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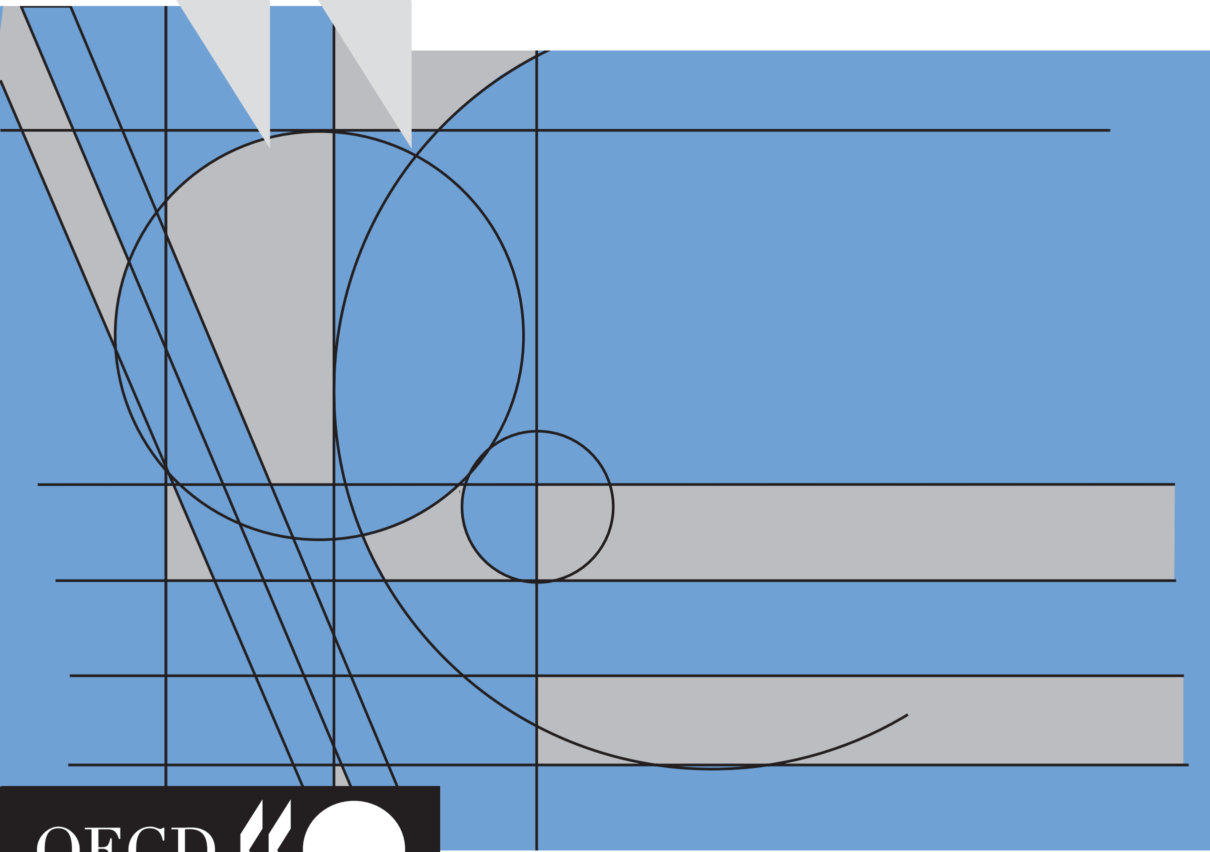

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OECD Investment Policy Reviews

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ISRAËL

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Foreword

On 11 July 2002, Israel became eligible for adherence to the OECD Declaration on International Investment and Multinational Enterprises after a full examination of its foreign direct investment policies. The Declaration promotes national treatment of foreign direct investment, proposes voluntary standards of behaviour to multinational enterprises and encourages moderation and restraint in the use of investment incentives and conflicting regulatory requirements.

The OECD has invited Israel to join the Declaration in view of its general openness to foreign direct investment and liberal orientation of its macroeconomic and structural policies. Since the establishment of the State of Israel in 1948, the Israeli economy has been progressively transformed from an agrarian economy to a technologically advanced and service-based economy. Trade liberalisation, abolition of exchange controls, adoption of modern corporate governance rules and intellectual property protection enhancement have led to the establishment of a generally enabling, transparent and non-discriminatory environment for domestic and foreign investment. Encouragement to high-tech industries and a wide network of international commitments have reinforced the beneficial effects.

Association with the OECD standards will also reinforce the Israeli government efforts to pursue business-friendly economic reforms. Particular attention needs to be given to reducing market access restrictions or distortions resulting from past heavy government involvement. Further progress may in fact largely depend on the acceleration of the privatisation process, the dismantling of monopolies and a less interventionist approach to business activity.

Adherence to the OECD Declaration represents an important step towards expanding Israel's co-operation with the Organisation and its Members. Upon adhering, Israel will be entitled to participate in the work related to the Declaration implemented by the OECD's Committee on International Investment and Multinational Enterprises, a Committee composed of officials from Ministries of Economic Affairs, Finance, Foreign Affairs, Trade and Industry.

This report assesses the role that foreign direct investment has come to play in Israel's economy and the policy measures susceptible of enhancing this role in the future. It is based on information current as of early June 2002. Under the

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auspices of the OECD's Centre for Co-operation with Non-Members and within the framework of activities of the Committee on International Investment and Multinational Enterprises, this report was prepared by Marie-France Houde, Rosemary Morris and Barbara-Chiara Ubaldi of the Directorate for Financial, Fiscal and Enterprise Affairs of the OECD Secretariat, with statistical assistance from Isabelle Ynesta and secretarial assistance from Jennifer MacGillivray. The report benefited from the comments by Pierre Poret, Head of the Capital Movements, International Investment and Services Division in this Directorate. The OECD is grateful to the Israeli authorities for their co-operation to the study. The report is published under the responsibility of the Secretary-General of the OECD.

Eric Burgeat

Director

Centre for Co-operation with Non-Members

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Overview

Israel's economy, based on an essentially agrarian system when the country was established in 1948, has been transformed into a modern technologically advanced economy well-integrated into global markets.

The state of Israel, established in 1948, covers an area of almost 5.5 million acres. Its population has increased seven-fold since 1948 to reach 6.4 million at the end of 2001. In the 1990s, a wave of immigrants – 1.2 million people – mostly from the former Soviet Union arrived in the country. Historically Israel's economy was an agrarian three-sector economy – the public sector, the Histadruth (General Federation of Hebrew Workers) and the private sector. During the 1980s a process of macroeconomic and structural reforms, including disengagement of the government from the economy and deregulation across all sectors, was begun. This was accelerated in the 1990s while at the same time Israel pursued a foreign policy designed to further integrate the country into world markets, concluding a range of bilateral and multilateral economic agreements.

During the 1990s, Israel experienced high levels of economic growth, achieving in 1999 an estimated GDP per capita of 88 per cent of the OECD average.

Today Israel has a modern, technologically advanced economy, with GDP per capita in 2001 at US$17 900, a 50 per cent increase over 1990 figures. Trade accounts for 80 per cent of GDP, and the relatively advanced high-technology sector – the key factor in Israel's economic growth over recent years – was largely responsible for Israel's annual average GDP growth of 5 per cent during the 1990s. Israel has well-developed capital markets and a sound financial sector. Based on purchasing power parity for 1999, it was classified as the most developed country in the "low-middle income" group by OECD comparative figures on GDP for 43 countries, with an estimated GDP per capita of 88 per cent of the OECD average.

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Foreign investment and in particular foreign direct investment (FDI) played a significant role in the development of the Israeli economy in this decade, with record levels being recorded in 2000.

Foreign direct investment (FDI), insignificant before the 1990s, came to play a significant role in the development of the Israeli economy. Towards the mid-1990s the rapid expansion of the country's high-tech sector, in combination with the opening up of financial and telecommunications sectors, was responsible for attracting large amounts of both foreign direct and portfolio investment. Indeed, FDI and foreign investment flows in general increased in tandem from the early 1990s onwards due to the strategic role played by high-tech industries and the central role of capital markets in financing the growth of these industries. In 2000, foreign investment inflows peaked at US$9 billion, accounting for 9 per cent of GDP. Portfolio investment accounted for 53.2 per cent of the total of foreign inflows and 46.4 per cent of total foreign outflows. FDI reached a record level of US$4.4 billion in the same year.

Accumulated stock of foreign capital at the end of 2000 amounted to US$117 billion, of which 21 per cent was accounted for by FDI.

Between 1995-2000, FDI represented 44 per cent of the total US$33.2 billion invested in Israel, a yearly average of US$2.3 billion. At the end of 2000, accumulated stock of foreign capital amounted to US$117 billion, of which 21 per cent was accounted for by FDI. FDI in 2000 represented 41.6 per cent of gross fixed capital formation and 4.1 per cent of GDP. Israel's developed capital markets, free from almost all exchange controls since 1998, have enabled investment through the Tel Aviv stock exchange and at the same time permitted Israeli firms to raise capital through foreign exchanges, in particular, the technology-oriented NASDAQ. In terms of the number of foreign companies registered for trading on this stock exchange, Israel is the second largest country of origin.

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Up until the mid-1990s, foreign investment inflows (both direct and portfolio) were almost exclusively from the United States. Investors from elsewhere, in particular from Europe, have shown an increasing interest in Israel as an investment location over recent years. However, the United States remains Israel's principal investing country; at the end of 2001 the United States and Canada accounted for 49 per cent of FDI in Israeli equities traded in Tel Aviv and abroad, compared with Europe's share of 27 per cent. While Israeli companies have tended to favour the NASDAQ for fundraising, the number of Israeli companies registered for trading on European stock exchanges has risen considerably. High-tech sectors, such as software, semi-conductors, Internet, communications and medical devices have attracted the largest amount of FDI. Foreign investors are also active in the banking sector and some insurance activities.

The lion's share of FDI originates from the United States, although in recent years investors from other countries have shown increasing interest in Israel. While high-tech sectors have attracted the most FDI, foreign investors are active in banking and other activities.

Foreign investment outflows also increased during the 1990s, with a peak in 2000 of US$5.7 billion. Most of these outflows were towards North America and Western Europe. As with investment into Israel, the high-tech sectors prevailed and FDI was actively involved; in 2001, 27 per cent of Israeli FDI stocks abroad were in communications and electronics, followed by 23 per cent in petroleum and chemicals, 16 per cent in hotels and construction and 9 per cent in trade and services (including software). Other significant investments were made in banking, insurance, tourism and traditional industries such as food production and mineral extraction.

Foreign equity investment outflows from Israel also increased during the 1990s, mostly towards North America and Western Europe and across a range of sectors.

The development of the business environment in Israel towards a modern and open one for foreign investment has been underpinned by comprehensive deregulation across all sectors of the economy. Apart from the introduction of a new Companies Law in 1999, the legal frameworks in other areas that affect the conditions for operating a business have also been reformed. Intellectual property laws, competition laws, those dealing with the fight against corruption and money laundering have all been substantially revised over recent years. There are no special approval requirements or operating permits for foreign-controlled enterprises. With the exception of

Comprehensive law reform in a number of areas directly related to doing business, combined with deregulation across all sectors, has resulted in a more favourable business environment for foreign investment.

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acquisition of rights to land use, and a number of sectoral measures largely based on national security considerations, the business regime is generally non-discriminatory for foreign investors.

Recently revised to make it more attuned to a global commercial environment, the legal framework for incorporating and operating a business entity contains new provisions that facilitate dual listing with several stock exchanges abroad.

Israeli law governing corporate activity is a modern law based on both American legal concepts and common law. It allows non-resident enterprises and individuals, on the same terms as nationals, to incorporate private or public companies. In addition, foreign companies may operate in Israel, providing that they register as such. There are neither minimum capital requirements nor minimum numbers of directors requirements for private companies. Since June 2000 dual listing of shares is possible on the Tel Aviv Stock exchange and exchanges abroad such as AMEX, the New York Stock Exchange and the NASDAQ without having to satisfy additional regulatory requirements. Foreign workers' participation in the workforce accounted for approximately 10 per cent in 2001. Intra-corporate transferees in service sectors may generally enter Israel on a temporary basis without having to satisfy labour market tests. There have nevertheless been some concerns about the granting of visas and entry permits. In terms of the local workforce, Israel's is one of the most highly skilled in the world.

Incentives to encourage investment and programmes based on promotion of research and development initiatives have been key to Israel's economic development.

Incentives to encourage investment have also played an important role in Israel's economic development policy, both on a regional and national level. Taking a range of forms – grants, tax reductions, infrastructure support, etc. – incentives have also been a key element of Israel's FDI policy. The creation of the Office of the Chief Scientist for the development of Research and Development (R&D) and various R&D initiatives such as Magnet, which encourages pre-competitive generic research of industrial companies working in partnership with research institutes and technological incubators, have been extremely successful.

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However, general grants and tax incentives aimed at encouraging foreign capital investment are being revisited in order to avoid market distortions and discrimination against domestic investors.

The experience has been mixed in the case of the general grants or tax incentives for the encouragement of capital investment. Tax incentives – such as the recently adopted two-three year capital gains tax holiday for foreign investment in Israeli venture capital funds – may still be too biased in favour of foreign investment. The Israeli authorities recognise the desirability of establishing over time a more level playing-field between foreign and domestic investors. They are also aware that excessive reliance on investment incentives can create vulnerabilities for the economy and that they should not become a substitute for broader policies aimed at a sound, enabling, business regulatory environment.

The growth of FDI in Israel has contributed to the financing of its current account deficit and enhanced foreign trade performance. Its concentration in high-tech sectors, facilitated by the strong venture capital industry, has enabled Israel to become a world leader in this industry.

The increased levels of foreign investments have substantially contributed to Israel's current account deficit financing and enhanced its foreign trade performance. In the case of many acquisitions of Israeli start-ups, the foreign investment has enabled the Israeli companies to have access to international markets and, similarly, Israeli direct investments abroad have permitted access to those markets via existing companies already established in a particular market. The convergence of a number of factors, such as the strong Israeli venture capital industry, the comparatively large amount of resources invested over the years in military research and development and incentives for specific activities have made the high-tech sector attractive to foreign investors. National expenditure on civilian R&D has increased by an average of 12 per cent at constant prices since 1998; of which the high-tech sector is relatively high. As a result, Israel has become a world leader in this industry.

Domestic reforms have been underpinned by an active international economic diplomacy, resulting in participation in numerous bilateral and multilateral agreements.

Israel is a party to several international agreements, which commit the economy to open trade in goods and services and open capital accounts. Adherence to these instruments has served to anchor domestic reforms into long-term legally binding undertakings and helps it overcome a difficult regional economic environment. Since the early 1980s, Israel has entered into 35 Agreements for the Promotion and Protection of Investment and some 34 Agreements on the Avoidance of Double Taxation largely based on OECD models. Parties to these

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agreements have included a wide range of non-OECD countries in addition to Israel's traditional economic partners.

The Israeli economy, like many others, experienced a downturn in 2001. While FDI has proven to be quite resilient, future performance depends upon world markets and Israel's geo-political situation.

While 2000 was a "record year", in 2001, the economy contracted, and with it, foreign investment. This was due to a number of reasons, including the global downturn in the high-tech sector and the worsening of the political situation in the region. Despite this, 4000 companies, of which three-quarters were start-ups, were still operating in Israel in 2001. FDI proved to be more resilient to the downward trend than portfolio investment, by surpassing the level reached in 1999. Nonetheless, while the geo-political situation continues to deteriorate, the short and medium-term outlook for FDI flows remains uncertain.

Priorities for the near future including stabilising relations with neighbouring countries, implementation of recent reforms, accelerating the privatisation process and removing administrative barriers, with a view to attracting foreign capital.

Opportunities for foreign investment exist in privatisations planned for the near future. Progress with the privatisation process, begun in Israel in the mid-1980s, has been to date relatively slow and sporadic and the role of foreign investment limited. During the last year however the government has considered options for accelerating the process, including in the banking sector the possibility of privatisation via international capital markets. This, along with implementation of the many new laws and regulations aimed at reducing piracy and other intellectual property rights abuses, are challenges for the near future. Full effective implementation of the new money laundering regime and simplification of licensing and other administrative procedures are also priorities for the enhancement of the general business environment. Israel has identified the improvement of relations with neighbouring countries as a priority for regional security and development and for Israel's medium-term economic outlook.

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The OECD Committee on International Investment and Multinational Enterprises reviewed Israel's legal regime in April 2002 and concluded that the country is willing and able to adhere to the *Declaration on International Investment and Multinational Enterprises* and its related Decisions and Recommendations. The Committee encouraged Israel to continue with its privatisation process, to keep up the momentum of liberalisation and deregulation and administrative reforms with a particular focus upon facilitating the participation of foreign investors in its economy. Israel's adherence to the Declaration will contribute to its programme for greater participation in OECD work. As an adherent to the Declaration, which is directed at the improvement of the business environment and the promotion of good corporate behaviour, Israel will be entitled to participate in work related to the Declaration and Related Acts, as a counterpart to the obligations undertaken under these instruments. It will share its experiences with other key investment players, also signatories to the Declaration, contributing to the mutual benefit from Israel's adherence.

The OECD Committee on International Investment and Multinational Enterprises concluded in April 2002 that Israel is willing and able to adhere to the Declaration on International Investment and Multinational Enterprises. As an adherent, Israel will participate in work related to the Declaration and share its experiences with other adherents.

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Chapter 1

Foreign Direct Investment Trends, Factors and Prospects

FDI: A new feature in the Israeli economy

Since the establishment of the modern State of Israel in 1948, the Israeli economy has been transformed from an underdeveloped agrarian economy to a technologically advanced and service-based economy.[1] In no other decade have the changes been more rapid and pervasive than in the 1990s. Following the collapse of the Soviet Union, a large wave of immigration of 1.2 million generally well-educated people (representing 29 per cent of the Israeli population in 1989), major breakthroughs in the peace process and strategic economic policy decisions combined to make a particularly favourable conjunction of factors for economic growth and development.

