank will decrease to approximately 6 percent.

Between 1997 and 2000, the State sold 72.4 percent of the total outstanding shares of Bank Hapoalim Ltd. in private sales for a total of $2.3 billion. As of June 2005 the State holds 0.01 percent of Bank Hapoalim.

Between 1993 and 1999, the State sold 97.2 percent of the total outstanding
shares of United Mizrahi Bank Ltd. in both public and private sales, for a total of $525.5 million. As of June 2005, the State holds 0.5% of United Mizrahi Bank. Between January 2000 and January 2005 the State sold 14.85 percent of the total outstanding shares of Bank Le-Israel Ltd. In March 2005, the State sold an additional 6.5 percent of the shares to a private bidder for a total of $266.7 million. As of June 2005, the State holds 28.3 percent of the shares of Bank Leumi. The government intends to complete the privatisation of Bank Leumi by mid-2006.

Table 6: Selected State Owned Companies (1) (at, or for the period ended, December 31, 2004) (in millions of dollars, except percentage)

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Total Assets</th>
<th>Long Term Liabilities</th>
<th>Total Revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct and Indirect Ownership of Government</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bezeq, the Israel Telecommunication Corp. Ltd. (2)</td>
<td>46.4%</td>
<td>$4,682</td>
<td>$1,721</td>
</tr>
<tr>
<td>Israel Electric Corporation Ltd.</td>
<td>99.8%</td>
<td>14,939</td>
<td>10,233</td>
</tr>
<tr>
<td>Bazan Oil Refineries Ltd.</td>
<td>74.0%</td>
<td>2,129</td>
<td>665</td>
</tr>
<tr>
<td>El Al Israel Airlines Ltd. (3)</td>
<td>30.5%</td>
<td>1,511</td>
<td>842</td>
</tr>
<tr>
<td>Israel Aircraft Industries Ltd.</td>
<td>100.0%</td>
<td>2,252</td>
<td>182</td>
</tr>
<tr>
<td>Rafael-Armament Ltd.</td>
<td>100.0%</td>
<td>773</td>
<td>109</td>
</tr>
</tbody>
</table>

(1) Based on Consolidated, NIS reported financial statements as of December 31, 2004, according to generally accepted Israeli accounting principles. Amounts converted from NIS to dollars at the exchange rate as on December 31, 2004 ($1=NIS 4.308).
In May 2005, the State chose a preferred bidder for the sale of most of the State shares. When the sale is completed the government’s percentage of direct and indirect ownership in Bezeq will be 16.4 percent (1% fully diluted).

The government’s percentage of Direct and Indirect ownership in El Al Airlines was 21.7 percent as of May 2005. Since June 2004, El AL is a Mixed Company.

Sources: Ministry of Finance, Government Companies Authority

Below are summary descriptions of the State-owned companies included in the above table. Also described below are specific steps planned or taken by the government to prepare companies for Privatisation or reform their structure and operations.

“Bezeq” The Israel Telecommunication Corp. Ltd. is the State-owned telecommunications corporation. Its operations are subject to regulatory arrangements by the government, including tariff and structural supervision. Arrangements implemented since 1994 are designed to increase competition in the communications sector. International telephony services are provided by six companies (of which one is a wholly-owned subsidiary of Bezeq). Cellular services are provided by four companies (of which one is wholly-owned by Bezeq). In June 1999, Bezeq’s exclusive right to supply fixed telecom services was terminated. Since the end of 2000, initial steps have been taken to introduce competition into the supply of fixed telecom services and other internal communication services, including competition from other communication companies involved in cellular and cable services. Between July 1997 and February 1998, the State sold a 21.4 percent interest in Bezeq in a sale to Merrill Lynch & Co. and in a public offering in Israel, which together raised a total of $508.7 million and reduced the State’s ownership level to 54.6 percent (fully diluted). In 2003 the State reduced its holdings in Bezeq in two trenches, representing 3.6 percent and 5.8 percent, resulting in income to the government of more than NIS 1 billion. As of November 2003, the State held 49.1 percent of Bezeq’s shares. As a result of these sales, Bezeq (with its subsidiaries) became a Mixed Company. In June 2004, the State sold 2.7 percent of Bezeq’s issued share capital on the TASE, which raised a total of $76.2 million, after which the State's holdings in Bezeq declined to 46.4 percent.
In July 2004, the Privatisation Committee decided to sell 30 percent of the total outstanding shares of Bezeq coupled with an option to buy another package of 10.67% percent. In addition, Bezeq’s employees would be entitled to purchase 4.7 percent at a discount of 30 percent from the sale price. In August 2004, the State published a tender and in October 2004, eight applications were submitted. In May 2005, the State chose a preferred bidder for the sale. The transfer of the shares is still pending the required regulatory approval. The selected bidder offered a total of $972 million. After completion of the sale, and if all options are exercised and the employees purchase the entire 4.7 percent, the State’s ownership in Bezeq will be 1 percent (fully diluted).

Israel Electric Corporation Ltd. (IEC) is a legal monopoly with responsibility for the entire Israeli electricity industry. Since 1992, IEC has been subject to tariff supervision that includes efficiency incentives. In March 1996, IEC’s exclusive concession from the government expired, the Electricity Sector Law was enacted, and an Authority for the supervision of public electric utility services was established. The purpose of the Law is to regulate activity in the electricity industry for the benefit of the public, and to achieve reliability, availability, quality and efficiency while guaranteeing cost minimization within a competitive market. The Law provides for a ten-year transition period during which IEC has a license to transmit, distribute, supply and market electricity. Under the Law, the owner of a license for transmission or distribution functions will be required to purchase electricity from other generators of electricity, and to enable other licensed generators to use the same transmission and distribution channels to supply electricity to their customers. On January 1, 1998, IEC received licenses, valid until March 3, 2006, to produce electricity at each of its 63 generation units.

In August 1999, the government decided to implement structural changes in the electricity sector in order to open the sector up to competition, as is common in other developed countries. For this purpose, the Minister of Finance and the Minster of National Infrastructures appointed an inter-ministerial committee headed by the Director General of the Ministry of Finance and the Director General of the Ministry of National Infrastructures. The committee was empowered to prepare a detailed proposal to implement the structural change. In recent years, the government began to open up the electricity industry to competition by setting rules for the entry of private electricity producers into co-
generation of electricity and publishing a tender for electricity generation. The government’s goal is to achieve a decentralized, competitive industry divided into the following segments: generation, which the government expects to be competitive; transmission, where the government expects a natural monopoly to take hold; and distribution, where the government expects regional monopolies to take hold.

In March 2003, the government decided to reform the electricity sector in accordance with the committee’s recommendations and amended the Electricity Sector Law accordingly. On May 29, 2003 the Knesset approved changes in the Electricity Sector Law that are designed to achieve a decentralised, competitive structure in the sector.

The Ports and Railways Authority was traditionally one of the strongest and most significant monopolies in Israel, with centralised operations, assets and control of all of Israel’s ports. On July 22, 2004, the Knesset passed a law to abolish the Ports Authority, and to divide its activities and framework by establishing three Government Companies to operate the Haifa, Ashdod and Eilat ports respectively. An additional Government Company would hold and manage the ports’ assets and lease them to the three port operating companies. In February 2005, the Port Authority was duly abolished and the four successor companies commenced operations. As part of the privatisation process, the three ports companies are expected to be competitive, and portions of these companies are to be sold to the public by public offerings.

Israel Railways was separated from the Ports and Railways Authority pursuant to a December 2002 amendment to the Ports and Railways Authority Law. On July 1, 2003, Israel Railways began operating as a Government Company. In 2003 the company commenced a five-year, $4.5 billion intensive investment plan which is expected to have a positive impact on Israel’s transportation system and the Israeli economy in general.

Bazan Oil Refineries Ltd. (“Bazan” – an acronym of the Hebrew name) is the only oil refinery company in Israel. Bazan operates within the framework of government reforms that have linked fuel prices in Israel to fuel prices in the international market. Bazan is permitted to sell its products strictly to wholesalers and to certain key customers. In May 1971 the government, which held 100% of the company, sold 26 percent of its interest in Bazan to The Israel Corporation Ltd. (IC), a public company, through a private placement. In December 2004 the
government decided to separate and privatise the refinery facilities. First, the refinery facility in Ashdod is to be sold in a private auction, then the refinery facility in Haifa will be offered to the public on the TASE. The government has announced that as a preliminary step prior to the planned privatisation of Bazan, the State intends to purchase back the minority shares of 26 percent from IC in the third quarter of 2005.

El Al Israel Airlines Ltd. used to be the Israeli national air carrier. El Al operates in a competitive market and competes with foreign airlines under the government’s “open sky” policy. In 1995 El Al emerged from a reorganisation programme according to which it had operated since 1982, due to labour difficulties at that time. In July 2002, after cancelling a prior privatisation plan, the Privatisation Committee decided to privatise the State’s holdings in El Al in stages. In June 2003 the government began the El Al privatisation process by offering 15 percent of El Al’s shares on the TASE. The shares were bundled with two sets of options for the remaining 85 percent of the shares. The first set of options was exercisable within the year. The second set of options is exercisable between 18 months and four years from the offering date. In addition, El Al employees were offered the opportunity to purchase shares and options for approximately 9 percent of El Al. The total amount raised through the initial offering (which did not include the exercising of options) was NIS 64 million, of which El Al received NIS 22.1 million and the government received the balance. As of May 2005, all of the first set of options were exercised, and a portion of the second set of options was exercised. As a result, the State currently holds 21.7 percent of El Al, and El Al has become a Mixed Company, controlled by a private entity. When all long-term options are exercised, El Al should become a fully privatised company.

Zim Israel Navigation Company Ltd. is Israel’s largest shipping company, most of whose operations are in international shipping markets. In 1970 the government sold control of Zim to The Israel Corporation Ltd. (IC), a public company. Prior to February 2003 Zim was a Mixed Company, with the State and IC holding 48.6 percent and 48.9 percent of the company’s share capital, respectively. In February 2003 the State sold the balance of its holdings to IC for $113 million.

Israel Aircraft Industries Ltd. (IAI), Israel Military Industries Ltd. (IMI) and Rafael-Armament Development Authority Ltd. are three defence related Government Companies. Currently, the State holds 100 percent of each of these three companies’ share capital. Over the past several years, these three companies
have been restructuring and streamlining their operations, primarily in preparation for privatisation. Rafael was formerly an authority under the Ministry of Defence; in January 2002 it was converted into a Government Company. IAI has reduced the number of its employees and is consolidating some of its operations. IMI, which is experiencing financial difficulties, was partially privatised through the sale of several factories. One subsidiary of IMI, Ashot Ashkelon Ltd., has already begun the privatisation process and IMI has been preparing for privatisation, starting with a reorganisation program and internal separation of the various units within the company.

Mekorot Water Company Ltd. ("Mekorot") is the State-owned water company. It supplies approximately 65 percent of the water Israel consumes. Approximately 27% of Mekorot’s income from supplying water is subsidized by the government through payments intended to compensate Mekorot for the below-market fees charged mainly to agricultural and other consumers. In 1993 Mekorot and the government agreed on an arrangement establishing efficiency incentives for the years 1993 through 1998 and securing Mekorot a normal return on equity, thus enabling it to raise capital in private capital markets rather than receiving subsidised loans from the government, and reorganising Mekorot and the government water factories. In 2002, the government and Mekorot agreed to continue to operate under a similar arrangement, which has since been extended. As part of the structural reorganisation plan, in July 2003, three new Government Companies were established: Mekorot Water Ltd., Mekorot National Carrier Ltd. and Mekorot Initiatives and Development Ltd. When the restructuring exercise is over, these companies would be subsidiaries of the new parent company, Mekorot Holdings Ltd. Mekorot Water Ltd. would serve as the National Water Authority under the Water Law, 1971 (and would be responsible for operation of the water system, including production and establishment and renewal of water enterprises). Mekorot National Carrier would have the leasehold on the properties of the National Carrier (and would be responsible for the maintenance and development of real property and other assets). Mekorot Initiatives and Development Ltd. would manage and operate various water-related projects (including cooperation with private entrepreneurs on new water and sewage infrastructures, wastewater purification and other activities in the competitive segment). After completing the structural
change, various units of Mekorot Water Ltd. and Electro-Mechanical Services Ltd., a wholly-owned subsidiary of Mekorot Water Company Ltd., would be consolidated and operate as a subsidiary of Mekorot Water Ltd. Petroleum and Energy Infrastructures Ltd. ("PENIN") provides infrastructure services for the petroleum industry, and acts as the sole provider of storage and transportation services for refined oil. PENIN’s subsidiaries plan, build, operate and maintain systems and facilities for the transportation and distribution of petroleum products. The State controls the rates of PENIN’s products and services. Until January 2001 PENIN operated under a concession from the government. In January 2001, an agreement in principle was signed between the State and PENIN to govern PENIN’s activities after the end of the concession. Implementation of this agreement is currently under negotiation.

C. Government Subsidies

Prior to 1985, the government heavily subsidised certain segments of the Israeli economy, including basic foodstuffs and agricultural products. Since 1985, the level of direct government subsidies has been significantly reduced. The remaining direct government subsidies consist primarily of subsidies for water, public transportation and agricultural production. Government subsidies for public transportation totalled NIS 1.8 billion during 2004. Government subsidies for water and agricultural production totalled NIS 2.2 billion during 2004.

D. Economic Incentives

The Government provides significant assistance to the manufacturing sector under laws designed to encourage investment in “approved enterprises,” mainly in peripheral regions of the country. A project that qualifies as an “approved enterprise” is eligible for assistance in the form of cash grants or tax benefits. Beginning in January 1997, the government significantly reduced the rate of grants. For the purpose of determining eligibility for grants, three industrial regions have been identified: Region A, generally the most remote regions of the country; Region B, generally the peripheral regions of the country (closer to the central regions than Region A); and Region C, all other regions. The grant rate for Region A is 24 percent for investments up to NIS 140 million and 20 percent for investments above this limit, as compared to 10 percent for Region B for all levels
of investments, and 0 percent for Region C for all levels of investments. Two regions have unique grants programs. In the northern border area the rate of grants is 30 percent for investments up to NIS 140 million and 26 percent for investments above this limit, and in the Negev area the rate of grants is 30 percent for investments up to NIS 140 million and 32 percent for investments above this limit. During 2005 the government will implement an experimental program targeted to encourage employment in regions A and B. Under this programme, industrial factories that increase the number of employees will be eligible for grants up to 20 percent of salary costs.

In the 2005 budget the government commitment for grants to the manufacturing sector totalled NIS 330 million, as compared to NIS 255 million in 2004 and NIS 400 million in 2003.

E. Improving the Efficiency of Public Services

The public sector suffers from excess bureaucracy and a sub-par level of services. The aim of the proposed structural changes in this area is to reduce the cost of such services to the citizen, while also raising their quality. Additionally, the public sector is characterised by high wages expenses. Civil servants should be encouraged to opt for early retirement, thereby reducing their numbers, and efficiency measures should be introduced in the various ministries, including incentives towards personnel cutbacks.

In 2005 the policy aims at improving efficiency in the public sector will focus on reducing the level of wage rises, streamlining and consolidating units, cutting back regulations, and allowing the private sector to provide services that formerly fell within the public sector’s domain.

The following are the key structural changes in this area, as they will be presented in the course of government discussions:

Improved efficiency and cutbacks in units and personnel
Implementing efficiency measures, streamlining superfluous units and reducing the number of employees, while providing ministries with incentives to implement these measures.
Transferring operations to the private sector
For example: maintenance and rehabilitation centres, geriatric facilities, the
Tadmor Hotel School, the Meteorological Service.

Incentives to consolidate local municipalities
Creating a series of incentives mainly aimed at the members of local authorities to encourage the voluntary consolidation of these entities.

Improved efficiency of agricultural training.
Transferring agricultural training to private bodies while maintaining a trimmed down training unit within the Ministry of Agriculture.

Responsibility for lawsuits deriving from medical malpractice.
Reducing expenses in the healthcare system owing to medical malpractice.

IX. CREDIBILITY PROBLEMS AND RECOMMENDATIONS

The government operates within a framework of long-term fiscal discipline, the purpose of which is to reduce the burden of debt, taxation and government expenditure on the economy. The Israeli public — households and the business sector alike — enjoy complete freedom in regard to foreign currency; the economy is an open one in the areas of trade and capital movements; the capital market is developing constantly, and the government has severely curtailed its involvement in it and in the economy in general; and the Bank of Israel pursues an independent monetary policy, mainly due to the Non-Money-Printing Law of 1985 which simply forbade the Bank to print money for the government's budgetary requirements.

It is important to observe at this early point that the main target of that long term strategy is the achievement of sustained growth which until it materialises, the government will not be able to meet the above-mentioned objectives. Sustainable economic growth is the basis for improved welfare among the entire population and for a welfare policy that will deal with its weaker strata.

The favourable turnaround in domestic activity in 2003-2004 was supported by firm government measures to restrain public expenditure, an essential step in returning the budget deficit and the public debt to a downward trajectory, and by structural reforms that bolstered such recovery and reinforced sustainable growth.

An economic programme to cope with the steep increase in the rate of the budget deficit was applied in the middle of 2003. The tough fiscal policy that was part of the programme, coupled with policy measures incorporated in the 2004 and 2005 budgets, did much to enhance fiscal credibility. This, together with the receipt of US government guarantees, boosted the confidence of the financial markets and
brought down the real interest rate on long term indexed bonds.

The key challenges facing Israel are to adhere to the ambitious agenda of limiting the fiscal deficit, thereby reducing the size of the public debt, to further reform the labour market to increase employment, and to carefully promote the development of the capital markets.

The government is establishing a credible commitment to maintain future deficits below 3 percent of GDP and to limit government expenditure growth in real terms to no more than 1 percent a year. The 2004 budget deficit reached 3.9 percent of GDP. Although such a deficit is still relatively high, particularly in light of the large public sector debt — about 105 percent of GDP — it represents a marked improvement compared to 2003, when the deficit was 5.6 percent of GDP. The fiscal effort is noteworthy because it is based in large part on curtailing government expenditures, which were estimated to decline by 2.4 percent of GDP in 2004.

Notable improvements in policies are prompting improved economic performance in Israel. Economic growth has revived and prices and the exchange rate are stable. While a favourable external environment and a better security situation have been important factors, appropriate policies have been no less instrumental in contributing to growth. In particular, the authorities have rebalanced macro policies and undertaken an ambitious fiscal consolidation, while appropriately easing monetary policy. Furthermore, the government's commitment to boost competition and efficiency have enhanced market confidence and laid the foundations for future growth. Welfare reform will improve the functioning of the labour market, privatisation will improve competition and market efficiency, tax reform will increase competitiveness, and pension reform, while assuring solvency of the system, should assist the development of the capital market.

The welcome commitment to limit the growth of public expenditure to 1 percent in real terms, as the IMF states, requires medium term planning and a detailed spending plan (IMF Country Report, 2005). Developing a detailed medium term spending plan would enhance credibility and ensure that future budgets are allocated according to long term priorities. In addition, in order to enhance transparency and planning, the government should present a detailed semi-annual report on progress in achieving its fiscal objectives, as well as in implementing various structural measures.

The IMF emphasises the importance of accelerating the path of debt reduction by
abstaining from further unplanned tax cuts and by broadening the tax base through the elimination of various tax exemptions. Maintaining a deficit of 3 percent of GDP in the years ahead, but a modest decline in public debt, relative to GDP, is not sufficiently ambitious. A smaller fiscal deficit would be preferable as the correspondingly more pronounced decrease in the stock of public debt would allow for lower interest rates, increased private investment, lower taxes in the future, and higher medium term growth. Accordingly, the automatic stabilisers ought to be allowed to operate fully should revenues over-perform, and should be reined in partially should revenues under-perform.

However, the economy remains vulnerable to the possibility of a worsening global environment, especially in the market for high-tech exports, political volatility in the region, and a deterioration of the security situation. Should real interest rates rise, the exchange rate depreciate rapidly, or real GDP growth slow substantially, the public-debt-to-GDP ratio risks becoming entrenched at around 110 percent or higher, thus making the fiscal consolidation all the more difficult. The government believes in “expansionary fiscal contraction” within current Israeli economic circumstances, i.e. tax cuts and curbs on public spending stimulate private sector effort via supply, given that spending and taxes are high and supply thus constrained. The government has clearly signalled to the markets a break with the past. A fiscal adjustment has been realised of almost 3 percent of GDP from 2002 to 2004. The fiscal effort has been accompanied by an easing of monetary policy. The key policy interest rate has been cut from 8.9 percent in March 2003 to 3.5 percent in February 2005. To strengthen a virtuous circle, the authorities have reduced distortive taxes and strengthened fiscal transparency and accountability to bolster confidence in the authorities’ fiscal programme. Furthermore, the government laid down the basis for sustainable non-inflationary growth through privatisation and other structural reforms as was mentioned in the previous section. By demonstrating credibility and commitment, the government has succeeded in changing market expectations. The public perception is that the authorities’ policies are prudent and the government is committed to structural reforms. The change in market expectations is visible in the favourable responses of stock, foreign exchange and long term bond markets, and in the reduction of the country risk premium.
X. CONCLUSIONS

In 2003, when the government began to introduce a set of ambitious market-oriented economic reforms, many NGOs, unions, think tanks, lobbies, analysts and publications united to criticise the reforms’ perceived lack of economic wisdom and social compassion. Concepts like empowering the taxpayer, downsizing the public sector and shrinking the social safety net were perceived as economic anathema and presented as moral abominations.

The shedding of State assets, the extraction of the pension funds from the Histadrut’s management, the shrinking of the working public’s financing of the non-working public, the narrowing of State wages for social causes, the slashing of the national budget and the capping of public-sector hiring - all of these are ultimately creating jobs. Initially, such measures seem to carry a high cost, both financially and socially, but ultimately they allow the government to lower taxes, consequently giving the middle class more buying power, and creating more opportunities for businesses, large and small.

Over the next several years, the government will continue to strive towards a low deficit path, in order to lower the burden of public debt to levels that are acceptable among developed nations. The reduction of public debt, especially when attained while lowering taxes and cutting the government’s current expenses, constitutes a crucial component in the policy for supporting growth. This would free greater resources for investments in the private sector, would lower the long-term interest rate, would reduce the cost of labour, would improve the rating of the Israeli economy in the eyes of foreign investors – and would therefore represent a vital element in creating the conditions for sustainable growth and the creation of jobs in the economy.

The tax reform was under discussion for much of this year. According to early unconfirmed reports, the former Finance Minister Benjamin Netanyahu wanted to reduce corporate tax from 34 percent to 25 percent and maximum income tax from 49 percent to 45 percent or 44 percent as soon as possible. At the beginning of May 2005, the press reported that the corporate tax would be reduced to 30 percent and VAT would be reduced to 16.5 percent, while the capital gains tax would be raised from 15 percent to 20 percent. The Finance Minister made his intentions to make sweeping tax reforms widely known, and often stressed the
importance of reducing corporate tax, as was done in Ireland and Singapore. Over the past few years, Singapore cut its corporate tax from 24.5 percent to 20 percent, while Ireland slashed its corporate tax from 24 percent to 12.5 percent. Israel’s corporate tax was already reduced by one percentage point on January 1. Mr. Netanyahu’s official programme involved gradually reducing corporate tax to 30 percent in 2007.

He resigned as Finance Minister on August 7\textsuperscript{th}, 2005, in protest at the imminent withdrawal of the Israeli presence in Gaza. Two days later, Israel’s cabinet approved the Finance Ministry’s proposed 2006 budget, which was drawn up by Netanyahu before his departure, and reflects his reform and austerity policy priorities, as indicated above. The proposed budget will have to go through several Knesset (parliament) readings. Maintaining the path of fiscal consolidation and structural reform is crucial for the sovereign credit ratings on Israel, which remain constrained by the comparatively weak financial position of the government. A short period of heightened uncertainty is unlikely to jeopardise the economic achievements of recent years or to undermine the sovereign credit ratings on Israel. Nevertheless, the fiscal dominance in the economy and the government’s heavy debt burden mean that even limited slippage could risk a quick return to unsustainable deficits and a renewed rapid increase in the public debt burden (Ministry of Finance, 2005).
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I. Transmission channels of monetary policy

A. Monetary policy: inflation is under control

Israel is a country with a history of high inflation in which disinflation was a long process that lasted 20 years. Until the 1980s, monetary and fiscal policies in Israel were quite expansionary. This led to a rapid increase of inflation rates up to nearly 450 percent and to a decline in growth rates. After the Economic Stabilisation Plan in 1985, which combined restrictive monetary and fiscal policies together with a fixed exchange rate regime, the inflation rate was successfully reduced to two digit values at an average of 18 percent per year until 1991. However, the reduction in inflation was not the result of inflation targeting but the result of targeting other variables such as the nominal exchange rate.

Also after the Economic Stabilisation Plan in 1985, Israel started a liberalisation process of its financial sector, in which in a series of agreements with the European Union and the United States, many barriers to international trade were removed (see section IV.f: Access to credit in Israel). As stated above, by that time the main monetary policy instrument was the nominal exchange rate.

Soon, monetary authorities realised that anchoring the nominal exchange rate together with the liberalisation of capital flows engendered cumulative real appreciation, which eroded competitiveness and fostered speculative attacks against the currency. Thus, a monetary policy driven with fixed exchange rate regimes was not effective in decreasing inflation rates further, below two digit values. As a result, the Central Bank of Israel had to adapt its monetary policy to maintain price and financial stability. Israel’s monetary policy thus evolved from an exchange rate-driven policy to an inflation targeting-driven policy. The inflation target was officially adopted by the Bank of Israel and the government in 1994.

In 1997, inflation was reduced to one digit values (7 percent) and in 1998 it was reduced even further (4 percent). Nonetheless, the inflation rate increased sharply at the end of 1998 to above 18 percent. This increase was the result of high consumer prices together with sharp domestic currency depreciation because of the crisis that began in Russia, and the volatility of world financial markets. Tight
monetary policy again successfully reduced inflation rates to 1.5 percent in 1999. Nowadays, the official inflation target is set at 1 to 3 percent. Figure 1 below shows the inflation rates and targets for the period 1992-2005.

**Figure 1: Inflation in Israel 1992-2005**

As is seen in Figure 1, inflation since 1999 has remained close to 0 and was below the inflation target except for the year 2002. Inflation in 2002 was the result of a timely increase in prices due to a depreciation of the exchange rate after several years of high interest rates, but it did not yield an inflationary process. The diminished level of inflation rates to below the target was the consequence of very tight monetary policy conducted by the Bank of Israel and the government.

Increased inflation aversion by the Bank of Israel, and its successful reduction after the Economic Stabilisation Plan in 1985 and the years after, induced the Bank to choose inflation as the main monetary policy concern. However, subject to the price stability objective, the BoI also took into account, and still continues to take into account, real growth and employment when setting monetary policy.
The figure below shows that Israel is one of the countries which departed from the highest level of inflation in the eighties. Nonetheless, the extensive efforts of the Bank of Israel and the government in terms of monetary policy led to a successful inflation reduction.

**Figure 2:**

[Inflation (end of period) - International Comparison]


In order to achieve the inflation target, the Bank of Israel explicitly used its short-term nominal interest rate for conducting monetary policy and abandoned the exchange rate as a nominal anchor. This allowed greater exchange rate flexibility and the eventual transition to a pure float (see section II.a: The exchange rate).

The following chart shows changes in the short-term interest rate.
As illustrated, the Bank of Israel announced fairly high interest rates until the year 2000. Indeed, until then tight monetary policy was needed to reduce inflation rates. Since then, with the exception of the year 2000, the Bank of Israel has announced lower interest rates due to persistent stability in the capital and foreign currency markets. The BoI announced in April 2005 that the interest rate would remain unchanged at 3.5 percent. This stabilisation of the interest rate reflects some measure of decline in the uncertainty of the Israeli economy. The rate is consistent with the inflation target and supports the recovery of real economic activity in the long term.

The figure below shows the interest rates announced by the Central Banks of different countries as of March 2005:
This figure shows that Israel's current interest rate is comparable to interest rates in advanced countries (i.e. United Kingdom, United States, Australia) and it is considerably lower than emerging country counterparts (e.g. Brazil, Mexico, South Africa, Turkey).

**B. Main instruments of monetary policy**

As clarified above, the primary objective of monetary policy in Israel is price stability. In order to achieve this target, the Bank uses various monetary policy instruments. The major instrument of Israel’s monetary control is auctioned time deposits for banks. Through this instrument, the Bank of Israel affects money supply and determines the level of very-short-term interest rates on its instruments-loans to the banks and deposits from them.