Gross Domestic Product (GDP) per capita, which stood at around US$11 828 in 1990, increased by more than 50 per cent, reaching US$17 900 in the year 2001. Israel became a much more open and dynamic economy, with trade, by and large free, accounting for almost 80 per cent of GDP. High technology industries – notably start-up companies in the cutting-edge computer technology and software industries – became the engine of economic growth. They were responsible during the period for 88 per cent of the increase of industrial exports and about half of the 5 percentage point annual increase in GDP. The IMF observed that from mid-1999 until the third quarter of 2000, Israel experienced its best economic performance in many decades.[2]

According to the World Development Report, Israel holds the 36th and 32nd positions in terms of GNP and GNP per capita respectively. It is defined as an "advanced economy" by the IMF World Economic Outlook and a "high income economy" by the World Bank Atlas. New comparative OECD figures on GDP for 43 countries, based on purchasing power parity for 1999, include Israel as the most developed country in the "low-middle income" group, with a per capita GDP equal to 88 per cent of the OECD average. In terms of quality of life, knowledge and standard of living, Israel is ranked 22nd by UNDP Human Development Report.

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The 1990s was also the period when foreign investors discovered Israel. External capital, a trickle before the 1990s, started to flow in large amounts towards the middle of the decade, both as direct and financial investment, attracted by – but also contributing to – the dynamic expansion of the high-tech industry, the competitiveness of more traditional industries (notably food and textiles) and the opening up of the financial and telecommunications sectors. Foreign investment inflows peaked at US$9 billion in 2000, accounting for 9 per cent of GDP. Foreign direct investment (FDI) accounted for 44 per cent of the total US$33.2 billion invested in Israel between 1995-2000 (a yearly average of US$2.3 billion) and over 21 per cent of the accumulated stock of foreign capital (US$117.0 billion) at the end of 2000.

The increased "maturity" of the Israeli economy was also reflected by the large amounts invested by Israeli residents abroad during the same period (US$10 billion), which registered a record high in 2000 (US$5.7 billion). The share of direct investment (57 per cent) in total outward flows was even higher than for total inward flows.

The entry into the new millennium witnessed a marked drop in both direct and overall investment flows into and from Israel, relative to the peaks achieved in 2000. This was the result of the downturn in the high-tech sector in the United States and Europe and the world-wide economic slowdown, in the context of a deteriorating geopolitical situation. However, by even exceeding in 2001 (US$3 billion) the level reached in 1999 (US$2.9 billion), inward FDI proved to be much more resilient to these developments than portfolio investments, which became insignificant in 2001 (U$S0.1 billion) in comparison to the level reached in 2000 (US$4.6 billion). That being said, the short-term outlook for further expansion of FDI remains uncertain.

This chapter focuses on Israel's FDI trends and their underlying factors since the beginning of the 1990s and on its future prospects, while the next chapter focuses on the broader effects of FDI on the Israeli economy.

Flows and stocks of foreign investments

Israel's foreign direct investment performance since the beginning of the 1990s has moved in parallel with foreign investment flows more generally (including portfolio investments excluding banks' equities and government bonds). The main reason for this is the strategic role given and played by high-tech industries in the economic development of Israel during this period and the central role of capital markets in financing the growth of these industries in Israel as well as worldwide.

The development of capital markets in Israel – supported by the removal of major exchange control restrictions in 1998 – has enabled foreigners to invest in

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Israeli enterprises through the Tel-Aviv Stock Exchange. It also enhanced the Israeli firms' ability to raise capital through foreign stock exchanges, mainly the NASDAQ (and more recently European exchanges). Foreign joint venture capital in particular has financed Israeli start-up companies, which were later acquired by foreign investors. Therefore, in order to understand Israel's FDI trends, it is useful to analyse them in tandem with foreign investment trends generally. In the year 2000, portfolio investment accounted for 52.7 per cent of total foreign inflows and 47.9 per cent of total foreign outflows.

Foreign investment flows into and from Israel increased dramatically during the 1990s. As indicated in Table 1, foreign investment inflows (net) into Israel, which were no more than US$72 million (of which net FDI were US$92 million) in 1990,[3] reached the amount of almost US$9.4 billion (of which US$4.4 billion were FDI) in the year 2000. As a result, foreign investment inflows, which were negligible only a decade ago, have become an important actor in the Israeli economy, equal to 41.6 per cent of gross fixed capital formation and 8.7 per cent of total GDP (Table 6).

At the end of 2000, inward foreign investment stocks reached US$117.0 billion (of which FDI stocks were US$21.0 billion) equal to 107.9 per cent of GDP.[4] Inward foreign investment stocks per capita substantially increased from US$3 479 (of which US$907 FDI) in 1994 to US$11 479 (of which US$3 374 FDI) in 2000. The sharp increase in foreign investment stocks, especially in 1999-2000, can be attributed not only to the large inflows but also to the increase in the value of these investments.

During the 1990s Israel became not only a substantial recipient of foreign investment inflows, but also a source of foreign investment outflows. As a result of domestic macroeconomic and regulatory developments in the Israeli economy, as well as the significant integration of the Israeli economy into global markets, foreign investment outflows from Israel, which were very limited in the early 1990s, increased dramatically throughout the last decade from US$183 million (FDI) in 1990 up to US$5.7 billion (of which FDI were US$2.9 billion) in 2000.

As a result of the above-mentioned increase, outward foreign investment stocks increased substantially. At the end of 2000 they reached US$70.3 billion (of which FDI stocks were US$9.6 billion), or about 65 per cent of the Israeli GDP.

Countries of origin and destination

Inflows

As indicated in Table 2,[5] through the mid-1990s, foreign investment inflows to Israel were almost exclusively from the United States. As a result of the Gulf

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Table 1. **Israel's foreign investment flows, 1990-2001**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Direct investment (FDI)												
Inflows (net)	92	139	269	417	463	1 397	1 538	1 831	1 772	2 856	4 437	3 039
(*In percentage of foreign investment inflows*)	128%	112%	57%	47%	13%	47%	29%	32%	42%	51%	47%	97%
Outflows (net)	183	275	424	636	616	566	614	708	1 124	933	2 939	1 188
(*In percentage of foreign investment outflows*)	69%	57%	32%	117%	69%	130%	231%	102%	103%	50%	52%	61%
Net	–91	–136	–155	–219	–153	831	924	1 123	648	1 923	1 498	1 851
Portfolio investments												
Inflows (net)	–20	–15	202	465	3 071	1 600	3 744	3 882	2 471	2 695	4 959	107
Outflows (net)	83	209	894	–91	279	–131	–348	–12	–34	935	2 711	744
Net	–103	–224	–692	556	2 792	1 731	4 092	3 894	2 505	1 760	2 248	–637
Foreign investment												
Inflows (net)	72	124	471	882	3 534	2 997	5 282	5 713	4 243	5 551	9 396	3 146
Outflows (net)	266	484	1 318	545	895	435	266	696	1 090	1 868	5 650	1 932
Net	–194	–360	–847	337	2 639	2 562	5 016	5 017	3 153	3 683	3 746	1 214

Note: Includes flows by or in the private, government and banking sectors.
Source: Bank of Israel.

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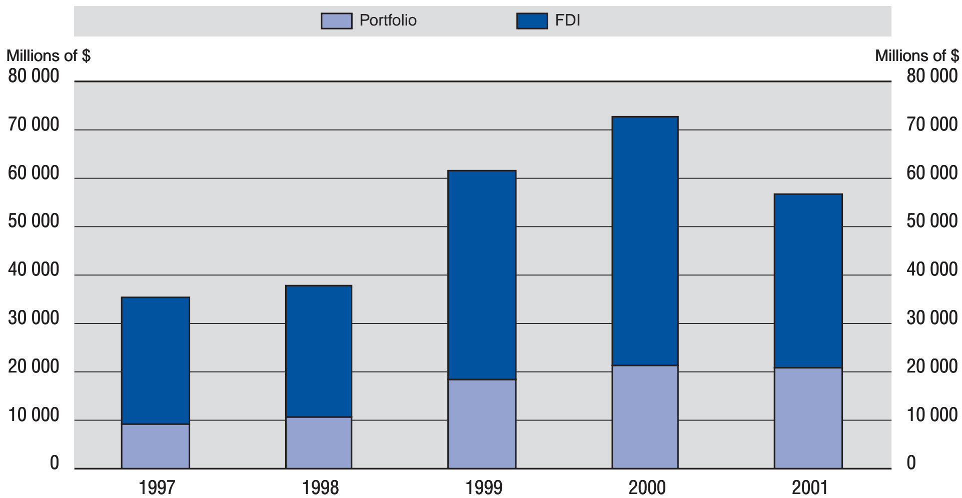
Figure 1. **Stocks of Inward foreign investment**



Source: Bank of Israel.

Co-operation Countries' 1994 declaration (which provided that the signatories would no longer implement the secondary and tertiary Arab boycott's regulation), the rise of the European capital market, and the creation of second stock exchanges for high growth companies, this situation has changed. Since the mid-1990s, more and more non-United States investors have begun to invest in Israeli companies, and their share in the total of foreign investment inflows to Israel has increased steadily. Yet, the United States has remained Israel's most important foreign investment source.

This is reflected both in the geographical distribution of foreign investment in Israeli equities traded in Tel-Aviv and abroad (Table 3). Although accumulated foreign direct investment *via* the purchase of Israeli equities traded was estimated around US$4.85 billion in 2001, the United States and Canada's share in the total was 49 per cent while Europe's share was 27 per cent (see Table 3 and Figure 2).

The NASDAQ was the Israeli companies' most favoured fundraising stock exchange, and more than 125 Israeli companies raised funds through public offerings of bonds and stocks during the 1990s. Indeed, Israel was the third largest country after the United States and Canada in terms of number of companies

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Table 2. **Tradable capital raising (stocks and bonds) of Israeli companies abroad 1990-2001**

	1990	1991	1992	1993	1994	1995
United States	0	0	237	184	89	454
of which: Bonds						
Europe	0	0	0	0	0	5
of which: Bonds						
Japan (only bonds)						
Total	0	0	237	184	89	459
of which: Bonds	0	0	0	0	0	0
	1996	**1997**	**1998**	**1999**	**2000**	**2001**
United States	1 809	1 583	685	2 891	2 709	1 364
of which: Bonds	600	816	401	1 162	762	890
Europe	40	16	126	502	1 341	12
of which: Bonds					371	
Japan (only bonds)		173	72	0	333	34
Total	1 849	1 772	883	3 393	4 383	1 410
of which: Bonds	600	989	473	1 162	1 466	924

Note: Includes mergers and private placements to parties at interest.
Partial data for 1990-1993.
Source: Bank of Israel.

listed for trade on the NASDAQ. At the same time, the number of Israeli companies registered for trading in European stock exchanges rose considerably, from 2 in 1996 to 29 in 2000. These companies opted to register in Europe because of the greater flexibility regarding conditions for registering companies there compared to the NASDAQ, and the high price obtainable on those stock exchanges by companies in the fields of biotechnology and medical equipment. Those stock exchanges also offer the possibility of raising relatively small amounts of capital.[6]

Table 3. **Geographical distribution of foreign direct investment position in Israeli equities traded in Tel Aviv and abroad – end of 2001**

	Total	TASE	Abroad
Europe	1 309	1 100	209
Far East	307		307
United States and Canada	2 345	1 150	1 195
Others	893	857	36
Total	4 854	3 107	1 747

Note: Includes only direct investment position. Not registered equities are excluded.
Source: Bank of Israel.

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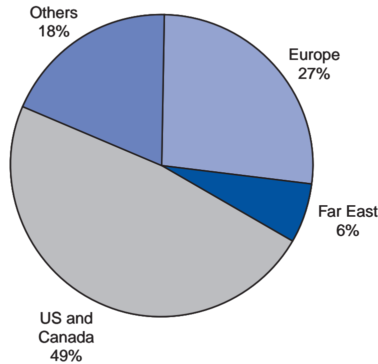
Figure 2. **Geographical distribution of foreign direct investment position in Israeli equities traded in Tel Aviv and abroad – 2001**



Source: Bank of Israel.

The geographical distribution of foreign direct investments through the Tel-Aviv Stock Exchange (TASE) was much more balanced, with the United States and Canada's share of 41.7 per cent and Europe's share of 41.6 per cent. Besides the United States, most significant was Switzerland's and Italy's share of 20.1 per cent and 10 per cent respectively. International investors' holdings accounted for 11 per cent of total TASE market capitalisation in 2000, divided between portfolio investments (5 per cent) and interested parties' investments (6.0 per cent).[7]

Outflows

As seen in Table 4, Israel's main FDI outflow destinations in the 1990s were North America and Western Europe. Notable is the Israeli FDI in North America of US$2.23 billion in 2000, which is directly related to the technology sector's economic boom in that year and can be explained by the acquisitions of American hitech companies by Israeli companies. Although the figures are low, there were substantial Israeli investments in Eastern Europe, in particular in the EU candidates. The low figures can be explained by use of Western European-based companies as a channel for Israeli investments in Eastern and Central Europe, due to tax considerations.

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Table 4. **Israeli outward FDI flows geographical distribution**

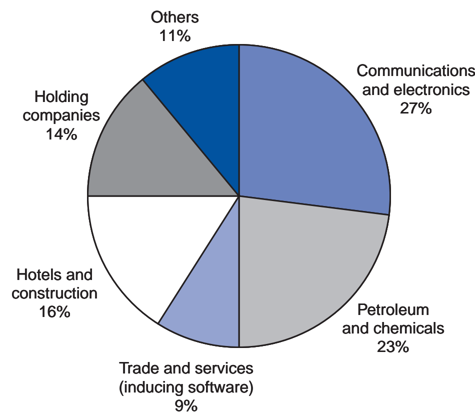
	1990	1995	1996	1997	1998	1999	2000	2001	Stocks 2001
Western Europe	10	182	260	200	678	334	258	320	3 714
Eastern Europe	0	30	12	14	10	24	–73	19	110
North America	52	224	354	303	444	379	2 227	262	3 259
Far East	0	4	18	7	8	24	5	10	151
Others	30	30	9	110	–86	–6	60	65	322
Total from direct reports	92	470	653	634	1 054	755	2 477	676	7 556
Total outward FDI						880	2 828	1 036	8 367
Coverage per cent of total outflows	100	100	100	100	100	83	83	69	90

Notes: The figures from 1999 onwards represent all transactions by reporting companies which hold direct investment stock over 5 million US$. The coverage of the report varies through the years.
The stock for 2001 is based on the stock reported for 2000, and the transactions in 2001.
Source: Bank of Israel.

Distribution by economic activity

In recent years, the major destinations for foreign investment inflows into Israel have been the hi-tech sectors[8] such as software, semiconductors, Internet, communications and medical devices.

Figure 3. **Israeli outward FDI stocks by sectoral distribution 2001 (Direct reporting system)**



Source: Bank of Israel.

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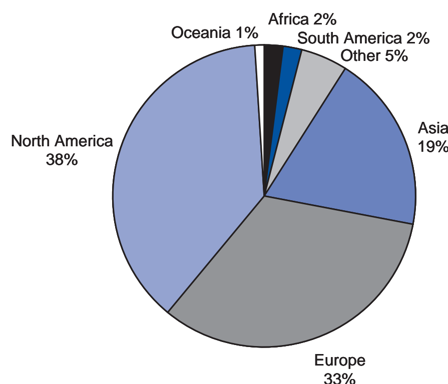
The dominance of hi-tech sectors has also prevailed in foreign investments of Israelis abroad. As can be noted in the Israeli outward FDI stocks sectoral distribution (Figure 3), communications and electronics are the largest destination (with a share of 27 per cent of the total), despite the substantial devaluation of companies' shares in recent months. Petroleum and chemicals (23 per cent), as well as trade and services (including software) sector (9 per cent) are also substantial destinations for Israeli FDI outflow, as are construction and hotels (16 per cent).

Export structure

Israel is largely dependent upon global markets as a destination for its products and as a source for its means of production and consumer goods. Israel's integration into global trade has been a factor contributing to the attractiveness of the economy to foreign investors. In 2000, foreign trade equalled 79.2 per cent of Israel's GDP. In 2000, total Israeli exports of goods and services increased by 23.8 per cent, reaching US$46.0 billion, equal to 42.4 per cent of the GDP. Exports of goods reached US$30.8 billion, equal to 68.3 per cent of total Israeli exports.

Israeli exports are geographically diverse and, as seen in Figure 4, despite the great distance, North America was Israel's major export destination in 2000. This can be explained by the large share of hi-tech products in Israeli exports, for which shipping costs are relatively low. 64 per cent of Israeli exports were concentrated in the European Union and the United States markets, with which Israel has a free

Figure 4. **Exports (goods and services) by region (2000)**



Source: Israel Central Bureau of Statistics.

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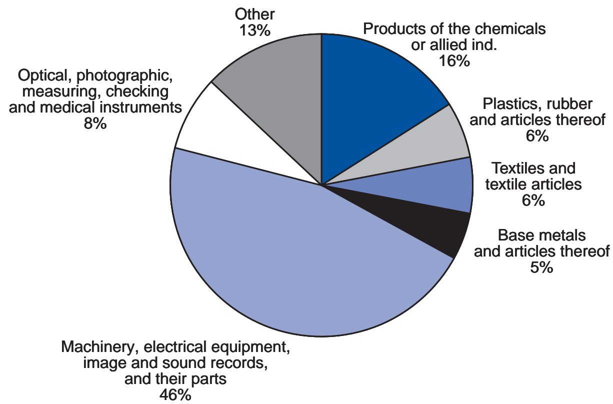
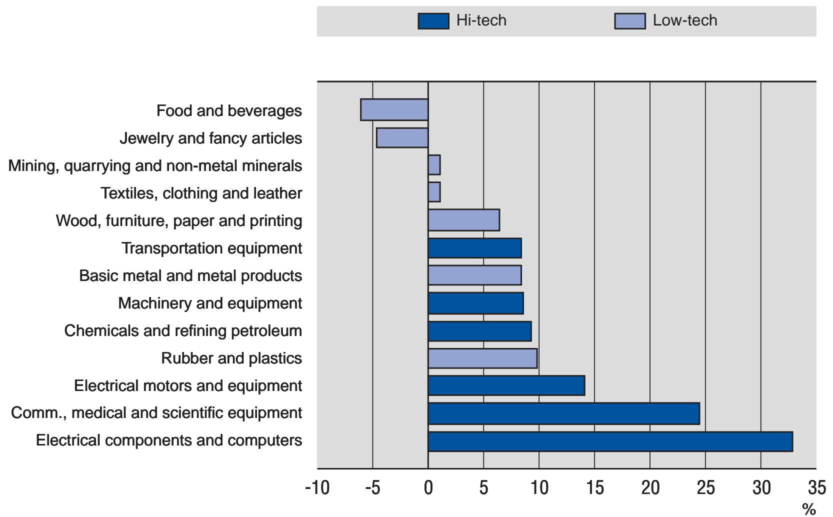
Figure 5. **Main merchandise export products by commodity group (excluding diamonds)**



Source: Israel Central Bureau of Statistics.