The monetary department of the Bank of Israel determines the amount auctioned, the banks offer different rates of interest at which they wish to make deposits, and the auction procedure determines the rate. The interest rate instrument
influences long-term rates, via the financial markets and via the term structure of interest rates and these in turn influence the money supply in the economy. The Bank of Israel ensures that the money supply rises at a rate which is consistent with the inflation target and with the rate of expansion of actual economic activity. Since 1995, the deposit auctions have gradually replaced loans to banks as the major policy instrument. The Bank of Israel uses the daily auctions primarily to offset flows from Government activities and the balance of payments.

Another instrument is the quota discount-window loans to banks which allow each bank to withdraw liquidity according to its requirements in the course of a day. A quota is set for each bank, at rising interest rates. The inter-bank market in which trade for liquidity between banks takes place, helps allocate liquidity in the system efficiently. Through the discount window, Israeli banks can obtain overnight loans to fulfil temporary funding needs.

Treasury bills also serve as a policy instrument. These are short-term securities issued by the Bank to affect money supply and the rate of interest in the money market. Selling Treasury Bills to the public reduces the supply of money whereas its purchase by the Bank, or its redemption by the public, increases the supply of money.

Managing the foreign exchange reserves is also an important element of economic policy. The reserves help to ensure Israel’s international economic standing, improve the credibility and stability of policy and meet unexpected demand for foreign currency. The reserves are invested in financial markets overseas: deposits in foreign banks, foreign government bonds, and other financial instruments.

The reserve requirement was an instrument of Israel’s monetary system until the beginning of the 1990s. Authorities changed the reserve rate at which they obliged banks to deposit at the central Bank a certain proportion of the money they had in the form of deposits by the public. The Bank no longer uses this instrument for monetary policy. The 3 percent reserve requirement on long-term restitution deposits was abolished in 1997.
C. Transmission mechanisms of monetary policy

Israel is a small economy open to trade with an increasingly liberalised financial sector. Capital movements are restricted to some extent, which implies that foreign and domestic assets are not perfect substitutes. Also, the exchange rate fluctuates within an upward sloping band. These two aspects give monetary authorities some room to move interest rates and the money supply so that these movements are consistent with the diagonal exchange rate band.

Movements in the monetary policy instruments for policy purposes may affect real economic activity through various transmission channels. The way the different channels affect economic activity depends on several factors which are specific to each country. For example: the specific context in which monetary policy is framed, the historical record of inflation in that country, the nature and depth of its financial system, the international financial background, and so on.

Given its financial structure and its exposure to international trade, the transmission channels which are relevant for Israel are: the interest rate channel, the bank-lending channel and the exchange rate channel. However, different sectors of activity may be affected differently according to each channel. For example, sectors that are open to trade are more likely to be affected by monetary policy through the exchange rate channel; while sectors closed to trade will more likely be affected through the interest rate or credit channel. Moreover, real activity may also be differently affected by the different channels further to structural changes in the economy. Thus, all these factors need to be taken into account when analysing the transmission channels.

In an empirical work for the period 1990 to 1997, De Fiore (1998) finds that industrial production does deviate from its usual behaviour in response to every monetary shock. However, the quantitative impact of monetary shocks on aggregate production is relatively small, particularly as compared to the impact of monetary shocks in the US. This result is consistent with the nature of a small open economy like Israel, and with the limited independence of its monetary policy during that period. Empirical evidence also shows that at a sectoral level, monetary shocks have larger effects on sectors open to trade. This is due to the
impact of the exchange rate channel in addition to the interest and credit channels.

When the author considers the different transmission channels, the interest rate channel is found not to have a strong impact on output. On the other hand, evidence supports the bank lending channel as a possible important transmission channel of monetary policy in Israel. It is found that monetary shocks have a strong effect on the total supply of credit from the banking sector; they have a strong negative effect on the domestic component of credit and a strong positive effect on the foreign component. The reason for this channel being relevant might be the high degree of concentration in the banking sector (see Section 4: The banking system).

As far as the exchange rate channel is concerned, support is found for this mechanism to be important in Israel. Indeed, monetary shocks are always followed by an appreciation of the nominal exchange rate and effects are stronger in those sectors that are relatively open to international trade and exposed to the exchange rate channel. Not surprisingly, the exchange rate channel is important in its impact on real activity in Israel. The reason is that many industrial sectors rely heavily on tradable goods whose prices reflect movements in the nominal exchange rate.

In another empirical study for the period 1989-2002 by Barnea and Djivre (2004), evidence is found of interest rate smoothing by the Bank of Israel and of structural breaks in its setting of the interest rate. They also find that changes in the interest rate affect the exchange rate, which in turn affect inflation and output. According to them, the restrictive monetary policy adopted by the Bank of Israel since 1997 due to its inflation aversion has had a significant impact on activity. Specifically, they find that the tightening of monetary policy has induced a fall in inflation but that this has happened at the cost of an increased output gap. The Bank’s ability to affect inflation increased after 1997 due to several factors: the rise in the sensitivity of the exchange rate to changes in the interest rate due to the flexibility of the former; the increased inflation aversion of the Bank; and the reduction of the time lag with which the exchange rate affects prices.
In conclusion, it is important to notice that the evolution towards a floating exchange rate regime and the liberalisation of capital flows have affected the transmission mechanism. Whereas the interest rate channel had a low impact on activity at the beginning of 90’s, changes in the interest rate have had a higher impact on inflation and output after 1997; suggesting a higher degree of efficacy of monetary policy in Israel over time. This is reflected by more aggressive monetary policy and higher volatility of the nominal interest rate.

II. Relevance of the exchange rate regime choice

A. The exchange rate

Following the Economic Stabilisation Plan in 1985, Israel started a liberalisation process of its financial sector by lifting some barriers to international trade with determined countries. The idea behind this economic strategy was that being a small economy, Israel would be able to exhaust its growth potential only by opening up to the world. By that time, in 1985, the exchange rate was fixed. However, with capital mobility and under fixed exchange rates, Israel was giving up control not only of its exchange rate but also of its interest rate (at least under perfect capital mobility). Thus, two reasons led the Bank of Israel to modify the exchange rate policy. First, with financial liberalisation it soon became obvious that the exchange rate was too difficult to be maintained at a predetermined value. Israel was suffering from numerous speculative attacks which rendered the task of maintaining a fixed exchange rate more and more difficult. Second, authorities soon realised that inflation rates would not fall to one digit levels unless they were targeted to these levels. As a result, Israel started adapting its policy to maintain price and financial stability rather than to anchor nominal exchange rates. From this moment, the exchange rate entered a process which would end with it ceasing to be a monetary policy target.

8 “In a series of agreements with the European Union and the United States, a number of barriers to international trade were removed. Unilaterally Israel reduced those barriers on trade with other countries as well, and cemented all these changes in a number of agreements in the framework of the WTO and by accepting Article 8 of the IMF Articles of Agreement. Furthermore, in the ’90s and the first few years of this decade, Israel gradually abolished all exchange controls.” Source: Bank of Israel. “The changing exchange rate regime”. D. Klein 2004
In 1989 the exchange rate fluctuated according to a horizontal band of 3 percent, which evolved to 5 percent in 1990. In 1991, an upward sloping exchange rate band was settled which reflected the differential between the national inflation target and the inflation targets of Israel’s main partners. The upward sloping exchange rate band later turned into an ever-widening band in order to end up in a floating exchange rate regime.

Nowadays, the Bank of Israel does not exert any intervention in the determination of the exchange rate. This means that the Bank permits the exchange rate to fluctuate continuously in response to financial and economic changes within the limits of the exchange-rate band, and to be determined by the market. The Foreign Currency Department, which helps to formulate and implement the Bank’s exchange-rate policy, is nevertheless allowed to intervene by purchasing or selling foreign currency on the inter-bank market if the need arises. The width of the exchange rate band currently stands at approximately 36 percent and it increases by 4 percent each year, so that the exchange rate becomes more flexible over time. The band is set in terms of the currency basket. However, during the preparation of the research, the Israeli Government decided to abandon completely the exchange-rate band, therefore starting at June 2005 the exchange rate fluctuates freely.

B. Benefits and costs of a floating exchange rate

When a company or individual is considering whether to invest in a certain country, one of the things to look at first is the interest rate differential between that country and the rest. But exchange rate risks also matter. Indeed, if exchange rates are not fixed by the central bank but, on the contrary, are determined by the market, the benefit of a higher interest rate in a determined country may be offset by the cost in terms of exchange rate depreciation. Moreover, investors must also take into account that their capital injection or

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9 The composition of the currency basket is based on the shares of four currencies: the US Dollar, the Pound Sterling, the Japanese Yen and the Euro. The currency basket and the weight of each currency reflect the share of those currencies in Israel foreign trade of goods and services (imports and exports, excluding diamonds). The Bank of Israel periodically checks and modifies the weight of each currency according to its share in trade during the previous calendar year and to international cross rates.
extraction of capital from the economy will have an effect on the floating exchange rate.

On the other hand, if the exchange rate is fixed, the risk of depreciation is, a priori, hedged by the central bank; thus, gains from interest rate differentials are certain and speculative attacks are often observed.

As shown by the crisis that began in East Asia in July 1997, fixed exchange rate regimes caused financial systems to collapse in many countries. In such countries, many transactions were made in foreign currency because central banks had promised fixed exchange rates. Soon it transpired that central bank reserves were not enough to maintain the exchange rate. As a result, investors abandoned the currency and the large devaluations led to financial collapse and crisis. Israel marginally suffered from that. Even after a depreciation of the NIS by 15 percent in October 1998, the Bank of Israel refused to intervene in the market.

The lesson to be learned from this is that avoiding hedging exchange rate risks, by giving up fixed exchange rates and leaving them to freely float, keeps investors aware of the potential losses and maintains capital flows and the stabilisation of the overall economy. Therefore, “as long as the exchange rate is determined by the market, fluctuations in interest rate differentials between Israel and the rest of the world will not cause fluctuations in the capital flows” (Bank of Israel, 2004).

To sum up, a floating exchange rate regime leads the public towards responsible management of investment; but this, provided that monetary and fiscal policy have become previously credible. Thus, what is needed for Israel’s financial stability is the setting of acceptable and credible monetary and policy targets together with a flexible exchange rate regime. In the following chart we are able to observe the evolution of the NIS exchange rate with respect to the US Dollar and the Euro over several years.
III. Debt management and monetary authorities’ rooms of manoeuvre

A. Debt management

Since the mid 1980’s, one of the main concerns of the Israeli government has been to reduce Israel’s deficit in order to achieve budget balance (see section 5.b: The Central Bank of Israel: Conflicts and Credibility). A low budget deficit and, in turn, a decreasing government debt is one of the prerequisites, inter alia, to ensure sustainable economic growth. Indeed, although in recent years the increase in the government deficit and in the debt to GDP ratio are not unique to the Israeli economy and have characterized many of the developed countries, an entry into a prolonged trajectory of deficits and a growing debt to GDP ratio may damage confidence in the markets and hamper the economy’s financial stability. In addition, another advantage of a reduction on the level of debt is that it lowers
interest payments, which are a heavy burden on the State budget and on the Israeli economy, i.e. equal to 31.1 percent of the State budget in 2003.

After the Economic Stabilisation Plan, in 1985 and up to the year 2000, the Israeli government debt to GDP ratio was constantly decreasing at a rate of about 5.1 percent per annum (on average), bottoming at a level of 88 percent of GDP in 2000. This decreasing trend was mainly due to economic growth in Israel during that period, to the State revenues from privatisation of public companies, and to the fiscal discipline that was maintained in spite of many pressures. However, in the period 2001 to 2003, Israel’s government debt dramatically increased. In 2001, debt amounted to 93 percent of GDP; in 2002 debt rose to 102 percent; in 2003 debt continued to increase up to 104 percent. In 2004 the debt to GDP ratio decreased back to 102 percent due to a sharp increase in GDP. However, even if the debt to GDP ratio decreased, the amount of debt increased by 2.3 percent (i.e. NIS 539 billion) as compared to its level in 2003. The reason for an increasing level of debt during these years was the severe slowdown in economic activity in the country. As a result of low activity, government tax collection diminished and the budget deficit increased beyond its planned target.

Despite the reduction in the Government's gross debt, the current debt to GDP ratio of 102 percent is higher than the average of 77 percent in OECD countries and 78% in the EU. Israel’s debt to GDP is definitely higher than the 60 percent target specified in the European Stability and Growth Pact (the Maastricht Treaty).

The following figure shows the evolution of Israel’s government debt and deficit as a percentage of GDP.
B. Financing and composition of Israel’s government debt

The Bank of Israel Law prohibits the Central Bank from extending credit to the government. There are two other ways in which the government may finance its debt. On the one hand, the government may finance its debt by raising the tax burden. On the other hand, the government may also finance its debt by borrowing from the public, i.e. by issuing government bonds. Both practices come with a cost.

When the government raises taxes, people are less willing to invest and work, and an underground economy emerges. Second, international competitiveness with respect to taxes decreases the inclination to increase overseas investment, to the detriment of domestic investment. This practice is not widespread in Israel. Indeed, Israel’s corporate tax burden amounted to 28.6 percent of GDP in 2003, a
much lower level than in most western countries. The corporate tax burden of OECD members averaged 36.3 percent in 2003.

On the other hand, the Israeli government may also finance its debt by issuing bonds. This practice, although the most common in Israel, also has a cost:

- When the government issues bonds, interest on those bonds must be paid yearly. A large amount of debt, and therefore of issued bonds, increases the amount of tax revenues that must be allocated in order to service debt. Such revenues decrease the amount of spending that the government would use for other purposes (like education or health, among others); this in turn creates pressure to increase debt even further in order to enable expenditure to rise.

- Government debt likewise has an inverse effect on the rate of interest. In Israel, as in many countries, the rate of interest on bonds is used as a benchmark to fix interest in the private sector. Thus, the higher the government debt, the greater the cost of capital for the whole economy.

- An increase in debt increases the debt to GDP ratio. The debt to GDP ratio is one of the indicators for rating the degree of financial stability in a country. If the debt to GDP ratio increases, Israel’s rating is decreased and the cost of capital increases both for the government and for the private sector.

- An increase in the budget deficit also has an adverse effect on the balance-of-payments deficit. When the government increases expenditure, the budget deficit increases. The reason is that an increase in government spending generally generates an increase in imports, while neither changing nor even reducing exports.

Nonetheless, an increase in government deficit and debt may also help to increase economic growth, yet a permanent increase cannot be sustained because it creates inflationary pressures and tension on the financial markets. Thus, the rate of increase in government deficit and debt must somehow be stabilised to low levels, or at least to a lower rate than the rate of economic growth.

Despite its adverse effects, Israel’s government debt is basically financed by the
issuance of government bonds. Israel’s debt is composed of domestic debt and external debt. Domestic debt is divided into non-tradable bonds and tradable bonds. The non-tradable domestic debt is made up of earmarked bonds issued to the pension funds and insurance companies, various loans, deposits, and emissions. However, as of January 2004 designated bonds to pension funds are expected to cease according to the reform approved in May 2003, pursuant to which a transition of the pension funds towards financing the professional and private sector and capital markets is required.

The tradable domestic debt comprises non-linked, CPI-linked, and US dollar-linked debt. In the past, the tradable domestic debt was almost entirely linked to the CPI or the US dollar. However, the Ministry of Finance made a substantial effort to increase the proportion of non-linked debt in order to obtain a more balanced debt portfolio. Holders of tradable domestic government bonds are diversified and include different types of financial investors: mutual funds, provident funds, insurance companies, banks, foreign investors, the public and pension funds. The share of foreign investors in the government bond market is low relative to their high participation in the Israeli corporate stock market.

At the end of September 2004, the government's external debt was equal to 25 percent of the total government debt. Despite its relatively low share in the total debt, external debt is issued in two forms: in the form of “Israel Bonds” and in the form of external loans guaranteed by the US Government.

At the end of 2004, 33.3 percent of the total external debt was raised by the Development Corporation for Israel (the Israel Bonds organization) in the form of “Israel Bonds”. Through this type of bonds, the Israeli Government obtains favourable terms relative to other external channels. This form of external borrowing is unique to the State of Israel, and it is due mainly to the ability to persuade Jews abroad to invest in Israel. Israel Bonds emphasize to worldwide Jewish communities the need to contribute to the economic wellbeing and security of the State of Israel. They serve as a stable source of external borrowing, and they fulfil an important role in maintaining ties with the Jewish Diaspora and in the diversification of borrowing sources, especially during periods when the government has difficulty borrowing from other external sources.
On the other hand, 47.1 percent of the Israeli Government's external loans are tradable debt guaranteed by the US Government. These loans are taken on favourable terms because the US Government's rating is substantially higher than that of the Israeli Government. From 2003 and up to 2005, new negotiable bonds guaranteed by the US government are expected to be the principal component of external government borrowing. At the end of September 2004, the share of US dollar-denominated debt in the Israeli Government's external debt was 91 percent. This high share is a result of the US Government-guaranteed debt of the total external debt and the US investors' dominance in the purchase of Israeli Government bonds. In recent years, the Government has been making an effort to further diversify the currency denomination of the government debt.

The Israeli Government also raises money by making non-tradable private placements. Although they are limited in size, these placements improve the pricing of long-term foreign currency denominated government bonds.

Regarding maturity, at the end of 2004 the maturity of total debt was 6.8 years on average and the maturity of internal debt was 5.3 years on average.

Finally, Israel will receive $360,000,000 in 2005 as a cash transfer from the US, acting through the USAID program. This cash transfer will be used by Israel to repay its debt to the US, including re-financed Foreign Military Sales debt, and to purchase goods and services from the US. In fact, the US encourages Israel to reduce government spending and deficits, and continue the structural reforms which go towards ensuring the country’s stability and economic growth.

The table below shows the composition of gross government debt and its financing.
### Table 1: Gross Government Debt and Government Borrowing

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<td><strong>B. Share of Government debt in GDP (percent)</strong></td>
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<td><strong>C. Composition of debt by indexation</strong></td>
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<td>32</td>
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<td>29</td>
</tr>
<tr>
<td>2. Unindexed</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>7</td>
<td>9</td>
<td>10</td>
<td>13</td>
<td>14</td>
</tr>
<tr>
<td>(fixed interest)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Dollar-indexed</td>
<td>4</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>3</td>
<td>4</td>
<td>3</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>------------------</td>
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<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>5. At floating interest</td>
<td>4</td>
<td>4</td>
<td>3</td>
<td>3</td>
<td>5</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>12</td>
</tr>
<tr>
<td>6. Total</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>

D. Share of interest payments on Government debt in GDP (percent)

| 1. Internal debt | 3.7 | 3.8 | 3.8 | 3.6 | 3.8 | 3.7 | 3.6 | 4.4 | 4.1 |
| 2. External debt | 1.5 | 1.5 | 1.4 | 1.2 | 1.2 | 1.3 | 1.2 | 1.2 | 1.2 |
| 3. Total debt | 5.2 | 5.3 | 5.2 | 4.8 | 5.0 | 5.0 | 4.8 | 5.6 | 5.3 |
| 4. Total debt according to Maastricht² | 12.4 | 10.2 | 10.7 | 6.1 | 5.1 | 5.8 | 7.8 | 4.9 | 5.8 |

E. Composition of Government borrowing by type of debt (percent, during period)

<p>| 1. Domestic | 76 | 76 | 79 | 84 | 86 | 89 | 87 | 73 | 72 |
| a. Tradable | 56 | 49 | 56 | 59 | 57 | 67 | 69 | 57 | 65 |
| of which CPI-indexed | 20 | 25 | 15 | 14 | 6 | 13 | 27 | 22 | 20 |
| Unindexed (fixed interest) | 19 | 18 | 17 | 22 | 29 | 33 | 26 | 24 | 29 |
| Dollar-indexed | 7 | 3 | 16 | 11 | 1 | 0 | 0 | 0 | 0 |
| At floating interest | 10 | 3 | 7 | 12 | 21 | 21 | 16 | 11 | 16 |
| b. Nontradable (all CPI-indexed) | 20 | 28 | 23 | 25 | 29 | 22 | 19 | 17 | 7 |
| 2. Abroad | 24 | 24 | 21 | 16 | 14 | 11 | 13 | 27 | 28 |
| 3. Total | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 |</p>
<table>
<thead>
<tr>
<th>F. Composition of Government borrowing by indexation (percent, during period)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. CPI-indexed (including nontradable)</td>
</tr>
<tr>
<td>2. Unindexed (fixed interest)</td>
</tr>
<tr>
<td>3. Dollar-indexed and in foreign currency</td>
</tr>
<tr>
<td>4. At floating interest</td>
</tr>
<tr>
<td>5. Total</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>G. Composition of domestic tradable borrowing (percent, during period)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. CPI-indexed</td>
</tr>
<tr>
<td>2. Unindexed (fixed interest)</td>
</tr>
<tr>
<td>3. Dollar-indexed</td>
</tr>
<tr>
<td>4. At floating interest</td>
</tr>
<tr>
<td>5. Total</td>
</tr>
</tbody>
</table>

1Balance of debt at end of period divided by GDP during period (the method used in the Eurozone).

2Nominal interest plus indexation differentials.

Bond management in Israel should go in the direction of integrating the domestic capital market into the global capital markets. At the end of 2004, the share of the unindexed fixed-interest debt accounted for 14 percent of the total amount of debt. This proportion should be increased because unindexed fixed-interest debt is the most widely traded debt in the international markets. At the same time, its term to maturity should be lengthened in order to promote financial stability.

It is also desirable that the share of tradable debt should continue to increase, and it is likely to do so due to the pension reform which put an end to the issue of non-tradable bonds to the pension funds. The market for tradable government bonds is the market which determines the long-term rate of interest in Israel. Moreover, an increase in tradable bonds will bring about a deepening and broadening of the tradable bonds market.

Finally, the amount of interest payments on the government debt is high compared to other countries: in 2004, interest payments in Israel amounted to 5.4 percent of GDP, whereas in OECD countries they were only 1.9 percent on average, and 3 percent in the EU. This is due to the high level of government debt in Israel compared to these countries. Therefore, it is desirable to continue reducing the budget deficit, which will also reduce debt and in turn the cost of servicing such debt.

The following graph compares interest payments and government debt among countries.
Figure 7 shows that both government debt and interest payments in Israel are well above the average for OECD countries and the countries in the Eurozone.

In order to lower the debt to GDP ratio, the Israeli Government should continue to reduce its budget deficit while maintaining inflation at low levels. With a decrease in deficit and debt, budget resources will be released to finance other vital
expenses. In the very short run, interest payments on the debt are an inflexible part of the budget and they restrict the government’s ability to allocate resources to other important objectives. Moreover, a reduction in government deficit and debt will favour the reduction of yields and the development of the private bond market, and will improve the credit rating of Israel’s economy.

Credit rating agencies estimate the probability with which a bond issuer (the government or a company) will be able to repay its debt. Credit rating agencies (like Standard and Poor’s, Moody’s or Fitch) make an evaluation of the risk linked to short-term and long-term bonds and thus reduce the uncertainty that potential investors face. For that purpose, rating agencies make an evaluation of different aspects which combine political and monetary indicators as well as debt characteristics, the foreign sector and a country’s government budget. As such, the debt to GDP ratio is one of the basic indicators used by credit rating agencies because it is a measure of economic stability. Thus, the lower the debt to GDP ratio, the lower the cost for both the government and the business sector to obtain financing.

Israel’s credit rating has been improving over the years. In the beginning of the 1990’s, rating agencies were rating Israel’s credit to BBB- levels. Nowadays, Israel’s ratings stand at A2 in Moody’s notation, and A+ and A- for long term and short term debt respectively in S&P’s and Fitch notation.10

IV. The banking system and the capital market. Liquidity and credit developments and disponibilities.

A. Israel’s banking system structure

Israel’s banking system is highly developed. At the end of 2001, there were 43 banking corporations operating in Israel. This number decreased since the 1990’s when there were 58 banking institutions; and decreased further to 38 banks in 2003. The banking sector is nonetheless very concentrated in Israel; the five largest banking groups (HAPOALIM (30.3 percent), LEUMI (29.6 percent),

10 A table for credit rating scales can be found in the Appendix.
DISCOUNT (16.4 percent), MIZRAHI (9.5 percent) and FIRST INTERNATIONAL (8.5 percent) held 95 percent of total assets in the system, and the first three accounted for over 76 percent of the holdings in 2003.

Israeli banks are allowed to conduct, in addition to traditional banking services, other non-banking activities such as underwriting securities, operating provident funds, intermediation and trading in securities through segregated non-bank subsidiaries.

However, Israel’s banking system underwent some structural changes in the last few years. On the one hand, the banking system, essentially state-owned at the beginning of the 1990’s with the State holding 90 percent of the four largest groups, has been considerably privatised. In June 2004, the State owned 36.9 percent of Bank Leumi Le-Israel and 57.1 percent of Israel Discount bank. Privatisation is still in progress; in May 2004, M. I. Holdings (the entity that sells bank shares on behalf of the Government) issued a public tender for the sale of Israel Discount Bank shares to a controlling party. On the other hand, several banks, particularly smaller banks, have closed or merged recently.

Another important reform in Israel’s banking system concerns the Prohibition on Money Laundering Law, which was enacted by the Knesset in August 2000, and the reporting requirements pertaining to the obligations imposed on financial entities which took effect on February 2002. The Prohibition on Money Laundering Law established the Israel Money Laundering Prohibition Authority to collect and process reports received in accordance with the provisions of the law and, where there is suspicion of money laundering activity, disseminate such reports to the proper authorities. The Law makes money laundering a criminal offence punishable by imprisonment and fines. The Law also requires various financial institutions to identify their clients before conducting a financial transaction, to report certain financial transactions to the Money Laundering Prohibition Authority and to maintain records of such transactions.

B. The Tel-Aviv Stock Exchange (TASE)

The Tel-Aviv Stock Exchange is the Israeli stock market. The Tel-Aviv Stock
Exchange was incorporated and commenced operations in 1953. In 1968, the Israeli parliament, the Knesset, enacted the Securities Law, which is the basis for regulating the TASE operations. In 1997, the fully automated Tel Aviv Continuous Trading, or TACT, system was introduced, and since the end of 1999, all listed securities as well as derivative products are traded on the new integrated trading platform.

The equity market is the main market of the Tel-Aviv Stock Exchange. Some 1,000 securities are traded, including shares, warrants and convertible bonds. The Fixed Income Market includes government bonds, which account for most of the trading, and corporate bonds. CPI-linked bonds were the most popular until recently, but the slowdown of inflation has substantially increased the proportion of non-linked bonds with either floating or fixed interest rates. Options and futures are traded in the Derivatives Market which, until 1999 used the open outcry method that was changed into the TACT system at the end of that year. The TASE trades put and call options and futures contracts on the TA-25 Index, the TA-Banking Index and the exchange rate of the local currency (shekel) versus the US dollar and the Euro.

The securities market has been growing in recent years. The turnover of equities, bonds and TA-25 index options reached a record level in 2004. The General Stock Index gained 20 percent in 2004. The TA-25, TA-100 and Tel-Tech indices rose 25 percent, 21 percent and 18 percent respectively. Such gains were due mainly to the favourable economic environment in Israel, the cut in the Bank of Israel interest rates and strong earnings reports by listed companies. These factors contributed to increasing rates in the stock markets despite the unstable security environment in the country.

In 2004, the total turnover in the equity market amounted to $147 million (daily average) which was the highest in TASE history. Capital raised was also the highest of the last decade, amounting to $3.6 US billion. Market capitalisation has also been increasing in past years, reaching $92.1 US billion and achieving $100 US billion only in the first quarter of 2005. Public offerings of TASE-listed shares in Israel and the US also increased drastically by $1.1 US billion, around five times the amount raised in 2003. $700 million were raised in the TASE stock exchange.
and $400 million were raised by dual-listed\textsuperscript{11} companies in the US. The government raised $140 million through the sale of shares, a drastic decline compared to $260 million in the previous year.

**Table 2: Main Indicators of the Equities Market, 1992-2004**

<table>
<thead>
<tr>
<th>Year</th>
<th>Daily Turnover (US$ millions)</th>
<th>Capital raised (US$ billions)\textsuperscript{(2)}</th>
<th>Market capitalisation (US$ billions)\textsuperscript{(1)}</th>
<th>Number of listed companies (1)</th>
<th>TA-100 Index % change (US$ terms)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>59</td>
<td>1.9</td>
<td>29.6</td>
<td>378</td>
<td>61.9</td>
</tr>
<tr>
<td>1993</td>
<td>123</td>
<td>3.1</td>
<td>50.8</td>
<td>558</td>
<td>17.0</td>
</tr>
<tr>
<td>1994</td>
<td>104</td>
<td>1.8</td>
<td>32.7</td>
<td>638</td>
<td>(30.7)</td>
</tr>
<tr>
<td>1995</td>
<td>37</td>
<td>0.7</td>
<td>36.5</td>
<td>654</td>
<td>15.7</td>
</tr>
<tr>
<td>1996</td>
<td>33</td>
<td>0.8</td>
<td>35.9</td>
<td>655</td>
<td>(2.4)</td>
</tr>
<tr>
<td>1997</td>
<td>59</td>
<td>2.2</td>
<td>46.4</td>
<td>659</td>
<td>26.8</td>
</tr>
<tr>
<td>1998</td>
<td>62</td>
<td>2.1</td>
<td>40.9</td>
<td>662</td>
<td>(12.4)</td>
</tr>
<tr>
<td>1999</td>
<td>86</td>
<td>1.5</td>
<td>65.4</td>
<td>654</td>
<td>62.7</td>
</tr>
<tr>
<td>2000</td>
<td>115</td>
<td>3.3</td>
<td>66.8</td>
<td>665</td>
<td>3.2</td>
</tr>
<tr>
<td>2001</td>
<td>64</td>
<td>1.3</td>
<td>57.6</td>
<td>649</td>
<td>(16.4)</td>
</tr>
<tr>
<td>2002</td>
<td>51</td>
<td>1.2</td>
<td>42.6</td>
<td>624</td>
<td>(30.6)</td>
</tr>
<tr>
<td>2003</td>
<td>80</td>
<td>0.7</td>
<td>70.4</td>
<td>577</td>
<td>73.9</td>
</tr>
<tr>
<td>2004</td>
<td>147</td>
<td>3.6</td>
<td>92.1</td>
<td>578</td>
<td>21.0</td>
</tr>
<tr>
<td>2005</td>
<td>221</td>
<td>-</td>
<td>100</td>
<td>-</td>
<td>3.2</td>
</tr>
</tbody>
</table>

\textsuperscript{(1)} At year end

\textsuperscript{(2)} Including issues abroad of dual-listed companies, tender offers, private placements and exercised warrants. Excluding issues of ETFs and closed-end funds exercise of warrants by subsidiaries.

*Source: Ministry of Finance, Israel.*

\textsuperscript{11} The Dual Listing Law came into effect in October 2000. Dual listing facilitates quick and uncomplicated listing on the TASE, for companies listed on the NYSE, AMEX and Nasdaq-National Market in the US.
In the bond market, debt raised by corporations and by suppliers of structured products increased to $4.7 billion in 2004, which is more than double in comparison with the year 2003. The government increased its debt raised abroad and sharply reduced the volume of domestic bonds. Overall, the capital raised by government bonds decreased only a little as compared to the previous year. Bond prices rose by 7.1 percent in 2004, following a sharp increase of 22.9 percent in 2003.

Table 3: Main Indicators of the Bond Market

<table>
<thead>
<tr>
<th>Years</th>
<th>Market capitalisation (US $ billions)</th>
<th>Capital raised (US $ millions)</th>
<th>Average daily trading volume (US $ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Government Bonds</td>
<td>Corporate Bonds</td>
<td>Government Bonds (1)</td>
</tr>
<tr>
<td>1996</td>
<td>37.8</td>
<td>2.9</td>
<td>566</td>
</tr>
<tr>
<td>1997</td>
<td>38.1</td>
<td>2.8</td>
<td>-1562</td>
</tr>
<tr>
<td>1998</td>
<td>34.7</td>
<td>2.7</td>
<td>-672</td>
</tr>
<tr>
<td>1999</td>
<td>36.9</td>
<td>2.8</td>
<td>-79</td>
</tr>
<tr>
<td>2000</td>
<td>38.9</td>
<td>2.5</td>
<td>-1995</td>
</tr>
<tr>
<td>2001</td>
<td>41.0</td>
<td>3.0</td>
<td>1237</td>
</tr>
<tr>
<td>2002</td>
<td>41.6</td>
<td>3.4</td>
<td>4933</td>
</tr>
<tr>
<td>2003</td>
<td>52.5</td>
<td>5.1</td>
<td>4196</td>
</tr>
<tr>
<td>2004</td>
<td>58.7</td>
<td>10.8</td>
<td>4149</td>
</tr>
<tr>
<td>31.05.2005</td>
<td>58.1</td>
<td>16.3</td>
<td>-811</td>
</tr>
</tbody>
</table>
(1) Issues-redemptions

Source: TASE

Table 4: Annual Yields of the Bond Indexes, 1994-2004

<table>
<thead>
<tr>
<th>Year</th>
<th>General Bond Index (1)</th>
<th>CPI linked (1)</th>
<th>Non-linked Bonds (1)</th>
<th>Dollar Linked</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>8.0</td>
<td>9.0</td>
<td>9.2</td>
<td>0.0</td>
</tr>
<tr>
<td>1995</td>
<td>5.2</td>
<td>5.2</td>
<td>13.0</td>
<td>5.3</td>
</tr>
<tr>
<td>1996</td>
<td>9.1</td>
<td>9.5</td>
<td>12.8</td>
<td>6.2</td>
</tr>
<tr>
<td>1997</td>
<td>3.3</td>
<td>2.4</td>
<td>7.0</td>
<td>4.3</td>
</tr>
<tr>
<td>1998</td>
<td>(7.2)</td>
<td>(8.8)</td>
<td>(5.2)</td>
<td>3.4</td>
</tr>
<tr>
<td>1999</td>
<td>6.5</td>
<td>4.9</td>
<td>14.0</td>
<td>4.2</td>
</tr>
<tr>
<td>2000</td>
<td>7.4</td>
<td>5.0</td>
<td>15.1</td>
<td>5.9</td>
</tr>
<tr>
<td>2001</td>
<td>3.6</td>
<td>5.3</td>
<td>0.7</td>
<td>3.0</td>
</tr>
<tr>
<td>2002</td>
<td>(6.7)</td>
<td>(6.0)</td>
<td>(9.0)</td>
<td>0.8</td>
</tr>
<tr>
<td>2003</td>
<td>22.9</td>
<td>19.5</td>
<td>29.5</td>
<td>3.0</td>
</tr>
<tr>
<td>2004</td>
<td>7.1</td>
<td>7.3</td>
<td>7.3</td>
<td>2.3</td>
</tr>
</tbody>
</table>

(1) In US $ terms

Source: Ministry of Finance, Israel

Despite recent developments and favourable economic conditions coupled with the larger presence of foreign capital, mostly in the high-tech industry, Israel’s stock exchange market remains among the lowest in terms of total market capitalisation as compared to developed countries. The following graph compares the total stock market capitalisation of several countries:
C. The banking sector and the capital market

In capital markets the world over, numerous non-bank financial intermediaries function alongside the commercial banks. In this way, the different entities in the capital markets compete with each other and reduce the costs of intermediation.
(both spreads and agency costs), thereby ensuring the efficient allocation of resources and enhancing the performance of the economy as a whole.

In sharp contrast to that system, in Israel both commercial banking and financial intermediation activities are completely dominated by banks. In fact, the degree of concentration of the Israeli capital market is one of the world’s highest. The existing market structure, with banks dominating in all areas of financial intermediation and no other significant financial intermediaries, creates several problems, such as:

- the absence of a non-banking credit market has made the business sector almost solely dependent on the banks. This concentrates credit decisions in the hands of a small number of participants and limits the amount of available sources of capital (both debt and equity);
- lack of competition and the acute dependency on the banking system increase the cost of capital and inhibit economic growth;
- the high level of concentration and the dependency created by it constitute a significant risk to the country’s financial stability.

The underdevelopment of the Israeli capital market is not surprising given the characteristics of the assets held by the main non-bank financial institutions. Until recently, those assets were mostly non-tradable, indexed government risk-free bonds. Moreover, several obstacles also limited the development of capital markets, such as tax and regulatory and accounting rules.

At the end of 2004, a proposal was formulated by the Israeli Ministry of Finance aiming to reform the capital market in Israel. The reform points towards creating a competitive capital market and, it explains, should be based on three main processes (Inter-ministerial committee – “Bachar” report, 2004):

- enhancing competition in the management of the public’s financial assets by developing alternative investment vehicles to those offered by the banks;
- enhancing competition in credit provision by developing non-banking
credit instruments;

- enhancing competition vis-à-vis the household sector by exposing households to alternative systems of credit suppliers and by considering measures that would make it easier to switch from one bank to another.

According to the Ministry of Finance, 80 percent of the money managed in mutual funds is owned by the banks and 73 percent of the assets in provident funds are also under banking system ownership. In the retail credit market the situation is even worse, with 100 percent held by the banks versus only 25 percent in the US, for instance, according to the Bachar Report.

The IMF report on the Israeli economy for the year 2004 points out that the capital market is underdeveloped. Indeed, the corporate bond market is thin, although growing, and a number of alternative instruments that are available in other capital markets are completely lacking in Israel. However, the IMF mission that wrote the report applauded the Israeli authorities for undertaking a series of procedures to remove obstacles to enhancing capital market development. In particular, they shed light on the following obstacles: both the reduction of non-tradable government bonds, and the limited bank exposure to individual and connected lenders will stimulate the demand for other capital market instruments; the removal of barriers to the development of capital market instruments will also have a positive effect on the development of the capital market.

On the other hand, the report also claimed that the development of the capital market will require stronger regulation in some respects, as for example regarding provident funds and pension funds, disclosure and transparency, and the monitoring and enforcement of these regulations. The independence of a regulatory body is also required as well as appropriate incentives in the market for the fostering of competition.

D. Competition in the banking sector

As highlighted above, competition is an important issue in the Israel banking sector. Competition can be measured with the help of different tools. A first tool for evaluating competition is the degree of concentration which can be measured
by the Herfindahl Index. Even compared to a decade ago, concentration in the banking system has decreased; the Herfindahl Index amounted to 0.24 in 1994 and diminished to 0.22 in 2000. The Index rose again in 2003 to 0.23. Notwithstanding, this measure shows that concentration in the banking system is higher in Israel than in peer countries. In 2002, the Herfindahl Index stood at 0.18 in Greece, 0.17 in South Africa, 0.16 in Canada, 0.10 in Spain, 0.9 in France and 0.4 in UK (Bank of Israel, 2003).

Indeed, as stated above, assets in Israel’s banking system are concentrated in the hands of a small number of banks, the proportion of assets held by the largest banking groups having increased since 2000 from 75.4 percent to 77.2 percent in 2003. A similar increase in concentration occurred with respect to deposits by the public.

Another measure of competition is the market power index, which is calculated as the difference between the bank’s price of its output (credit) relative to its cost. Data show that the market power exerted on households by Israeli banks is larger than the market power exerted on firms\textsuperscript{12}. But this phenomenon is also found in European countries. Data also show that market power has increased for both households and firms and that the gaps between the two have narrowed.

Contestability is also an indicator of competition. It accounts for the activity of the capital market and other financial institutions as a substitute of banking intermediation. The amount of credit extended by the banking industry in Israel decreased mainly after 2003 for two reasons. The first reason is that, after the lessons learned from the recession period, where excessive credit was allocated, the banking system reduced the amount of credit lent to the private sector in a cautious and regulated manner. The second reason is that, exploiting the boom in financial markets during 2003, firms issued a number of marketable and non-marketable bonds that competed with those of the banking sector. As a result, credit allocations from the banking sector fell by NIS 9 billion for the first time in a decade. Thus, even if the presence of credit substitutes only appeared due to a decrease in the supply of credit by the banking sector, contestability increased

due to the presence of these alternative sources of credit.

To summarize, the Herfindahl Index, the concentration of assets in the hands of a small number of banks and also the market power index suggest a slight to negligible increase in competition in the banking industry. This is a weakness in the banking sector industry in Israel. On the other hand, contestability shows a certain degree of development towards increasing competition. And, even if contestability is far from reaching efficiency, several developments are expected in the capital and money markets in order to impulse competition further.

The structural changes mentioned above also had an impact on the banking sector competition in Israel. Mergers and acquisitions had a very small or even negligible effect on competition due to the size of the banks merged; but liberalisation in financial markets and privatisation did have a positive impact in increasing competition. It is also important to note that, contrary to experiences in the past, potential collusion between the banking sector and businesses is drastically removed with the obligation of banks to disengage from major industry participation. Since 1997, banks have been forbidden to hold more than 20% of a firms’ non-financial assets.

In the IMF reports for the years 2003 and 2004 on the Israeli economy, several points are made about concentration in the banking industry. These reports encourage the continuation of the regulations undertaken to increase competition but they also stress the still insufficient degree of competition in this sector and its undesirable effects such as the potential conflicts of interest that may arise. In the 2004 IMF report, the dominance of the two largest banks in the areas of deposit taking, underwriting and managing mutual and provident funds is qualified as undesirable. However, it is observed that Israeli banks do not appear to earn monopoly profits, i.e. companies seem to be able to obtain funding on reasonable terms and competition seems to work effectively in some sectors of the market. This report also points out that it would be desirable for banks not to be the dominant suppliers of mutual and provident funds. Reforms should tend towards encouraging insurance agents to sell investment products other than life insurance in order to compete with banks.
E. Performance of Israel’s banks

As far as performance is concerned, Israel’s banking sector performance increased dramatically in 2003 following the two difficult years of recession that preceded it. The return on assets rose from 2.8 percent in 2002 to 8.4 percent in 2003. The main contribution to the increase in banks profits in 2003 was the development in the financial sector which resulted from a monetary policy that was less rigid than in previous years. Indeed, interest rates declined in 2003 both short-term (from 9.1 percent to 5.2 percent) and long-term (from 5.7 percent to 4.3 percent). Moreover, the increase in bank profits was also influenced by the recuperation of economic activity in Israel in the year 2003 following two years of recession. This recuperation was reflected in an increase of 1.3 percent in the GDP. The IMF report for the year 2003 on the Israeli economy also remarks that the banking sector was strengthened in 2003 in terms of profitability, capital adequacy ratios, and provisions relative to non-performing loans.

Despite increases in the growth rates of the GDP and the State-of-the-Economy (Composite) index in 2003, the credit risk in the banking system remains high. The ratio of problem loans to total credit rose from 10.1 percent in 2002 to 10.5 percent in 2003; the ratio of non-performing credit to total credit, which maintains a positive relationship with the probability of future loan-loss provision, was maintained at a level as high as in 2002 (2.6 percent); and the ratio of loan-loss provision to total credit actually decreased, though still remaining high relative to ratios in advanced economies. Moreover, due to a fall in credit resulting from regulations and the positive growth in GDP, the credit/GDP ratio declined in 2003. All these factors lead to the conclusion that the Israeli banking system is exposed to a high degree of credit risk.

In 2003, there was a rise in the risk-weighted capital ratio because of economic recovery in Israel. This raised the safety margin of the capital ratios above the requisite 9 percent minimum. The average ratio for the five major banking groups was 10.32 percent, compared to 9.9 percent in 2002. This will allow banks to increase credit allocations again in the future. However, the risk-weighted capital ratio remains low in Israel relative to other western banking systems, where this ratio is above 11 percent.
F. Availability of bank credit in Israel

Until the mid-1980’s, large-scale government borrowings to finance government activities severely limited the role of financial intermediation by banks and other private sector financial institutions. This in turn limited the availability of capital resources in Israel. The reductions in government deficit and borrowing since that time, along with capital market reforms, have reversed this trend. Availability of capital resources to the private sector has significantly increased, giving the banks a larger role in the financial system.

Over the past decade, the trend was towards significant increases in bank credit (an average rise of 8 percent annually), but this trend halted in June 2002. Furthermore, for the first time in a long period, the balance of outstanding credit of the five major banking groups declined by 1.3 percent in 2003 from its level in 2002. Also for the first time, the credit to GDP ratio declined in 2003 (although only very slightly) and stood at 1.08 at the end of the year, down from 1.11 at the end of 2002. The decline in credit is in equilibrium the result of both the decline in the supply of bank credit, and the drop in demand for such credit. The aggregate demand for credit was affected by the ongoing recession in the principal industries, which led to a sharp decline in investment, and consequently, a drop in demand for credit by businesses.

Despite these developments, large firms took advantage of the economic recovery in the stock market and issued negotiable and non-negotiable bonds totalling approximately NIS 15 billion in 2003. Bond offerings replaced bank credit, and thus constituted a major factor in the lower demand for bank credit from these companies, and the increased contestability facing the banking system.

During the past two years the share of bank credit in total credit declined significantly. This process is known as disintermediation, which was evident mainly in 2003, and indicates an increase in contestability (an important element in developing competition in the banking sector) with regard to raising credit between the banking system and alternative sources of supply.
Although the weight and scope of this contestability are far from adequate, it can be considered that basic steps to be taken in the future to improve financial and capital markets - particularly those relating to introducing substitute deposits and credit, such as repurchase agreements, buying or selling short, issuing commercial paper, encouraging securitization in the various markets, and speeding up the process of issuing corporate bonds - will contribute to boosting competition in the banking industry, to the greater benefit of the public.

There was also a slight decline this year in the share of deposits by the public in banks within the total portfolio of public assets. This was the result of an increase in public assets not held in banks because of the stock market boom.

To summarize, the improved capital/risk-weighted-assets ratio in 2003, which took place against the background of early signs of economic recovery, raised the safety margin of the capital ratios beyond the required 9 percent minimum. This will allow the banks once again to increase the amount of credit extended to the public in the future, thereby contributing towards helping the economy out of the recession. Nonetheless, it is important to remember that the capital/risk-weighted-assets ratio in Israel’s banking system is still low relative to that of other western banking systems—10.3 percent compared with over 11 percent respectively.

G. Access to credit in Israel

As mentioned in previous sections, Israel underwent a process of financial liberalisation after the Economic Stabilisation Plan in 1985, with all barriers to international trade being removed. In order to go along with the lifting of foreign exchange controls, the Central Bank and the government had to implement an extensive deregulation of the domestic money and capital markets. Indeed, since the beginning of 1990s, there has been progress in the liberalization of foreign exchange controls and Israel’s economy is now open to the free flow of goods and capital. However, the capital account has been liberalised in an asymmetric manner: restrictions on inflows have been removed faster than on outflows. Thus, inflows of private capital have increased notably in recent years. In particular, inflows doubled from 1998, when they were $5,786 million per annum, to
$11,684 million per annum in 2000. As for capital outflows, they also increased but at a lower rate: $5,858 million in 1998 to $9,333 million in 2000. In the years 2001 and 2002, both capital inflows and outflows decreased due to the economic recession that took place in Israel; nevertheless, both flows began increasing again from 2003 and increased still further in 2004. Investment in Israel by non-residents in 2004 was $6,649 million, and overseas investment by residents was $9,563 million (Bank of Israel, 2005).

Starting in 2002, the amount of capital raised by Israeli companies through the issue of shares both at the Tel-Aviv Stock Exchange and abroad continued to rise in 2004 and at the beginning of 2005. Issues totalled NIS 21.4 billion in 2003 and amounted to NIS 56 billion in 2004 and NIS 27.8 billion in the first quarter of 2005. The increase of funds raised on the stock market is the result of the Israeli banks’ conservative credit policy - which drove companies to seek alternative non-bank sources of finance - the expectation of growth and profitability of the issuing companies, and the development of capital markets.

In addition, increased investment in Israel is also due to the State of Israel’s clear objective to create a favourable environment for both national and foreign investment. This favourable environment takes the form of financial aid and fiscal advantages that apply to both national and foreign investors. One of the most important instruments to attract investment in Israeli corporations is the partial or even complete waiver of taxes. Among other benefits, investors can also enjoy higher amortization rates. The legal environment is favourable too: foreign investment is completely free, only a declaration is required if the investor wishes to enjoy the existing advantages. The net outflow of international portfolio investments totalled $400 million in the first seven months of 2004. However, towards the end of the year the trend reversed, and the net inflow for the whole year totalled $480 million, the highest ever. At the end of the year, international investors held 10.5 percent of the market capitalisation.

Moreover, foreign investment in Israel in the past was directly linked to Israel’s industrial evolution towards high-tech sectors, telecommunications, electronics, aeronautics, biotechnologies and medical engineering. More than 3,000 start-ups have appeared in these sectors and around 100 of them are listed on American
financial markets, in particular on NASDAQ.

Foreign investment corresponds mostly to American firms which have participated in such start-ups via venture capital financing. Capital raised by Israeli Venture Capital funds has also been in line with economic and political trends. A large increase was seen at the end of the 90’s, which then decreased in 2001, 2002 and 2003 because of an overall economic slowdown and political instability. Nevertheless, the trend evolved towards an increase in 2004. Indeed, capital raised by Israeli venture capital funds in 2004 was $724 million. $300 million of this was raised by Pitango for a fourth fund, $200 million was raised by Gemini for a fourth fund, and Giza Venture Capital raised $120 million for its fourth fund. The evolution of venture capital raised is illustrated in the figure below:

**Figure 9:**

*Capital raised by Israeli Venture Capital Funds during 1995-2004*

Source: Bank of Israel data.

Finally, according to the Israeli Venture Capital Research Centre, capital available for investment in the first quarter of 2005 is equal to $1 billion, and $1.5 billion is projected to be raised by VCs in 2005.
V. Credibility issue

A. The Central Bank of Israel: independence

The Bank of Israel was officially established on the December 1st, 1954 and, since then has been in charge of Israel’s monetary policy. The Governor of the Bank is appointed by the President of Israel, at the recommendation of the Government, for a period of five years. The current Governor of the Bank of Israel is Professor Stanley Fischer. The Governor manages the Bank of Israel but also serves as economic advisor to the Government on currency and other economic matters; he also participates in meetings of the Ministerial Committee of Economic Affairs.

With the establishment of the Bank, the Bank of Israel Law was also introduced in 1954. Since then, only one amendment has been made. In 1985, after the Economic Stabilisation Plan, a legislative change was introduced known as the Non-Printing Law, in which the government was forbidden from asking the Bank to print money for government purposes.

The Bank of Israel Law places special emphasis on the Bank’ independence; however, even if the degree of independence of the Bank of Israel has evolved over time according to economic changes and thinking and is nowadays not inconsiderable, some changes still need to be implemented. In particular, the amendment to the Bank of Israel Law, proposed by the Israel Ministry of Finance, has been examined by the legal department of the European Central Bank. This department analyses the central bank laws of all countries wishing to join the Union, and verifies that those laws do not contradict the European Union requirement of central bank independence. In an assessment of the proposed amendment of the Bank of Israel Law, the European Central Bank states that “The Bank of Israel Law and the amendment proposed by the Ministry of Finance are basically inconsistent with the European Union Treaty and the European System of Central Banks Statute” (Bank of Israel, 2002) The Statute specifies that central banks shall have institutional, financial and operational independence, and decision makers must have personal independence. In some respects the BoI Law needs updating. In its assessment, the ECB explains that the Bank of Israel Law proposed by the Ministry of Finance runs counter to the institutional independence

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of the Central Bank. There are several reasons for this:

1) The BoI Law does not give higher priority to price stability than to other targets, such as the support of the government’s economic policy, a high rate of investment or a low rate of unemployment. Multiplicity of objectives hampers Central Bank credibility. Thus, the Law should be amended so as to specify price stability as the Central Bank’s primary objective. Moreover, the Monetary Council’s decisions should not be subordinated to the policies determined by the government in order to guarantee Central Bank independence. In this respect, the BoI Law is incompatible with EU requirements.

2) As far as operational independence is concerned, the BoI Law lacks a statement of exclusive responsibility of the Bank in the formulation and implementation of monetary policy. Indeed, the existing Law requires government approval of any decision regarding the issuance of securities for monetary policy purposes, and decisions related to the regularisation of liquidity. Both clauses compromise the independence of the Central Bank.

3) The ECB Statute also requires personal independence to ensure that no conflict of interest arises among decision makers in the central bank. Therefore, the European law prohibits members of a monetary council from holding any office in a business organization or public body. The Bank of Israel Law does permit members of the Monetary Council to hold a position in a business organisation, thereby leaving scope for conflicts of interest among parties.

4) The financial independence of a central bank is also crucial: a central bank should have enough economic sources to carry its role. The Bank of Israel Law does not contradict European requirements in this respect. However, the Law specifies that the budget of the Bank should be approved by an external body, such as the Knesset (Israel’s parliament) and this is contrary to the European Statute, since it could generate conflicting interests and, again, jeopardize the Bank’s credibility.

5) The International Monetary Fund has also given some recommendations with respect to BoI transparency and accountability. The IMF argues that it is important to update the current Bank Law to reflect international best practices, which are desirable in their own right and also
would help achieve price stability.

To summarize, the Bank of Israel nowadays enjoys a not inconsiderable degree of independence. However, the existing Law is outdated: it lacks a proper definition of the Bank’s primary objective, which should be set to price stability; it renders ambiguous the division of tasks between the Bank and the government, thus allowing scope for potential conflicts of interest; it lacks an independent body to make policy decisions; and it lacks formal schemes of transparency and accountability. All these factors combine to endanger the credibility of the Bank in shaping monetary policy. Thus the BoI Law requires amendment in order to be compatible with the new reality and strengthen Israel’s macro-economic infrastructure.

B. The Central Bank of Israel: conflicts and credibility

As was seen in the section above, a credible monetary policy which guarantees financial stability must begin by ensuring Central Bank independence. However, several economic theorists (Sargent and Wallace 1981; Woodford 2001) have argued that it is equally important to avoid fiscal dominance when attempting to guarantee effectiveness of monetary policy which, in turn, is crucial for financial stability and credibility.

Fiscal dominance is defined as the duty of monetary policy to ensure the solvency of the public sector for any arbitrary fiscal policy. In other words, with fiscal dominance, fiscal policy moves first and monetary policy accommodates it so as to achieve budget balance. The undesirable effects of fiscal dominance are the eventual failure of monetary policy in its attempt to reduce inflation, i.e. disinflation must be at some point be sacrificed in order to ensure public solvency.

Fiscal dominance has unfortunately been present in the Israeli economy during two periods in past years. The first was, fairly obviously, the inflationary era that Israel experienced between the years 1973-1985. During this period, high inflation rates and large deficits characterized the Israeli economy, i.e. an inflation target was non-existent. The second period was the more recent years of 2001 to 2003. During that time, the worldwide economic slowdown and the compromised political situation in Israel induced the Israeli government to act towards a
dominant fiscal policy which strongly affected credibility and left monetary policy ineffective.

As recently argued by Meir Sokoler, the current Deputy Governor of the Bank of Israel, one of the important issues to enhance credibility in Israel is to recognise that guaranteeing Central Bank independence is not enough to avoid fiscal dominance. The interaction between monetary and fiscal policy is considerably affected by the legal and institutional framework in Israel. Several factors account for this:

1) Section 45 of the Bank of Israel Law prohibits the Central Bank from extending credit to the government.
2) The Budget Deficit Reduction Law in 1992 requires that the government’s budget deficit as a percentage of GDP declines year by year.
3) By law, the Governor of the BoI is also economic advisor to the government. He participates in the government’s discussions on budget issues such as government expenditure, taxes, size and sustainability of deficit and debt.
4) By law, the BoI is the fiscal agent of the government; thus, the Treasury must discuss debt management issues with the BoI.

However, whereas all these factors should lead us to think that the institutional status in Israel is enough to ensure Central Bank independence and monetary policy effectiveness, recent circumstances have shown that the situation is more problematic than previously thought.

The deterioration of world economies and the security and political situation in Israel at the end of the year 2000 changed the trend in GDP growth from 6% in 2000 to -0.9 percent in 2001 and 2002. During 2001 the situation worsened and it became evident that the deficit target, which was to be decreased year by year as established by the Budget Deficit Reduction Law, would be exceeded by a large amount. As a result, the Budget Deficit Reduction Law was breached many times with its first amendment in 1997.
In response to the persistent budget deficits, the Knesset approved the Deficit Reduction Law in 1992. This law required that the targeted domestic budget deficit (excluding credit granted by the government), as a percentage of GDP, should decrease each year during the period between 1993 and 1997. In 1997, an amendment of this Law specified the budget deficit targets for each year until 2001 (see figure below). Total deficit, excluding net allocation of credit as a percentage of GDP, amounted to 2.8 percent in 1997, 2.4 percent in 1998, 2.5 percent in 1999, 0.7 percent in 2000, 4.5 percent in 2001, 3.8 percent in 2002 and 5.6 percent in 2003. Other amendments to the Deficit Reduction Law were passed in recent years. Under the last amendment approved by the Knesset, the total budget deficit is targeted not to exceed 4.0 percent in 2004 and 3.0 percent in 2005 as a percentage of GDP (previous targets were 3.5 percent and 2 percent for 2004 and 2005 respectively). This amendment was required as a result of a sharp decrease in activity within the Israeli economy, caused by a world economic slowdown, a severe crisis in the high-tech sector and the deterioration of security conditions in Israel, which drastically reduced revenues collection, and made it difficult to attain the pre-specified deficit targets.