Figure 6. **Annual change in industrial exports (excluding diamonds) 1995-2000**



Source: Israel Central Bureau of Statistics.

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trade area agreement (FTA). By the end of 2001, Israel had FTA agreements with 30 countries, covering more than 70 per cent of its exports.

One of Israel's major export merchandising groups was machinery, electrical equipment, image and sound records, and their parts, which accounted for 46 per cent of its total merchandise exports (excluding diamonds) in 2000.[9] In the 1990s, substantial structural changes occurred in Israeli exports when low to medium-tech sectors stagnated and even decreased, while medium high-tech and high-tech sectors increased extensively, as Figure 6 indicates. As a result, in 2000, the share of hi-tech sectors in the total manufactured exports (excluding diamonds) reached 76 per cent.

Major investors

In the 1990s foreign investments in Israel grew not only in number and total sum, but also in average size. At the end of the 1990s, the Israeli economy experienced several mega-investments of more than US$1 billion. In fact, since the late 1990s, foreign investments of more than US$100 million have become commonplace in Israel.[10] Most of the large-scale investments were in the hi-tech sector, yet there were some large-scale investments in banking, insurance, tourism and traditional industries such as food production and mineral extraction. A majority of these large investments also originated from North America. Nevertheless, there has been a substantial number of investments originating in Europe, smaller in size, yet highly important since they were made by leading corporations in their respective sectors. For example, the Italian-based Generali Insurance Co. purchased 29 per cent of Bank Leumi's Migdal Insurance company for US$285 million, and German-based Volkswagen established a joint venture with Dead Sea Works to extract magnesium.

Particularly remarkable was Lucent's US$4.8 billion purchase of Chromatis in May 2000. The United States-based Telecom company was interested in Chromatis for its major R&D product Metropolis, which was designed to connect office buildings to optic fibres and to connect operators. Chromatis has recently been closed due to the global downturn. Another significant investment was the Canada-based Marvell Technology Group's US$2.7 billion purchase of Galileo Technology Ltd.

Main factors behind foreign investments in Israel in the 1990s

The Israeli authorities attribute the substantial rise in foreign investment inflows to Israel during the 1990s to favourable macroeconomic and political developments in Israel and the Middle East. The main factors behind these developments are considered to be:

– *Growing international interest* in the emerging markets and the hi-tech sector – since the beginning of the 1990s and until the financial crisis in Asia, Russia

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and South-America, fast-growing economies have generally enjoyed increasing interest in international financial markets and growing inflows of foreign investments. Israel is classified both as an emerging market owing to its high growth rates as well as to its advanced economy because of its sophisticated economic structures, providing emerging market investment funds with a relatively low risk investment destination. At the same time, the growth potential of the hi-tech sector and the new economy led to an unprecedented investment wave worldwide, from which Israel benefited due to its relatively large, fast growing hi-tech sector as a result of its new comparative advantages in this sector.

– *Highly educated and productive population, and the growth of the hi-tech sector* – the Israeli population is considered to be highly educated and skilled. Approximately 37 per cent of the Israeli population (over the age of 15) has a university or other advanced degree. The immigrants from the former USSR who are highly educated and skilled in the scientific and technical professions, further increased Israel's pool of human capital resources and productive capacity. This was the basis for the dramatic growth of the hi-tech sector in Israel in the 1990s, which in turn attracted foreign investment inflows.

– *Continuous economic growth* – From 1990 through 2000 GDP grew by an annual average of 5.0 per cent. This continued growth was both a result and a cause of the ever-increasing foreign investment inflows as it increased confidence in the Israeli economy and created expectations for future growth.

– *More favourable geo-political environment* – Since the Madrid Conference in 1991, through to the signing of the "Declaration of Principles" between Israel and the Palestinian Liberalisation Organisation (PLO) in September 1993, and until the more recent outbreak of hostility in October 2000, the Israeli economy enjoyed a distinctively more favourable geo-political environment than the one it had known in the past. The 1993 agreement with the Palestinians was followed by a peace treaty between Israel and Jordan in 1994 and the 1995 Interim Agreement on the West Bank and the Gaza Strip. Further progress was made in 1998 when Israel and the Palestinian Authority signed the Wye River Memorandum. The Peace Process substantially reduced investment security risks in Israel and improved the prospects for regional co-operation. One of the most important results was the 1994 Gulf co-operation Countries' decision to halt the implementation of the Secondary and Tertiary Arab Boycott's regulations. As a result, more and more multinationals, which until then had been shying away from investing in Israel, owing to the fear of being boycotted by the Arab League Member countries, started to do business in Israel.

– *Privatisation and deregulation* – Since the mid-1980s, the Israeli economy has undergone a process of reduced government involvement in the economy

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and liberalisation of regulated sectors. As in many other countries, privatisation enabled foreign investors to buy shares in Israeli companies, either directly or through Israeli holding companies. Deregulation of monopolised sectors also opened up new investment opportunities, particularly in sectors (such as telecommunications) particularly appealing to foreign investors. They responded to these incentives by establishing local companies and a commercial presence.

– *More favourable monetary and fiscal policies* – Since the mid-1980s Israeli authorities have been increasingly successful in controlling inflationary pressures, government deficits and the national debt. In 2000 the Israeli economy enjoyed a 0 per cent inflation rate while the fiscal deficit was 0.7 per cent of GDP. Such price and financial stability is important to foreign investors since it allows for a better planning of investment decisions and reduces the risks related to exchange rate fluctuations. The confidence of world financial markets in the Israeli economy is shown in the high rating which government bonds have received from the major credit rating agencies. Israel withstood the 1998 world financial crisis rather well. During the recent slowdown, these agencies have also decided to maintain Israel's high credit ratings in view of the sound fundamentals of the Israeli economy.

– *Foreign currency liberalisation* – During the 1990s Israel liberalised its exchange system.[11] In September 1993, it accepted the IMF Article VII obligations by removing almost all constraints on current account transactions. In May 1998 the shequel became almost fully convertible when most exchange control restrictions were lifted. This further reduced the risk of investing in Israel particularly as it provided the guarantee to foreign investors who could withdraw their investments at any time. The new regulations also enabled Israeli individuals and firms to invest abroad with practically no limitations. They also contributed to the unprecedented rise in Israeli investments abroad.

– *Successful fundraising abroad by Israeli companies* – Successful fundraising abroad has often left Israeli companies with more funds than they actually need for business development. In many cases these companies have preferred to reinvest their surplus capital in foreign companies rather than repatriate it to Israel. This particularly appears to have been the case with the increase in foreign investment outflows in the late 1990s.

– *Further liberalisation in the Israeli trade regime* – Although it substantially liberalised its foreign trade regime during the early 1990s on a unilateral basis, Israel's policy has been aimed at further trade liberalisation through the expansion of a network of bilateral free trade agreements. As a result, many Israeli firms had to relocate part or even all of their production processes in order to preserve their competitiveness within the Israeli and global markets.

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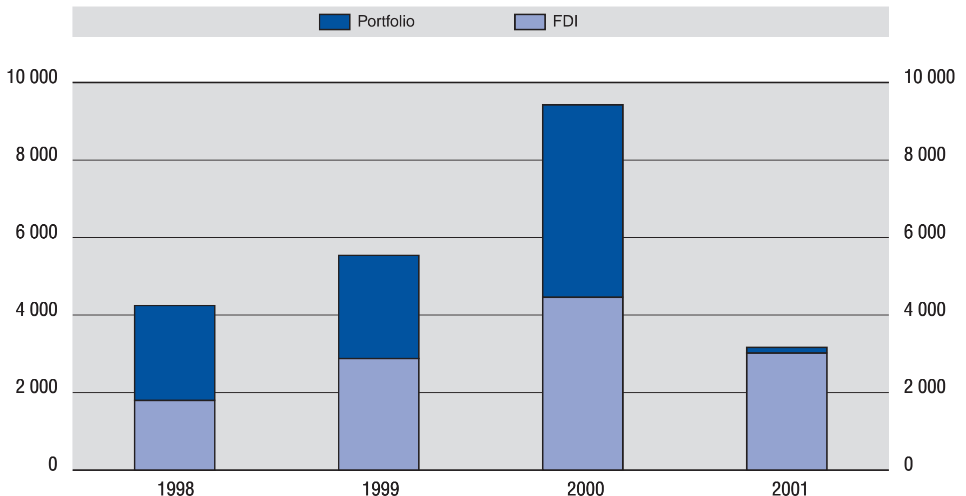
The negotiation of several bilateral investment protection treaties and double taxation agreements provided foreign investors with additional incentives to invest abroad by reducing the costs and risks of such investments.

– *Government support* – the Israeli Government provides investors with various incentives, including grants and tax reduction, which are available to both domestic and foreign investors. The relative importance of such government support in comparison with the above-mentioned factors is difficult to measure, however.[12]

Recent developments and future prospects

The global downturn, which severely damaged the capital-risk prone hi-tech sector, and the sharp deterioration in the geo-political environment since the outbreak of violence in October 2000 have had a negative effect on Israel's economy. Israeli hi-tech companies and venture capital funds were unable to raise money on the NASDAQ and the European stock exchange due to the sharp decline in these markets. There has also been a halt in acquisition of Israeli hi-tech start-ups by foreign companies as a result of Israeli firms' own financial difficulties. Because

Figure 7. **Recent development in foreign investment inflows into Israel**



Source: Bank of Israel.

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of the large share of portfolio investments in total foreign investment inflows, Israel experienced a 66 per cent decrease in foreign investment inflows in 2001 as compared with 2000. As can be seen in Figure 7, while FDI inflows into Israel in 2001 shrunk by 30 per cent (from US$4 437 million in 2000 to US$3039 million in 2001), the portfolio investment inflows experienced a large drop (from US$4 959 million to US$107 million) during the same period.

Table 5. **Israel: selected economic indicators**

Percentage change, unless indicated otherwise

	1996	1997	1998	1999	2000	2001
National accounts (constant prices)						
Real GDP	4.5	3.3	2.7	2.6	6.4	–0.5
Private Consumption	5.2	3.9	4.3	3.2	6.6	3.1
Public Consumption	5.3	1.8	2.4	3.1	1.1	3.2
Gross capital formation	7.1	–2.1	–7.1	9.5	–3.5	–4.3
Exports of goods and services	4.9	8.0	6.6	11.6	23.9	–13.1
Imports of goods and services	7.7	3.3	1.7	14.8	12.2	–6.4
Labour market indicators						
Israeli civilian labour force	2.2	2.5	2.6	3.5	3.8	2.8
Overall employment	2.4	1.4	1.5	3.1	4.0	2.6
Unemployment rate (in per cent)	6.6	7.5	8.6	8.9	8.8	9.1
Prices (end of period)						
Overall CPI	10.6	7.0	8.6	1.3	0.0	1.4
Underlying CPI (excluding housing, fruits and vegetables)	10.1	6.7	8.5	1.7	0.9	0.2
Money and credit (period average)						
Narrow money (M1)	15.9	13.2	12.0	9.6	11.0	14.2
Broad money (M3)	27.3	25.3	22.2	21.8	19.7	
Net domestic credit	24.6	19.1	16.1	16.7	13.1	10.9
Interest rates (average, in per cent)						
Discount rate	15.2	13.8	11.8	12.1	9.3	
Non-directed credit in new sheqalim	20.7	18.7	16.2	16.3	12.8	10.2
Public finance (per cent of GDP)						
Central government balance[1]	–4.2	–3.4	–3.3	–3.4	–0.7	–4.6
General government balance[1]	–5.8	–4.3	–3.8	–4.8	–2.2	–3.7
Public debt	107.9	105.0	108.1	101.9	92.8	99.6
Balance of Payments						
Trade balance (per cent of GDP)[2]	–7.2	–5.2	–3.3	–4.5	–3.4	–4.1
Current account (per cent of GDP)[2]	–5.7	–3.9	–1.4	–2.9	–1.2	–2.5
Foreign reserves (end of period, in US$ billions)	11.8	20.6	23.1	23.2	23.8	29.2
Exchange rate and terms of trade indices						
Nominal effective exchange rate (1990 = 100)	–2.7	0.2	–6.4	–7.7	9.1	
Real effective exchange rate (1990 = 100)	5.9	7.0	–3.0	–3.8	8.0	
Terms of trade (1995 = 100; index level)	102.8	106.8	108.6	110.2	108.3	

1. Operational concept, excludes the inflation component of interest payments on domestic government debt.
2. Staff preliminary estimates for 2000 and 2001.

Sources: Data provided by the Israeli authorities; and IMF, International Financial Statistics.

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The future prospects of foreign investments in Israel are dependent on the recovery of the world economy, the economic growth rates in the United States and Europe, future trends in world capital markets and on political developments in the Middle East. The acceleration of privatisation, tax and other structural reforms could also contribute to the future expansion of FDI. While the sharp reduction of portfolio investment shares in total foreign investments reduces the effect of future decreases in portfolio investments, it is unrealistic to expect that, under present circumstances, FDI inflows into Israel will return to previous high levels in the near future.

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Notes

1. For an excellent description of the main features of this transformation, see "The Israeli Economy, 1990-2000: Strategy for Change and Recent Developments", comments prepared by David Klein, Governor, Bank of Israel, for a meeting of the Chamber of Commerce Switzerland-Israel, 7 December 2000.
2. Israel: 2001 Article IV Consultation – IMF Country Report No. 01/133, August 2001.
3. In the same year net portfolio investments of the private sector (excluding banks) were –20 million dollars (*i.e.* foreign investors withdrew more money than they invested).
4. Investment stocks are subject not only to the aggregated flows but also to the changes in the value of the investments (*e.g.* share prices).
5. Contrary to FDI outflows, the Bank of Israel does not compile country breakdowns of FDI inflows into Israel. Available but not fully satisfactory substitutes for this data include statistics on tradable capital-raising of Israeli companies abroad (Table 2) cumulative investment in stocks traded in Tel-Aviv and abroad (Table 3 and Figure 2). The total outstanding balance of foreign direct investment in tradable equities of $4.9 billion at the end of 2001 compares with a total outstanding accumulated inward FDI stock of $21.5 billion. This means that the majority of foreign direct investment in Israel is non-tradable made.
6. The SWX New Market has proven popular with Israeli life science companies. The SWX New market has designated rapidly growing companies from both within and outside Switzerland. Three of the 16 firms trading in this market are from Israel. The Newer Market, operated by the Deutsche Borse, was one of the world's best performing markets while technology stocks were still rising. It attracted Israeli technology companies. NASDAQ Europe trades a number of Israeli stocks. London has become a favourite destination of Israeli companies, first regarding the Alternative Investment Market (AIM) and more recently, regarding the techMark launched in 1999, which seems to have been particularly responsive to the needs of technology companies. Israeli companies can also be found on the Euronext markets (combination of Paris, Belgium and Amsterdam stock exchanges).
7. See the Tel-Aviv Stock Exchange, *www.tase.co.il*
8. The high-tech sector is defined by the Central Bureau of Statistics as including the following: pharmaceuticals, electronics, aeroplanes, communication, software and R&D. The Bank of Israel data capture most of the BOP transactions (including services) of this sector.
9. The diamond sector, which accounted for almost one third of Israeli exports in 2000, is excluded from the trade statistics due to its relatively low added value and decreasing share in Israeli total exports in past decades.

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10. According to the Bank of Israel, the share of small and medium-sized FDI transactions (defined as less than $10 million) was 30 per cent of the total FDI in 2001, as compared with 25 per cent in 2000 and 40 per cent in 1999.
11. See further discussion in Chapter 3.
12. This issue is discussed in Chapter 3.

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Chapter 2

The Economic Impact of Foreign Investments

The previous chapter illustrated the rapid growth of foreign investment into and from Israel during the last decade. The present chapter examines more closely how inward and outward foreign investments have impacted upon, either directly or through externalities, Israel's main indicators of economic performance (such as capital formation, the capital account in the balance of payments, employment and technological development).

Fixed capital formation

In a matter of years, foreign investment inflows have grown in importance in relation to GDP and gross fixed capital formation (GFCF). As Table 6 indicates, foreign investments' percentage of GDP grew from 0.2 in 1991 to 8.7 in 2000 while FDI's percentage of GDP grew from 0.2 to 4.1. The relative importance of total foreign investment to GFCF grew even more – from 0.7 per cent to 41.6 per cent. At the same time, the share of FDI in GFCF grew from 0.8 per cent to 19.4 per cent.

Foreign trade and current account

Foreign investments have contributed significantly to Israel's current account deficit financing, which has notably grown from practically zero in 1990 to a peak of 5.9 per cent of GDP in 1996 and to an average of 3.2 per cent of GDP in the 1990s. Foreign investments have allowed the Israeli economy to finance its current account deficit without increasing its debt burden. Although there has been much fluctuation in the deficit coverage ratio over the years, since 1998 foreign investments have exceeded the current account deficit and the deficit coverage ratio average during 1995-2000 was 144.8 per cent. In the year 2000, the coverage ratio even reached 298.4 per cent. The FDI coverage ratio in the same period was, however, much smaller; it averaged during the 1995-2000 period no more than 50 per cent. In 2000, for the first time, net FDI exceeded the current account balance. This was the result of both an unprecedented increase in FDI, and a significant decrease in the current account deficit, as a result of a US$1.56 billion decrease in the merchandise trade deficit and a US$1.75 billion increase in the trade in services surplus.