Thus, the amendments of the Budget Deficit Reduction Law have often revised the deficit target upwards and have pushed the date for achieving a zero target deficit further and further in the future. The two figures below show actual deficits and deficit targets over several years, and the breaches of deficit targets.

**Figure 10:**
Figure 11: Target deficit updates

It soon became apparent that the new targets would not be achieved either and financial markets sharply reacted: the exchange rate shot up and became more volatile, inflation expectations moved upwards, well above the target, the probability of large depreciation of the shekel increased and interest rates also increased for all maturities. The response of the government to these conditions was to shorten the maturity of the new bonds issued. This fact was perceived by the public as a move towards fiscal dominance.

The BoI reacted by increasing interest rates several times; however, very negative reactions in the financial market persisted and the government was forced to pass a new upward revision of the budget deficit to 3 percent in 2003. Afterwards, the Knesset was dissolved.

The total government budget deficit in 2003 amounted to 5.6 percent of the GDP. This was a considerable deviation from the planned deficit of 3 percent. The origin of this deviation was the government’s domestic activity, and the increase in domestic deficit was mainly due to substantially less tax revenues than originally planned (a decrease of 3.3 percent in real terms as compared to 2002). However, the domestic deficit in 2003 was financed for the most part by raising net capital in Israel, and a small proportion was financed from capital raised abroad.

Nevertheless, after 2003 the situation in Israel stabilised in a rather low activity level but an emergence from recession became apparent after several strict policy measures and recovered security in the country. In 2004, improvement in tax revenues led to an improvement in the budget deficit for that year, which was targeted to 4 percent of GDP. Moreover, a decline in the budget deficit led to a decline in the public debt level and hence a decline in the debt/GDP ratio. The Bank of Israel also took some measures to bring down the nominal interest rate which amounted to 9.1 percent in December 2002. The nominal interest rate was reduced to 5.2 percent in 2003, and continued to fall, reaching 4.1 percent in 2004.
VI. Final assessment and recommendations

When looking at Israel’s economy, one can observe that on the monetary side, monetary policy is a success, i.e. very low rates of inflation, low expected inflation and price stability. According to the Central Bureau of Statistics (CBS), the year-on-year rate of inflation in June 2005 was only 0.3 percent compared to 1.3 percent in December 2004. And in mid-July, expected inflation increased to around 2.0 percent, still within the government target range. At the same time, the short term interest rates fixed by the BoI are at their lowest level ever. Given the relative stability in inflation expectations, the BoI announced that its benchmark interest rate for July 2005 will remain unchanged at 3.5 percent, and it is also likely to remain at this level in August (Bank Leumi Le-Israel, 2005). On the other hand, the CBS documents an increased GDP growth in the first quarter of 2005 to 3.3 percent instead of 2.9 percent as previously estimated. As pointed out by Professor Stanley Fischer (2005), these results were achieved despite the long-lasting dispute with Israel’s neighbours. Israel’s economic development was accompanied by a high degree of integration into the global economy, a complete openness to foreign direct investments and a stability of the exchange rate. Israeli high-tech companies are very active in the international financial market and in particular on the US Nasdaq.

Yet despite these positive achievements some problems remain unsolved. These include a high unemployment rate, a high debt/GDP ratio and fiscal dominance. These factors make it more difficult for the Israeli economy to realise its full potential (Sokoler, 2005). Indeed, for the BoI to be able to fulfil its functions more efficiently, i.e. price stability and robustness of the financial system, a new BoI Law is necessary to increase the Bank’s independence, and thereby its international credibility.

With regard to macro-economic policy, a more efficient “policy mix” (i.e. coordination between monetary policy and fiscal policy) is required alongside a responsible fiscal policy, i.e. one that will decrease the tax burden and the debt burden in the long term. Furthermore, close attention must be focused on financial markets and the banking system to make them more competitive and more efficient in the financing of the economy.
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VIII. Appendix

Table 5:
Table of rating scales for long term – S&P, Fitch and Moody’s

<table>
<thead>
<tr>
<th>Moody’s investment grade</th>
<th>Aaa, Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2, Baa3</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P / Fitch investment grade</td>
<td>AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB-</td>
</tr>
</tbody>
</table>

Source: Israel Ministry of Finance, capital markets.
CHAPTER IV: GOVERNANCE AND INSTITUTIONAL ISSUES

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I. The Israeli Political Process

A. Background

The system of governance in Israel is a coalition democracy, with the President as the Head of State.

The Israeli parliament, the Knesset, is elected once every four years. It is comprised of 120 delegates, known as Knesset members. Knesset decisions are carried out by the Prime Minister and cabinet members, who represent the major parties in the Knesset. Elections are direct and confidential, based on parliamentary lists and not independent candidates. The electoral system in Israel is based on national proportional representation. In other words, the elected lists are represented in the Knesset according to the relative percentage of all voters that voted for them. The parties are required to pass a "qualifying threshold" (a minimum percentage, currently about 2% of all votes) in order to enter the Knesset. The lists that pass this threshold win seats in the Knesset proportionately to their electoral power.

Israel's government is headed by a Prime Minister, who is selected through a process of coalition negotiations and pacts. These are political alliances between the different parties that want to be part of the coalition, based mainly on agreements on common policy and methods. Both the pacts themselves and the negotiations towards them must be transparent and disclosed to the public. If such a pact is breached, or if a coalition party disagrees with government policy, such party is liable to threaten to leave the coalition, thereby causing its collapse and hence the collapse of the government. This is a popular method for parties to gain power and is used as a means of exerting pressure on the government to promote a given party's interests. In building coalitions, prime ministers aspire to "broad coalitions" of over 61 Knesset members, in order to ensure greater stability of the coalition and broader public legitimization for implementing public, national, defence, and social policies, which are often stumbling blocks for governments.

In other words, the Knesset is the "house of representatives" of the State and as such, its members represent the public. The parties that participate in the
elections and pass the qualifying threshold are represented in the Knesset by "factions." The factions that support the government are called "coalition factions," and those that do not support the government are known as "opposition factions."

It is noteworthy that parties that deny Israel's right to exist as the State of the Jewish people, negate the democratic character of the State, or incite racism are not eligible to participate in elections.

1. The different authorities

In a democratic regime, there are three different authorities. The government authorities are not interdependent and they operate separately, but at the same time they check and balance each other, and the division is intended to prevent the concentration of government power in any one authority.

The legislative authority - The Knesset

The Knesset is named for the Great Knesset, the supreme institution of the leaders of the Jewish people and its sages in ancient Jerusalem, after the return of the Jews from the Babylonian Diaspora in the fifth century BCE. The number of members in the present day Knesset, 120, is also identical to the number in the ancient Great Knesset.

Knesset members represent the different interests, views, and groups of citizens in the State of Israel. Their election reflects the power relations of the different parties among the citizens who vote in the elections. Thus, interrelationships develop among coalition and opposition factions within the Knesset. These affect the relationship between the government (the executive branch) and the Knesset, and the work of the Knesset as the legislative authority and the authority that oversees the executive branch.

The Knesset simultaneously fulfills two roles: it is responsible for enacting the laws of the State and for creating a constitution. Therefore, it is also known as the "constituent-constitutional authority." In addition, the Knesset is also responsible for ensuring the existence of a democratic regime in Israel. In this capacity it oversees and controls the government and is responsible for the election of the President of the State and the State Comptroller.
The Knesset is the only governing authority in Israel that is authorized to enact laws. These laws apply to all citizens of the State, as well as government authorities. According to the principle of government by law, all citizens are subject to the law and equal before it. Laws passed in the Knesset are known as "primary legislation." In the Knesset, the legislators determine the general instructions of the law. In order for the government to act according to the laws determined by the Knesset, it publicizes the instructions for performance of the law in the form of regulations and decrees. This government legislation is known as "subsidiary legislation" or "administrative legislation." Subsidiary legislation must not contradict primary legislation. The initiative for enactment of laws may come from Knesset members ("private members' bills") or from the government ("government bills").

As previously stated, the Knesset is divided into two groups – the coalition and the opposition. The coalition is a combination of parties that pass the qualifying threshold in the Knesset elections and support the government. The opposition consists of parties that pass the qualifying threshold in the Knesset elections, but do not support the government and its policies. The role of the opposition is to criticize the government and monitor its activities. The opposition has the right to propose a vote of no confidence in the Prime Minister, to submit proposals for the agenda and inquiries to initiate public discussion on the government's functioning, and to vote on laws and call public attention to issues it considers important.

The opposition presents an alternative to the existing government, but also protects the right of the public that elected it during the present government term. The opposition tries to offer an alternative to the present government and to bring it down by expressing lack of confidence in the Prime Minister and the government, delaying or rejecting bills (thus impairing the government's ability to function as the executive branch), or voting against the budget. It may also bring about the downfall of the government through the State Comptroller, who is elected by the Knesset to prepare a critique of the government and its ministries, as well as other institutions, and submit them for Knesset discussion and approval.

The Knesset also has semi-judicial authority, including removing a Knesset
member's immunity and removing a State President from his or her position.

**The Executive Branch: The Government**

The law states that "the government is the executive authority of the State." The law defines the government as the executive authority, thereby separating it from the legislative authority (the Knesset). However, the term "executive authority" is not completely accurate, since the government is primarily an independent body that makes decisions and determines and implements policy, and not merely a body that implements the decisions of the legislative authority. In effect, it can be said that the government is not the executive body of the Knesset, but rather of the entire State. It is the government that makes decisions regarding going to war, signing peace agreements, changing economic or social policy, and the like.

The government is composed of the Prime Minister, ministers, and the heads of the civil service (directors general, department managers, etc.). Every government minister is responsible for a particular government ministry (a "portfolio"), but there may also be people holding the rank of minister who are not responsible for any ministry ("ministers without portfolio").

The Prime Minister and Deputy Prime Minister must be members of the Knesset, but this constraint does not necessarily apply to other ministers. All ministers must be Israeli citizens and Israeli residents.

The Israeli government usually has a large number of ministers, which encumbers its ability to make decisions effectively and swiftly. For this purpose the cabinet, a smaller and more efficient body, was set up. The cabinet is not mentioned in the Basic Law: The Government. The cabinet makes decisions on highly important issues, and considers only select issues. Despite the existence of the cabinet, it is the government that directs matters of State and makes decisions on most important issues. Not every government of Israel has had a cabinet.

Among the powers of the Israeli government are policy making and decision making, the institution of regulations and issuing decrees, acting in the name of the State and managing its affairs (as long as this power is not invested by in another authority, "residual authority"), and the institution of regulations for times of emergency.

In the government, as in the Knesset, a large portion of the work is implemented
in the framework of either permanent committees or committees established to handle specific matters. When Israel is engaged in negotiations, whether with a hostile country during war or in peace negotiations, the State may be represented by a "team of ministers," which is not a formal body and is not anchored in the law, but fulfills an important role in the decision making process.

A government resigns when its term of office ends, the Prime Minister resigns, and the government does likewise, the Prime Minister dies, or the government loses a no-confidence vote against it. The Basic Law: Government specifies the situations in which the government completes its job. Moreover, the outgoing government continues to fulfill its role until a new government is founded. This government, known as a "transition government" wields all the authority of a regular government. It cannot be brought down by a no-confidence vote and its ministers are forbidden to resign, so that the State is not left without a functioning government. If the Prime Minister dies or is unable to fulfil his role, one of the ministers who are also a Knesset member is appointed by the government to serve as Acting Prime Minister until the new Prime Minister assumes office. The Acting Prime Minister has all the rights of the permanent one, except for the right to dissolve the Knesset.

B. Constitutional Framework

The State of Israel has no official constitution. At the time of the Declaration of Independence of the State, a decision was made to prepare such a constitution, but this was delayed because of opposition from the religious parties and the government’s fear that such a body of law would encumber it. In the 1980s, the debate on the establishment of a constitution spread beyond the walls of the Knesset and became a public struggle, led by a group of professors from Tel Aviv University. However, to date there is still no constitution. The debate on the importance of the constitution and its content continues today. There are those who consider the State of Israel a Jewish state and believe that any constitution should reflect this, while others see the State of Israel as a democratic state for the Jewish people, and believe that the constitution should be of a liberal democratic nature, determining democratic norms and values as accepted in Western democracies.
In addition, there are some religious Zionists who think that the constitution of Israel should reflect an integration of the values expressed in the original Jewish teachings and Western democratic principles. Many members of the ultra-Orthodox community completely negate the idea of a man-made constitution, considering the Jewish Scriptures to be the sole constitution governing the Jewish people. In 1950, at the end of the initial debate in Israel regarding the institution of a constitution, a compromise was reached. Known as the "Harari Resolution," it instructs the Knesset to build a constitution chapter by chapter, with each chapter constituting a separate Basic Law. When all the Basic Laws are approved, they will become the constitution.

1. The Basic Laws of Israel

The Basic Laws of Israel differ from ordinary laws in status, content, and form. In status, Basic Laws are of a higher order, meant to stand above regular legislation. This is ensured by two means. First, the alteration of such a law requires an absolute majority (over 61 Knesset members) or a special majority (over 80 Knesset members), and not an ordinary majority (the majority of those voting, regardless of their number). However, some Basic Laws in Israel are not protected in this way. Second, every Basic Law includes a clause that prevents legislators from passing any bill that conflicts with the values and principles contained in that Basic Law.

In content, Basic Laws express the principles of the State according to two fundamental values – a Jewish state and a democratic state. The Basic Laws determine the structure of the regime, define the powers of the government and the interrelationship among the authorities, and ensure human and civil rights.

In form, the wording of the Basic Laws is general (details are specified in ordinary laws) and structured as formal laws. The year of legislation is not specified, unlike ordinary laws, for which the date of legislation has significance because a later law cancels out an earlier law on the same subject. This highlights the notion that the time a Basic Law was enacted is meaningless with respect to its relevance and existence.
2. Basic Rights:

In 1991, the State of Israel ratified the international charters on human rights that it had signed in the past. The State undertook to protect and preserve human rights within its territory and adapted its laws to the spirit of the chapters to set up mechanisms to enforce these laws. In addition, the State undertook to report regularly to international organizations on the upholding of the principles of the charter.

The following is a list of charters that the state of Israel has signed and ratified:

- The Civil Rights Charter (1966)
- The Charter of Elimination of All Types of Racial Discrimination (1966)
- The Charter Against Torture and Any Inhuman or Humiliating Treatment or Punishment (1984)

As a Jewish State, Israel's implementation of these charters and rights is deficient, because of the requirement to protect national security and preserve the Jewish character of the State alongside the commitment to protect human rights. The State of Israel also expressed reservations about some sections of the charters which it signed and ratified, particularly regarding the freedom to marry and establish a family without discrimination.

Although the State of Israel does not have a constitution, its judiciary system includes several regular laws and two Basic Laws that protect human rights in the State of Israel. The intention is to legislate a declaration of Basic Rights in the State of Israel gradually, right by right.

In comparison with the laws mentioned above, there are laws in the State of Israel that discriminate against different population groups, such as the Basic Law: Israel Lands and the Law of Return.

The following are a few examples of human rights laws in Israel:

- Women’s Equal Rights Law (1951)
Equal Rights for People with Disabilities Law (1998)

Government authorities in Israel have an obligation to intervene when human rights are violated, and to provide services that ensure the safeguarding of these rights. In addition, government authorities must not intervene in a person's private affairs. It is possible that government authorities will violate or overlook human rights that are not protected and guaranteed by law or by a constitution. This situation may arise from the State's interest in ensuring its security.

The courts in Israel, and especially the High Court of Justice, play an important role in protecting human and civil rights in the State of Israel, whether anchored in the law or not. Rulings of this Court have created a series of precedents that safeguard such rights in Israel. They have created social and cultural norms, a sort of bill of judiciary human rights, to recognize human and civil rights in the State of Israel and guide government authorities and courts to act accordingly.

Various voluntary organizations also work to preserve and protect human rights in the country. These include the Association for Civil Rights, the National Council for Child Welfare, the Women’s Lobby in Israel, Adalah (The Legal Center for Arab Minority Rights in Israel), and the Council of Arab Women.

C. The Law-making Process and the Rule of Law

1. Law-making Process

In the process of enacting laws, a distinction is made between a bill presented as a private resolution (independently, by a Knesset member) and a government bill. When a bill is submitted personally, it must be approved by the Speaker or Deputy Speakers of the Knesset (who constitute the Knesset presidium). To be approved, a bill must not negate the values of the State, must not be racist or antidemocratic, and must not contradict the existence of the State of Israel as the homeland of the Jewish people. After approval is obtained, the bill is presented for preliminary discussion to the Knesset plenum (the plenum is a meeting of all Knesset members in the Knesset meeting room). After preliminary discussion, a vote is taken on whether to continue the legislative process. This stage of
preliminary discussion and the voting that follows it is called "the preliminary reading stage." Once the resolution passes this vote by a majority, it is referred to a relevant Knesset committee. That committee then prepares the bill for the first reading before the Knesset plenum.

In comparison, in the case of a government bill, the ministers discuss the resolution and vote on its approval. The bill is then submitted for a first reading in the Knesset.

When a bill is brought to the Knesset plenum, three separate voting stages take place (first, second, and third readings). Between votes, the bill is discussed and amended, outside experts are consulted, and so on. When a bill is approved at the third reading, it is brought before the President, the Prime Minister, and relevant minister to sign. Bills become effective upon signature. Every new law cancels the preceding law that dealt with the same issue. Laws are published immediately upon their approval by the State.

2. **Separation of Powers in Israel**

The classic model of separation of powers differentiates between the legislative, executive, and judiciary branches and recognizes the need to differentiate the three functions and assign each to a different authority, in order to ensure political liberty. This model requires a balance of powers, but it does not require absolute separation of authorities, as they can be balanced even if their areas of activity overlap slightly. Aware of this classic model, the founders of the government in Israel determined that the legislative authority, the Knesset, would determine policy, and the government would execute this policy. In other words, the "legislator" supersedes the "executor." When it was decided that it was not necessary for government ministers to be Knesset members, the government ceased being a "committee" of the Knesset and thus the principle of separation of power still exists.

The government is not the legislative authority, but it initiates many of the laws and executes subsidiary laws. The judicial authority also issues precedents and interpretations of the law. Furthermore, it performs a sort of control over the existing legal situation and may call upon the government and the Knesset to propose laws in order to alter the situation.
The implementation of laws is usually entrusted to government bureaucracy, but the Knesset also passes private bills (such as the Law to Reinter Herzl's Remains in Israel - 1949, which was actually an executive-administrative decision.) The Supreme Court can be seen as intervening in execution and the other courts implement laws and estates.

Although the judicial branch is charged with making its decisions according to all rules and laws, there is intensive judicial action in the framework of "administrative law," or bodies that include judges on behalf of the executive authority.
In addition, the Knesset is solely authorized to judge the State President and State Comptroller, as well as make disciplinary judgments in the Knesset and decide on removal of the immunity or suspension of a Knesset member. According to the law, the Knesset and the government may also participate in the judiciary process by means of investigative committees. Investigative committees are always headed by a judge.

3. Judicial Authorities

The judicial authority in the State of Israel is comprised of regular law courts and tribunals, which are granted their power by the Basic Law: The Judiciary. The regular courts have general judiciary authority over criminal, civil, and administrative matters. In contrast, the tribunals have judiciary authority in very specific areas and between very specific people. For example, the religious tribunals rule on domestic matters (marriage and divorce) and the labour tribunals have authority over cases dealing with labour relations.

In 1980 the Courts Law was enacted, for the first time determining the basis of Israeli law. According to the Courts Law, whenever there is no legislation or explicit ruling on a given matter, the court shall base its decision upon the principles of liberty, justice, fairness, and peace, as expressed in Jewish heritage. The law does not define Jewish heritage, and this concept may be interpreted in different ways. Judicial authority is not dependent upon other government authorities or on any person. The judge is subject to the rule of the law of Israel.
alone. This arrangement is meant to ensure objectivity, equality, and a fair trial between individuals. Judges are permitted to rule according to the formal wording of the law, or to interpret the law as they see fit, according to the accepted democratic principles at the time of the decision. In the absence of an explicit law, precedents set by judges on these bases have created a judiciary charter of human and civil rights.

Court hearings are meant to be open, so that justice can be seen by all to be done, but the court has the authority to decide on a discussion being held in camera (behind closed doors), in order to protect national security, a minor, or in matters of domestic or ethical law. In camera discussions may also be held when a public discussion may deter witnesses. It is forbidden to publish the contents of a discussion behind closed doors without the explicit consent of the court. The judicial authority is also responsible for the appointment of judges at all court levels, as well as appointment of judges to national investigative committees.

The regular court system comprises several levels, or jurisdictions:

The Magistrates Court has first jurisdiction over criminal and civil matters as defined by the law (criminal offenses for which punishment is up to seven years imprisonment, and civil offenses for which the fine is up to a given amount of money). In the Magistrates Court a single judge presides over each case. Appeals of decisions of the Magistrates Court can be presented to the District Court.

The Magistrates Court also serves as the Family, Small Claims, Municipal and Traffic court. In every Magistrates Court, there is a bailiff’s office, which is responsible for carrying out the decisions of the courts and tribunals.

The District Court has first jurisdiction over matters that are not within the realm of the Magistrates Court,, as well as second jurisdiction to hear criminal and civil appeals of decisions of the Magistrates Court, and to amend or overturn them. It has the same authority regarding appeals of rulings of administrative tribunals and other bodies. The District Court is also authorized to hear petitions from prisoners, appeals regarding taxes and appeals on election to the Knesset.

A single judge presides over regular hearings of the District Court. When the
hearing deals with an appeal of a Magistrates Court ruling, or the first jurisdiction of a particularly serious case, three judges preside over the court. Appeals of the decisions and rulings of the District Court are presented to the Supreme Court. When the District Court hears a second proceeding (an appeal), the judge's ruling must specify permission to appeal to the Supreme Court. The Supreme Court judge may also grant such permission. There is no need for permission to appeal where the District Court served as the first jurisdiction.

The **Supreme Court** is the highest court in the State of Israel. Rulings of the Supreme Court supersede all lower courts and all other government authorities in Israel. The court usually sits in panels of three judges. In exceptional instances, a panel of eleven judges may hear a case. The Supreme Court also serves as the appellant court and as the High Court of Justice.

When the Supreme Court serves as an appellant court, it hears second and third appeals of judicial decisions and rulings of District Courts and the Magistrates Courts. In addition, it hears other judicial matters, such as the legality of Knesset elections, disciplinary law of the Bar Association, petitions of prisoners, and matters of administrative detention.

As the High Court of Justice (known by the Hebrew acronym Bagatz), the Supreme Court hears first and last proceedings on matters between citizens and the government, particularly challenges to the legality of decisions of different authorities, such as national and local government, or other bodies and public officials.

The **High Court of Justice** has the authority to issue different orders, such as *habeas corpus* (release orders, e.g. to a prison governor, requiring the presence of a person in court so that he or she can prove the illegality of his or her detainment or imprisonment); orders to authorities to act in favor of a petitioner, or an instruction not to perform a given act towards a citizen); prohibition and inquiry orders (prohibiting special, e.g. military or religious courts, from hearing a given matter). The High Court of Justice may issue an order for inquiry if it believes that a court did not abide by all the rules of hearing as defined by law (in other words, the High Court may discuss legal proceedings, but not the deliberations of the judges or the decision itself); or an order releasing a
4. The Governance System:

The structure of the governance system is one of checks and balances. As we have shown, it is difficult for the government to move its policy smoothly through the different governing systems.

The system is characterized by three central elements, each of which requires the approval of the others in order to perform its activities and promote its interests. These entities are:

• The government and its ministers, which represent the ruling political forces of the country;
• The Knesset, which includes both the political opposition and the interests and agents of all the political forces; and
• The professional government staff who, although not strictly civil servants in the British sense, bear a much closer resemblance to the British model than to the American one, in which the minister appoints the chosen staff.

Although this mechanism has a significant disadvantage, as shown, of compromise on optimal policy on the one hand, on the other hand it creates a balanced system of relations that prevents the promotion of activity by one party without the supervision, control, and agreement of the other governance systems.

The Prime Minister is head of the executive branch and the cabinet, and has enormous influence on the coalition that dominates the Knesset. The Prime Minister is also the head of his political party, a formal position that enhances his political power.

Between 1996 and 2001, prime ministers were directly elected by the voters. According to Arian A. Nachmias D. and Amir R., as a consequence, they were elevated to primus in relation to the cabinet. Following the reform, the Prime Minister was given the authority to appoint and dismiss cabinet members, to set the jurisdictional responsibilities of ministries and to reorganize their functions and
structures. Moreover, he had the power to appoint, with the cabinet’s approval, the head of non-elected power-sharing institutions such as the Governor of the Bank of Israel, the Attorney General and the Director of the Mossad. The direct election of the Prime Minister was aimed at resolving the deadlocks of governance in Israel’s parliamentary democracy, but in fact, according to Arian A. Nachmias D. and Amir R., it achieved quite the opposite effect: “The reform eroded the electoral strength of the two big parties, thus intensifying the Knesset’s partisan fragmentation. As a consequence, directly elected prime ministers became institutionally and personally more powerful while at the same time their ability to steer and govern become even more dependent on forming relatively stable and policy-coherent governing coalitions.” Consequently, the reform had been cancelled after 2001.

Moreover, in cases of policy disagreements the Prime Minister tends to appeal directly to the voters, proposing a referendum and bypassing the Knesset.

Another important element, which is outside the direct realm of activity but serves as a check, is the judiciary system. This system is particularly important to factors outside the government, such as NGOs. These organizations have learned to use the judiciary system, and particularly the High Court of Justice, in order to prevent government and Knesset activity (or failure to act).

One of the main organizations that take advantage of the judiciary system for the promotion of government activity is Adam Teva V’din, the Israel Union for Environmental Defense (IUED). This organization has succeeded in preventing government activities that were liable to harm the environment and in promoting government intervention in cases of ongoing environmental hazards.

D. Power-Sharing with Non-elected Authorities


The Commission for Future Generations is defined in chapter 8 of the Knesset Law, in an amendment dated March 2001. The Law calls for the establishment of a parliamentary entity that will have the means to develop an overall, comprehensive view of the legislation and secondary legislation produced by the
Knesset, and to monitor it in terms of future implications, insofar as it may affect future generations of Israeli residents. The Law gives the Commissioner for Future Generations different powers during the legislative process, in order to examine bills that may be detrimental to future interests, to develop opinions on them, and to present information and recommendations to Knesset members, in the subcommittees discussions and attached to the proposal presented for a vote to the Knesset plenum. The Commission also has the power to voice an opinion and make recommendations on matters besides bill proposals and secondary legislations brought to a vote in the Knesset. In addition, it may advise Knesset members on any issue that is of special interest to future generations.

In order to fulfill these roles, the Commissioner for Future Generations has different powers within the legislative procedure and outside of it, including, among others, the authority to obtain all proposed bills, private and government, as well as secondary legislation placed on the Knesset table; to announce its intervention in the proposal of a given bill; to be invited to meetings of a committee discussing a bill; to express a position or opinion; and to be granted reasonable time by the committee chair to present such opinion. The Commissioner also has the authority to demand and receive any document, announcement, or report needed in order to fulfill these tasks, from any controlled body.

The Commissioner for Future Generations is granted authority to act in an extensive range of areas. These include the environment (the health environment bill, the tire recycling bill, the greening of the Knesset bill), as well as different environmental issues (air pollution, sea pollution, open spaces, Israel's shores, and others), natural resources (the energy economy, mining and quarrying; the natural gas economy); and so forth. They also include development and technology (genetic cloning, cooperation with the Knesset Science and Technology Committee, the Chief Scientists Forum, i.e. a body comprising the Chief Scientists of government ministries, the different research institutes, the Council for National Security and others); education (sustainable education, promotion of legislation in the field of education, inclusion of children with special needs in regular education); health (air pollution – a long-term budget for investment in infrastructure that takes into account long-term implications of present day economic measures); demography; planning and construction (a national committee for planning and construction of national infrastructure); quality of life;
law (law of sustainable development, the impact of legislation on children); and any matter that the Constitution, Law and Justice Committee determines as having a considerable impact on future generations.