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Table 6. **Foreign investment flows into Israel and gross fixed capital formation from 1995-2000**

	Gross Domestic Product (GDP), US$ million	Gross Fixed Capital Formation (GFCF), US$ million	Foreign investment (FDI + portfolio), US$ million	Foreign direct investment, US$ million	Inward foreign investments as per cent of GDP	Inward FDI as per cent of GDP	Inward foreign investments as per cent of GFCF	Inward FDI as per cent of GFCF
1991	69,550	18,057	124	139	0.2	0.2	0.7	0.8
1995	88,244	22,781	2,997	1,397	3.4	1.6	13.1	6.3
1996	92,699	24,860	5,282	1,538	5.7	1.7	22.2	6.2
1997	95,756	24,341	5,713	1,831	6.0	1.9	23.5	7.5
1998	99,518	22,610	4,243	1,772	4.3	1.8	18.8	7.8
1999	102,090	22,358	5,551	2,856	5.4	2.8	24.8	12.8
2000	108,441	22,725	9,447	4,419	8.7	4.1	41.6	19.4

Source: Central Bureau of Statistics, Bank of Israel.

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Table 7. **Foreign investment flows and current account 1994-2000 (US$ million)**

	1990	1995	1996	1997	1998	1999	2000
Current account balance	161	–5 164	–5 437	–3 662	–1 439	–3 045	–1 416
Current account as % of GDP	0.0	–5.9	–5.9	–3.8	–1.4	–3.0	–1.3
Israeli investments abroad	–183	–563	–462	–761	–990	–1 016	–5 221
FDI	–183	–563	–602	–626	–1 081	–880	–2 801
Portfolio	..	0	140	–135	91	–136	–2 420
Foreign investments in Israel	72	2 997	5 282	5 713	4 243	5 551	9 447
FDI	92	1 397	1 538	1 831	1 772	2 856	4 419
Portfolio	–20	1 600	3 744	3 882	2 471	2 695	5 028
Net foreign investments	–111	2 434	4 820	4 952	3 253	4 535	4 226
Net FDI	–91	834	936	1 205	691	1 976	1 618
Net foreign investments as % of current account balance	–68.9	–47.1	–88.7	–135.2	–226.1	–148.9	–298.4
Net FDI as % of current account balance	–56.5	–16.2	–17.2	–32.9	–48.0	–64.9	–114.3

Source: Central Bureau of Statistics.

Inflows and outflows of foreign investments into and from Israel can also be directly linked to Israeli foreign trade, in particular the exports of goods and services. First, foreign investors provide Israeli local companies with their international marketing and distribution facilities, and enable them to penetrate markets, which had previously been closed to them. This was the case with many of the acquisitions of Israeli start-ups by large foreign companies in their fields, since without the latter's networking, these start-ups would have encountered extreme difficulties in exporting their products and their survival would have been in constant threat.

Second, Israeli firms purchase foreign companies in order, among other things, to facilitate their penetration into foreign markets using their marketing and distribution chains, but no less important, their knowledge as to the foreign market needs. Particularly representative were the Alon Israel Oil Company Ltd. acquisition of 1 700 TOTAL-FINA gas stations and oil refinery terminals, and a pipeline in the United States. This acquisition enabled the Israeli oil company to penetrate the American market, using FINA's brand name and existing facility.

Israeli foreign equity investments abroad are also directly linked to efforts to gain and preserve competitiveness in the world and in Israel. In recent years, more and more Israeli factories have relocated parts of (or even entire) production facilities to foreign countries in order to reduce their costs and to be able to

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successfully compete in foreign markets against other producers. This has been most common in traditional, labour-intensive industries, which have faced intensive competition from Asia and Central and Eastern Europe. According to the Israeli Manufacturers Association, more than half of the Israeli textile producers have relocated at least a part of their production abroad in recent years. Among the beneficiaries of this process are Egypt and Jordan, where several large Israeli textile companies have established factories.

Israel's attractiveness to foreign investors can also be attributed to its special commercial position. Israel has established a large number of free trade agreements (FTA) with other countries, and exports to these countries accounted for 70 per cent of its exports in 2000 (see also Chapter 6). Most significant are the 1995 Association Agreement with the EEC (successor to the 1975 FTA agreement) and the 1985 FTA with the United States. Besides these two agreements, Israel has signed FTAs with the two other NAFTA members (Canada and Mexico), the EU candidates (Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovak Republic, Slovenia and Turkey) and the EFTA countries. This network of FTAs provides Israeli producers, as well as foreign investors, with free access to Israel's most important markets. No other country, except Mexico and Jordan, has FTAs with the two biggest trading blocs at the same time.

Finally, foreign investments are directly related to exports since many companies use the public offerings of shares abroad to promote their product sales and at the same time take advantage of their product's reputation in order to promote capital raising. In this context, one should mention the recent capital raising of three Israeli medical equipment companies in the SWX New Market in Switzerland.

Productivity and salaries

Although one cannot fully separate the effect of foreign investments on productivity and salaries from other macroeconomic developments in the Israeli economy – such as exposure to foreign competition, privatisation, and deregulation – the extensive inflow of foreign investment during the 1990s contributed to the rise in labour productivity and average salaries. Yet, since foreign investments were not equally distributed among the different sectors in the economy, the productivity and wage increases differed among various industries.

Table 8 shows the productivity development in Israeli industry by sector, using product to employee ratio. As one can see, while productivity in the low-tech, the medium-low-tech and the medium-hi-tech industries increased by approximately 15 per cent from 1994-2000, the high-tech sectors' productivity increased by almost 50 per cent. This increase can partially be attributed to foreign investment inflows, notably FDI inflows, which brought in not only capital but

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Table 8. **Development of manufacturing productivity by technological intensity 1994-2000**

Production/employee ratio, 1994 = 100

	Low technology	Medium-low technology	Medium-high technology	High technology	Total manufacturing
1995	103.8	106.5	100.8	104.9	104.4
1996	105.1	108.4	102.2	113.6	108.3
1997	108.9	108.5	102.4	116.4	111.4
1998	111.6	108.8	109.5	121.5	115.7
1999	113.7	110.7	110.3	126.5	118.9
2000	114.6	114.3	115.9	148.0	129.3

Note: Based on the CBS data.
Source: Central Bureau of Statistics.

also knowledge, management skills, and working standards, all of which increased labour productivity.

Hi-tech sectors, which attracted the lion's share of foreign investments and had the most substantial productivity increases in the late 1990s, were the sectors which experienced the most significant rise in wages. Between 1997 and 2000 the average real wage in Israel increased by 11 per cent. At the same time the average real wage in the control and supervision, medical and scientific industries increased by 23.7 per cent, electrical components showed an increase of 22.2 per cent, and electronic and communication equipment rose by 22.0 per cent. The wage increases in the hi-tech sector spilled over into other sectors, which did not necessarily experience a similar increase in productivity through the increase in aggregate demand and Israel's unique mechanism of wage indexing to the national average.[1] This was particularly the case in the public sector.

The hi-tech sector

Israel is among the world leaders in hi-tech/start-up industries. Currently there are about 4000 hi-tech companies in Israel – the largest concentration in the world outside California. The fast growing hi-tech sector was the major destination for foreign investment flows to Israel. According to the Bank of Israel's data, non-residents' gross direct investments in electricity and electronics, software and communications accounted for 53 per cent of the total non-resident gross direct investments in 1998.[2] At the same time, software and communications companies' share of the total titles issued in foreign stock markets was more than 75 per cent.[3]

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There are several reasons for the unprecedented success of the hi-tech companies in attracting wide foreign investments:

- Hi-tech companies have enjoyed a growing demand for their products. During 1995-2001 the electrical components and computers sector enjoyed an average yearly exports growth of 32.9 per cent and the communication, medical and scientific equipment sector enjoyed an average yearly exports growth of 24.4 per cent. By 2000, hi-tech sectors constituted 75 per cent of the Israeli non-diamond industrial exports.
- Israel's highly educated population, in particular the new immigrants from the former USSR specialised in the fields of science, and its internationally renowned education and research institutions, together with a highly developed communications infrastructure, have provided foreign investors with a solid base for R&D activities. Indeed, in recent years, many multinationals, such as Intel, IBM and Microsoft, have established development centres in Israel for their products.
- Government financial and other supports are generally available to foreign investors. The government provides significant funding for R&D, which is also available for sub-contracted R&D work in Israel by foreign companies. Moreover, the Israeli Government has established bi-national funds for qualified research and development projects with Canada, Korea, the United States, the United Kingdom and Singapore. Furthermore, Israel has participated in the EU's fourth and fifth R&D programmes. An assessment of these programmes is given in Chapter 5.
- Due to its security needs, Israel has invested extensive resources in military R&D over the years to develop advanced defence technologies. As a result, many scientists and engineers have gained wide experience in these cutting edge technologies. In recent years, there has been a successful transformation and adaptation of military technologies to civil needs and uses.

The creation of a strong venture capital industry, alongside the technological companies, was another cause of the spectacular growth of the Israeli hi-tech sector and its success in attracting foreign investors. A venture capital fund (VC) is a limited partnership managed by a company (the general partner) that engages in financing young companies with good growth potential. The other investors (the limited partners) are usually institutional investors. Due to their technological knowledge and familiarity with market demands, VCs provide non-professional investors with the necessary tools for reducing the risk factors when investing in an uncertain environment, such as the hi-tech sector. At the same time, VCs provide hi-tech companies not only with the finance needed for their R&D activities, which in many cases is unavailable through the traditional financial system, but also with management and commercial skills. In particular, mention should be made of VCs'

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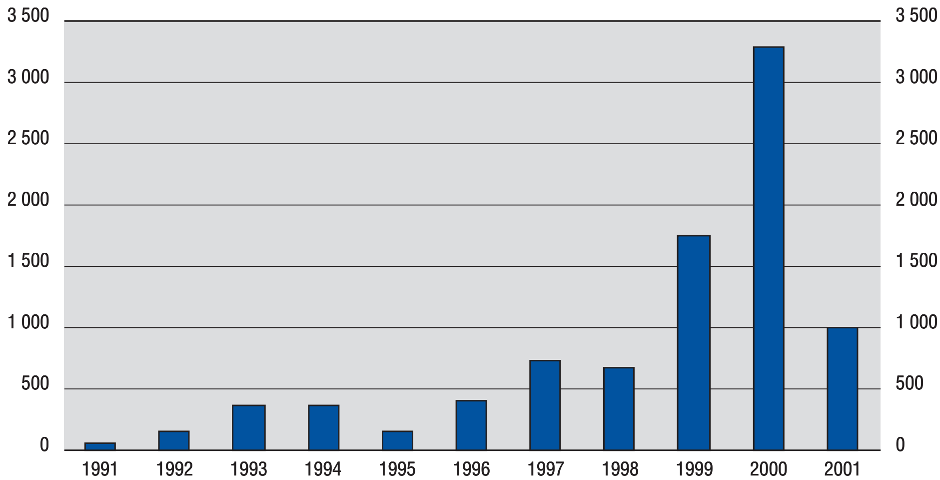
Figure 8. **Capital raised (annually) by technology Venture Capital funds (1991-2001)**
In millions of US dollars



Source: Israel Venture Capital Association.

guidance for initial public offerings (IPO). This added value is crucial in the case of start-up companies, which are very small in size and are usually owned and operated by young people, with limited experience in the field of financing and marketing.

The first VC active in Israel was Yozma – a government owned VC, which was established in 1992 and was later privatised. Yozma was established in order to deal with the market failure whereby small, fast growing, hi-tech companies were denied access to financing through traditional financial institutions. In 1999 there were 60 Israeli and 20 foreign-owned VCs. In 2000, the number of Israeli VCs reached 88. Most of the capital managed by VCs (both Israeli and foreign-owned) came from foreign investors.[4] According to the Israeli Venture Capital Association, during 1991-2000 the Israeli VC industry raised US$7.9 billion, of which US$3.3 was raised in 2000 alone. In 2000 the Israeli VCs' investments were distributed among four major sectors: communications (38 per cent), Internet (29 per cent), software (15 per cent) and life sciences (11 per cent). As mentioned above, VCs have also backed hi-tech fundraising abroad. Out of the 186 Israeli hi-tech companies that raised a total of US$9 billion through public offering in the United States and Europe during 1993-2000, 82 companies, raising US$4.3 billion, were backed by VCs based in Israel.

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Box 1. Start-up companies

Israel's high-tech industry has expanded markedly in the last few years, and much of it has been through start-ups. According to Central Bureau of Statistics estimates, start-ups accounted for 2 per cent of GDP in 2000. Start-ups are characterised by being active in the high-tech industry, producing primarily knowledge, being without earnings at this stage of their life, and having the bulk of their shares held by hedge funds.

The number of start-ups operating in Israel is estimated at between 2 500 and 3 000, and they are financed by some 130 venture capital funds. About 80 of them are defined as Israeli funds, *i.e.* funds whose managing company is registered in Israel, while 50 of them are foreign-owned. Most of the amounts invested in these funds, including the Israeli ones, derive from non-residents.

In 2001, non-residents transferred US$720 million to start-ups, compared with US$820 in 2000. Only part of the payments made by non-residents to the start-ups is expressed in the financial account of the balance of payments. Thus, in 2001 only US$280 million of the total transfers of non-residents to start-ups was recorded as investment in share capital, the remaining US$440 million being recorded as purchase of services, wage payments, etc.

In addition to the Israeli start-ups, there are start-ups that are connected with Israel, *i.e.* they are registered abroad even though their development centres and most of their employees are in Israel. The trend towards registration abroad accelerated in 2000, in the context of tax and accountancy benefits abroad *vis-à-vis* Israel.

On the basis of estimates and surveys made by Israeli research bodies, the Israeli venture capital funds – which in the last few years have accounted for 35-45 per cent of all investment in start-ups – raised a total of US$6.4 billion in 1997-2001, US$2.6 billion of which has been used to date. Approximately US$2.3 billion of the capital stock accrued is intended for follow-on investment, and the remaining US$1.7billion is earmarked for new investment.

In 2001 there was a steep drop in capital raised by the Israeli venture capital funds, to US$1 billion, compared with US$2.4 billion and US$1.6 billion in 2000 and 1999 respectively. Notwithstanding, there was only a slight dip in the various categories of their investments – in Israeli companies and companies connected with Israel – and these fell from US$1 billion in 2000 to US$0.8 billion in 2001. Most of the investments were directed to follow-on investment, and most of the slowdown was in the companies which are still in the early stages; this will be expressed in the future in the number of companies reaching exit.

Source: The Bank of Israel.

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Table 9. **Capital raised in public offerings of Israeli companies in the United States and Europe (1993-2000)**

	Europe		United States	
	Number of offerings	Capital raised (US$ millions)	Number of offerings	Capital raised (US$ millions)
1993			17	529
1994			10	336
1995	1	6	16	608
1996	5	44	31	982
1997	3	28	22	743
1998	5	122	12	505
1999	12	446	19	2,010
2000	6	253	27	2,469
Total	32	899	154	8,182

Source: Israel Venture Capital Association.

The second feature of the Israeli hi-tech sector is the extensive use of public offerings abroad to raise money. As seen in Table 9, during 1993-2000 public offerings abroad by Israeli hi-tech companies increased dramatically both in number and size, reaching a cumulative amount of more than US$9 billion. Most impressive was the rise in the number of public offerings in the European Stock Exchange due to the creation of many second stock exchanges for high growth companies in Europe. NASDAQ is still, however, the Israeli companies' favourite stock exchange. The number of Israeli firms listed in the NASDAQ is disproportionate to Israel's economic size and makes Israel the second largest foreign country (after Canada) in terms of the number of companies registered for trading on the NASDAQ.

Lastly, a common way of investing in the hi-tech industry is through mergers and acquisitions (M&A). In many cases, foreign hi-tech companies preferred to merge with, or acquire Israeli companies, rather than to purchase its products or technology. From the Israeli companies' point of view, merging with foreign companies embodied advantages related to investing in these companies, most important marketing infrastructure and better access to the market's needs.

Foreign investments and telecommunications/broadcasting services

The former government-owned monopolistic telecommunications sector has experienced major deregulation and privatisation in recent years, which have led it to expand significantly and become a major destination for foreign investment. One of the main reasons for the attractiveness of the Israeli telecom market for foreign investors is the Israeli consumer's high consumption of telecom services. As

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of September 1996, for example, 96 per cent of Israeli households had at least one direct telephone line and by 2001 more than 5.5 million cellular lines were in use in Israel (constituting a penetration rate of 85 per cent).

The long-distance telephone service market was opened for competition in July 1997, with the establishment of two new operators: Barak and Golden Lines, which broke Bezeq's monopoly in this market. Barak is partly owned by United States Sprint (25 per cent), German-based Deutsche Telekom (10.5 per cent) and France Telecom (10.5 per cent). Golden Lines is partially owned by the Italian-based Italy Telecom (26.4 per cent). As a result, prices dropped significantly despite the market's substantial growth. For example, while the number of calls to the United States rose from 459 million minutes in 1997 to more than 1 billion minutes in 2000, average prices were reduced from NIS 3.52 to NIS 0.69 during the same period. As of 2000, 40 per cent of the outgoing calls market was controlled by Bezeq, 30 per cent by Barak and 30 per cent by Golden Lines through which 18.7 per cent is controlled by foreign investors.

Cellular phone services have been operating in Israel since 1987. Currently there are four cellular services providers in Israel in which foreign investors are highly represented: Pelephone, Cellcom, MIRS and Partner/Orange. The Canadian based Shamrock Holdings currently holds 50 per cent of Pelephone (which controls 28 per cent of the market), the United States based Bell-South currently holds 34.75 per cent of Cellcom (which controls 40 per cent of the market), the Hong Kong China based Hutcheston Telecom currently holds 42 per cent of Partner (which control 28 per cent of the market) and the United States based Motorola holds 66.6 per cent of MIRS (which controls 4 per cent of the market). As a result, foreign investors control 42.5 per cent of the Israeli cellular phone market.

Foreign investors are also active in the TV industry, although to a much lesser extent. Currently there are three cable TV operators, each with a monopoly in a specific geographical region, one operator of satellite direct broadcasting services (DBSs), two commercial channels (which are operated by several operators), and three public channels. Foreign investors are active only in one of the commercial channel's operators (the Canada-based Shamrock Holdings holds 23 per cent of Telad) and one of the cable TV operators (the Holland-based UPC (United Pan-European Communications) holds 45 per cent of Tevel).

Foreign investments and the banking sector

Although foreign banks have displayed a growing interest in Israel in recent years, and there are no formal restrictions placed upon the entry of foreign banks into Israel, the presence of foreign investors in the Israeli banking sector has, nonetheless, remained minimal.

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As a result of the rapid economic growth, within the hi-tech sector in particular, business and private banking opportunities were opened to foreign banks and their interests in the Israeli economy have grown. Indeed, in recent years nine foreign banks (HSBC Republic Bank, BNP PARIBAS, HSBC Bank USA, Discount Bank and Trust Company, Union Bancaire Privée, Multi-Commercial Bank, CA IB Investment Bank, Crédit Industriel et Commercial, Bank of America International) have opened representative offices in Israel and three banks (Standard Chartered Bank, HSBC and Citibank) have opened branches in Israel. Currently there are only three relatively small, foreign-owned banks (Bank Polska Kasa Opieki, Investec (Israel) Otzar Ha'shilton Ha'mekomi Ltd.), operating as subsidiaries and allowed to provide full banking services.[5] No other foreign bank has penetrated the Israeli banking system directly or through acquisition of a local existing bank. The main reason for the relatively limited activity of foreign investors in the Israeli banking system is the centralised, but at the same time, developed nature of the Israeli banking system. In addition, until the early 1990s, foreign banks had limited interest in Israel, both because of the Arab Boycott against companies, which were engaged in business transactions in Israel or Israeli firms, and because of unfavourable macroeconomic conditions, such as high inflation and the large fiscal and current account deficits.

Nevertheless, there have been engagements of non-banking foreign investors in the Israeli banking system. For example, the selling of the controlling interest (34.5 per cent) in Bank Hapoalim, Israel's largest bank, to a United States investor group (Arison) by the government in 1997, and the Italian-based Generali's 9.6 per cent holding of Bank Leumi, Israel's second largest bank (see Chapter 4).

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Notes

1. For comprehensive description, see "Israel at Fifty – Economic Achievements", Moshe Felber, Israel Ministry of Foreign Affairs, 2000.
2. World Trade Organization (1999), Trade Policy Review. More recent figures show that non-residents' investment in the technology industry as a share of their total investment increased to 72 per cent in 2000 but decreased to 43 per cent in 2001.
3. The Bank of Israel estimates the impact of start-ups on GDP growth rates at 0.3 per cent in 1999, 2.0 per cent in 2000 and –0.9 per cent in 2001.
4. Bank of Israel (2000), Controller of Foreign Exchange Annual Report – 1999, p. 143.
5. See further discussion of the differences between representative office and branches in Chapter 3.

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Chapter 3

The Legal and Regulatory Framework for FDI – General Measures

An increasingly friendly business regulatory environment

Confronted with a triple-digit inflation problem in 1984, the government embarked in the second half of the 1980s on a three-pronged medium-term strategy of price stability, fiscal discipline and structural reform.[1] While the path has been difficult and progress laborious, successive governments have remained committed to this programme. Today the Israeli government considers itself able to target the Maastricht-type criteria[2] as benchmarks for its macroeconomic management. Trade liberalisation, deregulation, removal of exchange controls, and disengagement of the government from industrial activity have been – and still are – the major goals of structural reform.[3] Recent international ratings of Israel reflect positive results.[4]

The present chapter shows how Israel's legal and regulatory framework has developed into a generally favourable one for both national and foreign investment. The main finding is that Israel has a sophisticated business regulatory environment in which foreign investors are generally treated for the large majority of sectors open to competition in a similar way as their Israeli counterparts. The Israeli legal system – a combination of Anglo-American influenced legislation and common law – is considered to provide fundamental guarantees largely comparable to those provided by developed countries. Israel's Companies Law has recently been redrafted to incorporate legal concepts from other systems and to continue to adapt the business framework to the needs of a modern economy. Foreign currency transactions are practically free of controls, with the last restrictions – on institutional investors' placements abroad – to be lifted at the end of 2002. Israel also has a well-developed competition law whose enforcement is entrusted to an independent regulatory authority. As an increasingly important producer of intellectual property (IP), Israel has made substantial changes to its IP legal framework. The local workforce is one of the best educated and most highly skilled in the world.

However, beyond the market access restrictions identified in the following chapter, Israel maintains complicated licensing procedures and regulations that

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may be seen as significant burdens on business. Some complaints have been registered, for instance, regarding the recent tightening of the hiring procedures of foreign personnel. Foreign investors have also identified some significant problems with intellectual property rights enforcement, notably in the area of piracy, to which the government has recently responded by increasing its investment in the enforcement infrastructure. However, the acquisitions of rights to use land is the only area (reviewed in this chapter) where foreign-controlled established enterprises are subject to a more burdensome *de jure* treatment *vis-à-vis* Israeli-controlled enterprises. This calls for an exception under the National Treatment instrument along the lines suggested in Annex 2.

After an examination of the general legal framework for establishing and operating an enterprise in Israel, subsequent chapters will explore regulatory issues pertaining to privatisation and individual sectors, investment incentives (particularly as regards the high-tech sector) and describe Israel's economic policy in the area of international direct investment.

General foreign exchange regulation of capital movements

Since the end of the 1980s the Government of Israel and the Bank of Israel have been progressively implementing a policy of full foreign currency convertibility.

The process of liberalisation started in 1989, with a permit to individuals to undertake portfolio investments abroad. In 1993 Israel formally accepted the obligations of Article VIII of the IMF's Articles of Agreement, which prohibit exchange restrictions on payments and transfers for international current account transactions.

In August 1994 the Ministry of Finance together with the Bank of Israel, announced a series of reforms that further decreased Israel's currency control regulations. This proceeded gradually until it finally culminated in mid-May 1998 when virtually all restrictions were removed from both Israeli residents and foreign residents. In September 2000, when the last restriction referring to foreign residents – on the conduct of some transactions in derivatives – was lifted, the only remaining restriction was the ceiling imposed on foreign investments by institutional investors. In December 2001 the ceiling was raised from 5 per cent to 20 per cent of total assets, and as of January 2003 it is to be abolished altogether.

Today Israeli residents can trade freely and make portfolio and direct investments overseas, including the purchase of real estate in either Israeli or foreign currency. There is no need for provision of documentation when carrying out foreign exchange trading, nor are there limits on the amounts of money transferred or traded. However, there is an obligation to report the nature of transactions to the Bank through which it is executed, and there are some direct reporting requirements from corporations, individuals, non-profit organisation and institutional investors, for statistical purposes.

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Approval and operating permits

Foreign investors wishing to operate in Israel via an incorporated enterprise are subject to ordinary corporate registration requirements, except in cases where they seek approved status in order to be eligible for special incentives and assistance under the Law for the Encouragement of Capital Investments. In those cases an application must be submitted to the Investment Centre, in the Ministry of Industry and Trade (see chapter on incentives). There are no special rules or procedures for the acquisition of Israeli companies by foreign investors.[5] However, approval procedures for construction of plants may take up to several months and licensing procedures have been reported to represent a significant burden for businesses.[6] Foreign investors may also operate as "foreign companies" provided they register as such in Israel (see below).

The Companies Law

Israeli legislation governing corporate activity is relatively new. The Companies Law (1999), the result of several years work by a special committee headed by the Israeli Chief Justice, came into effect in February 2000. It provides a revised legal framework that introduces a number of concepts previously not existing in Israeli law (see box below), *inter alia*, in order to make it more conducive to the international business environment.[7] Unlike the former *Companies Ordinance*, the new Companies Law is independent from interpretative links with English law. One observer has characterised the new Law as representing *a real will from the Israeli legislators to create a modern and comprehensive company law that can give original and independent answers to most company law issues.*[8]

The Companies Law applies to three types of corporate entity: private companies (including those formed by one person), public companies and foreign companies. The Securities Law contains obligations for public companies and their activities are also regulated by the Securities and Exchange Authority.

Companies incorporated in Israel

In order to obtain legal status, firms must register with the Registrar of Companies. For companies incorporated pursuant to the Companies Law, there is a simple distinction between "public companies", being those whose shares are listed for trading on a public stock exchange, or have been offered to the public pursuant to a prospectus, and "private companies" – all others. Non-resident individuals and enterprises may incorporate a company under the same conditions as their Israeli counterparts. All company documents are required to be in Hebrew. Under the new Law, the distinction between the memorandum and the articles of association of a company has been abolished. Now the basic founding document

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Box 2. New concepts in the Companies Law (1999)

***One-person company*:** a company may be founded by a single person.

***Basic founding documents*:** the corporate by-laws have replaced the memorandum and articles of association as the basic founding document of the company.

***Company's purpose*:** a company's purpose is to maximise its profits while operating in accordance with business considerations, which may include the interests of its employees, creditors and the public.

***Rights and obligations of shareholders and directors*:** the new Law includes the right of shareholders to initiate a derivative suit and class action, to receive information and view corporate documents. Similarly the rights and obligations of directors are regulated by the Law, including their right to information, to initiate proceedings and hire consultants.

***Mergers*:** are defined in the new Law as follows: "the transfer of all assets and liabilities, including conditional, future, known and unknown debts of an absorbed company to a surviving company, as a result of which the absorbed company is absorbed..." (Section 1). Mergers are more readily available and do not require (as previously) the approval of 75 per cent of shareholders and the approval of the court. Under the new Law, the approval of the boards of directors and the general meetings of both companies is required.

***Tender offer*:** the following purchases may only be effected under the new Law via a special tender offer: those in which a person becomes a holder of a control block (25 per cent of voting rights) if there is no control block in the company, and those in which the purchaser's holdings increase to more than 45 per cent of voting rights if no other person holds more than half of the company's voting rights.

***Forced sale of shares – freeze-out*:** a complete tender offer, *i.e.* a tender offer of all the shares or all shares of the same class, is required for a purchase that results in the buyer holding more than 90 per cent of the shares or class of shares in a public company.

***Company purchase of its own shares*:** is possible using capital that may be used to pay dividends.

Source: Ministry of Justice, State of Israel.

is, as in American law, the corporate by-laws.[9] There is no discrimination on the basis of residency or nationality as to who may incorporate a company. There are, however, "Israeliness" requirements for the composition of the board of directors and controlling or ordinary principals under special laws or in companies in which the government holds a "golden share" (see the section on privatisation in Chapter 4).[10] There is no minimum capital requirement.

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The most common form of corporate entity operating in Israel is the limited company. There is no minimum number of directors requirement for private companies; the company may be founded by a single person. However for public companies, at least two of the directors must come from "outside" of the company, *i.e.* directors who have no business or other relationship with the company.[11] Outside directors are elected at a general meeting provided that one of the following applies: the majority of votes in the general meeting includes at least one third of all the votes of those shareholders who are not holders of control and present at the meeting, or the total of opposition votes is not greater than 1 per cent of all of the voting rights in the company. Generally, outside directors are required to be Israeli residents, although the *Relief for Foreign Companies Regulations* permit companies that list their shares abroad to appoint a non-resident director.[12]

Disclosure requirements in the Companies Law, also regulated by the Securities Law, are more onerous for public companies than is the case for private limited companies. For example, public companies must file annual financial statements, details about shareholders, and reports of decisions taken in shareholder meetings. Income statements and balance sheets must be published on a regular basis.[13] Dual listing of shares is possible with stock exchanges abroad and since July 2000 companies traded on the New York Stock Exchange, AMEX and NASDAQ NM may be listed on the Tel Aviv Stock Exchange (TASE) without having to satisfy any additional regulatory requirements.[14] Exemptions from some provisions of the Law are possible for those public companies making a public offer of shares in Israel and abroad, in order, for example, to prevent conflicts of laws with foreign stock exchanges.[15]

The fees for registration under the Companies Law are NIS 2000 (US$426) and the annual fees are approximately NIS 1000 (US$213) Stamp duty applies to the allotment of shares in some circumstances (1 per cent), the issue of bearer certificates (2 per cent) and for private companies the transfer of registered shares (1 per cent). The types of shares normally issued are ordinary, preferred and deferred shares. Since the enactment of the new Law, companies are permitted under certain conditions to acquire their own ordinary shares. In terms of decision-making, a simple majority is required for most company decisions, including election of members of the board. Institutional investors are obliged to be present at general assemblies and to vote. Companies may participate in limited partnerships, joint ventures and co-operative societies. In the latter case, shares may not be transferred.[16] General meetings must be held every year.[17]

Other, less common forms of business entity include the partnership, which may be either general or limited, co-operatives and non-profit organisations. Each of these is a legal entity and needs to be registered with the appropriate business authority.[18]

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Foreign companies

Foreign companies wishing to "maintain a place of business" in Israel (other than by creating a subsidiary) are obliged to register as such with the Registrar of Companies, and nominate an Israeli resident to have power of attorney and be capable of receiving notices for the company. A foreign company must file an annual report each year, if so required by the Minister of Justice. No such requirement has yet been set. Company documents must be translated into Hebrew. A registration fee, adjusted each year according to a cost-of-living index, and an annual fee apply but there is no capitalisation fee.[19] The law does not contain a precise definition of "maintaining a place of business"; this is determined on a case-by-case basis.[20] The liquidation provisions in Israeli law apply also to foreign companies that hold property in Israel.

Corporate governance

The Companies Law contains a number of important corporate governance principles. Some of the standards and rules apply only to public companies and some are for both public and private companies. For example, all companies are required to appoint an accountant-auditor, and a public company must, in addition, appoint an internal auditor and an auditing committee. Regulations apply to transactions with interested parties in both types of companies involving an office-holder, covering disclosure and board approval for certain transactions. Reporting requirements in respect of alterations to company founding documents, change of directors, mergers, allotment of shares, etc. apply for transparency purposes. In the case of public companies, additional obligations of this nature apply under the Securities Law.

Land and real estate

Approximately 93 per cent of Israel's 5 436 million acres is the property of the State of Israel, the Jewish National Fund[21] or the Development Authority (referred to as "Israel lands"). Israel's Basic Law[22] relating to Israel Lands is the Israel Land Law (1960) which stipulates that the transfer of ownership of Israel lands by sale or in another way is prohibited, unless explicitly permitted under the Law. The Land Council, established by the Law, determines the policy by which the Israel Land Administration administers Israel Lands. As a general rule, transfers of rights to such land are made by lease. Israel's legal regime has been found to guarantee a high degree of protection for property rights.[23]

Foreign-controlled enterprises are entitled to acquire rights to land use. However, before being able to acquire such rights, they must receive prior approval from the Israel Land Council, following a recommendation from the Committee for Urban or Agricultural Land. In this context, "rights to land" refer to ownership or

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lease for a period of longer than five years, including the contractual right to bestow ownership or a lease for a period of longer than five years.[24] Approval is normally granted for business purposes. This special requirement applicable to foreign investors constitutes nonetheless an exception to the National Treatment instrument, and for that reason appears in the proposed list of Israeli exceptions (see Annex 2). There is no discrimination in terms of the lease period or any other specific restriction relating to land use.

Enterprises with "approved status" under the Encouragement of Capital Investments Law (see Chapter 5 – Investment Incentives and Promotion) are eligible for land allocation in regions that have been classified as either "top priority – A" areas or "second priority – B" areas, upon recommendation of the Development Area Unit of the Ministry of Industry and Trade. Reduced prices also apply for approved enterprises. In addition, grants and tax benefits are accorded to encourage investors to establish in priority areas.[25]

A resolution of the Land Council[26] provides that in the following cases the Israeli Land Administration may agree to bestow or to transfer rights to land to foreign-controlled companies: when a recommendation has been received from *i*) the Minister of Finance or the Minister of Industry and Trade regarding cases being handled by the Investment Centre or *ii*) the Minister of Industry and Trade regarding land for industry, labour or trade or *iii*) the Minister of Tourism, regarding land for hotels and tourism. In the case where the foreigners requesting land rights are linked to religious organisations, their request is treated separately and the professional opinions of other Ministries are solicited.[27] The legal regime governing rights to land is currently under inter-ministerial review.

Employment and labour relations

Employment of foreign personnel

Israel has a generally open policy towards the employment of foreign workers who, in 2001 accounted for approximately 10 per cent of the workforce.[28] Non-residents wishing to work in Israel require a *visa* and a *work permit*. The *visa*, required for entry into Israel, is obtained from the Ministry of Internal Affairs, which also examines recommendations for work permits according to public health and national security criteria.[29] The potential employer must apply for the *work permit* from the Employment Service.[30] Unfavourable decisions may be appealed to a special committee within the Employment Service, as well as to the appropriate court. In general, intra-corporate transferees in service sectors that fall into the categories of *managers* or *executives* are permitted to enter Israel temporarily, without having to satisfy labour market tests. Highly skilled specialists may also be granted work permits, subject though to labour market testing (*i.e.* a deficiency in the local labour supply must

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be established before the employment opportunities are opened to foreign workers).[31] Illegal foreign workers became a problem for Israel in the 1990s, particularly after the 1995-96 terrorist bombings led to a reduction on the numbers of Palestinian workers entering the country. In order to ensure minimum living standards for foreign workers, notably those originating from East Asia and Eastern Europe, the Knesset approved a Law at the end of 1999 that includes provisions aimed at ensuring appropriate living conditions and health insurance for foreign workers. Violation of these regulations is a criminal offence. Under the Law, the monies put aside for those purposes are released to the foreign worker once s/he has returned to his home country within a specified time frame (usually a few months). This Law requires an application fee payable by the employer of a foreign worker that accompanies a request for an employment licence of NIS 350 (US$75) as well as an annual fee of NIS 3 000 (US$640) per employed foreign worker.[32] Internal procedure regarding request and licence fees is currently under preparation with a view to increasing legal certainty and administrative transparency.