2. **The Governor of the Bank of Israel**\(^{13}\)

The Bank of Israel is in charge of monetary policy in Israel. The bank has several main areas of activity:

a. **Policy on interest and cash supply** – The bank determines the level of monetary interest (in the short term). By means of this policy, it influences the scope of investment in the economy, the rate of inflation, and as a result all economic activity in the economy.

b. **Supervision of commercial banks** – The bank is responsible for supervision of all aspects of the banking system – credit risk management, prevention of price fixing, prevention of money laundering, prevention of injury to consumers by creating increased competition, transparency, and flexibility in the movement of consumers from one bank to another.

c. **Management of Israel's foreign currency balances** – The bank manages balances of some $26 billion, which are invested in financial markets throughout the world.

d. **The Governor of the Bank of Israel is the government's economic advisor** – As part of his job, the Governor prepares opinions on the economic policy of the government of Israel. For this purpose, the bank has a research department, which spearheads economic research in Israel.

More recently, as monetarism has received much greater emphasis in macro-economic policy making, due to its success in controlling inflation pressures, the Central Bank has gained more influence. In Israel, unlike most other democracies where a board or a monetary council makes decisions collectively on monetary policy, the Governor is the government’s economic advisor and the sole authority in determining interest rates and regulation of foreign currency. When the Governor and the government disagree on inflation or exchange rate policies, the Governor may use his formal advisory role and the media to influence government decisions. As stated by Arian Asher, Nachmias David and Amir Ruth: “In the bargaining process thus created, the governors may use their authority as

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\(^{13}\) See also what is said on this matter in Chapter III.
economic advisors to make a particular proposal to the government; in exchange for accepting their proposals, they may use their authority at the Bank to accommodate a request of the government.”

3. **The State Comptroller**

The State Comptroller is appointed by the Speaker of the Knesset at the recommendation of the House Committee, for a renewable term of five years. He is completely independent of the government and is responsible to the Knesset only.

Even the State Comptroller’s budget is exempt from consideration by the Ministry of Finance and is submitted directly to the Knesset’s Finance Committee. The State Comptroller’s Office employs hundreds of staff members charged to check on the legality, regularity, efficiency and ethical conduct of public institutions. It controls the financial accounts and activities of all ministries, the armed forces, local authorities, corporations and organizations subsidized by the state.

The State Comptroller lacks any authority to enforce compliance and has no statutory authority of his own. He relies entirely on the Knesset to impose sanctions on the different bodies.

The State Comptroller benefits from extensive public support in comparison with other government institutions and his reports receive extensive media coverage. He enjoys broad freedom regarding topics to be investigated and the methods to be used.

4. **The Professional Staff**

The influence of the professional teams working in government institutions has increased proportionately to a growth in professional standard and expertise, operational codes and ethical codes.

For example, a government minister who wishes to promote an issue must first obtain government approval, and then get an appropriate bill through the
Knesset. Once the bill is approved, the professional ranks must implement it. This is when government bureaucracy enters the picture. The government staff has many tools for delaying and even preventing implementation of such policies. For example, there may be legal considerations that prevent its implementation, lack of funds, deviation from existing procedures, and the like. Without the support of the professional staff, and particularly that of the Ministry of Finance, implementation of such policy is liable to fail. On the other hand, if the staff has an interest in promoting a policy, it will always find solutions to obstacles and the budget to carry out that policy.

Similarly, an activity initiated by a Knesset member requires the agreement of the coalition (which comprises the government). However, as in the previous example, without the help of the professional ranks, it is difficult to carry out the action. For example, the Economics Committee demanded that the Ministry of the Environment transfers 20 million shekels from the Cleanliness Foundation budget to a recycling corporation, in order to purchase automatic collection machines. The staff in the Ministry of the Environment and the Ministry of Finance did not agree with this action, and therefore, citing deviations from the tenders law, blocked the transfer of funds. In order to persuade the ministries, the Economics Committee had to agree to promote a new law, which the ministries wanted and which had been delayed in the Economics Committee because of pressure from interested parties.

In a similar manner, the professional staff cannot act without the help of the Knesset, as demonstrated in the example of the Deposit Law amendment that the Knesset opposed. A combination of agreements and a give-and-take system is essential to the promotion of economic activity based on public policy.

5. Advantages and Disadvantages of the Actual Process

The electoral system based on integral proportional representation, and characterized by a very low threshold vote, enhances inclusiveness of all political trends of Israeli society. The striking feature of Israeli democracy is the co-existence of a highly centralized executive along with a highly fractionalized
Knesset. In order to govern, prime ministers have to rely on governing coalitions with a variety of parties. Ironically, as stated by Arian Asher, Nachmias David and Amir Ruth, as the power of prime ministers has increased, their influence in controlling majorities in the Knesset has declined. Small parties, particularly religious parties, gained disproportionate influence in the coalition formation process and consequently gained more political leverage and public resources than their strength in the Israeli electorate.

E. Business Environment

1. Background

The private sector is essential in promoting growth and expanding wealth in any country. Protection of property rights, access to credit, efficient taxation systems, regulatory costs of business have impact on investments in the private sector. The World Bank measures the business environment according to the following seven factors: Starting a Business, Hiring and Firing Workers, Registering Property, Protecting Investors, Enforcing Contracts, Getting Credit and Closing a Business.

1. The challenge of launching a business in Israel is shown through four measures: procedures required to establish a business, the associated time and cost and the capital requirement. Entrepreneurs can expect to go through only 5 steps to launch a business (regional average: 10 steps; OECD average: 6 steps) over 34 days at a cost equal to 5.5% of GNI per capita. Unlike most countries around the world, there is no minimum deposit requirement in Israel to obtain a business registration number.

2. The difficulties that employers in Israel face in hiring and firing workers are shown in the Rigidity Overall Employment Index. This index assigns values between 0 and 100, with higher values representing more rigid regulations. The Overall Index is 33 for Israel compared with the regional average of 38.7 and OECD average of 34.4.

3. Registering property in Israel is a long and costly process. Seven procedures
are necessary to transfer a property title from the seller to the buyer and it takes 144 days to register property, compared with the regional average of 54 days and the OECD average of 34 days.

4. The Credit Information Index measures the scope, quality and accessibility of credit information available through public and private registries. The index ranges from 0-6, with higher values indicating that more credit information is available. Israel has a score of 4, compared with the regional average of 2.1 and an OECD average of 5.

5. Israeli investors are highly protected (which is per se something very positive). The World Bank has created a disclosure index, which measures the transparency of transactions in 7 ways: information on family, indirect ownership, beneficial ownership, voting agreement between shareholders, audit committees reporting to the board of directors, use of external auditors, financial information to current and potential investors and public availability of ownership. The index varies between 0-10, with higher values indicating more disclosure. Israel has a score of 8, compared with the Middle-East regional average of 5.5 and the OECD high income countries score of 6.

6. Enforcing a commercial contract in Israel requires 27 procedures (regional average: 38; OECD average: 19) and lasts 585 days from the moment the plaintiff files a lawsuit until actual payment (regional average: 437 days, OECD: 229 days). The cost of enforcing contracts in Israel is 22.1 percent of debt, compared to 17.9 percent in the region and 10.8 percent in OECD countries.

7. It takes 4 years to resolve bankruptcies in Israel, whereas in OECD countries it takes only 1.7 years. Court costs and fees to insolvency practitioners, lawyers and accountants amount to 23 percent of the estate, compared to 13 percent in the MENA region and 6.8 percent in OECD countries. The Recovery Rate, measuring how many cents on the dollar claimants recover from the insolvent firm, is only 38 percent in Israel, compared to 72.1 percent in OECD countries.
F. NGOs and Interest Groups

Several main players influence economic policy in Israel:

1. The General Federation of Labor (*Histadrut*) – the organization that encompasses most of the labor unions. In the past, this organization had many assets and businesses, but due to economic difficulties, it was left with only the labor unions. Over half of the salaried employees in the economy belong to the Federation. It wields considerable power in the economy and during labor disputes, and is capable of shutting down the entire economic system. The Federation sometimes rallies all its members for strikes in specific sectors.

2. The Manufacturers' Association – the organization that encompasses most of the industrial plants in the country. The association wields considerable political power and influence on different government ministers, including the Minister of Finance. The association is involved in all structural changes and economic legislation.

3. The Chamber of Commerce – the organization that encompasses most of the merchants and importers in the country. This organization has some influence on government ministries. It is not an important player in the public decision making process.

4. Other associations and unions – numerous other associations, such as those of contractors, the self-employed, the Bar Association and Institute of Certified Public Accountants, the Hotel Association, and the like. These organizations have influence on their relevant sectors only, and are not major players in Israel's macro-economic activity.

5. Environmental organizations – dozens of such organizations exist in Israel, and their power is growing. Their influence is mainly on economic decisions that affect natural resources and the environment. These organizations have brought about changes in government decisions and increased public awareness of the environment. Their sphere of action concentrates mainly on the Knesset, the courts, planning and construction committees, and public information activity.

The main interaction in macro-economic discussions is with the Ministry of Finance, the General Federation of Labor and the Manufacturers' Association (the President of the latter is also head of the Federation of Israeli Economic Organizations, FIEO, which comprises of representatives of all the different employers).
1. Type of Existing Principal-Agent Problems

Implementation of government policy by means of government corporations:
The government performs some of its tasks by means of government corporations. The activities of such companies may sometimes deviate from or even negate government policy. This is because of the built-in conflict between the goal of the State, which is to maximize the welfare of the economy, and the goal of the corporations, which is to maximize their own profit. The following are a few examples:

a. Mekorot, (Israel National Water Company) supplies water to all consumers in Israel. According to an agreement between the company and the State, the company's expenses are covered according to normative energy costs. It is in the State's interest that Mekorot also supply water to consumers in distant and high places, which entails high energy costs, thus incurring losses to the company; Mekorot uses different claims to refrain from supplying the water.

b. Amidar (Israel National Housing Ltd.) manages State property in which residents are housed at a reduced rent. The State decided some time ago to sell these assets to their residents and appointed Amidar to perform the task. However, if Amidar sells these assets, it will lose the income it earns from managing them.

c. The State is interested in increasing the recycling of hazardous waste and reducing the scope of its burial. The Environmental Services Company holds the exclusive license to bury hazardous materials. Since every ton recycled reduces its scope of income, the company is now attempting to prevent the entry of companies that recycle hazardous materials.

G. Civil Society, the Media and Civic Liberties

The question of civil rights and civil liberties has always been an important concern of Israeli governments. It is reflected by the Declaration of Independence of the State of Israel which contains the following excerpts:
“The State of Israel will ... foster the development of the country for the benefit of all its inhabitants; (...) It will ensure complete equality of social and political rights to all its inhabitants irrespective of religion, race or sex; it will guarantee freedom of religion, conscience, language, education and culture.”

1. Political Rights and Inclusiveness

Inclusiveness is based on the notion of equality. It means that all citizens are guaranteed basic rights, including gender and racial equality before the law and the right for all to participate in the governance process on an equal basis. Therefore we are considering two main issues in this section: ethnic and gender equality in Israeli society.

Gender Equality

Gender inequality in Israel is deeply rooted. In 1999, women’s monthly wages were, on average, 60 percent those of men. Women’s hourly wages were on average 81 percent those of men. The fact that many women work part time explains some of the gap (40 percent) in monthly earnings.

To complete the analysis, we will use the comparative study of the World Economic Forum, measuring the extent to which women in 58 countries have achieved equality with men in five critical areas:

Economic participation, economic opportunity, political empowerment, educational attainment and health and well-being.

The economic participation of women is measuring the presence of women in the workforce in quantitative terms by comparing unemployment levels, the levels of economic activity and remuneration for equal work.

The economic opportunity index measures the quality of women’s economic involvement beyond their mere presence as workers. Data on the duration of maternity leave, the percentages of wages paid during the covered period and the number of women in managerial positions encapsulate the variation between the economic opportunities available to women in different countries.
Political empowerment defines the equitable representation of women in decision-making structures both formal and informal. It was measured by using data on the number of female ministers, seats in parliaments held by women, women holding senior legislative or managerial positions and the number of years a woman has been head of the state.

Educational attainment is the most fundamental prerequisite for empowering women. It is measured by collecting data on literacy rates, enrolment rates for primary, secondary and tertiary education, and average years of schooling across the population.

Health and well-being is a concept related to the differences between men and women in their access to adequate nutrition, healthcare and reproductive facilities and to issues of fundamental safety.

Israel performs particularly well on economic participation (28th rank) and on educational attainment (28th rank), coming ahead of France, Netherlands and Spain in both indices. However, Israel falls close to the bottom of the ranking on economic opportunities (40th rank), behind Greece (21st rank) and Jordan (32nd rank). While Israeli women have generally high levels of economic participation, they also appear to be subject to a lack of opportunities for advancing their careers.

The average female participation in the Knesset, which was low in 1996, standing at 7 percent of seats, behind Tunisia and Syria with 12 percent and below the world average of 15 percent, improved significantly in recent years. In the actual parliaments, women hold 18 of the total of 120 seats, bringing Israel exactly in line with the world average of 15 percent.

Israel ranks poorly on the specific elements of health and well-being (39th rank), behind Thailand (32nd rank) and Indonesia (29th rank).

Apparently Israel has not yet managed to eliminate the gender gap. This study highlights the priority areas for reform: enhancing economic opportunities for women in Israel and promoting health and well-being.

Ethnic division

Israeli society is a melting pot far more complex in nature than its American counterpart. The society is composed of a wide variety of citizens, encompassing

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14 The reader should also refer to the section on gender inequality in wages in chapter V.
immigrants from East European, Russian, Ethiopian, Middle-Eastern and Asian origins.

The main dilemma in modern Israeli society is whether Israel is perceived by the majority of its citizens as a western state with a majority of Jewish people, or whether it is a state characterized by traditional Judaism. We are not referring here to a theocratic state but to a society following the social, cultural and religious tradition of Judaism. Israeli society is divided on the basis of two distinct groups, one aspiring to a liberal western society while the other draws its identity from the tradition of Judaism. The last election in 2003 clearly reflected this issue with the emergence of the liberal Shinui party as the third biggest party while the Shas, representing traditional Sephardi jews, still remains a very influential party in Israel.

Political representation of Arab minorities at the Knesset is quite in keeping with their proportion in the Israeli population. Arab and Druze representation at the Knesset also improved over the last decade. The actual average Arab participation is 31.6 percent of seats, and the average Druze participation 9 percent. However, discrimination against Israeli Arabs can be seen in the Israeli labor market. Israeli Arabs are employed mostly in manual and lower status occupations. Therefore, opportunities for better occupations and wages in the Israeli labor market are limited for Israeli Arabs. Moreover, this discrimination encourages Israeli Arabs to establish an enclave economy with its own labor market.

Divisions within Jewish society are also apparent. Immigrants from Asia and Africa during the 1950s generally began their life at a considerable social and economic disadvantage, compared with the veteran Ashkenazi population. The socio-economic gap in the areas of income, education and social influence continued into the 1970s. The degree of power and influence held by Sephardim in the media, the intellectual elite, top positions in private and public sectors was negligible. Violent outbreaks by the Israeli Black Panthers in the early 1970s led to a considerable narrowing of the socio-economic gap. Beginning in the 80s, oriental ethnicity became a political resource. At that time there was a reconfiguration of the political debate characterized by a strong nationalist discourse in which the future of the Occupied Territories played a central role. The
Sephardi (Jews of Middle Eastern origin, often from Arab countries) right-wing votes were quickly seen as the expression of a nationalist trend, originating in their past culture. The Sephardis’ relations with the Arabs were viewed in the light of their past history, so that their conflicting relations appeared to represent revenge for the past.

As the following table illustrates, the income of Arab citizens of Israel is the lowest; in fact, relative to the average income, this income has been declining since 1995. The income of Sephardi Jews is somewhat higher. Their average income has increased over the past decade and even distanced itself somewhat from the average income of Arabs. The gap between the income of Ashkenazi Jews and Sephardi Jews remains constant. The income of Ashkenazi Jews is the highest, well above the other two groups. In 1995, it was on average 1.5 times that of a Sephardi employee, and twice as much as that of an Arab employee. Educational gaps may be explanatory variables for differences of income.

Table 1: Monthly Income of Urban Ashkenazi, Sephardi and Arab Employees’ 1995-1999
Based on 100 as the average

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Employees</th>
<th>Native Israeli born to European or US- born father</th>
<th>Native Israeli born to Asian or African-born father</th>
<th>Arabs and Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>100</td>
<td>140</td>
<td>89</td>
<td>72</td>
</tr>
<tr>
<td>1996</td>
<td>100</td>
<td>146</td>
<td>92</td>
<td>72</td>
</tr>
<tr>
<td>1997</td>
<td>100</td>
<td>137</td>
<td>91</td>
<td>72</td>
</tr>
<tr>
<td>1998</td>
<td>100</td>
<td>139</td>
<td>94</td>
<td>71</td>
</tr>
<tr>
<td>1999</td>
<td>100</td>
<td>139</td>
<td>92</td>
<td>66</td>
</tr>
</tbody>
</table>

Notes:
“Employee” includes all respondents who had any work-related income during the three months prior to the survey.
“Income” refers to all wages earned by employee respondents.
Source: CBS, Income Surveys, various years.
The socio-economic gap continues to exist, especially in education. Today only 16.5 percent of native born Sephardi Jews as compared with 56 percent of Ashkenazi “sabras” have received a college education. This is at one and the same time the result of socio-economic disparities and a major cause of their perpetuation.

2. The Influence of the Religious Communities

One of the prominent distinctions or rifts among the different groups in Israel is based on religion, a major source of controversy in Israeli society. The State must guarantee that the individuals living within its borders can choose their religion or beliefs, perform rituals, and abide by religious commandments, as they see fit, including the choice not to believe, perform rituals, or fulfill any commandments. The State does not impose any conditions on the rights and liberties of inhabitants and citizens to associate or refrain from associating with any religious group or fulfilling its commandments.

The State of Israel is the state of the Jewish people. Actually, Judaism is both a religion and a nationality; the Jewish people share one common religion – Judaism. It is this religion that has kept the Jewish people together and given them their distinct character in the Diaspora. The majority of Jews in Israel and abroad associate their belonging to the Jewish people with the basic foundations of the Jewish religion. Moreover, the decisive majority of Jews living in Israel see it as a Jewish state. However, there is controversy among them regarding the Jewish character of the State, that is, the optimal balance of religion and democracy, as well as the correct amount of Jewish religion to be incorporated into the State of Israel.

In general, there are two extreme groups – the non-religious Jews, at one end of the spectrum, and the ultra-Orthodox Jews (haredim), at the other end. Other groups, falling between these two extremes, tend toward one or the other. The non-religious, or secular Jews see Israel as the democratic state of all its citizens. They are not strictly observant; indeed some are atheists. They believe in
the need to separate religion and state, and not to interfere in the individual’s religious beliefs or impose beliefs on those who choose not to embrace them. This group of Jews is heterogeneous; it includes people who choose to abide by some religious commandments, particularly those related to traditions of the Jewish people, such as celebrating Jewish holidays.

Meretz-Yahad and Shinui, parties that represent secular Jews in Israel, fight against religious legislation and religious coercion of the non-religious public. In addition, these parties aim to ensure the equal rights and duties of religious and secular citizens.

The ultra-Orthodox Jews refute the State of Israel’s very right to existence, as humans established it as part of the Zionist endeavour, and it was not part of a process of messianic redemption. Moreover, they believe that the laws of the State should be religious Jewish laws and that the national leadership should be religious. Some ultra-Orthodox Jews participate in the political system and try to influence it from within, while a minority does not recognize the State of Israel or its institutions. The ultra-Orthodox Jews do not recognize the other, more modern streams of Reform and Conservative Judaism.

The political parties representing the ultra-Orthodox communities are Degel Hatorah and Agudat Hatorah (Ashkenazi ultra-Orthodox Jewry), and Shas (Sephardi ultra-Orthodox community). These parties are subject to the religious and political authority of the rabbis that head them as spiritual leaders, and they base their political decisions on the rulings of those rabbis.

In between the two extremes on the scale of religious beliefs are some other prominent groups:

**National (or Zionist) Religious Jewry:**

In contrast to the ultra-Orthodox, who do not recognise the establishment of the State of Israel because it is not part of the messianic redemption, the religious Zionists view the establishment of the State as the beginning of the redemption of the Jewish people. They recognize Israel as a democratic state with Western characteristics, despite their own dedication to the principles of Jewish law. The
members of the religious Zionist movement participate fully in the social, economic, cultural, and political life of the State of Israel, including fulfilling national obligations, such as military service for men or non-military national service for women.

The most prominent religious Zionist party is the National Religious Party (NRP or, by its Hebrew acronym, Mafdal). This party advocates strengthening the Jewish religious character of the State of Israel by means of religious legislation based on Jewish law and by inculcating Jewish values in Israeli culture and education.

**Traditional Jews:**

Most of the Jews in the State of Israel describe themselves as “traditional.” This group is not homogeneous. It is distinct in that most of its members believe in the existence of God and ascribe to a mixture of religious and national identity. The traditional Jews are mostly observant. Not all uphold the same commandments, but most celebrate Jewish festivals, perform traditional rituals, and observe *kashrut* (the Jewish dietary laws concerning the suitability of food). Traditional Jews are interested in preserving the Jewish character of the State, including enactment of religious legislation on family matters, for the sake of the unity and integrity of the Jewish people.

In addition, there are small groups that belong to the modern Reform or Conservative streams of Judaism. These streams adapt Judaism to modern times and advocate equality in Jewish society, particularly gender equality in all aspects of keeping the commandments (such as bar/bat mitzvahs and reading the Torah in synagogue), and marriage of those who are denied the right to marry under strict religious law. They also advocate a different, non-Orthodox form of conversion to Judaism. They are not recognized by the Orthodox stream, which rules the religious institutions of the State of Israel.

The influence of the religious parties and institutions in Israel is expressed in several realms of life.

- **Israeli Politics**
The religious parties in Israel enjoy wide support from their constituents, as expressed in election results and in the high rate of representation in the Knesset. Because of their power, these parties are “courted” in the process of coalition formation and when important decisions are set before the Knesset or the government. The religious parties pledge their support to coalitions and governments and advocate their policies and decisions on the basis of coalition agreements.

The parties take advantage of their power and of the desire of the coalition and the government for their support (whether for public legitimization or to maintain the coalition and the government) on behalf of the interests of the public they represent. Thus if often happens that in the framework of coalition agreements, these parties demand the allocation of additional funds or promises not to cut back existing budgets they receive, in return for joining the coalition or promising to vote in a particular way in crucial votes.

It is noteworthy in this context that the majority of political decisions taken by the religious parties are determined by the rulings of rabbis, who are the spiritual leaders of the parties and, in effect, dictate the way the party behaves. Many non-religious people consider this mode of party activity an offense to Israeli democracy.

The religious parties encourage religious legislation, that is, laws that combine religion with State. Such legislation is based on Jewish law and is enacted in order to preserve the distinctly Jewish character of the State of Israel.

Examples of such religious legislation include the Religious Courts Law, which determines that family matters, including cases of marriage and divorce, are to be heard only by rabbinical courts, which rule solely according to Jewish law. Thus, civil marriage and divorce, or marriage by those religiously “unfit” for marriage, are not possible in Israel.

Other laws deal with kashrut, such as the Festival of Matzot (Prohibition of Leaven) Law, which prohibits the public display and sale of foods that are not kosher for Passover during the Passover holiday in places where the majority of the population is Jewish; and the Pork Law (1961), which prohibits breeding pigs in a predominantly Jewish area. Another example is the Kosher Food for
Soldiers Ordinance (1948), which ensures that kosher food must be available to all Jewish soldiers serving in the Israel Defence Forces.

Some view this legislation as a means to preserve the Jewish character of the State of Israel, and a tool that facilitates the integration of religious people in Israeli society, without fear that their beliefs or emotions will be offended. By contrast, many secular people consider these laws to be a form of religious coercion, dictating a religious way of life and breaching their civil rights as citizens of a democratic state to exercise free choice of religion (including no religion) and, in general, to determine their lifestyle.

- The Israeli Economy

The Israeli economy is strongly influenced by religious legislation and the lifestyle of the religious community. Those who observe the religious commandments, both traditional and ultra-Orthodox, account for a considerable portion of Israeli society, and in some matters they are joined by non-religious citizens who believe that the State of Israel should bear clear Jewish characteristics. Against this background, religious law or the sentiments of the religious community sometimes determine critical economic issues and decisions valued in the millions of dollars.

One example is the issue of daylight savings time. Daylight savings time is instituted in order to enable more hours of work and less consumption of electricity, due to less need for lighting. Because of religious holidays, and particularly Jewish customs related to Yom Kippur (the Day of Atonement) and the preceding prayers for forgiveness, religious groups object to the continuation of daylight savings time at that time of the year (early autumn). In addition, they claim that daylight savings time leads to desecration of the Sabbath, as the Sabbath ends late (because of the late hour of the sunset), while public services, including public transport, resume before that. Thus they insist on resuming standard time early, costing the Israeli economy millions of dollars every day that daylight savings time could have continued.

Similarly, businesses refrain from operating on the Sabbath, for fear of losing their religious customers. Kashrut certificates are also withheld from food enterprises that operate on the Sabbath, and religious customers will not shop at
businesses without such a certificate, for fear that the food is not kosher. Public services, such as emergency services, also operate only on a limited basis, and public transport does not operate on the Sabbath.

**Israeli Society and Culture**

There is no question that the religious community and its representatives – the religious parties – play a significant role in maintaining the Jewish character of the State of Israel. However, there are some debates within Jewish society regarding issues of religion and state and the religious community:

**The Military service issue**

The non-religious and national religious communities resent the fact that the ultra-Orthodox Jews do not serve in the army and therefore do not share the burden of national security or fulfill their national duty. Ultra-Orthodox Jews who study in yeshivas (religious seminaries) are allowed to defer their army service, which in practice means they are released from the obligation of military service. The religious consider Torah (Bible) study itself to be a means of defending the State of Israel and any attempt to recruit them as lack of consideration for their lifestyle. Some yeshivas, named the “arrangement yeshivas” (*yeshivot hesder*), compromise on this matter by combining military service with Torah studies.

The Tal Law (2002) enables ultra-Orthodox Jews to obtain a legal exemption from mandatory military service. Formerly the exemption was given on an *ad hoc* basis. The new law has angered many members of the secular and national religious community. The secular parties, led by Shinui, view the law as a perpetuation of inequality of obligations and rights in the State of Israel, and are working to annul it.

**Observance of the Sabbath**

The Sabbath (from Friday sunset to Saturday sunset) is the official day of rest of the Jewish religion and therefore, of the State of Israel. However, many businesses and institutions of entertainment and art do operate on the Sabbath.
This is due to demand from the secular population, which protested the interference of the religious community in its activities on this day of the week. Many people are content with the present situation and oppose legal interference on the subject, despite the desire of the religious parties to anchor Sabbath observance in the law. Although there is no law in Israel that forbids commerce on the Sabbath, businesses that operate on this day face withdrawal of their kashrut certificates by the Chief Rabbinate and the relevant rabbis, and consequent loss of observant customers. Despite progress on this issue, the emergency services in Israel still operate on a restricted basis and there is no public transportation on the Sabbath in almost all of the country (besides Arab villages and in Haifa due to its mixed population).

**Culture**
The religious community sometimes finds the secular culture in Israel offensive. Occasionally they object to the broadcasting on government-sponsored television of certain programs and films on subjects that they believe inappropriate (such as same-gender sexual relations). The religious also protest what they consider inappropriate exposure of the body at national events and performances or on television.

- **The Status Quo Agreement with the Religious Communities**
Against the background of the controversy between the religious and secular communities in the State of Israel regarding the Jewish character of the state, in 1947 an agreement was reached between the labor parties and the religious and ultra-Orthodox parties. Known as the Status Quo Agreement, it addresses four main issues:
  - Kashrut observance in public and military institutions.
  - Sabbath observance in public places.
  - Ensuring the autonomous status of the religious education system.
  - Granting the rabbinical courts exclusive jurisdiction over family matters.
This agreement was intended to provide a way in which the two camps could live together, and to establish principles that would serve as the “rules of the game”
for public discourse on the issue. Some of these issues have over time become law in the State of Israel. Despite the implementation of the Status Quo Agreement and the preservation of its principles to this day, and given that social and political conditions in Israel have changed, there are still arguments about those issues that are not grounded in the law, such as Sabbath observance in public places.

3. **Labor Standards toward Foreign Workers**

Israel is a member of several international bodies, most notably the United Nations (UN) and the International Labor Association (ILO), which obligate it to ensure certain minimum standards for its workers, domestic as well as foreign. The basic right for everyone – without discrimination – to work in a favorable environment is ensured in article 23 of the Universal Declaration of Human Rights, along with the right to equal pay for equal work.

The International Covenant on Economic, Social and Cultural Rights, to which Israel is a signatory, includes provisions for an adequate standard of living and adequate medical services.

Article 12 of the UN Convention on the Elimination of All Forms of Discrimination Against Women (CEDAW) requires Israel to provide health services, including family planning and pregnancy related services. Although far from perfect, Israel’s health services for legally employed migrant workers generally comply with the treaty’s obligations.

Moreover, Israel’s labor codes are in compliance with some of the ILO’s advised regulations concerning domestic workers. Among these are the prohibition of child labor, ensuring a proper procedure for dismissal, maternity benefits and vacation pay.

In response to the growing importance of foreign workers and their manpower placement agencies, the Knesset adopted the Employment of Employees by Manpower Contractors Law in 1996. This law states that in addition to the client employer having legal responsibility to the employee, the manpower agency is also responsible for the worker’s well-being as a legal employer. This law has had both positive and negative effects on migrant workers in Israel. Manpower agencies have incentives to maintain strong ties with both the client-
employer and the employee during the first few weeks of employment, because
the common practice is to provide a new employee free of charge if the
relationship fails within the first six months. Although some incentives exist for
protecting workers’ rights, the protection that workers actually receive is too often
insufficient to ensure their right.
Moreover visas issued to foreign workers in Israel are particularly problematic due
to the “binding arrangement”. Migrant workers’ legal status is dependent on the
individual employer specified on their work visa. An abused migrant is thus faced
with an impossible choice: leave the abusive employer and become illegal or stay
and continue to suffer the abuse.
Several steps must be taken in order to create a just working environment for
migrant workers. The most important reform has to concern the binding
arrangement.
As Kav La’oved – an NGO dedicated to protecting the rights of disadvantaged
workers in Israel, and primarily migrant workers – proposes, the Israeli
government should eliminate specification of an employer on a migrant worker's
visa in favor of specification of an industry.

4. Freedom of the Press

The Israeli press is for the most part highly independent and a reliable source of
information. The press plays a leading role in investigating and uncovering many
scandals involving official corruption and mismanagement. The influence of the
press is considerable: On a daily basis more than 75 percent of all adult Israelis
read one daily newspaper and some 11 percent read two or more.

The Israeli Arab and Jewish press have faced the same censorship constraints.
The Press Ordinance of 1933 was first enacted by the British Mandatory authority
and was adopted by Israel from 1948. The Ministry of the Interior licenses,
supervises and regulates the press. The IDF administers censorship regulation and
most Hebrew language newspapers can exercise self-censorship, sending to the
Censor only articles dealing with national security matters.

According to the Reporters without Borders’ 2004 Report, the state of press
freedom inside Israel is the highest in the MENA Region. This index reflects the degree of freedom enjoyed by journalists and news organizations in each country and the efforts made by the state to ensure respect of that freedom. It includes every kind of violation directly affecting journalists and news media, such as physical attacks, censorship, confiscation of issues, and so on. It also takes account of the legal situation affecting the news media and the behavior of the authorities toward the state-owned news media and the foreign press. Israel, in 36th place (out of 167 countries), is far ahead of other Middle East countries (Saudi Arabia 159, Iran 158, Syria 155, Iraq 148). Press is even freer in Israel than is Spain (39), Italy (39) and Japan (42).

The State of Israel inherited the "co-optation model" of relations between the political establishment and the media from the pre-State Jewish community. According to this model, the media was largely subordinate to the political establishment and willingly enlisted in the national effort, sometimes at the expense of other democratic principles. This pattern has left its mark on the relations between politics and the media in Israel, and its influence is evident to this day.

The social and political process has somewhat eroded the co-optation model and introduced other social and media norms, bringing the media model closer to one of "social responsibility," in which it feels it should report to the public and present it with views other than those of the political establishment. This pattern is based on freedom of expression and the right of the public to know, and the media works vigorously to uphold these rights.

The public's right to know enables the public to obtain information on what is happening in the State and requires the government to convey information about its policies and actions. However, the government must at the same time weigh this obligation against the duty to protect State security.

In light of this situation, a "mixed model" has gradually developed in Israel. Many wonder whether this pattern really represents the media in a democracy, i.e., whether the media really does operate freely in Israel. Do the different restrictions imposed on the media – from the censors (both military or political) to pressure
from the political establishment to mobilize on its behalf – limit its movement and prevent the public from knowing what it should and has the right to know, or from presenting opinions other than the accepted ones?

Today, with the development of pluralism in politics and among the Israeli public, accompanied by numerous internal tensions among different forces, it is more difficult to supervise the media establishment. Even political forces see the media as their allies and their opportunity to express their views, actions, and policies to the Israeli public. In addition, technological means have developed significantly and media channels have multiplied, including some (such as the Internet) that are very difficult to control. This increases the resistance of the media to restrictions and control of the political establishment.

Nevertheless, the concentrated private ownership of the media in Israel is developing economic interests, which sometimes require the assistance and protection of the political establishment. These two forces seem to balance each other out, so that the media is not totally unrestrained, giving voice to any whim of its operators; yet rarely are political forces able to prevent the media from publicizing something when it is determined to do so.

5. Corruption

In order to measure levels of corruption in Israel we use the Transparency International Corruption Perceptions Index (CPI) of 2004, which ranks 146 countries. The CPI is a pool of polls, reflecting the perceptions of business people and country analysts. The 2004 Index draws on 18 surveys conducted by 12 independent institutions. CPI scores relate to perception of the degree of corruption and range between 10 (highly clear) and 1 (highly corrupt).

Israel's position is a good one (26th rank), with an index of 6.4, behind rich countries with very low levels of perceived corruption such as Australia, Canada and most European countries. Israel is less corrupt than Russia, Latin American and Middle-East countries.
H. Strengths and Weakness of the Political Process: Evaluation of the gap between due political process and correct government policy

1. Implementation of Government Policy by the Different Government Ministries

Government policy is implemented by the different government ministries. However, only one-third of government decisions are actually implemented. Among these, some are implemented only partially or aimed towards different goals than those defined by the government.

Every government ministry is charged with certain tasks that affect the general public. The appointment of ministers is determined by coalition agreements among ruling parties, a proper political process in a democratic state, which leads to heterogeneous representation of the public in the governance process. Every minister belongs to a specific party, which has a given electorate and public agenda. Often ministers use the government ministry and budgets to promote their specific sector, at the expense of the general public. The means for balancing and moderating this influence is based on the power of the representatives of the Ministry of Finance – the Budget Department and the Accountant General – to prevent the flow of resources to the sector designated by the appointed minister.

2. The Process of Approving the State Budget

The national budget is one of the primary tools for implementing government policy. In practice, the budget constitutes the plan for implementing the policy. It can be used to set incentives to promote government ideology (such as the decision to disperse the population and strengthen the periphery, both by promoting infrastructure for access to the region and by helping set up factories in the regions), and to set government priorities regarding preferred realms of activity (e.g. promotion of environmental issues or aid for welfare).

After the State budget is approved by the government, it must be ratified by the Knesset. This process enables different political parties (both opposition parties,
which are not part of the coalition, and Knesset members within the coalition who are not government members) to relate to and influence government policy, both by presenting reservations about the budget in the plenum, and in separate discussions of budget sections in the Finance Committee. This is a proper political process, which enables minorities to influence government policy and place their issues on the public agenda.

In practice, this method creates a form of "horse trading" between the different parties and the government. In order to persuade opposition, as well as coalition members to support the budget, the government has to pay special monies to specific institutions that are associated with their parties, or even with individual Knesset members. For instance, in obtaining approval for the 2005 budget, the government was forced to pay hundreds of millions of shekels to specific religious institutions in order to obtain the support of an ephemeral ultra-religious party. At the same time, other parties also demand their piece of the pie, thus creating a pattern of dividing the budget according to the level of political pressure of each Knesset member, rather than adapting it to overall government policy, which is meant to provide for the population as a whole. The level of the sectors' shares depends on the given political situation. The less stable the government, the more it succumbs to the dictates of parties and single Knesset members. Furthermore, instability increases the chances of government collapse and new elections. In this situation, the MK's (Members of Knesset) make every effort to transfer money to their respective electorates, to ensure their support in the upcoming elections.

An even graver problem arose in the discussion of the 2005 budget, due to controversy over a central political issue (the "disengagement plan" and removal of settlements from the Gaza Strip). Knesset members who belonged to the coalition decided to vote against the State budget. When a budget is not approved in the Knesset by March 31 of the year to which it relates, the government falls and new elections are held. This law was intended to prevent a government from continuing to rule even if it has lost its parliamentary majority (a correct political measure). In this case, some of the Knesset members in the coalition tried to prevent the disengagement by taking advantage of this law and opposing the state budget. The assumption was that if the government did not succeed in getting the budget through by 31 March 2005, it would fall and new elections would be held, canceling or at least delaying the disengagement.
This action did cause grave concern for the government. As it was having difficulty getting the budget approved, and the final date was approaching, it was forced to turn to members of the opposition for their support. This situation gave the opposition great power, which, of course, they employed in order to influence the budget. However, because of their fear of upcoming elections, most of their demands involved the transfer of money to organizations associated with them, and an attempt to influence the overall government policy.

3. Passing Legislation in the Knesset Committees

One of the central tools for promoting government policy is legislation. Without appropriate legislation it is impossible to effectively implement a large portion of government policy. Every law in Israel must undergo a process of approval in the main parliamentary plenum, followed by approval in the relevant committee, and finally re-approval by the plenum. While the ruling parties have a majority in the plenum, the situation in the committees is not necessarily the same.

The distribution of Knesset members in committees and as committee heads is based on the relative proportion of the different parties in the Knesset. Therefore, opposition parties are represented on Knesset committees and their members may even be appointed as heads of some committees. This political structure allows the opposition to express its view and sometimes to pass laws (or prevent their legislation), as well as enabling public discourse among different sectors, and gives the minority group some power.

In practice, because some of the coalition Knesset members are appointed to other roles in the government – ministers and deputy ministers – the opposition often holds a majority in committees. It is the committee head who decides whether or not to discuss a given bill. If this committee head is a member of the opposition, he or she may schedule the discussion when most of the Knesset members from the coalition are absent. It is thus possible to defeat government-sponsored bills or pass bills proposed by the opposition. It is difficult to pass bills of the opposition in the plenum, but it is possible to prevent the government from passing its laws in the committee, therefore preventing certain government
actions.

The government, which is aware of this problem, takes counter measures. It tries to prevent the passing of laws in these committees. To this end it may employ other means, even if they are less effective and may be very costly to the State. Therefore, this process ultimately leads to the implementation of less effective and more expensive policy.

For example: In order to approve a structural change in the Ports Authority and increase the level of competition among ports, the government had two courses of possible action: legislation or negotiations with the employees. Because it encountered difficulties in gaining approval of legislation in the Knesset, it was forced to pay the workers unreasonable sums in order to obtain their agreement to the change. The amounts paid set a dangerous and problematic precedent for any government policy in the field of structural change, and will lead to a significant increase in government spending, in order to increase competition in different industries.

Pressure from interested parties on Knesset members: another political problem that arises from the legislative mechanism is the ability of economic entities with financial means to influence MK’s and alter bills that the government wishes to promote for the sake of the general public.

These organizations hire professional lobbyists, who have connections with the media and with members of different parties. These lobbyists can help Knesset members appear in the media and promote them and their parties.

For example, the government of Israel wanted to implement changes in the law on deposits for bottles, expanding it to include other containers (thereby doubling the scope of the law), increasing competition, and correcting other flaws in the existing mechanism. The beverage manufacturers and retailers, who opposed the law, employed a lobby in the Knesset and blocked the amendment. Thus, the State is stuck with old law, which benefits the economy less than it might otherwise do and creates many problems. In order to get the amendment through, the government will have to agree to a compromise, which will also result in a situation that is less favorable to the economy. The ability of the lobbyists to prevent legislation makes it impossible to achieve the law that is best
II. Consequences for the Economy and Lessons

A. Economic Consequences of the Political System

A review of the past few years reveals a significant change in public government activity. In the past, most of the public players acted on behalf of strong economic organizations and owners of large assets in the economy. There are many examples of this from the field of real estate. Property barons obtained permits to deal with State land, against the interests of the general public. Examples include the construction of the marinas in Herzliya and Haifa, which included building apartments in contravention of the law, real estate projects along the beaches, which took up a considerable share of the vacant oceanfront in Israel (closing the beaches to the general public), and others. These permits were granted under pressure from developers on politicians in both local and national government.

In recent years, there has been a significant change in the entire approach to these parties. In 2004 a law was passed that prohibits all construction along the shores (within a range of at least 300 meters from the shore), in effect preventing contractors from taking up the beaches. Similarly, the courts recently prohibited marina owners from selling property for the purpose of transforming them into residential apartments and forced the existing apartment owners to convert their apartments into vacation units. Claims have been filed against contractors who used the land in violation of their permits (such as Shefayim, which was fined over 30 million shekels, Yarkon Junction, where the property was confiscated, and others).

Another example refers to the structure of competition in the economy. In the past, the government refrained from making economic changes and structural reforms, because of the power of the strong unions. Consequently, in many fields, the economy lagged well behind and many industries were ruled by monopolies. Lack of competition led to high prices, poor service, and slow introduction of advanced technology, as typical of a market without competition. In the last
decade, and particularly in the last two years, the government’s approach has changed significantly. Opening the market to competition was accompanied by hard battles and massive strikes in the relevant industries, and sometimes across the entire economy, but in the long-term, these measures resulted in notable growth in competition and in economic activity.

A prominent example is the communications industry, which in the past was controlled by a single company (Bezeq). Several other similar reforms have been introduced, but the most significant change has taken place in the last two years.\(^{15}\)

The biggest winners in these cases are consumers and private companies that enter the field. At the same time, the workers have not suffered, as the rate of employment has increased. However, the General Federation of Labor and the unions have weakened considerably, losing their ability to influence such changes. Moreover, the Federation is losing its ability to shut down the entire economy. These changes are creating a less centralized economy, in which the influence of government ministries and parliament are also waning, due to diminishing involvement of government corporations and other government organizations in the market.

B. Reforms Needed

Some reforms should be implemented to improve the effectiveness of governance in Israel. The main recommendations are:

- **Streamlining the planning process**
  
The planning processes have become one of Israel’s major bottlenecks. Obtaining approval of plans has become a prolonged, exhausting process that sometimes involves unreasonable compromises simply in order to obtain approval. On the other hand, those with “connections” manage to push through plans that are detrimental to the general public.

  Well-structured and simple criteria, regulations, and methods should be developed

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\(^{15}\) For more information on opening the telecom market for competition please refer to the “Fiscal Policy Issues” and “Trade Issues” chapters (III and II respectively).
for the approval of plans. The criteria should include principles of what is permitted and what is forbidden. If a plan meets all these criteria, it should pass through a speedy process of approval. Plans that do not meet the criteria should be denied approval or required to undergo a longer process, including careful examination, in order to prevent the approval of plans that contradict the public welfare.

In addition, all organizations involved in the process should be required to meet a specified response time, and organizations that delay plans for unfounded reasons should be fined.

• **Definition of authority**
An overall examination should be made of the fields of responsibility and authority of government ministries. The realms of activity should be divided so that every ministry is exclusively responsible for different realms of activity. Within its own realm, each ministry should have full authority and overall responsibility. There should not be realms that are divided up among numerous ministries, so that responsibility disintegrates somewhere between them. Furthermore, there should be supervision and control mechanisms (such as the State Comptroller) to monitor the activity of the ministries in terms of performance, decision-making process, meeting schedules, and the like. The Comptroller’s office should have the means to impose sanctions on ministries and on decision makers in the ministries, including a recommendation to the government to dismiss the Director General or senior officers of a ministry. Such recommendations may be determined on the basis of the ministry’s performance and not only on the basis of illegal activities (as is the case today).

• **Reduction of the Knesset’s authority to approve the budget and budgetary transfer payments**
Because the Knesset is comprised of politicians who may be devoted to the interests of given sectors, the scope of their influence over the State budget and transfer payments, among and within the ministries, should be reduced. In order to diminish their influence, clear regulations should be determined regarding the type of changes that MK’s are allowed to make in budgets (for example, it should be forbidden to demand designation of budget funds to certain population groups without clear and transparent criteria). In addition, it should be determined that if
the State budget is not approved by the end of December, the Knesset will automatically disband and there will not be an additional 90 days’ grace period for approving the budget.

- **Reduction of the authority of Knesset committee chairpersons**
  A set time should be determined for the discussion and approval or rejection of each law assigned to a committee. If proposals are delayed in a committee beyond the set date, the chairperson will automatically be dismissed from chairing the committee. Representatives of different organizations should not be allowed to participate in or observe committee discussions except for a specific number of discussions to which representatives will be invited. Any meeting in which a vote is taken will be closed to the media and to outside parties.

- **Limitation of the right to strike**
  A law should be passed to limit the right of different institutions and organizations to strike. Such a law would specify essential services that are not permitted to strike at all and other services that may strike only after passing a test comprised of several criteria. In any case, no strike should be allowed without the approval of the majority of employees in the organization (strikes may not be decided upon by leaders alone).

**III. Conclusions**

Governance in and on the occupied territories has been voluntary left aside in this report. Strictly speaking, the settlements can be considered part of the Israeli economy, but their economic relevance is minimal reaching only 2 percent of the GNP, which justify the exclusion.

Generally speaking, Israel’s performance in the area of governance is very good, with standards very close to those in Europe and the United States. Executive governance respects the separation of power between legislative and executive institutions, the law-making process is quite effective and transparent and the State of Israel is based on solid democratic principles. However inclusiveness and accountability of the public sector are the main areas where there is room for improvement and much work still remains to be done on gender and ethnic equality issues.
IV. References:


Shachmurove Yochanan, *Economic Development in the Middle-East*, The City College of the City University of New York and The University of Pennsylvania.


World Bank, *Better Governance for Development in the Middle-East and North


CHAPTER V: ISRAEL, LABOUR AND HUMAN RESOURCE DEVELOPMENTS

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Table 5: Gross Money Income from Wages and Salaries
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I. General Orientation

Over the past 30 years, significant sectoral modifications took place in the labour market in Israel. The most significant of these probably concerns the shift from ‘traditional’ sectors to ICT since 1967 (includes manufacturing industries, service industries, communications, computerization and R&D services). The sector represents a share in private sector employment and product which significantly exceeds rates observed in any OECD country. Due to the restricted size of the domestic market, the sector is for the most part geared towards exports. To a large extent it is also biased towards the development of new products, which typically takes place in start-up companies. There is little doubt that ICT will be a mainstay of the country’s economic future. Other sectoral employment changes include a rising share in the areas of “commerce and services”, as well as “transport and communications”, to the detriment of the agriculture, construction, and manufacturing sectors.

The level of civilian labour participation is still low despite continual increase. Unemployment has grown markedly since 1969 to reach a high of 10.7 percent in 2003. With the emergence from recession, the private sector allowed unemployment to drop to 10.4 percent in 2004, despite a slow nominal decrease in public employment. In 2003 holders of academic degrees were employed 2.6 times more than those without high school diplomas. Some unemployment patterns have noticeably been exacerbated recently, such as the average unemployment time (33 percent increase during the years 1995-1998) and the increase in long term unemployment (over 20 percent of unemployed people have not worked for over a year). Also noteworthy is the fact that the country’s periphery has unemployment levels considerably higher than in urbanized regions.

Israeli civil and labour law grants all women formal equality with men. Gender based inequalities nonetheless remain in the labour market, as shown by indices of unemployment, participation in the civilian workforce and wages. In 1997 women’s hourly wages represented on average 83 percent those of men and their salaries only 63 percent of men’s. A gender gap also exists in the number of hours worked and the wider prevalence of part-time employment among women.

Over the past 20 years the industrial relations system has undergone a profound change, as demonstrated by a drop in the unionisation rate from 80 percent of the workforce to less than 50 percent from 1980 to 2004. Real wages began to rise in
2004, more so in the public than in the private sector. The average wages nevertheless did not catch up with the levels of the 1995 to 2001 period. The natural population growth rate is 2 percent per annum. The main demographic change resulted from huge waves of immigration in the early 1990s from the former USSR (880,000) and Ethiopia (40,000). New immigrants from the former USSR were characterized by a high level of skills and education; they were instrumental in supplying the ICT industry with skilled labour-intensive labour. Growth of the Israeli private sector in recent decades was largely spearheaded by ICT technologies. This naturally created a labour demand focused more on skill-intensive workers. At the same time, the demand for a low-skill workforce tended to decline due to less demand and increased supply. On the one hand, the economy shifted away from industries intensive in unskilled labour. On the other hand, the labour supply increased considerably due to the sizeable influx of migrant workers from Eastern Europe, and the Far East (these immigrants are considerably cheaper than Israeli or Palestinian workers). As a consequence of these trends, the employment prospects for low-skill workers are probably not very promising. Taking into account the recent slash in transfer payments, this population is at risk of being increasingly marginalized and pushed into poverty. Indeed, since the mid-1970s there has been a consistent increase in inequality in Israel, a statistic that is currently one of the highest among Western countries. According to the Bank of Israel, the number of households below the poverty line increased from 18.1 to 19.3 percent in the year 2003 alone.

In 2002 the government launched an Economic Recovery Plan (ERP) whose objective was to reduce the deficit from 7 percent of GDP to 4 percent, accompanied by large cuts in government spending. The government’s comprehensive plan implemented a number of measures to transform the labour market and make it more flexible. Transfer payments were slashed by over 20 percent with the view of removing implicit labour disincentives, and unemployment eligibility criteria were tightened. Public sector employment diminished considerably, and will continue to do so in 2005 and 2006. The number of foreign workers was reduced in favour of substitution by Israeli workers. Some accompanying measures are planned, such as the ‘Wisconsin programme’ to reintegrate disadvantaged populations into the workforce through counselling and professional training in designated centres.
The main challenges facing macroeconomic policy in coming years will be to sustain the nascent growth process guided by the business sector, while reducing unemployment and closing the poverty gap.

II. Labour Market Structure

A. Labour Supply


Israel has 6.7 million inhabitants in 2005, of which 50.5 percent are women. The life expectancy at birth during the years 2000-2005 stood at 79.6, placing it in the top 10 countries worldwide (United Nations, 2005). The country is in the third stage of demographic transition. The fertility rate for the years 2000-2005 was 2.85 and is expected to continue decreasing to 2.36 in the years 2015-2020. The annual rate of population change will consequently follow the reduction trend from 2 percent in 2005 to approximately 1 percent in 2025.

**Table 1: Israel Population Age Structure, 2005-2050, Percentage of Total Population**

<table>
<thead>
<tr>
<th>Age groups:</th>
<th>0-14</th>
<th>15-59</th>
<th>60-79</th>
<th>80+</th>
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</thead>
<tbody>
<tr>
<td>2005</td>
<td>27.8%</td>
<td>59%</td>
<td>13.3%</td>
<td>2.5%</td>
</tr>
<tr>
<td>2050</td>
<td>18.1%</td>
<td>57.2%</td>
<td>24.6%</td>
<td>6%</td>
</tr>
</tbody>
</table>

Source: UN World Population Prospects, The 2004 Revision
The main demographic change during the 1990s consisted of two immigration waves, from the former USSR (880,000) and Ethiopia (40,000). The influx of immigrants was especially large during the years 1991-1992 (315,000) and 1997-2001 (260,000). The population growth in Israel among the Jewish sector is mainly due to migration balance, but is also related to a natural increase in the Arab sector. In 2004, the working-age population rose by only 1.8 percent for the second consecutive year. This demonstrates the small increase in mean permanent population due to a low immigration level. Figure 1 points to a clear correlation between population originating from immigration and working-age rate during the last 15 years.

Segmentation by ethnic and socio-cultural origin is a feature of Israeli society and its labour market. The fruits of the growth of recent decades have been unequally divided between the sectors. The phenomenon is well documented and is the basis of salient analysis of the labour market (such as those of CBS). The following groups are predominantly visible: Jews from African/Asian descent, Jews from European/American descent, ultra-orthodox Jews, Palestinian citizens of Israel, Bedouins in the Negev, foreign workers including Palestinians from the

Source: Bank of Israel

Figure 1: Immigration and Working-age Growth Rate, 1990-2004
territories, and new immigrants (predominantly from the former Soviet Union and Ethiopia).

2. Labour Force Participation Rate by Gender, Age and Years of Schooling

The level of civilian labour participation in Israel is lower than in most developed countries (see Table 2). Among the OECD countries presented in Table 2, only Italy has a lower participation rate throughout the 1990s. The low figures for Israel are attributed to religious and traditional lifestyle patterns among large segments of the population, high military employment (including soldiers serving compulsory military service, and professional military personnel) and important levels of transfer payments. The government set itself an objective of increasing the participation rate under its ‘welfare to work programme’, as described in section 3.

Table 2: Labour Force Participation Rate, an International Comparison, 1991-2002

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<td>54.1</td>
<td>53.7</td>
<td>53.5</td>
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<td>54.3</td>
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<td>63.9</td>
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<td>64.6</td>
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<td>64.7</td>
<td>64.7</td>
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</tr>
<tr>
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<td>47.5</td>
<td>47.9</td>
<td>47.3</td>
<td>47.1</td>
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<td>48.1</td>
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<td>Japan</td>
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</tr>
<tr>
<td>France</td>
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<tr>
<td>Canada</td>
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<td>65.5</td>
<td>65.2</td>
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<td>64.7</td>
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<td>62.8</td>
<td>63.8</td>
<td>63.7</td>
<td>64.0</td>
</tr>
</tbody>
</table>

*Population over 15 or 16 years old.

Source: Central Bureau of Statistics and US Department of Labour

Labour force participation has continuously risen in recent decades, with an increase from 50 to 55 percent between 1969 and 2004. However, examination of
the rates by gender shows diverging trends for men and women. As the female participation rate rose from below 30 percent in 1969 to almost 50 percent in 2004, the participation rate among males decreased from 70 percent to 60.6 percent. Women's participation has increased steadily over the past 35 years as a result of changes in social and normative patterns, such as increased education and the declining number of children per family (figure 2). The Equal Retirement Age for Male and Female Employees Law, 1987 affected the female labour participation rate by allowing them the option of retiring at the age of 65 instead of 60.

The decline in male participation in the workforce is seen in other Western economies; however, Israel has the fastest rate of all OECD countries. One earlier explanation (Berman and Klinov, 1997) focused on the growth of the ultra-orthodox Jewish community, characterized by a much lower participation rate. The ultra-orthodox would account for one third of the declining rate. Another common explanation focuses on the welfare system offering negative incentives to join the workforce. The noticeable increase in transfer payments in the 1990s seems to indicate that welfare does indeed play a large role in explaining lower participation. Finally, additional factors are to be found in later entry into the labour market, the consequence of a prolonged study period, and an earlier exit than in the past (Ahituv, 2000).

Figure 2: Labour Force Participation Rate, 1969-2004
Figure 3 below presents the distribution of labour force participation by age for males and females separately. The trend seems very similar for both sexes, increasing until the age of 44 and decreasing thereafter. Women’s participation rate is lower throughout the distribution, with the exception of the 18 to 24 age bracket (Krauss, 2003). This exception can probably be explained by a longer period of compulsory military service for men. As shown by the curve in the diagram, the gender gap increases up to the age of 64. It is interesting to note that the highest gender difference is found at ages 60 to 64, despite the 1987 Equal Retirement Law.

Figure 3: Labour Force Participation Rate by Age and Sex, 2003
Approximately 6 percent of the Israeli labour force is employed through manpower agencies, a figure considerably higher than Western Europe and the US (Kav La’Oved, 2005). Temporary employment schemes do not grant the employee job security and the wage structure is 40 percent lower than that for regular employment. According to recent estimates, 50 percent of temporary workers earn the minimum wage or less. In 2000, the Knesset enacted the Manpower Law which limits temporary employment to a nine month period, after which it becomes mandatory to hire the employee full time. The law is not convincingly implemented due to regulation loopholes and inadequate monitoring and enforcement.

Finally, the distribution of labour force participation is positively correlated with the number of years of schooling. In 2003 the rate was over 65 percent for people with more than 13 years of education and less than 30 percent for those with less than 8 years of education.

**B. Labour Demand**

From what was originally a centrally managed economy, Israel has transformed itself into a competitive market-based economy. Many areas formerly
monopolized by the State have been privatised and liberalized (including transportation, communications, etc.). Alongside this development, the business sector has become increasingly pre-eminent as the country’s main employer. The business sector is the engine behind the 1.7 percent recovery of employment levels in 2004 (2.5 percent change rate from the previous year, with a negative 0.6 percent for public employment). The decrease in employment results from government motivation to reduce the public debt, which was notably characterized by dismissals and the encouragement of voluntary early retirement. Employment cuts occurred mainly in civil administration, while health services, welfare and social work were rather spared.