In December 2001 the Government announced that as part of the economic "package deal" agreed between the Ministry of Finance and the Bank of Israel, it would reduce the number of foreign labourers, notably in the construction sector, by a further 15 000 and levy a one-off fee on employers of foreign workers.[33]

Employment of Israeli nationals

Israel's workforce is highly skilled and has one of the world's highest proportions of engineers and scientists for its population. Almost one third of the population over the age of 15 has post-secondary or degree-level qualifications and illiteracy is practically non-existent. Nonetheless, at least recently, the economy's growth rate, notably in high-tech sectors, gives rise to a demand for around 4 000 new skilled workers each year.[34] While highly educated Russian immigrants who came to Israel after the disintegration of the Soviet Union were able to meet this need in the early 1990s, their numbers are now declining.[35]

The majority of Israel's labour laws were established in the 1950s and 1960s, when the government was generally more oriented towards socialist ideology than it is today. Structural reforms began in the 1980s have separated public and private sector wage development, while at the same time enhancing private sector wage flexibility.[36] Today, while a large part of the labour movement remains unionised, the General Federation of Labour, the Histadrut, is considered to have a less influential role over labour, health and social policy. Strikes are rare, and in general workers and employers have a co-operative relationship.[37] A system of collective bargaining is in place that provides for agreements covering wages, conditions of employment and social benefits. Collective wage bargaining is increasingly undertaken at industry and factory level, rather than at national level

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as it was previously. Wage increases are being linked more often to productivity rather than flat increases. A minimum wage applies (in February 2002 it was set at NIS 3,267 (US$698 per month). Given that foreign ownership tends to be concentrated in high-wage sectors, such as electronics for example, wages in foreign-owned firms are generally higher than the minimum wage.[38]

Unemployment rose to 9.9 per cent in November 2001[39] and is predicted to be at least as high in 2002.[40] However, the number of employed persons increased in the third quarter of 2001 by 40 000 since the end of September 2000, to some extent due to a substitution of Israeli workers for Palestinian labourers. Wages have increased by 4.2 per cent in the first eight months of 2001 over the same period in the previous year.[41]

Intellectual property rights protection

Given that Israel is a significant producer of intellectual property, it has a keen interest in its intellectual property rights (IPR) protection regime corresponding to international norms. Israel has devoted substantial resources to the revision and enforcement of its extensive IPR regime, particularly over the last two years. Israel is a member of the World Intellectual Property Organisation (WIPO), and thus a signatory to the principal multilateral agreements covering intellectual property rights.[42] As a WTO member, Israel is a party to the TRIPs agreement. Its intellectual property law covers patents, trademarks, designs, copyright, appellations of origin and geographical indications, performers' and broadcasters' rights, trade secrets, integrated circuit topography and new plant varieties. It has been in conformity with the TRIPs agreement since 2000.[43]

The acquisition, exercise and enforcement of intellectual property rights were, up until recently, governed by a number of statutes based largely upon British models, and common law. The Ministry of Justice is in the process of generally reforming the IP legal framework, in order to respond to new commercial needs. This involves extensive changes to all areas of IPR. Starting in the 1980s with the areas considered the most urgent, such as enforcement, the reform process is almost complete. New laws, replacing the essentially English legal framework, have been inspired by WIPO models and Australian and Canadian jurisprudence. Civil remedies that are common to English law, such as the Anton Pillar order, the Mareva injunction,[44] are available to offer interim relief, an important element in IP rights enforcement. Injunctive relief may generally be obtained contemporaneously with the initiation of infringement proceedings. Other laws, such as the Commercial Wrongs Law, the Civil Wrongs Ordinance and the Law on Unjust Enrichment may also provide protection for violations of IP rights.[45] The Integrated Circuits Protection Law was enacted in 1999 and a modern industrial

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design Law, intended to replace the current law, is expected to be presented to the Knesset in 2002.

In December 2000 an amendment to the Consumer Protection Law was enacted which requires products, including products protected by copyright, such as optical media, to bear a marking indicating the identity of its manufacturer. In addition, a Bill was introduced to establish a special district court jurisdiction for the resolution of disputes involving royalty payments in respect of works of copyright, performers' rights and broadcasters' rights. A revised enforcement programme for the Customs Authority has been put in place[46] and other public agencies have undertaken initiatives as well. For example, the government has implemented programmes and blanket licensing schemes to ensure that there is no longer any scope for unauthorised use of computer software by Government officers and employees. Similarly, the Ministry of Education has initiated courses at high-school level on IP protection.[47]

However enforcement problems in relation to IP rights have been a significant issue in Israel, and the country was placed on the United States Trade Representative's Special 301 Priority Watch List in 2000 and 2001 because of concerns as to the adequacy of Israel's copyright law, high levels of piracy, and enforcement deficiencies.[48] The International Intellectual Properties Association (IIPA) has claimed that piracy in software, cassettes and tapes is a significant problem in Israel; the Federation of Israeli Chambers of Commerce (FICC) has estimated that copyright violations alone were responsible for NIS 1.2 bn (US$256 million) in 2000.[49]

Nonetheless, according to the Israeli authorities, criminal enforcement of intellectual property rights has been substantially improved over the last two years following significant governmental investment in the enforcement infrastructure, including establishment and ongoing training of special intellectual property police units and prosecutors. Many recent convictions relating to piracy and trademark infringements have resulted in actual imprisonment and several suspended jail sentences, community service and significant fines intended to make infringement unprofitable.[50] Moreover, the two new Bills that increase the maximum jail sentences for copyright piracy and trademark counterfeiting are to be enacted by the Knesset in 2002.[51]

Competition law

Israel's local market is relatively small, with a history of government participation in various segments and limited geographic integration. These characteristics have given rise to oligopoly problems, entry barriers, problems with concentration of ownership and so-called "natural" barriers to cross-border competition in some markets. These market attributes affect Israel's ability to benefit from the full benefits of FDI by entailing competition policy implications, such as sensitivity to

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competition in services and unimportable goods as well as to cross-ownership, and tension between size-efficiency and competition.

Israel's competition law framework dates back to the 1956 enactment of the first Restrictive Business Practices Law. The Law was fundamentally revised in 1988, including the introduction of rules for merger control. Since then there have been some important legislative reforms, supplemented by court and administrative decisions. The law is based on a mix of European, American and Canadian antitrust models and concepts. It covers restrictive agreements, hard-core cartels, mergers, monopolies and abuse of dominant position. Recent amendments reinforced competition-related proceedings and have extended responsibility for antitrust activities beyond corporate entities to also include company executives.

The Antitrust Commissioner is responsible for competition law enforcement. The Commissioner also serves as the General Director of the Antitrust Authority, an independent government agency created in 1994 that supports the Commissioner in the discharge of his duties. An antitrust tribunal located in the Jerusalem district court has exclusive jurisdiction over non-criminal governmental antitrust proceedings, including appeals on decisions of the Antitrust Commissioner.[52] A survey in 2001 undertaken by the American Antitrust Institute found that Israel's competition laws and institutions were "well-established".[53]

Antitrust enforcement is considered by the Israeli authorities to be an essential complement to the liberalisation process of local markets and to opening the country's borders to the free movement of goods, services and capital. Since the 1988 amendments, the law prevents the creation of monopolies and market power through mergers. In addition to mergers, other forms of agreements potentially harmful to competition are reviewed by the authorities (under the restrictive arrangements rules) and those agreements that substantially lessen competition are blocked. The rigorous enforcement of the anti-cartel rules which has included criminal prosecutions, substantial fines and prison sentences is deemed to have resulted in a decrease of anti-competitive practices.[54]

The Restrictive Business Practices Law provides, *inter alia*, a general definition of restrictive agreements as being agreements made between two or more parties conducting business, according to which at least one party restricts itself in a way that may harm or reduce competition. Price fixing, agreements as to market share, profit margins or quotas are examples of restrictive agreements. Some agreements, such as the entitlement to use proprietary rights for example, are excluded from the definition of restrictive agreements. Participation in a restrictive agreement is prohibited unless the agreement has been approved by a court, received a temporary permit or been granted an exemption by the Antitrust Commissioner. Following the European model, the Law provides for a system of block exemptions

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that exempt certain agreements from the approval or specific exemption requirements. The exemptions include R&D agreements, joint ventures, vertical agreements,[55] franchises and there is a block exemption for agreements that do not substantially harm competition.[56] These block exemptions were published at the beginning of 2001 by the Antitrust Commissioner.

The provisions of the Law applying to mergers are based largely on American jurisprudence. Mergers that come under the legal definition must be notified to the Antitrust Authority. The merger may not proceed before the Commissioner approves it or 30 days have passed from the filing of the notice without any action by the Commissioner. The standard that needs to be met to justify blocking a merger is of substantial harm to competition.[57]

Monopolies, defined as a market share control of over 50 per cent, or less if found to have a decisive influence on the market, are also covered by the Law, including those regulated and designed by concessions.[58] Monopolies are subject to restrictions similar to those in the European legislative framework, namely restrictions as to abuse of dominant position.

The Israel Antitrust Authority is an active player at the international level: it has observer status at the Competition Law and Policy Committee of the OECD, and is a member of the steering group of the newly formed International Competition Network (ICN) – an international organisation of antitrust agencies. It also heads the Merger Investigation Techniques Subgroup of the ICN.

Money laundering

In August 2000 the Israeli Knesset enacted the Prohibition on Money Laundering Law. The Law, among other things, establishes offences with respect to money laundering, states obligations on providers of financial services, and establishes financial sanctions. Since then the Israeli legislative regime concerning money laundering has been additionally developed and it currently includes regulations on obligations of identification, record keeping and reporting pertaining to provident funds, stock exchange members, portfolio managers, insurers and insurance agents, provident funds and companies managing provident funds, the postal bank and currency services providers; customs legislation concerning individuals entering or leaving Israel; regulations pertaining to financial sanctions; and more. The various departments and bodies involved in combating money laundering in Israel have taken the necessary steps to ensure full and effective implementation of the legislative framework. On 17 February, 2002, the Israel Money Laundering Prohibition Authority (IMPA) formally began to operate and its staff now reaches 23 professional persons. IMPA was admitted into the Egmont Group in June 2002.[59]

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Anti-corruption measures

Israel's 1977 Penal Law contains several specific corruption offences: bribery, fraud, breach of trust, as well as a number of offences specifically related to public servants, such as bribery, forgery, theft and conflict of interest committed by public servants. Bribery offences include activities committed by intermediaries. Specific bribery offences also exist in the Customs Ordinance and the Ports Ordinance. Other relevant offences such as fraud and forgery within companies and use of blackmail, deceit and threats are included in the Penal Law.

Corruption-related offences are punishable by the following sanctions: imprisonment, fines, forfeiture of funds arising from crimes in certain conditions and compensation for the victims of the crime. For example, accepting a bribe carries a penalty of up to 7 years' imprisonment and a fine; offering a bribe is punishable by up to 3 and a half years' imprisonment and a fine, while theft and forgery by a public servant is punishable by up to 10 years' and 7 years' imprisonment respectively. The Law provides for extraterritorial application so that it applies, for example, in relation to bribes and inducements offered by Israeli enterprises, or individuals who are citizens or residents abroad where the act is a crime in the country in which it is committed.[60] In addition, as Israel's corruption-related offences carry sanctions of at least one year's imprisonment, they qualify as "extraditable offences" in the terms of extradition treaties that Israel has concluded with other countries.

Israeli law also imposes duties of maintaining accurate books and records and criminalises "off the book" accounts which may serve to disguise the proceeds of crimes. Within the general framework of a draft Law against organised crime, there is a section that criminalises the conduct of a public servant using his position to promote the activities of organised crime.

Government procurement

The Israeli government and its agencies are significant purchasers of goods and services. The Mandatory Tenders Law (1992) is the principal law governing these activities. Regulations made pursuant to this Law prescribe bidding procedures and a scale of threshold values, above which procurement by public tender is required. The Israeli legal framework provides for a system of preferences, *e.g.* to domestic industries, subject to local content requirements and for local offsets and sub-contracting. Established foreign-controlled enterprises can benefit form this system of preferences on the same basis as domestic producers provided they fulfil the same local content conditions. This system of preferences does not apply, however, to suppliers of members of the WTO Government Procurement Agreement (GPA) which has a different coverage and rules (see below).

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Build-Operate-Transfer (BOT) and Public Finance Initiative (PFI) contracts, in which an Israeli partner may be obligatory, are new types of infrastructure procurement contracts.[61] Israeli partners may also be required in other tenders, depending upon the nature of the tender. Foreign-controlled established enterprises can participate in these tenders.

Israel is a member of the WTO Government Procurement Agreement (GPA). The renegotiated GPA entered into force in 1996 and establishes rules guaranteeing fair and non-discriminatory conditions for international competition in government procurement of goods and services. The key feature of the GPA general rules is the provisions for transparency of laws, procedures and practices. Israel's obligations under the GPA extend to most government entities and state-owned corporations but like many other GPA members, it excludes purchases by the Ministry of Defence, the Office of Internal Security and the aircraft industry. Given that Israel invokes developing country status under the GPA, it is permitted to implement "off-set arrangements", *i.e.* measures to encourage local development.[62] Israel amended its GPA obligations in September 1998 following an agreement with the EU, under which Israel opened up additional services sectors[63] *vis-à-vis* all GPA members and enhanced market openness to the EU in some urban transport sectors. Israel has offered this to other GPA members on the basis of reciprocity.[64]

A number of Israel's free trade agreements with both GPA members and non-members contain clauses on government procurement. Its agreement with the United States for example, lowers the minimum value of the contracts open to a partner-country supplier, while the agreement with the EU covers the mutual opening of procurement in the telecommunications sector. It has also signed a Memorandum of Understanding with the United States that accords United States competitors equal status with domestic suppliers for procurement by the Ministry of Defence. Its free-trade agreements with Hungary and Mexico, which are non-GPA members, extend GPA obligations to suppliers from these countries.

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Notes

1. The main tenets of this policy were first outlined in the 1985 Economic Stabilisation Programme.
2. The Maastricht Treaty provides for five criteria of economic convergence that EU member states were required to satisfy in order to qualify for the final stage of the European Monetary Union. These relate to the level of inflation, interest rates, the budget deficit, the level of the public debt and the stability of the exchanges within the European Monetary System.
3. See various press releases by the Governor of the Bank of Israel, notably Israel's "Macro-Economic Policy and European Standards", of 4 September 2001 and "Updating Government Economic Policy for 2002" of 21 January 2002.
4. The results can be appreciated from various international independent observers. The World Competitiveness Yearbook 2001 – which compares how key players in the world compete – includes Israel in its "top 16". It ranks Israel 21st out of 49 for economic performance, 15th for government efficiency, 16th for business efficiency and 17th for infrastructure (World Competitiveness Yearbook 2001, *www.imd.ch/wcy*). The 2001 Milken Institute Capital Access Index ranks Israel 22nd out of a total of 83 examined countries [2001 Milken Institute Capital Access Index (CAI), www.milkeninstitute.org]. On the basis of 19 areas of market openness, the Emerging Market Access Index 2000 of the Tuck School of Business ranks Israel 14th out of 44 Emerging Market Economies [Emerging Market Access Index 2000 (EMAI), *www.dartmouth.edu/tuck/fac_research/centers/caee_emai.html*]. In the Economic Freedom Index of the Heritage Foundation 2002, Israel has risen to be 43rd out of the 156 countries examined (Index of Economic Freedom 2002, *http://cf.heritage.org/indexoffreedom.cfm*). The World Market Analysis Risk Rating – which measures political, economic, legal, tax, operational and security risks, puts Israel in 58th position out of 185 countries. It also gives it a Sovereign Credit Rating of B1 (just below the best score A) (World Markets Country Analysis and Forecast at www.worldmarketsonline.com). This compares with a credit rating of A-stable by Standard and Poors, and of A2 by Moody (*www.moodys.com/moodys/cust/RatingAction*).
5. Economic Intelligence Unit, Country Commerce – Israel, October 2000.
6. The Heritage Foundation, 2002 Index of Economic Freedom, New York, 2001.
7. World Markets Analysis, Risk Rating 2001.
8. Cohen, D., "Finally, the new Israeli company law", *Israel British Trade*, available on the web site of the British Israel Law Association, *www.bisla.com*.
9. Cohen, D., "Finally, the new Israeli company law", *Israel British Trade*, available on the web site of the British Israel Law Association, *www.bisla.com*.
10. Ministry of Finance, written submission, January 2002.