1. Employment Trends

Labour input expanded by 1.1 percent in the business sector in 2004, compared to a decrease of 1.7 percent in general government. Since 2002, there have been sharply contrasting trends between labour input in the business and public sectors (see figure 4). In a weighted average, this represents an increase of 0.6 percent. The difference between the increase in employment and labour input may reflect the rise in the number of part-time jobs. According to the 2004 CBS Labour survey, this phenomenon is due to limited demand rather than worker preference. This trend is rather unexpected for a recovery period during which the numbers of hours generally increase before new workers are hired.

Figure 4: Total Labour Input: Business Sector versus Government, 1997-2004

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16 Israelis and non-Israelis included.
17 Unless specified otherwise, all figures in this section are from the Bank of Israel Annual Report and Research Department.
In 2004, the labour input annual rate was not homogenous among different workforce components. Indeed, it decreased by 11.9 percent for foreign workers and rose by 2.9 percent for Israeli workers (figure 5). It confirms the efficiency of the measures introduced to reduce employment of foreign workers, as do other figures presented further. Figure 5 also illustrates that Palestinian and foreign workers may be substitutable in the Israeli labour market. The number of employees also evolved differently between Israelis and non-Israelis. For local workers, following a slight upward trend, the largest increase took place in agriculture (13.2 percent), hotels and catering services (9.7 percent) and business services (7.5 percent). On the other hand, the number of foreign employees diminished sharply in 2004. The phenomenon was particularly prominent in manufacturing (-26.3 percent), commerce and the vehicle repairs sector (-16.2 percent), and business services (-16.2 percent). Finally, the average number of Palestinian workers diminished despite a steep rise in some sectors. Indeed, the employment of Palestinians rose by 43.1 percent in the commerce and vehicle repairs sectors but dropped by 8.6 percent in construction.

Figure 5: Total Labour Input in Business Sector: Israelis, Palestinian and Foreign Workers, 1994-2004
A look at figure 6 shows modifications in the employment structure by industries in the Israeli labour market. Commerce and services, and to a lesser extent transport and communications, are the two industries that have grown the most in terms of employment share over the past ten years. In contrast to these results, agriculture, construction and manufacturing have suffered relative job losses. Public administration saw a large decline in the past two years, from 6.0 percent in 2002 to 4.8 percent in 2004. It would, however, be misleading to draw conclusions from the aggregate industry figures. Some of the selected sectors have undergone noteworthy structural modification pertaining to capital and labour structures, nature of production, and/or intensity of workers’ skills and education. The next sections attempt to explain the most noticeable sectoral structural changes and their impact on labour demand.
Figure 6: Selected Industries, as Percentage of Total Employment in Israel, 1995-2004

Source: Bank of Israel, Table 1A.2.5., 2004
Note: Commerce and services include commerce, catering and hotel services, and financial and business services.

2. Employment Composition

An initial general observation indicates changes towards an increase of services over goods. Though the phenomenon occurs in all advanced economies, the proportional size of service-based industries and associated growth rates are important in Israel (Figure 7). They reflect the economy’s successful adaptation to globalization changes, and its transformation to the new economy through better utilization of its human capital.

Figure 7: Share of Services and Goods in the Private Sector (Product), 1996-2003
The manufacturing industry accounts for about one quarter of the business sector product. The years 2001 and 2002 saw a considerable decrease in the manufacturing product (-5.0 percent and -1.9 percent respectively) and an even more pronounced slump in electronic production (-10 percent each year), which had a ripple effect through the entire sector. In 2003 and 2004, global manufacturing demand (for high-tech products in particular) rose, leading to a general increase in the manufacturing product (1.2 percent for second quarter of 2003). Against the trend of increasing manufacturing exports (3.5 percent for second quarter of 2003), domestic sales have plummeted due to both long term and short-term factors. Real exchange-rate developments favoured short-term import substitution over domestic products. Chief among long-term factors is the growing openness to world trade. Following national competitive advantages, Israel intensified specialisation in the production of human capital intensive and export-oriented products, at the expense of labour-intensive import substitutes. It should however be noted that the market share of Israel’s electronic components exports to the US and the EU is presently declining, because of aging plants and technologies (Bank of Israel, 2005).

The employment share of manufacturing has significantly declined over the past ten years, down from 20.9 to 16.5 between 1995 and 2004. On the other hand, the industry’s share of GDP has remained stable (26 and 24 percent in the years reviewed). These contrasting developments indicate significant modifications in
the industry structure. The most notable adjustments consist of accrued physical capital investments, and the switch from low skill employment towards more intensive human capital as demonstrated by the comparison of the engineers’ share in manufacturing employment between 1995 (12 percent) and 2002 (19 percent). Alongside these changes, Israeli traditional industries and labour-intensive products are becoming increasingly less competitive against emerging market competition (Bank of Israel, 2005).

Agriculture currently accounts for less than 2 percent of GDP. Over the past 25 years the share of employment in the agricultural sector fell from 5 percent to 2.1 percent. The sector showed a twofold productivity increase during the same period, alongside a 50 percent decline in income for the self-employed. In contrast to other industries, the government maintains a high level of involvement in agriculture in the form of import tariffs, zero VAT on fresh produce, and subsidies representing 2.4 percent of total agricultural output.

ICT is the conglomerate of production and services industries at the core of the ‘new economy’. It plays a key role in the globalization process. It is characterized by international competition and investments, and by a high-skill mobile labour force. ICT includes manufacturing industries, service industries, communications, computerization and R&D services. In Israel, the sector represents a large portion of the GDP. Its share in private sector product is notably higher than the rates observed in any OECD country (figure 8).

Figure 8: Share of ICT Industries in Private Sector Product: International Comparison
Three distinct sources of human capital collectively explain the high level of skills that are indispensable to the development of the high tech economy. First, the entry rate into tertiary education is comparatively higher than most developed countries: in 2002, 64 percent of the relevant class age entered higher education compared to 55 percent for the OECD country mean (OECD 2005). Second, the wave of immigration from the former Soviet Union in the 1990s provided an influx of skilled scientists and engineers. And finally, the role of the government and the military establishment is critical to the model of Israeli economic success, but its actual input is difficult to measure. Following the 1967 war the government decided to emancipate the military from their dependency on foreign technology supplies, and invested heavily in enabling infrastructure for ICT development. The government created the position of Chief Scientist, a position elevated to a well-funded and politically high profile post. In the 1990s, Israel became the eighth country in the world to develop and launch satellites. The defence industry thus provided a market for high-tech equipment and services. With the decline in military spending in the late 1980s and early 1990s (and the termination of the Lavi fighter jet project), hundreds of trained engineers with experience at the cutting edge of aerodynamics, avionics, computers and electronics were released onto the market.

Finally, ICT has become a key source of labour demand in the last 15 years. In 2004, the number of employed persons was almost 3 times higher than in 1990.
It grew from 55,700 to 164,600 today. Moreover, the share of ICT employees in the whole economy shifted from a 3.5 to a 6.0 percent contribution to employment (Table 4).

**Table 3: ICT, Employment Trends and Composition**

<table>
<thead>
<tr>
<th>Employed persons (x1000)</th>
<th>'90</th>
<th>'95</th>
<th>'97</th>
<th>'98</th>
<th>'99</th>
<th>'00</th>
<th>'01</th>
<th>'02</th>
<th>'03</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of the total in the economy</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.4%</td>
<td>4.6%</td>
<td>5.0%</td>
<td>6.1%</td>
<td>6.4%</td>
<td>6.2%</td>
<td>6.0%</td>
</tr>
<tr>
<td>% of total in the business sector</td>
<td>4.7%</td>
<td>5.2%</td>
<td>5.5%</td>
<td>5.9%</td>
<td>6.4%</td>
<td>7.7%</td>
<td>8.3%</td>
<td>8.0%</td>
<td>7.8%</td>
</tr>
</tbody>
</table>

Source: Central Bureau of Statistics

The construction sector output has been declining for the past 7 consecutive years with annual average changes ranging between -4.0 and -6.3 percent. Falling demand pressured prices downwards and created a slump affecting all sub-sectors, with the exception of defence construction, which was boosted by the security fence/wall. Demographic and social changes have bought the average annual household increment down since 2000, a trend which is not expected to change based on the population age distribution. It is however possible that the recession has brought young couples to delay establishing new households, in which case the economy recovery will translate in an increase in demand for residential construction.

In terms of employment, the construction share decreased from 7.4 percent to 5.5 percent of the labour market between the years 1995 to 2004. The composition of the labour force changed in 2003 as a consequence of the government policy of reducing the number of foreign workers. An estimated 20,000 jobs were vacated by foreigners and half of such jobs were filled by Israelis, bringing the share of Israeli employees from 50 percent to 63 percent in the year reviewed. The other half of vacated jobs remained unfilled, playing a part in the drop in construction activities.

Commerce and services represent a broad category including catering and hotels, business and financial services, education, health, and so on. The sector has been enjoying positive growth rates since 1995, excluding the years 2000 and 2001,
during which there was a moderate decline. The sector stabilized in 2003. Last year, it grew considerably (8.4 percent) thanks to the global economy recovery and relative amelioration of the security situation. The 14.2 percent rise in exports has been the main growth engine, and domestic demand increased as well, albeit moderately. Following these developments, employment rose by 3.1 percent across all sub-sectors, particularly in R&D for high skilled employees, and in catering and hotels for other workers.

3. Foreign workers

Since the late 1960s Palestinians have been employed in large numbers in agriculture, construction and the manufacturing industries. Palestinian workers were attractive to Israeli employers following a short supply in the Israeli workforce in these sectors, and generally lower wages. With the first Intifada and the frequent closures of border checkpoints, and later the first Gulf War, Israeli employers started looking towards migrant workers. These workers would be more reliable (not prevented from working by border closures) and cheaper to employ, since they did not need to conform to the constraints of Israeli trade union wage-rates and maximum working hours. The Ministry of Labour began to issue work permits for workers from the Far East, Latin America and Eastern Europe. Figure 9 shows opposing trends between rates of change in numbers of foreign and Palestinian workers, indicating an apparent substitution effect.

Israeli authorities have identified the presence of foreign workers as a key unemployment factor, due to lower wages and reduced social security costs. Foreign workers are estimated to be 20-40 percent cheaper to employ than Palestinian workers, and Palestinians 35 to 50 percent cheaper than native Israelis (Friedberg and Sauer 2003). From 2002, the Government began reducing the number of foreign workers by both voluntary and enforced departures. The total foreign workforce has been reduced by over 10 percent in the years 2003 and 2004. The policy seems to have encouraged local employment in some sectors, such as construction, in which Israeli employment grew by 12 percent despite the industry slow-down (CBS, Labour Force Statistics 2004). However, other evidence points to the fact that jobs vacated by foreigners are only marginally filled in by Israelis (Kav La’Oved, 2005). Generally migrant workers take the lowest-status or lowest-paying jobs, and as a consequence such a vacated job would tend to
remain unfilled. If the latter argument is valid, it would indicate that the current pattern of employment of foreigners does not create major disincentives to hiring Israelis.

Numerous reports point to widespread situations of abuse toward migrant workers (Ellman and Laacher, 2003). These reports have led to calls for reform in the employment standards of foreigners. Suggested improvements are: 1- Freeing workers to ties with one particular employer (the current practice of granting work permits to the employers limits employees’ bargaining power and creates downwards wage pressure), 2- Applying minimum wages to all workers regardless of citizenship, 3- Requiring employers to provision workers’ accounts for unemployment and dismissal insurance, since foreigners are not eligible to participate in the National Insurance scheme.

Figure 9: Employment of Palestinians and Foreign Workers in the Private Sector, Rates of Exchange or Percent

C. Wage Setting and the Industrial Relation System

In recent decades the Israeli labour market has witnessed several structural changes aimed at transforming an originally European corporatist system into an
Anglo-Saxon one. Indeed, the labour relation systems until the early 1980s was based on high union membership rates and on large collective agreements covering no less than 80 percent of the entire workforce. Since then, collective bargaining coverage dropped to 45 percent and the number of firm level agreements has increased in consequence. The current wage structure and industrial relations system mirror this lengthy but inevitable mutation.

1. Wage Structure

The structure of Israeli wages is somewhat intricate. Some of the elements comprising it are uniform for all employees, whereas others are specific to the individual employee situation. All in all, three components form the general wage structure: the basic wage which is the fundamental industry component; the cost-of-living increment which results from a basic general collective agreement and covers all employees; and finally special wage supplements like departmental or occupational supplements. Moreover, the wage structure is framed by several benchmarks such as the Minimum Wage Law (1987)\textsuperscript{18} or the prevention of wage discrimination.

2. Labour Relations System

In Israel, union rights are rather respected; employees are free to join them and have the liberty of establishing collective bargaining. The majority of the unions are affiliated to the Histadrut Ha Hadasha (created in 2001, superseding the old Histadrut of the 1920s). Although Trade Unions claim approximately 700,000 members, almost the entirety of the Israeli workforce is covered by unions' collective bargaining agreements.

During the first 40 years of the country’s existence, the labour relations system rested on employees’ and employers’ organisations, but also on government involvement. At the time, most employees were members of the Histadrut, the General Labour Federation (established actually in 1920, before the creation of the State). They were covered by collective agreements in which wages were built upon national and occupational elements. The Histadrut was a key player for

\textsuperscript{18} This will initially amount to 47 percent of the average wage and will be automatically increased in accordance with the rate of the cost-of-living increment, any price increase compensation, or any other addition to the wage that is determined by a general collective agreement.
several reasons. The high membership enrolment was the direct result of its central role in the social and economic area – a role approved by the Labour governments that were in power from 1948 to 1977. Indeed, the Histadrut was not only the largest non-State employer; it was also responsible for pensions and healthcare. While employees were organised around the Histadrut, most employers were affiliated to the Economic Organisations Coordination Bureau. The two bodies would for decades negotiate wages and working conditions together.

During the past 20 years, the industrial relations system has changed. The unionisation rate dropped from 80 percent to less than 50 percent of workforce wages. The severe drop can to some extent be attributed to the 1995 Health Insurance Reform which disconnected healthcare services from the Histadrut. Moreover, the number of firm level agreements has risen, as has the number of employees covered by personal contracts. As a result, Israel has switched from a continental European system to a system at the crossroads of European countries and the United States or Japan. Indeed, Israel’s union density\(^{19}\) rate is higher than that of Anglo-American systems\(^{20}\) and even higher than the rates found in most corporatist European countries (like France and Germany). However, Israeli union coverage\(^{21}\) rates no longer match European corporatist levels. This particular position seems to reflect the transient stage of the Israel labour market system.

D. Labour Market Performance

1. Unemployment Trends by Age, Gender and Education

Unemployment has grown markedly since 1969. In 2004, the unemployment rate reached a level of 10.4 percent and is now higher than the rates found in most developed countries (see Figure 10). Over the last 10 years, it has nearly doubled in absolute terms from 143,000 in 1995 to 277,700 in 2004 (CBS, Labour Force Survey). During the same years, the unemployment rate grew from a low of 6.8 percent to 10.4 percent of the national workforce. In the years 1998-2000 the rate slowed down and remained somewhat stable, only to increase significantly again during the last recession. In 2004 the unemployment rate declined slightly

\(^{19}\) percent of unionised workers

\(^{20}\) United States, Canada, Japan, and United Kingdom

\(^{21}\) percent of employers covered by collective agreement.
following the economy growth and Economic Recovery Plan. The decline was the
direct result of the decrease in the unemployment rate of men as compared to a
rise in the women’s rate. A persistent gender gap is noticeable throughout the
period, and has even widened since 2002 (figure 11).\textsuperscript{22}

\textbf{Figure 10: 2003 Unemployment Rate, Israel vs OECD}

![Unemployment Rate Chart]

Source: Central Bureau of Statistics

The first factor explaining the increase in unemployment since 1995 is to be found
in the sharp decline in the economy’s growth rate – from 5 percent in the mid-
1990s to a negative growth in two of the past 3 years. To a large extent this is a
consequence of political and security-related tension, along with a growth
slowdown at global level. The downward growth trend created shrinkage to up to
half of the vacancies, and destroyed other existing positions. A second factor is to
be found in additional pressure deriving from demographic and immigration
trends, which led to increases in the labour force of 3.5 percent a year. A third
factor is linked to the considerable augmentation of foreign workers in the 1990-
2002 period, increasing the supply of low-skilled jobs at the expense of nationals.
To a lesser extent a role was also played by other factors, such as the structure
and level of pensions in comparison to minimum wage, a mismatch between job
seekers’ profiles and a geographical mismatch.

\textsuperscript{22} See Section 2.4.3 for more details on gender issues in the labour market.
The emergence from recession in 2003 was accompanied by a parallel rise in employment and the participation rate, without adversely affecting the unemployment rate. In 2004, however, unemployment was reduced from 10.7 to 10.4 percent. The largest factor is the increased demand of labour by the business sector, following the upturn in the business cycle. Other contributing factors include cuts in transfer payments and the contraction in the number of foreign workers by 10 percent in each of the years 2002-2003.

**Figure 11: Unemployment Rate, 1969-2004**

![Unemployment Rate Chart](image)

* Central Bureau of Statistics definition and sample were changed in 1995.
* Source: Bank of Israel

During the past years various unemployment patterns have worsened. The average unemployment time grew by 33 percent during the years 1995-1998 and stood at 28 weeks on average in 2003. Furthermore, over 55 percent of all unemployed people have not worked in the last 12 months and 23 percent have been seeking a job for more than 53 weeks. These long term unemployed figures constitute the ‘hard core’ of Israeli unemployment (Ministry of Industry, Trade and Labour, 2003).

**Figure 12: Extent of Unemployment, 1995-2004**
When looking at the unemployment rate by level of education, it is notable that educational achievement is strongly correlated to employment status. In 2003, holders of academic degrees were employed 2.6 times as much as those without a secondary school diploma. A modification has nonetheless underway, and unemployment is nowadays rampant at all educational achievement levels. The university educated population used to be somewhat protected from unemployment, yet the rate grew from 3.8 percent in the 1990s to 5.8 percent in 2003. The most significant educational threshold for improved employment lies in upper secondary education. Those with an upper secondary education have an unemployment rate of 8.6 percent whereas those without have an unemployment rate of 13.2 percent (in CBS, Labour Force Survey 2003) Indeed, the sharpest drop in education participation in Western economies occurs not at the end of compulsory education, but at the end of lower secondary education (OECD Employment Outlook, 2004).

Human capital theory suggests that educational levels should be inversely related to the rate of unemployment, since higher education ensures a larger relative number of job openings for them (Filer, Hamermesh and Rees, 1996). However an unusual pattern exists around employment of the least educated sector in Israel. Unemployment among those with no formal education at all is in fact lower
than unemployment among holders of primary to intermediary school diplomas (17.1 percent versus 18.5 percent in 2003). The appropriate explanation appears to be in traditional public policies aimed at assisting the poorest sectors of society.

**Figure 13: Unemployment Rate by Years of Schooling, 2003**

Another cutting scale concerns the Periphery/urban differences; the country is divided into six districts. The country’s central districts and urbanized regions show higher employment levels than the periphery. Furthermore, given limited employment opportunities in the northern and southern districts, prospective workers there are more likely to stop looking for a job. Consequently, covert unemployment is expected to be higher in these regions, and the employment discrepancy between the districts would then be higher than is actually revealed by official statistics. The periphery has a higher unemployment rate because of:

1) a difference in the profile of the labour workforce (lower skills and education);
2) urban areas are more developed and more economically active. An important factor is the high level of employment dependency in the periphery on local factories, due to limited flexibility hampered by often inadequate infrastructures. The last recession hit periphery manufacturing industries harder, thereby fuelling employment reduction. Not only is unemployment higher in the periphery, so too are the average waiting time until finding a job and the proportion of long-term unemployment. In addition, the average wage level is considerably lower in the southern and northern districts. The population’s lower education level and a concentration of lower-skill industry partly account for wage differences.
2. Evolution of Real Wages

Following the downward trend in 2002 and 2003, real wages began to rise in 2004 in the whole economy, except for the transport and communications industry (see Table 4). The highest increases are seen in financial services, business services and the manufacturing sector. However, rises in the business sectors are still below the averages for 1995 and 2001. The rise in the public sector was higher than in the business one. The versatility of wage levels in the public sector reflects the conclusion of new collective agreements and changes in the timetable of periodical payments.

Table 4: Real Wages by Sector\textsuperscript{a}

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>+5.5</td>
<td>+4.2</td>
<td>+3.4</td>
<td>+3.1</td>
<td>+2.7</td>
<td>+5.3</td>
<td>+8.3</td>
<td>-5.5</td>
<td>-0.7</td>
<td>+1.4</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>+3.9</td>
<td>+2.2</td>
<td>+5.7</td>
<td>+5.5</td>
<td>+5.2</td>
<td>+4.3</td>
<td>+3.2</td>
<td>-4.2</td>
<td>-0.2</td>
<td>+2.5</td>
</tr>
<tr>
<td>Electricity &amp; Water</td>
<td>+5.8</td>
<td>+3.5</td>
<td>+2.5</td>
<td>+2.8</td>
<td>+2.3</td>
<td>+7.3</td>
<td>+2.5</td>
<td>-3.2</td>
<td>-2.7</td>
<td>+0.4</td>
</tr>
<tr>
<td>Construction</td>
<td>0.0</td>
<td>-3.3</td>
<td>+3.8</td>
<td>+2.3</td>
<td>+3.9</td>
<td>+6.3</td>
<td>+4.3</td>
<td>-5.1</td>
<td>-3.5</td>
<td>+1.4</td>
</tr>
<tr>
<td>Commerce and Repairs</td>
<td>+1.1</td>
<td>+1.9</td>
<td>+1.4</td>
<td>+2.7</td>
<td>-0.4</td>
<td>+6.1</td>
<td>+2.2</td>
<td>-6.3</td>
<td>-2.7</td>
<td>+0.2</td>
</tr>
<tr>
<td>Hotel and Catering services</td>
<td>-1.1</td>
<td>+1.1</td>
<td>+2.1</td>
<td>+0.6</td>
<td>+1.2</td>
<td>+4.0</td>
<td>-0.1</td>
<td>-6.4</td>
<td>+0.7</td>
<td>+0.1</td>
</tr>
<tr>
<td>Transport &amp; Communications</td>
<td>+0.1</td>
<td>-1.5</td>
<td>+3.9</td>
<td>+1.4</td>
<td>+0.6</td>
<td>+1.5</td>
<td>+0.9</td>
<td>-5.1</td>
<td>-2.6</td>
<td>-0.7</td>
</tr>
<tr>
<td>Financial services</td>
<td>-4.3</td>
<td>+5.7</td>
<td>+5.0</td>
<td>-2.6</td>
<td>+3.9</td>
<td>+12.0</td>
<td>+1.7</td>
<td>-6.8</td>
<td>-3.3</td>
<td>+10.8</td>
</tr>
<tr>
<td>Business Services</td>
<td>+0.2</td>
<td>+4.7</td>
<td>+4.8</td>
<td>+4.2</td>
<td>+10.3</td>
<td>+14.2</td>
<td>+3.6</td>
<td>-8.6</td>
<td>-4.2</td>
<td>+3.8</td>
</tr>
</tbody>
</table>

| Business sector              | +0.6 | +1.5 | +3.4 | +3.0 | +3.6 | +6.6 | +3.3 | -6.7 | -2.5 | +1.9 |
| Public sector                | +5.6 | +1.9 | -0.2 | +0.4 | 0.0  | +5.4 | +2.6 | -4.3 | -4.1 | +4.4 |
| Total                        | +2.2 | +1.6 | +2.3 | +2.2 | +2.6 | +6.2 | +3.0 | -6.0 | -3.0 | +2.7 |

\textsuperscript{a}(Annual changes at constant prices)

Source: Bank of Israel & Central Bureau of Statistics.

While the average number of hours worked per employee increased by 1.1 percent in the business sector, labour productivity rose by 5.5 percent in 2004, almost reaching its 2000 level (see figure 14).
In the following diagram we present the index of real wages by sector from 1980 to 1993 and from 1994 to 2004. During the 1980s and the early 1990s, real wages increased by an average annual rate of 2.6 percent. However, the real wage growth was far from being homogeneous. For example in the business sector, real wages grew by 10.4 percent in 1981 and fell by almost 7 percent in 1985. After the 1985 Economic Performance program, real wages increased again by 9 percent in the Business sector. Correlated at 0.68 to the Business sector, real wages in public sectors followed also an eclectic path during the eighties. Indeed, real wages rose by 10.2 percent in 1981, decreased by 14.3 percent in 1985 and rose again by 9.8 percent in 1994.

For the last decade the average annual rate has been 1.4 percent for both sectors. In the public sector, real wages remained virtually stable between 1997 and 1999. After a sharp decline in 2002 and 2003, they recovered to their 1999 level. Finally, real wages increased in the public sector by 4.4 percent in 2004. The growth rate in the business sector sustained high levels until 2000, reaching 6.6 percent during this last year. During the last recession, real wages fell below
their 1999 level. Last year, real wages rose by 1.9 percent in the business sector. The behaviour of real wages in past years may suggest a certain level of flexibility in the Israeli labour market. Indeed, this sharp decrease could be the result of wage cuts and of fast dismissals of high-paid workers. On the one hand this perhaps allowed employers to react directly to the first signs of economic recovery. On the other hand it would indicate a decline in the efficiency of social safety nets.

Figure 15: Real Wages by Industry, 1980-2004

- index of real wages, new classification from 1994, old classification (1994=100),
3. Gender Segregation

Israeli civil and labour law grants all women formal equality with men. Gender based inequalities nevertheless remain in the labour market, as shown by indices of unemployment, wages, and participation in the civilian labour force. Labour force participation rates were presented above (see Figure 2). It should be noted here that despite the increase in the participation rate, women’s employment is still focused on lower-level positions and the traditionally ‘feminine’ occupations. Figure 16 shows that women are still concentrated in education and in health, welfare and social work services. Together, these sectors employ almost 40 percent of the entire female workforce. Furthermore, government is the largest employer of women. Despite these facts, employee distribution is biased downwards by rank and gender (Krauss, 2003).

The occupation distribution also reveals a clear concentration of women in certain occupations. In 2003, 26.4 percent of women were clerical workers, followed by 23.3 percent in sales and services and 19.8 percent as associate professionals and technicians. Moreover, a persistent difference exists between the share of male and female managers, 10.8 vs. 4.6 percent (CBS, 2004 Labour Force Survey). Finally, the participation rate of Arab women is still far below the level of Jewish women; this is because of traditional norms, lower education levels and lack of transportation facilities.

Figure 16: Employed Persons by Industry and Sex, 2003
The unemployment gender gap is significantly closing. Over the past 10 years the ratio of women’s to men’s unemployment has dropped from 1.6 to 1.1, at a compound annual growth rate of -4.1 percent. Although the gender disparity exists among those with the highest educational levels, it is much narrower than among those with lower qualifications; the unemployment rates are equal for men and women holding a postgraduate degree (5.3 percent in 2003, in CBS Labour Force Survey, Table 12-07). This statement implies that among women the difference in unemployment ratio by level of educational achievement is even higher than for men. Indeed, the ratio of unemployed female workers is 4 to 1 for those with primary education vs. those with a second university degree, while for men the equivalent ratio is about 3 to 1.

Despite the Equal Payment Law, women and men do have different wage levels. In 1997 women’s hourly wages were on average 83 percent those of men, and 63 percent of men’s monthly salaries. In the year 2002, the gap widened to 79 and 61 percent respectively. The income disparity tends to increase at the extremes of educational achievement (0-8 years and over 16 years of schooling). Wage differences occur in all occupational categories and industry sectors, including the academic and scientific field. Among the public sector the wage differential is estimated to be 25 percent. Neuman and Oaxaca (2004) find that gender wage
gaps are greater than ethnic ones. They also show that the contribution of human
capital differences to the whole gender wage gap varies from 35.7 to 73 percent.
Polices based on education only are therefore not sufficient to resolve the gap.
Affirmative actions are also necessary in order to reach the equal standard goal.