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11. EIU, Country Commerce – Israel, October 2000.
12. Ministry of Finance, written submission, January 2002.
13. EIU, Country Commerce – Israel, October 2000.
14. "Overview of Israel's hi-tech industry", Doing Business in Israel, *www.bdo-israel.co.il*.
15. For example, the provisions applying to publications of notices of general meetings in Israeli newspapers will not apply to a company that lists its shares abroad only.
16. EIU, Country Commerce – Israel, October 2000.
17. Cohen, D., "Finally, the new Israeli company law", I*srael* B*ritish* T*rade*, available on the web site of the British Israel Law Association, *www.bisla.com*.
18. *i.e.* the Registrar of Partnerships (Ministry of Justice), the Registrar of Co-operative Societies (Ministry of Labour and Social Affairs), and the Registrar of Non-Profit Organisations (Ministry of the Interior).
19. EIU, Country Commerce – Israel, October 2000.
20. Ministry of Justice, written submission, December 2001.
21. The Jewish National Fund was established in 1901 with the objective of purchasing land for Jewish people. It was registered as a company in England in 1907 and owned by the World Zionist Organisation. Prior to the establishment of the State of Israel in 1948, the JNF focussed upon the construction of settlements and forests. Today it has diversified is environmental activities to include water and redevelopment projects as well as education programmes.
22. Israel does not have a formal constitution. The Knesset has however introduced several constitution-like laws – formulated in "Basic Laws" and a series of decisions by the Supreme Court.
23. The Heritage Foundation, 2002 Index of Economic Freedom, New York, 2001.
24. Resolution 371 of the Israel Land Council.
25. The Economist Intelligence Unit, Country Commerce – Israel, October 2000.
26. Resolution 371 of the Israel Land Council.
27. Israel Land Administration.
28. This calculation is based upon figures for both reported and unreported employment; State of Israel, Ministry of Labour and Social Affairs. Foreign labourers work predominantly in the construction and agriculture sectors.
29. Economic Intelligence Unit, Country Commerce – Israel, October 2000.
30. See "Doing Business in Israel"; BDO Israel, *www.bdo-israel.co.il*.
31. Government of Israel, see also Israel's schedule of GATS commitments, GATS/SC/44, available at *www.wto.org*.
32. Foreign Workers (Prohibition of Unlawful Employment and Assurance of Fair Conditions Law (1991); Economic Intelligence Unit, Country Commerce – Israel, October 2000.
33. Economist Intelligence Unit, Country Report – Israel, Palestinian Territories, January 2002.
34. Economic Intelligence Unit, Country Commerce – Israel, Updater, April 2001.
35. IMF, Israel: selected issues and statistical appendix, (country report No. 01/134), Washington, August 2001.
36. WTO, Trade Policy Review – Israel, WT/TPR/58.

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37. Economic Intelligence Unit, Country Commerce – Israel, October 2000.
38. Economic Intelligence Unit, Country Commerce – Israel, October 2000.
39. State of Israel, Ministry of Labour and Social Affairs.
40. Federation of Chambers of Commerce in Israel.
41. Economist Intelligence Unit, Country Report – Israel, Palestinian Territories, January 2002.
42. Israel is a member of the Paris Convention for the Protection of Industrial Property, Stockholm revision (1967) Bern Convention for the Protection of Literary and Artistic Works; Brussels revision (1951); Stockholm revision, Articles 22 to 38 (1967). Patent co-operation Treaty, (PCT) (Washington 1970) Madrid Agreement for the Repression of False or Deceptive Indications of Source on Goods (1891); Lisbon revision (1958); Stockholm revision (1967). Nice Agreement Concerning the International Classification of Goods and Services for the Purposes of the Registration of Marks (1957); Stockholm revision (1967). Lisbon Agreement for the Protection of Appellations of Origin and their International Registration (1958); Stockholm revision (1967). Strasbourg agreement Concerning the International Patent Classification (1971). Convention for the Protection of Producers of Phonograms Against Unauthorised Duplication of Their Phonograms (1971). Budapest Treaty on the International Recognition of the Deposit of Micro-organisms for the Purposes of Patent Procedure (1977). International Convention for the Protection of New Varieties of Plants (UPOV) (1979) (1991 Act). Universal Copyright Convention (1952). Convention Establishing the World Intellectual Property Organisation (1967).
43. State of Israel, Ministry of Justice, Recent developments in Intellectual Property Rights in Israel, Jerusalem, February 2001.
44. The Mareva injunction and the Anton Pillar order are forms of interim relief for complainants that derive their names from English cases.
45. State of Israel, Ministry of Justice, Recent developments in Intellectual Property Rights in Israel, Jerusalem, February 2001.
46. United States Trade Representative (USTR), 2001 National Estimate Report on Foreign Trade Barriers, available on the USTR website: *www.ustr.gov*.
47. Ministry of Justice, written submission.
48. See USTR, 2001 Special 301 Report, available on the USTR website: *www.ustr.gov*.
49. The Economist Intelligence Unit (EIU), Country Commerce – Israel, Update, April 2001.
50. State of Israel, Ministry of Justice.
51. The Economist Intelligence Unit, Country Commerce – Israel, October 2000.
52. Israel Antitrust Authority, presentation to the OECD committee on competition law and policy; 1999.
53. See *www.antitrustinstitute.org/*.
54. State of Israel, Antitrust Authority.
55. Such vertical agreements are: exclusive purchase and exclusive distribution.
56. See the website of the Antitrust Authority, *www.antitrust.gov.il* for further details.
57. See the website of accountancy firm BDO Israel, *www.bdo-israel.co.il*.
58. Israel Antitrust Authority, written submission to OECD, November 2001.

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59. Financial intelligence units (FIUs) are specialised government agencies dealing with the problem of money laundering. The Egmont Group defines an FIU as a "central, national agency responsible for receiving (and as permitted, requesting), analysing, and disseminating to the competent authorities, disclosures of financial information concerning suspected proceeds of crime, or required by national legislation or regulation, in order to counter money laundering." The Egmont Group of FIUs began in 1995 and now consists of 69 members. The goal of the Egmont Group is to provide a forum for FIUs to improve support to their respective national anti-money laundering programmes. This support includes expanding and systematising the exchange of financial intelligence, improving expertise and capabilities of the personnel of such organisations, and fostering better communication among FIUs through the application of new technologies. For more details, see *www.fatf-gafi.org/Ctry-orgpages/org-egmont_en.htm*.
60. Other conditions apply: *e.g.* in order to be prosecuted under Israeli law the person must not have already been exonerated of the crime in the state in which it was committed.
61. Ministry of Finance, written submission, January 2002.
62. For example, all international public tenders with a value of NIS 2.15 million (approximately US$456 000) or above must include a clause on "industrial co-operation" (IC) with Israeli entities in the amount of at least 30 per cent of the value of the contract (Ministry of Finance, written submission, January 2002). Israel has negotiated under the GPA a gradual reduction in the IC requirement over a period of nine years (up to 2005) to 20 per cent (United States Trade Representative (USTR), 2001 *National Estimate Report on Foreign Trade Barriers*, available on the USTR website: *www.ustr.gov*).
63. Namely, maintenance and repair services, building cleaning services, property management, publishing and printing on a fee or contract basis.
64. State of Israel, Ministry of Industry and Trade, February 2002.

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Chapter 4

The Legal and Regulatory Framework for FDI: Privatisation and Sectoral Measures

Main features

Historically, the government has had substantial involvement in nearly all sectors of the Israeli economy.[1] This goes back to the establishment of the State of Israel in 1948, when all natural resources were nationalised. The new State developed into a three-sector economy, comprising the public, the Histadruth (the General Federation of Hebrew workers) and the private sector. In the mid-1980s, however, the government started a process of deregulation and disengagement from direct business activities with a view to stimulating economic growth, foreign investment and lowering prices through increased competition. The Histadruth also began disposing of its commercial holdings so as to concentrate its activities on trade union organisation, social services, educational and cultural activities, and economic development projects.

Today's Histadruth is no longer active on the production side of the Israeli economy and the government has made significant progress in reducing its presence in the economy through the privatisation of state-owned enterprises and the reduction of the subsidisation of economic activity. However, despite headway in banking and telecommunications, the process has been disappointingly slow, sporadic and complicated and foreign investors' participation in it rather limited. This may be explained by several factors, notably the complexity of the Israeli political system, vested interests, a tenacious belief in the need for selective government involvement, Israel's particular geopolitical situation and the ups and downs in the domestic and international economic performance. New privatisations and active preparation of others over recent months are indicative, however, of a renewed determination to accelerate the state disengagement from government companies, including in some large defence industries. This effort includes exploring more efficient ways of increasing foreign investors' participation, notably through equity sales, via international capital markets. The actual results remain contingent, however, on political developments and the evolution of the capital markets.

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Beyond the dominance or presence of public enterprises in a certain number of activities and the *de jure* or *de facto* monopolies and concessionary regimes – a problem equally shared with private sector Israeli entrepreneurs – foreign investors have also encountered over the years market access restrictions based on their "foreign" character. As in other countries, such restrictions can originally be traced back in various instances to national security or public interest considerations. This is certainly the case with some defence industries and communications services. In some cases too, some restrictions have been lifted or their effectiveness substantially reduced with deregulation and privatisation, technological developments and world liberalisation trends.

Nonetheless Israel still maintains a non-negligible number of discriminatory "entry" restrictions, either in the form of equity restrictions (notably in the communications, electricity and transport sectors), incorporation requirements (securities) or reciprocity considerations (banking), motivated in part by economic considerations. A number of these restrictions apply equally to the "post establishment" phase of investment (in the case of air transport, communications, electricity, and education services). Preferential conditions may also apply to the granting of state aid (to films, education, religion, academic research, arts and sports). The discrimination exercised towards already established foreign-controlled enterprises needs to be covered by exceptions to national treatment, as suggested by the Israeli authorities (see Annex 2). The authorities have also notified discriminatory measures based on national security considerations (notably in defence industries) for the purpose of transparency (see Annex 2). The Israeli authorities have indicated that they are very much aware of the need to pursue liberalisation and intend to implement this objective in the context of future structural reforms.

Privatisation

The current situation[2]

As of 31 December 2000, the number of active companies with government participation amounted to 105, compared with 106 at the end of 1999 and 107 at the end of 1998, 34 of which (excluding government subsidiary companies) are commercially oriented enterprises.[3] These companies are in turn divided into three categories: *a*) government companies; *b*) mixed companies; and *c*) state-owned banks acquired pursuant to the Bank Shares Arrangements at the time of the stock market crisis of 1983.[4] Government companies are those in which the government owns more than 50 per cent of the voting shares and which are subject to the provisions of the Israeli Government Companies Law and related regulations.

At the end of 2000, total assets of commercially-orientated government and mixed enterprises were estimated at NIS 116,927 million (US$25 billion) and their

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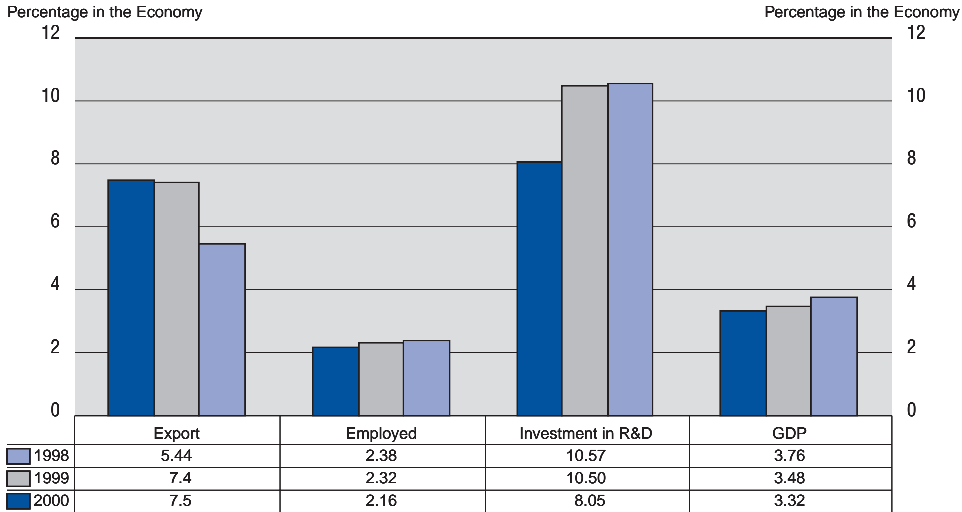
Figure 9. **Government business companies share in economy 1998-2000**
Not including mixed companies



	Export	Employed	Investment in R&D	GDP
1998	5.44	2.38	10.57	3.76
1999	7.4	2.32	10.50	3.48
2000	7.5	2.16	8.05	3.32

Source: State of Israel Government Companies Authorities, June 2001.

equity at NIS 25 199.40 million (US$5 billion). Government companies represented 82 per cent of these sums. As can be seen from Figure 9, commercially-orientated companies were responsible for 3.32 per cent of GDP, employed 2.16 per cent (48 000 persons) of the Israeli workforce and contributed respectively to 7.5 per cent of Israeli exports and 8.05 per cent of Israeli R&D efforts. Figure 9 also shows that, except for exports, the relative economic importance of these companies is on a declining trend.

Government 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. Specifically, the state retains monopoly ownership of Israel Electric, Mekorot Water Ltd., the main defence industries (Israel Aircraft Industries, Israel Military Industries and Rafael, the weapons development authority) and EL Al (the national airline). In addition to certain banks, the state maintains controlling stakes in Industrial Development and in Bezeq Israel telecom, Zim Navigation Lines and Oil Refineries Ltd.

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Table 10. **Total inflation-adjusted assets of commercially-oriented government and mixed companies by economic sector**
In NIS. Millions of December 2000

	Government companies		Mixed companies		Total government + Mixed	
	2000	1999	2000	1999	2000	1999
Electricity and water	55 024.00	55 327.90	0.00	0.00	55 024.00	55 327.90
Industry and commerce	362.10	343.30	12 839.40	12 653.40	13 201.50	12 996.70
Transport and communications	22 369.50	22 274.00	4 837.60	5 005.30	27 207.10	27 279.30
Energy and oil exploration	6 883.90	6 436.00	0.00	0.00	6 883.90	6 436.00
Defence	10 455.40	9 859.00	347.70	566.70	10 803.10	10 425.70
Agriculture	750.20	763.20	536.20	549.40	1 286.40	1 312.60
Construction and housing	390.40	707.90	0.00	0.00	390.40	707.90
Tourism	259.50	382.00	0.00	0.00	259.50	382.00
Other services	165.60	167.50	1 705.90	1 541.20	1 871.50	1 708.70
Total active companies	96 660.60	96 260.80	20 266.80	20 316.00	116 927.40	116 576.80

Source: State of Israel Government Companies Authorities, June 2001.

The government remains the largest single land-holding entity. Table 10 provides a breakdown of government companies by sectors which shows that these companies were mainly concentrated at the end of 2000 in electricity and water, transportation and communications; defence and energy and oil exploration (for a total of 29 operating companies).

The privatisation process

The government's policy is to encourage foreign investors' participation in the Israeli government companies. Government companies, mixed companies and state banks are subject to different legal provisions. Their privatisation is also handled by separate governmental authorities.

Government companies are subject to the provisions of the Government Companies Law of 1975 as well as directives of the Government Companies Authority set up in 1960. The legislation regulates the management and operations of government companies, including the rights to convene board meetings, and the procedures under which the Government may sell shares in these companies. These procedures involve the preparation of companies for privatisation, the identification of the relevant steps and timing, the necessary co-ordination between relevant agencies and ministries and the execution and management of the privatisation processes. In the case of mixed companies, the management

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powers of the government are limited to the appointment and qualification of directors and the establishment of employment terms.

Privatisation of all state-owned enterprises, other than banks, is administered by the Government Companies Authority. The Government Companies Authority is responsible for the promotion and execution of privatisation operations for all state-owned enterprises, other than banks. The responsibility for the privatisation of banks is with the Ministry of Finance, through a wholly-owned government entity (MI Holding). MI Holding manages privatisation according to the Minister's instructions. It is also responsible for the management of the "Yozma funds" following the sale of the Government Company "Yozma".

The decisions are taken by the Privatisation Committee (consisting of the Prime Minister, as chairman, the Minister of Finance, the Minister of Industry and Trade, the Minister of Justice and the Minister of the Interior). The Privatisation Committee has the power to initiate the privatisation of any government company or mixed company and to implement structural changes or other preparatory measures necessary to give effect to such privatisations. The Privatisation Committee also determines the conditions under which privatisation operations are to be carried out. It is allowed, in exceptional cases, motivated by national security considerations, to limit the level of foreign participation in a specific privatisation (see Annex 2). The consent of the Ministers directly responsible for concerned state companies is not required although they are consulted as a matter of course.

Privatisation may be realised through direct sales to investor groups or public offering on the Tel Aviv Stock Exchange (TASE) and foreign stock exchanges. Golden shares may be assigned to protect the state's interests. In cases where a golden share exists, the Companies' Regulations include an "Israeliness" (or citizenship) requirement with regard to the composition of the board of directors and the controlling or ordinary principals in the company. Currently, the state holds only one golden share in Chimikalim Le'Yisrael (Israel Chemicals) and Zim Israel Navigation Ltd.

During the period of 1986 to June 2001, the total volume of privatisation reached US$8 707.5 millions and 79 companies ceased to be government companies. This has not been a linear process, however, as most of the privatisations took place in 1991-1994, 1997 and 1998. There was a resumption of activity in 2000 but it substantially dropped in 2001 as a result of the deterioration in market and security conditions.