Table 5: Gross Money Income from Wages and Salaries, by Years of
Schooling and Gender, 2002, NIS amount

<table>
<thead>
<tr>
<th>Years of schooling</th>
<th>Monthly income</th>
<th></th>
<th></th>
<th>Hourly income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Women</td>
<td>Men</td>
<td>Total</td>
<td>Women</td>
<td>Men</td>
</tr>
<tr>
<td>0-8</td>
<td>2,930</td>
<td>5,088</td>
<td>4,324</td>
<td>22.0</td>
<td>28.4</td>
</tr>
<tr>
<td>9-10</td>
<td>3,365</td>
<td>5,325</td>
<td>4,663</td>
<td>23.2</td>
<td>28.5</td>
</tr>
<tr>
<td>11-12</td>
<td>4,165</td>
<td>6,871</td>
<td>5,606</td>
<td>27.9</td>
<td>35.2</td>
</tr>
<tr>
<td>13-15</td>
<td>5,182</td>
<td>8,622</td>
<td>6,855</td>
<td>36.8</td>
<td>46.3</td>
</tr>
<tr>
<td>16+</td>
<td>7,562</td>
<td>13,562</td>
<td>10,479</td>
<td>52.1</td>
<td>69.5</td>
</tr>
<tr>
<td>All</td>
<td>5,322</td>
<td>8,654</td>
<td>7,070</td>
<td>36.7</td>
<td>46.3</td>
</tr>
</tbody>
</table>

Source: CBS, Labour Force Survey, Table 12-42

A gender gap is furthermore present in the number of working hours. In 2004,
male workers carried out an average of 41.6 hours per week as opposed to 30.8
hours for female workers. Moreover, 41.1 percent of the latter are part-time
workers, as compared to 19.3 percent for men. This situation does not favour
women's integration, especially their earning and advancement potentials. Last
year, the share of male part-time workers increased by an impressive 15.2
percent, while it rose by 6.2 percent for female workers. Male and female workers
take on part-time employment for very different reasons. Indeed, 14.1 percent of
women are part-time workers because of constraints of childcare and/or
household management, as compared to 0.8 for men. By contrast, studies
constitute the primary reason for men (more than 28 percent of them chose part-
time employment for this reason, a surge from 12.9 percent in 2003). The most
dramatic statistics pertaining to part-time employment refer to their percentage
among employees who were newly hired in 2004: 94 and 77 percent for women
and men respectively (Bank of Israel, Annual Report 2004).

4. Poverty and Labour Market Performance
According to the Bank of Israel Annual report, 366,000 families were living below the poverty line in 2003, which represents an increase from 18.1 to 19.3 percent of all households. The average poverty gap\(^{23}\) also rose between 2002 and 2003. In recent years, GDP growth did not affect the different sectors similarly. The highest growth rates were noticed in the high-tech and financial sectors, while traditional sectors like the textile or food industries grew by a relatively low rate. This variation can be explained by the concentration of investments. Since the actual growth is mainly skilled-labour-intensive, its impacts on the poverty level could be weak. The high unemployment rate among unskilled workers therefore risks persisting at a time of transfer payment cuts. This trend in the evolution of inequality is not new. Indeed, since the mid-1970s, inequality in Israel has constantly risen and its current level is one of the highest among Western countries.

Flug and Kasir (2003) characterised the Israeli poor population in 2001 as being composed of 63 percent of households without a salary earner, and 71 percent of heads of households with less than twelve years of schooling. The poverty rate varies among different groups. The national average of households below the poverty line is 17.4 percent, but it reaches 41.5 percent in the Arab population, 44 percent in households with four or more children, 84.7 percent among the ultra-orthodox with no wage earner, and 58.7 percent among families without a wage earner. Testing the marginal contribution of each characteristic, they find, for example, a clear negative impact on poverty for years of schooling. For the Arab population, the probability ratio is 3.1 controlling for education, family size, age, etc. This may be a confirmation of the existence of discrimination within the labour market, and the low quality of education in Arab areas. Flug and Kasir (2003) regressions also show that single-parent families are more vulnerable, while the probability of poverty is also affected by the continent of origin, the size of the households and the age of the family head. As expected, young heads of households, post-1990 immigrants and Israelis of Asian/Africa origin are in a higher probability group for poverty.

Looking at inequality inside the labour market, Kristal et al. (2005) show that the Gini index increased by 20 percent for salaried income between 1980 and 2003. They also find that part of the increasing inequality is due to the increasing

\(^ {23}\) The difference between the average income of poor families and the income level defined as the poverty
difference in the mean real wages between the highest and the lowest deciles of wage distribution. Moreover, they assess that the structure of wage distribution differs among the different groups that compose the heterogeneous Israeli society. Female workers, the ultra-orthodox, new immigrants and low-skilled workers indeed seem to have a stronger presence at the bottom end of income distribution. These findings are supported by the empirical results of Flug and Kasir (2003). Furthermore, they also find inter-industrial wage differentials, salaries in banking, electricity, and water sectors being relatively superior to the ones in agriculture and construction industries.

All these figures on inequality among salaried workers confirm the determinant role of the labour market as a factor of inequality, a role that is not limited to unemployment or labour force participation levels. This might imply that an efficient policy against inequality cannot depend only on raising the employment level. Alongside the “classic” explanation based on technological changes, Kristal et al. (200) put forward changes in the structure of the labour market to explain increasing inequality. They found that the decrease of union density and coverage rate in recent decades has probably allowed a further increase in income inequality.

**III. Labour Market, Employment Policy and the Educational System**

**A. Government Intervention in the Labour Market: Recent Trends**

Israeli governments have traditionally played dominant roles in economic and social affairs. Similarly to many Western countries, State intervention has decreased in the economic sphere, the national budget was reduced and significant privatisation and deregulation measures have been introduced. This last trend has not been implemented equally across all sectors and led to a mix of strong state intervention in some areas and liberal economic mechanisms in others.

In 2002 the government launched the Economic Recovery Plan (ERP) whose objective was to reduce the deficit from 7 percent of GDP to 4 percent, accompanied by large cuts in government spending. Similarly, the government
accelerated the privatisation of national companies with a target divestment of $1.5 billion by the end of 2005. The government comprehensive plan articulates a number of measures to transform and elasticise the labour market. Under the heading ‘From welfare to work,’ transfer payments are being reduced with the goal of removing the implicit labour disincentive. The process is staggered from 2006 to the end of the decade. In the year 2003 alone, income maintenance and unemployment compensation payments tightened in real terms by in excess of 20 percent. Access to transfer payments is similarly affected by the tightening of unemployment eligibility criteria to one of the strictest standards in Western economies (for instance, a minimum employment term of 360 days during the 540 prior to unemployment is required for eligibility). It should be noted that social safety net slashes are not limited to employment related allowances only and also affect, for instance, child allowances (by introducing a flat rate per child to replace the previous progressive rates based on family size). Employment in the public sector is to be considerably diminished. This is being achieved by delaying non-compulsory hiring on the one hand, and by implementing massive layoffs and early retirement procedures on the other hand (the education sector alone is expected to loose 2,500 teachers). The economic plan encompasses wage reduction in the public sector. The main instruments comprise deferred wage rise, postponement of additional payments, and reduction in average salaries by inducing senior employees to retire early. The government intends to favour the substitution of foreign migrants with Israeli workers in the agriculture and construction industries. A reduction in the foreign workforce is being accomplished by ordinary departures, forced expulsions and diminishing working visa allocations. The number of foreign migrants decreased by more than 10 percent in each of the years 2003-2004. The Israeli plan to reintegrate disadvantaged populations into the workforce through counselling and professional training in designated centres is commonly referred to as the Wisconsin programme, after similar pilot projects in the US State of that name. Four similar centres have been outsourced to international companies, and were expected to open in July 2005. The project’s objective is to decrease the numbers of unemployed individuals who are dependent on public services for income. However, several voices are questioning the real benefits of the programme. First, the limited number of centres planned is unlikely to reach a significant proportion of disadvantaged populations. Second, the original
Wisconsin programme itself falls short of having proven that it can grant economic independence to a majority of participants. A recent evaluation commissioned by the Wisconsin legislative house outlines major gaps between the programmes’ expectations and results observed. About half of programme graduates had to re-enrol in the programme to complete formation, and only 20 percent of graduates managed to earn wages above the poverty line.

The impacts of ERP and ‘From welfare to work’ have not yet been fully felt. It is, however, possible to suppose some early partial conclusions. In 2003 the programme led to a moderate public employment growth (1 percent, which is below the population growth rate), and in 2004 public employment decreased by 0.6 percent. Such a phenomenon had not happened since the rigorous economic stabilisation programme of 1985. In 2003, the nominal average wages of government employees declined by 3.1 percent as compared to the preceding year, to a 1.7 percent reduction in the private sector. The substitution of foreign workers with Israelis took place in the construction and personal services industries, which contributed to some extent to a slight unemployment decline in 2004. The positive impact of the budget deficit control (connected to the Bank of Israel key interest rate being at its lowest level ever in January 2005) and government debt decrease will almost certainly bear fruit in the next couple of years.

The significant cuts in transfer payments have caused some individuals to join the labour market, yet the quality of newly created jobs (in terms of wages and employment stability) is by and large below national standards. Doubts may be cast on the plan’s ability to create jobs adapted for low skill workers at reasonable wage levels. The social net shrinkage occurred before any real alternative was proposed for the exposed population and too few accompanying measures were put in place (one example would be wage subsidies for single parents who receive income maintenance benefits). Even positive domestic growth may end up increasing poverty if the distribution of income deteriorates, so that the total number of people below the poverty line actually increases. The plan may also fail to result in significant unemployment reduction among disadvantaged populations, due to the concentration of Israeli growth in skill-intensive industries. Consequently special policy measures are required in order to reduce poverty,
chief among them being the establishment of quantitative poverty alleviation targets for the long run and broadening the scope of accompanying measures.

B. Educational System

Under the Compulsory Education Law, 1949, compulsory education applies to all children between the ages of 3 and 15 inclusive. It also provides for free education for adolescents until completion of 11th grade in accordance with the curriculum. The State is responsible for providing free compulsory education.

The educational level is clearly correlated to various employment indicators such as labour participation, employment status, wage levels, and even personal satisfaction. Education is moreover a tool for the maximisation of human capital and is an issue of general interest for society as a whole. Because so much of its economy is based on exports and high-skill industries, Israel must maintain a competitive advantage by investing heavily in education. Expenditure on education per student relative to GDP per capita is a good indicator of the educational effort, since it takes a country’s relative wealth into account. Table 6 shows that Israel’s total education expenditure equals 8.6 percent of GDP, and is almost 40 percent higher than the figure for total OECD. The share of public funding across all education levels is 83 percent compared to 77 percent for total OECD.

Table 6: Expenditure on Educational Institutions as % of GDP, Level of Education, source of Funds, year 2001

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In employment terms, the Israeli educational sector represents a significant share of the labour market. Teachers and support staff represent 43 percent of the public civilian labour force in 2004 (CBS). This is characterised by an overwhelming proportion of women (about 4 out of 5 teachers are women), and a high proportion of part-time employment, estimated at half of salaried workers, or almost twice as much as the ratio in the labour force (Zuzovsky and Doitsa-Schmidt, 2004).

The demand for high-quality education standards translates into a higher cost per student. The input/output rate indicates how efficient the system is; yet estimating whether the resources invested yield adequate return is difficult to answer. One method would be to look at the rate of students obtaining secondary education. The rate of upper secondary achievement has consistently increased in past decades, but it is still relatively low at 46.8 percent of 17-year-old students (‘normal’ completion age). It would, however, be wrong to assume that increasing rates are necessarily a sign of improvement. A growing share of the secondary diplomas obtained do not qualify students to enrol in tertiary education (15.4 percent in 2003), as variation in quality levels increases. The relative decline in educational standards follows the growth in students enrolling in alternative school systems, state-religious education and other educational frameworks. Researchers observe a decline in the establishment of a normative path from elementary school to university. The increasingly unequal standards are particularly noticeable when comparing the different geographical districts. About 56 percent of all schools reach the 50 percent attainment objective set by the Ministry of Education, but the rate is around 45 percent for the newer
development towns and probably no more than 20 percent for Israeli Arab and Bedouin localities. (Sviersky an Atkin, 2004).

The attainment level for Type A tertiary education among the 25-64 age group in 2002 (i.e. long track and advanced higher education) is 26 percent in Israel, compared to 16 percent in the OECD (average), 19 percent in the UK and 29 percent in the US (OECD 2005). This is partially a result of the extraordinary growth in the sphere of tertiary education. Between 1990 and 2003 the number of students enrolled in higher education institutions rose by 140 percent (Ministry of Education). This spectacular expansion has been enabled by a parallel rise in non-university academic institutions and professional colleges. In the years 1990-2003 the proportion of students enrolling in non-university institutions out of total tertiary education grew from 15 to 47 percent (Ministry of Education). It is remarkable that some of these new institutions have developed in the periphery, thereby creating new educational opportunities across the country.

One of the main goals of public education is the provision of levelled education regardless of socio-cultural differences. Therefore, the problem of unequal secondary education is critical. The educational attainment gap between populations of different ethnic backgrounds seems to persist over time and calls for serious reforms. Successive governments have not addressed the issue, and the last sizeable reforms occurred nearly 40 years ago.

In 2003 a committee was charged with proposing reforms for the national education system. Its recommendation included organisational reforms, such as partial transfer of responsibilities to local authorities ('localisation’ of hiring mechanisms); introduction of cost saving measures and reduction in the growth of the public education budget (recent developments indicate that 2,500 to 4,500 teachers’ positions might be eliminated in 2005 or 2006); an increase in teachers’ productivity with the introduction of differential wages following individual evaluations; additional opportunities for the expansion of private schools; and finally the introduction of a long school day (Israeli schools typically offer schooling during morning hours only).
Opponents to the reforms stress that their implementation would be likely to exacerbate unequal standards due to the high heterogeneity of local authorities. They warn of severe consequences, such as cutbacks in study hours in those districts, and an increase in the number of students per class. The extension of the school day could have great educational, social and economic impact, such as allowing more parents to join the labour market. The Knesset ratified this under a 1990 law, but in the absence of adequate funding, it was not implemented.

IV. Economic Growth and Labour Market Structure

A. 2004 Economic Growth Picture

In 2004, the Israeli GDP rose by 4.3 percent after three years of disappointing growth rates. The recovery was led by an expansion of the business sector product which grew by 6.1 percent. This upturn was mainly due to a strong growth in world trade and the high-tech industry, to the amelioration of the security situation, and a sustained improvement of both fiscal and monetary policy. At the same time, capital stock expanded, while employment grew by 3 percent. The rise in the participation rate and employment, mainly in the business sector, may be explained by both transfer payments cuts and the increase in labour demand.\(^{24}\) However, the current growth expansion attracts principally skilled workers while the demand for low-skilled workers is limited. In other words, the actual situation impacts moderately on the large pool of low-skilled unemployed workers.

The growth path is also characterised by an enhancement in profitability\(^{25}\) and an increase in Total Factor Productivity (TFP). These two phenomena could indicate a deep-rooted economic growth process. However, as explained below, the average TFP rise in the last decade is relatively modest compared to previous periods (see Figure 17). This can be explained by last year’s weak demand, which impeded full factor utilisation, but also by long-term factors. An historical perspective may provide a better understanding of these long-term factors. The chronological analysis will focus on the period surrounding the Economic Stabilisation Programme of 1985.

\(^{24}\) See Section 2 for more details.

\(^{25}\) This may be explained by the decrease in labour costs in the last two years.
B. Major Factors behind Israeli Economic Growth

Since the Independence of the State of Israel in 1948, the Israeli economy has undergone a major transformation. The GDP share due to agriculture consistently decreased, while the manufacturing and services shares rose.\(^{26}\) At the same time, important changes occurred within each sector, such as the increased share of human-capital-intensive industries at the expense of labour-intensive industries in manufacturing. These changes are illustrated by the TFP growth path and its contribution to economic growth. Indeed, as highlighted by Helpman (2003), from 1960 to 1991 the TFP growth share of the GDP rise was almost equal to the contribution attributable to capital accumulation and hours worked. Until 1973, the GDP annual growth rate reached a level of 9.7 percent per annum, while it fell to a 3.4 percent between 1973 and 1989. In parallel, a sharp decrease took place in the annual growth rate of total hours worked, before, during and after 1973. Focusing on the 1970-1991 period, Helpman (2003) suggests to focus on the workforce’s educational level and creation of know-how via investment in R&D to explain the productivity rise. During this period, TFP contributed to 41 percent of total real GDP growth. Assuming a productivity/R&D elasticity of 0.078, he found

\(^{26}\) In the last 50 years the GDP share contributed by agriculture decreased from 12 percent to approximately 2.6 percent in 2001.
that the share of the productivity rise that is attributable to R&D investment was 17 percent. He also noted that the R&D capital stock expanded by an impressive factor of 7.3 during this period, as it stayed at a relatively low level of stock. Indeed, in the early 1990s the stock was about 5.5 percent of the GDP in Israel, as compared to 23 percent in the US or 16 percent in France. At the same time, Israel benefited from an R&D capital stock increase from its foreign trade partners. This spill-over effect added 8 percent to GDP growth. Finally, human capital, by means of an average increase in years of schooling, contributed to 12 percent of the GDP rise (Helpman 2003).

To summarise, GDP grew by 137 percent between 1971 and 1990. 70 percent of this rise is due the growth in working hours and investment, while 30 percent of this 20-year rise was made possible by an increase in productivity.

**Figure 18: Business Sector Product (year-on-year volume change, percent)**

Source: Bank of Israel Annual Report 2004 – Statistical Appendix
Flexibility in the labour market is another element that may reasonably account for sustainable growth. As previously explained, the Israeli labour market shifted from the dominance of a national trade-union to widespread individual labour contracts. The cost-of-living increment element of wages allows for downward flexibility at a steady rate. Moreover, real wages in the private sector followed a different path than in the public sector, and both reacted predictably to the last recession. All in all, it seems that the flexibility level has increased. The evolution of the employment structure also supports this view, since the percentage of foreign and Palestinian workers increased. Paradoxically at the same time, the minimum wage level has been legally elevated. Although the literature does not provide clear-cut assessment of the minimum wage impact on employment and general wage levels, the Israeli case suggests that it can be the source of some kind of rigidity (Sussman and Lavi 2001).

Finally, the evolution of productivity plays an essential role as an indicator of growth. The productivity decline most of the last years may indicate that the Israeli economy still has some way to go before achieving a sustainable growth rate. For instance, Ribon (2003) found that labour productivity contributed a negative -0.6 percent to the average output growth between 1989 and 2002. She also estimated that unexpected changes in output were mainly derived from unexpected changes in productivity and immigration. According to Flug et al. (2000), technological progress explains part of the productivity shocks. Their evidence relies on the fact that demand for high-skilled workers has increased within, rather than between industries. For their part, Hercowitz et al. (2000) demonstrate that new immigrants from the former Soviet Union had a negative impact on Total Factor Productivity during their first years. Flug and Kasir (1998) suggest that the productivity of new immigrants increases as they accumulate social capital, linguistic skills and tenure inside Israel and climb the occupational ladder.

From this analysis we deduce that the emphasis should be placed on human capital, R&D capital accumulation and increased investment in infrastructure in order to enhance productivity, as well as more efficient utilisation of production factors in the long-run. As regards human capital, a relatively high tax rate on labour income could hinder its accumulation. As for infrastructure investment,
some progress has been noticeable recently, such as the extension of interurban railways or the suburban railway projects in Jerusalem and Tel Aviv; both of these could have a direct impact on productivity. To sum up, the decrease in TFP in recent decades emphasises the need for a competition-oriented policy, educational reform, and a focus on human capital and infrastructure investment.
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Appendix: a multi-criteria analysis to benchmark the position of the Israeli economy with respect to other countries around the world and, in particular, with respect to the Euromed region

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After 15-20 years of structural adjustment and 10 years of Barcelona process, how does the Israeli economy rank with respect to its economic performances, relative to the other regions, European countries and the Mediterranean Partners? The multi-criteria method used below allows to position Israel with regard to other economies, not only European countries, new members and certain candidate countries, which appear directly in classifications, but more generally with regard to all regions in the world.

1. The classification method

The method applied indeed does not compare the countries of a sample between each other, but every country in the sample with external profiles established on a hierarchical basis. The profiles are built for every criterion from the “performances” of all economies in the world (this is the sample used here) for which a value of the criterion is available. For every criterion, the “reference” value of the class 5, which will include the most performing economies in this domain, is fixed by the 80th centile of the whole distribution (for example best performing with regard to 208 countries referenced in the World Bank WDI database). So, this means that a country which belongs to class 5 from the point of view of a criterion, realizes a performance « at least so good » as 80 % of countries in the world: the economy ranks in the most successful 20 % around the world.

For example, in the case of the “life expectancy” criterion, to belong to class 5 requires to reach a “life expectancy” of at least 75 and a half years (rounded to one and a half year). In 80 % of countries, the “life expectancy” is lower than this threshold, a “performance” which does not allow them to be ranked in class 5. For the following class, the threshold is fixed to the 60th centile. Coming back to the life expectancy illustration, the threshold of the class n°4 is 71,8 year-old equal (rounded to 0,9 year, what we call an indifference threshold and which means that we suppose that the difference between offering 71,8 years of life expectancy and offering 70,9 years is not relevant: this threshold uses in fact the 5% centiles of the distribution). Yet, to belong to class 4 requires to offer a life expectancy equaling or exceeding the situation prevailing in 60 % of countries in the world. For the class 3, the threshold uses the 40th décile. The class 2 refers to the 20th centile (indicating that in class 2, 80 % of the countries enjoy a better situation). Then, the class 1 groups together those who are situated in the last 20 percent:

The method consists in using numerous criteria which are in relation with the problem to be tackled. The question of the global position is more complex, because the classification is then made on a “majority” of criteria: an economy is compared with the profile of the class and is considered as « at least as successful », when it equals (at least) the profile in a majority of cases, without being less successful in too numerous domains. In the present analysis, the majority is fixed to 70 %: to be in the class of the best 20 %, it is necessary to be classified in these 20 % for at least 7 criteria among 10. If the economy only performs in 6 criteria, then it cannot be considered as so-successful as the profile.

2. The used criteria and the domains they define

The chosen criteria follow the logic of the process of Barcelona: the creation of an area of prosperity, peace and social development, what includes, according to Femise logic:

i) An indispensable human development, based on 9 criteria: illiteracy rate, GDP per capita, women enrolment ratio in higher education, UNDP synthetic indicator of human
development (HDI), life expectancy, population having access to safe water, probability at birth to reach the age of 65 years, total activity rate and women activity rate.

ii) The social balance needs economic prosperity to be sustainable, a fact, which motivates a “macroeconomic performance” domain. The issue here is to measure the quality of the economic results, not only with respect to the consensual approach of preserving main equilibriums, but also with respect to the sustainability of the actual situation. 11 criteria form the Economic Performance domain: the access of the private sector to credit and credit supplied by the domestic banking sector, current account balance, budgetary balance, foreign direct investment in proportion of GDP, domestic investment rate, inflation, openness commercial rate (measured with regard to the population), the share of manufactured goods in exports, unemployment rate and the debt service ratio.

iii) It is well established that economic equilibrium spreads inside societies through institutions and through legal frameworks, which can be then considered as transmitting (or not) supposed positive effects. This motivates to take into consideration the domain of governance and the reforms processes. It is essential to note that, in this domain, points of view are widely subjective and the debates are numerous around nominal or real implementation of reforms. To legislate and to create is not enough, it is necessary to watch furthermore the application and especially, what is the longest but the most significant feature, namely the modification in depth of the behavior. For this Governance-reform domain, the criteria are typically coming from “experts’ point of view”, by using miscellaneous ratings, like the one established by the « Heritage Foundation”, which gives a mark for a criterion. It is however evident that we cannot use without precaution this kind of classification, heavily related to subjective parti-pris. But, in another way, they are also really representative of the perception of the functioning of a country. It is all our interest to take into account the mark, but not the scale the rating uses, in applying here also the same method to establish the profiles based on the analysis of the distribution: it is a way of eliminating the ideological bias and increasing the relativity aspect of the method. Finally, 8 criteria form this “governances-reforms” domains: level of corruption, black market control, Property rights, regulation, foreign investments framework, financial transactions with foreign limitations, trade tariff and not tariff barriers, participation and transparency.

iv) The last domain is that of the tools (not included elsewhere) allowing to establish a knowledge based economy in the country. The conditions of implementation of such a development mode are complex and among the indicators allowing to identify the potentialities of an economy to succeed, some were already taken into account in the other domains. So that here, the domain refers more to the necessary or basic “infrastructures”, in particular in education and NTIC. 8 indicators form this space: the average number of educational years of the adults, the gross enrolment ratio in the primary and the secondary education, the internet density, computer equipment and telecommunications density (fixed telephony), the pupil-teacher ratio in the primary school and the level of the public spending in education.

On the whole, the analysis of the situation of the PM with regard to the European Union countries (and to the other countries in the world) is based on 36 equally weighted criteria, which represents the Barcelona objectives: human development and institutional development, sustainable economic prosperity, which conciliates economic balances and openness to trade, development of a knowledge based economy.

3. The classification of Israel

As underlined in the introduction of the report, the main purpose of the present analysis is not the Israeli-Palestinian conflict. But, as already said, we cannot completely disregard it since the multi-criteria analysis puts some emphasis of its impact on the economic domain. The global classification of the economy of Israel indeed indicates a position in the first class, equivalent to the average level of the former 15 European Union member countries and in progress with regard to 1995.
But, this overall picture does not correctly depict the situation, something we can see, when we focus on the classification envisaged domain by domain (following graphic Cf.).

The current result is indeed the combination i) of a position corresponding to that of the best performing modern industrial nations in terms of human development, governance (although a little bit behind as regards to “participation and transparency”), and especially of Knowledge based economy, which constitutes for Israel a factor of competitiveness; ii) and of a relative position which is strongly behind from the point of view of economic performances, in the center of the class of the middle (while the country is classified in first class with respect to the other criteria); the relative position according to the economic criteria is then significantly below the performances realized by the other advanced economies. As shown by the following graph, this relative position, (based on the performances of year 2004) is also in very significant retreat with regard to 1995.

Evolution by domains, with regard to the World

The sustainability of the situation is threatened by the performance in the economic domain, as already stated in the introduction. Is the current dynamics for a small open economy, far enough from the big industrious hearts of Europe, Americas or Asia sustainable in the long-term? We shall take certainly into account the real bounce of the economy, especially during the second semester of 2005 according to provisional figures for the year. This tendency should however have to be confirmed to be able to counterbalance the risks observed in the 1995-2004 period. These risks seem important as one of the main conclusions of the report is that the human factor is the main long term development resource for Israel. If we now examine in detail the criteria explaining the classifications of the economy according to the various
First of all, the labour market suffers terribly. It is firstly the unemployment rate which is very high, with regard to the achievement of other economies, but also with regard to the world performances generally: the 10,7 % rate in 2004 places Israel at the end of the front last class, indicating that more than 60 % of economies show better performances. Here also, it is advisable to indicate the positive tendency observed in 2005: the unemployment rate strongly decreased to an estimated 9,0 %, according to the last figures of the Ministry of Finance. The relative position is modified somewhat, Israel taking place now at the top of this class, but always below the median rate (8,7%). But unemployment is not the only disappointing indicator, the activity rate is also very weak, with regard to the other advanced economies.

Then, we shall underline a classification in the second class as regards “participation and transparency”, a position relatively good in general, but far away from standards in industrial nations, notably in the European Union.

Finally, in terms of economic performances, it is still indicators of sustainability that show weak performances. The budget deficit is very high compared with the one of other economies: even if it is substantially reduced from 4,3 % in 2004 to a 2,1 % estimation for 2005, according to the preliminary national accounts of the Central Bureau of Statistics, this does not modify the relative position with regard to the other countries. The performances remain also just average in terms of foreign investments attractiveness (measured in proportion of the GDP) with, in 2004, inflows almost divided by 2 relative to 2003 and representing only 1,6 % of the GDP. According to the Central Bank, the tendency is still contrasted in 2005: « investment in Israel by nonresidents declined in the 2005 second quarter. The drop in direct investment was relatively moderate, and its level remained higher than the 2004 average, while nonresident portfolio investment contracted steeply, relative to both 2005 first quarter and to the 2004 average ». However, the forecasts for the annual result let again to expect an important progress, due to a more positive second semester. But, the moderate level of FDI in proportion of GDP, with regard to the other economies, is coupled with a weak domestic investment (calculated also in proportion of GDP), which tends to indicate unfavourable anticipations about the general dynamics of the economy, made both by the foreign investors and the national private sector.

Thus it seems certainly that the global ranking of Israel in this benchmark is now positive, and 2005 trends seem to indicate a net amelioration from the economic point of view with regard to the reference year of this analysis: 2004. But, it seems difficult to venture more than that because the dynamics appears uncertain, especially if the recent trend of 2005 does not continue. What should now be the government's priority is to reverse the dynamics of 1995-2004 (or to secure the 2005 trend).