As can be observed from Table 11 below, 66 per cent of the privatisation revenues between 1993 and mid-2001 were generated by the sale of banks. Since the early 1990s, two small banks have been privatised while the four largest banks are undergoing rapid privatisation. In 1997 the controlling interest in Bank Hapoalim (the largest bank in Israel) was sold to an Israeli-US investor group. In 1998

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Table 11. **Privatisation and capital raising in stocks and convertible equities during the period of 1993 to 06/2001 in US$ (millions)**

Company	Total raised	Bank	Total raised
Chimikalim Le Yisrael (Israel chemicals)	819.5	Igood	88.9
Mivney Taasia (industrial constructions)	200.7	Hapoalim	2 782.3
Shekem	114.1	Leumi	1 166.7
Nafta	65.4	Mizrahi	529.1
Magen Mashabi Gaz Veneft (oil and gas resources)	5.3	Discount	260.5
Koor Industries	139.76		
Menoei Beit Shemesh (Beit Shemesh engines)	0.8	Total Banks:	4 827.5
Malam	19.6		
Lapidot	17.9		
Shikun Upituach (housing and development)	288		
Mispanot Yisrael (Israel seamanship)	14		
Tahal (Israel water planning)	12.9		
Yozma (initiative)	14.8		
Keren Nitzanim – Yozma (iniative: spring fund)	9.3		
Bezeq	508.7		
Beit Sefer Le'Tayroot (tourism school)	0.3		
Chanal (national oil company of Israel)	26		
Keren GPV – Yozma (initiative: GPV Fund)	9.2		
Keren Gemini – Yozma (initiative: Gemini Fund)	9.2		
Polaris Fund	9.45		
InvenTech Fund	9.61		
Hachevra Le'Hadbarat Isvey Bar (grass root disinfestation company)	1.78		
Shikun Ovdim	4.3		
Keren Verofund – Yozma (initiative: Vero Fund)	8.8		
Keren Vetrax – Yozma (initiative: Vetrax Fund)	8.8		
Chevrat Hashkaot Le'Pituach Hataasia Be'Yisrael (industry development investment company)	51.6		
Shor Van Hakranot (Shor Van projections)	0.5		
Otzar Hashilton Hamekomi	10.4		
Afridar	19.6		
Total companies:	2 424.44		
Companies	2 424.44		
Banks	4 827.5		
Total:	7 251.94		

Source: State of Israel Government Companies Authorities, June 2001.

and 1999 the Government sold controlling interest in Discount Bank and Bank Leumi.[5] The government is currently exploring ways of completing these privatisations in the near future, and to encourage more involvement by foreign investors, notably through an increased recourse to public offering in international markets. Table 11 also shows that privatisation in the non-banking sector has so far involved relatively small operations with the exception of the full privatisation of

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Israel Chemicals, the partial privatisation of Bezeq and the sales of the Housing Development Corporation, Industrial Construction and Koor Industries. Over recent months, government energies have focussed on the privatisation of Zim Israel Navigation (almost completed) and the sale of the government controlling interest in Bezeq. An inter-ministerial Committee has also recently been established with a view to exploring the possibility of starting the privatisation of large defence industries such as the Israel Aircraft Industries. Further details of the government's privatisation plans is provided under the headings of different sectoral measures reviewed in the remainder of this chapter.

The role of foreign investors in the privatisation of Government enterprises has been quite limited. Indeed, in the non-banking sector, foreign investors have only engaged in the privatisation of the Otzar Hashilton Hamekomi. Otherwise, foreign investors have invested in two former government-owned banks: Hapoalin Bank and Leumi Bank. The government is hopeful that future foreign investors' involvement in privatisation will be substantially larger.

Financial sector

Foreign investors are active in the banking sector and present in some insurance activities. Reciprocity conditions may apply in the granting of a banking licence to foreign banks not established under Israeli jurisdiction. There are incorporation requirements for some activities in securities. None of these measures are inconsistent with the National Treatment instrument however. The Israeli financial sector is generally considered to be "sound, healthy and modern".[6] While there is a good level of supervision, co-ordination between supervisory authorities could be improved. Legislation that would enhance information sharing between the Bank of Israel (the Central Bank) and other supervisory agencies, such as the Israel Securities Authority, is under preparation. Pension reform, a new Bank of Israel law, and review of the provisions for bank exit have also been identified as priority areas as were better payments supervision and the introduction of a deposit insurance scheme.

Banking

Market structure and regulatory environment

Israel's banking system is relatively highly developed. Over forty banking corporations – commercial banks, mortgage banks, investment-finance banks, financial institutions and foreign banks – were operating on the market at the end of 2000. It is also highly concentrated, with the five largest banks (Bank Hapoalim, Bank Leumi, Discount Bank, Mizrahi Bank and First International Bank of Israel) controlling 93.7 per cent of all bank assets, and the three largest among them

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accounting for over 75 per cent.[7] Since the economic crisis in the early 1980s the government has maintained significant holdings in the banking sector, although it is divesting itself gradually through its privatisation programme.

The Israeli banking sector has traditionally been a sector subject to concentration. During the economic crisis in the early 1980s the government took a controlling interest in a large part of the banking system. The comprehensive reform of the sector in the 1990s has however succeeded in enhancing competition and improving the regulatory framework.[8] The increased number of foreign competitors on the market is predicted to lead to a series of mergers and acquisitions in banking, another sign that corporate financing in Israel is undergoing transformation.[9]

Up until 1995, banks were allowed to engage in a number of non-banking activities, such as operating provident funds, underwriting securities and intermediation. Since 1995, only traditional banking services may be offered by banks, and if they wish to offer other services, they need to create non-bank subsidiaries. The holdings of banks in non-financial firms was common until a legislative amendment in 1996 introduced new restrictions on a banking corporation's real investments, that impose a ceiling of 25 per cent of the bank's capital. Such investments are permitted according to the following schema: up to 15 per cent of a bank's capital may be invested in one or more companies as long as the bank does not hold 20 per cent or more of each company; an additional increment up to 5 per cent of the bank's capital may be invested as long as the bank does not hold 5 per cent or more of a company and cannot appoint a director; and an additional increment of up to 5 per cent of capital may be invested in foreign corporations.[10]

Banking reform has also included the reduction of reserve requirements for public deposits; since November 1994 a reserve requirement of 6 per cent on deposits with maturity of up to 6 days, 3 per cent on those with maturity up to a year and 0 per cent on longer-term deposits. Most restrictions on interest rates and minimum terms of deposits and credits have been removed.[11]

Finally, privatisation has been an important element in the reform process. Begun in the late 1990s, the privatisation programme covers the largest banks in the sector. The government has sold all of its shares in Bank Hapoalim and sold its controlling interest in Mizrahi bank in 1994. It reduced its holdings in Bank Leumi to 41.7 per cent and in Discount Bank to 57.1 per cent at the end of 2001.[12] The closure of a number of branches of Discount Bank is envisaged for 2002. The government has been looking for a buyer of its shares in this bank, as well as for its remaining holding in Bank Leumi.[13] Unfavourable market conditions have resulted in limited success so far, and led to the consideration of other options, including in the case of Bank Leumi the possibility of privatisation via international capital markets. Special legislation ensures that the government is not involved in management decisions of banks in which it holds an interest.[14]

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The Bank of Israel is responsible for supervision and surveillance of banking corporations. The Licences Committee of the Bank of Israel makes recommendations on the issuing of licences to establish or purchase a controlling interest in a banking corporation, as well as approval for establishing a branch. An applicant who requests a permit for holdings of 10 per cent or more in a bank or who wishes to control a bank (alone or as part of a group) must qualify as "fit and proper". This involves verification of the integrity, financial capability and source of funds of the controller.[15] The Basel Committee's international standards are followed. The sector has been assessed as having good regulatory supervision and highly developed underwriting mechanisms.[16] The international credit rating agency Standard and Poor's issued a risk analysis report on Israel's banking sector in September 2001,[17] concluding that the sector was basically robust. Despite the current high degree of concentration, Standard and Poor's predict that the combination of technological advances, increased activity of foreign banks and the eventual conclusion of the sale of the government's remaining stakes in the banking system could lead to a deconcentration in the sector.

FDI *in the banking sector*

Activities of foreign banks are not subject to any specific restrictions.[18] Israel made commitments under the Financial Services Annex[19] to the General Agreement on Trade in Services (GATS),[20] concluded at the end of 1997. It has scheduled a number of banking activities as "unbound" for non-banking institutions, meaning that no commitments were made for service trade through establishment with regards to the following services: acceptance of deposits and other repayable funds from the public; lending of all types and financial leasing. There are no limitations on market access or national treatment for banking institutions wishing to offer these services. Similarly, there are no limitations for a range of other banking services[21] supplied by a foreign-controlled bank established in Israel. A number of activities involving securities may only be carried out by banks through subsidiaries. In addition, Israel has taken a most favoured nation (MFN) exemption in relation to banking services by maintaining a possible application of reciprocity conditions on the granting of banking licences.[22] To date, no licence has been refused because of this reciprocity condition. This condition does not apply to already established foreign institutions and thus does not need to be covered by an exception to the National Treatment instrument.

The first American bank to open an office in Israel was Citibank in 1996. It subsequently received a full service banking licence in 1999. Since then nine other foreign banks have opened representative offices (Union Bancaire Privée, Discount Bank and Trust Company, Credit Industriel et Commercial, HSBC Republic Bank (Suisse) SA, HSBC Bank USA, BNP-Paribas, Multi Commercial Bank, Bank of America Securities Limited, JP Morgan Chase bank). Three have opened branches

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– Standard Chartered Bank, HSBC and Citibank – and each has a full banking licence.[23] Foreign banking institutions have remained in Israel, despite the recent downturn in both economic and political terms; indeed foreign financial institutions are playing an increasingly important role in the domestic economy.[24] Tending to be principally oriented on investment and private banking, United States banks are particularly active in these sectors, and have played a central role in encouraging Israeli high-tech companies to list their shares on the NASDAQ and other foreign exchanges. Many have also been partners in venture capital fund investments in the high-tech sector. European banks have been more active in the private banking sub-sector.[25]

Holdings of foreign residents in the Israeli banking system were estimated at US$1 billion at the end of 2001. This figure includes holdings of foreign residents who are part of controlling groups in banks as well as foreign residents holding more than 5 per cent of the capital of a banking corporation.[26]

Securities

Legal and regulatory environment

Israel began its programme of financial deregulation in 1986. Today, it has a well-developed capital market and a comprehensive regulatory regime. Capital is available on terms comparable with international markets and foreign financial institutions are becoming increasingly active in the Israeli financial system.[27] Institutional investors, in particular provident funds, severance-pay funds, mutual funds and advance study funds, are major players on Israeli capital markets. Assets held by all of these funds totalled US$43.6 billion at the end of 1999. Government bonds account for the lion's share of publicly issued debt securities in Israel. Despite measures introduced in the late 1980s to encourage private bond market development, this segment is relatively small.

The Israel Securities Authority (ISA) is an independent statutory regulatory agency established in 1968. Its primary function is to ensure the protection of investors by ensuring the fair and orderly functioning of the securities markets. The ISA has 12 members and a Chairperson appointed by the Minister of Finance. It supervises the activities of the Tel-Aviv Stock exchange (TASE) as well as public offerings by companies and the ongoing disclosure of public companies. It is therefore responsible for granting permits to publish prospectuses, supervision of financial reports submitted by companies and approving the bylaws of the TASE. It also regulates the activities of mutual funds and grants licences to portfolio managers and investment advisors.[28] The ISA enforces the Securities Law through its criminal and civil enforcement powers. In some instances it may impose civil fines. The ISA may order a company to correct its financial reporting and where the

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company does not comply, the ISA may apply to the courts to enforce a company's reporting requirements. In specific circumstances, the ISA may require the TASE to suspend trading in the securities of a company that has failed to comply with the reporting requirements of the ISA.

Beginning operations in 1953, the TASE is Israel's only stock exchange. At the end of 2000, it had 28 members (12 banks and 16 brokerage firms, one of which is a foreign-owned subsidiary); 665 companies had equity securities listed on the TASE and the total market value of these securities was US$66.8 billion. TASE members must comply with the minimum capital requirements (NIS 9.5 million) and maintain liquid assets in an amount equal to 50 per cent of the minimum capital requirement. Annual trading volume was US$28.5 billion in 2000. Its electronic trading system, the TACT, is the forum for trading of shares, convertibles, treasury bills, government bonds and derivatives. The TASE launched an options market in 1993.

Companies wishing to trade on the TASE must satisfy both the Securities Law and TASE listing standards. A condition for listing on the stock exchange is the sale of at least 25 per cent of equity capital to outside shareholders. For securities trading activities, a security broker office in Israel operating in foreign securities on behalf of Israeli residents requires an authorisation from the Controller of Foreign exchange.[29]

Foreign investments on the TASE were minimal in the early 1990s but expanded during the decade to peak at 15 per cent in 1998 (see Chapter 1). Since the stock market correction of April-May 2000 the flow of financial investment has returned to its formerly low levels.[30] Dual listing is possible with any stock exchange abroad, provided that the company requesting listing on the TASE complies with the registration procedures of the Securities Law and the TASE regulations. In the case of companies traded on the NASDAQ NM, the NYSE and the AMEX, new regulations enable Israeli companies to register for trade on the TASE based on the same documentation, without any requirement to lodge a new prospectus. Non-Israeli incorporated companies may also register through this arrangement, subject to the ISA's approval. Such corporations need only file with the ISA the same disclosure-related documents already filed in the United States. The benefits of these new dual-listing rules, which were approved in October 2000, are the creation of a wider investor base, larger trading volumes and improved liquidity that will enhance share values.[31] At the end of February 2002, sixteen new companies had dual-listed on the TASE and a United States stock exchange according to the new regulations.[32]

FDI *in the securities sector*

Due to prudential considerations, portfolio manager licences and investment advisor licences are only granted to Israeli citizens or residents and Israeli registered

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companies in Israel. An Israeli mutual fund's manager or trustee is required to be incorporated as an Israeli registered company (in the case of a foreign company it must be registered as such, according to the Companies Law). There are no other particular discriminatory requirements applied to foreign-controlled enterprises.

Insurance and pension funds

Market structure and regulatory environment

Retirement savings and income in Israel are provided for by pension funds, provident funds and life insurance polices. Although these activities are open to foreign and domestic competition on the same conditions, the insurance industry tends to be dominated by a few large firms. As a result of a spate of mergers and acquisitions in the late 1990s, four groups dominate the market: Migdal, Clal Insurance Phoenix and Harel.[33] The gradual liberalisation of the sector has resulted in insurance companies no longer being issued designated government bonds; they have therefore tended to become more oriented towards the capital market.[34]

The Commissioner of insurance, a Treasury official with statutory authority, is responsible for regulation of the sector. Establishment of a new pension or provident fund requires approval from the Ministry of Finance and the Income Taxation Commission. A management company must satisfy the requirements of these two institutions before the fund will be accorded an income tax authorisation.[35] All companies wishing to offer insurance services must submit a business plan and receive approval for policies and rates.

A number of restrictions apply to the investment operations of insurance companies for prudential reasons: they are only allowed to purchase foreign securities up to 20 per cent of their investments,[36] and there is a general restriction on the amount of portfolio investments that they may maintain. Minimum capital adequacy is NIS 35 million (US$7.5 million) in life insurance, NIS 40 million (US$8.5 million) in general insurance and NIS 60 million (US$12.8 million) in life and general insurance combined.[37] Life insurance companies will be subject to reinforced identification, reporting and record-keeping obligations as part of the legislative reform recently introduced to combat money laundering.[38]

The insurance sector underwent significant regulatory reform in 1995, the principal objective of which was to aid in the recovery of the ailing pension funds sector. Most workers participate in a pension fund, to which the employer and the Government also contribute. Since 1995 the Government's support of such funds has taken the form of special non-marketable bonds

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bearing real rates of 5.05 per cent per year. The reform plan included, among other things, revised rules as to new members: existing pension funds were closed to new participants, who were subsequently directed towards the new independent funds. It was estimated at the end of 1999 that this recovery plan will cost the Government approximately NIS 124 billion (US$26.8 billion) over the next 80 years, with a little over a third of that amount accounted for by pension payments that the existing funds will be unable to make and the remainder for the subsidy part of the special bonds issued to the funds by the Government.[39] There are now two types of accrual-type pension funds through which pension insurance is provided: "old" and "new" pension funds. The latter category applies to those established in 1995-1996 pursuant to a government resolution. While traditionally pension plans involved non-profit organisations, for-profit organisations have become increasingly active over recent years.[40] At the end of 2001 there were 35 pensions funds (18 of which were established before the 1995 reforms and are closed to new investment) and 335 provident funds.[41]

Pension funds established before 1995 are required to hold 92 per cent of their portfolio in government papers, whereas the same obligation for the newer funds is at 70 per cent. Subsidised government bonds are issued to pension funds and insurance companies but no longer to provident funds. Contributions to pension, provident and life insurance funds are tax deductible, accumulated profits are free from tax and certain withdrawals are tax exempted.[42]

FDI *in the insurance sector*

There are no restrictions on foreign investment in the provision of insurance and pensions (the latter being subject to the same law).[43] However, foreign participation has to date been limited in the insurance sector and non-existent in pensions. There are only two foreign-controlled companies at present: American AIG group has established personal insurance and mortgage guarantee insurance companies and the Italian-based Assicurazioni Generali has controlled Israel's largest insurance company Migdal since 1996.[44] There has been a tendency towards cartel formation in the insurance sector; this has been brought to light recently through several anti-trust prosecutions in the sector. Until recently the pension funds market has been dominated by the Histadrut (Israel's largest trade union), which controlled the three major pension funds. For these reasons, the Israeli government has indicated that it welcomes the participation of foreign investors in both insurance and pensions markets. All insurance companies are required to invest capital in Israel. Foreign-based brokers may sell reinsurance via brokers directly in Israel but individual policies may only be sold by licensed companies.

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The non-financial sector

Transport

Air Transport

Israel's only air carrier operating scheduled international flights, El Al, is a government-owned company established in 1949. It competes with 45 other scheduled airlines operating in Israel pursuant to bilateral aviation agreements and several charter companies. The company owns several enterprises that undertake ancillary activities, such as charter flights, cargo handling and supply of food to aircraft. The airline has not been a profitable business for some time, registering losses even when tourism was at high levels.[45] Despite a temporary increase of travellers preferring the security of the national airline after the September 11 2001 terrorist attacks in the United States, tourism and business travel to Israel, both of which depend principally on air travel, have declined dramatically since the deterioration of the peace process in late 2000. In response to this, the company has undertaken a series of measures aimed at cost saving.[46]

During the 1990s the government adopted a policy of liberalisation and facilitation of greater competitiveness in the international and domestic civil aviation sector. Some restrictions on the capacity supply of companies were lifted, transport charter flights policy was liberalised. Measures aimed at market entrance of new companies and flexibility in flight price setting were implemented. In addition the establishment of new Israeli air flight companies in the sector of passengers and cargo was permitted. These measures have led to significant price reduction in flights, flights to new destinations and an increase in the flow of passengers and cargo to and from Israel.

The government has been trying unsuccessfully to privatise El Al. A steering committee headed by the Minister of Transportation, and including representatives of the Prime Minister's Office, the Ministry of Finance, the Government Companies Authority, and the Ministry of Transport has been established to speed up the process. A number of outstanding issues need to be resolved beforehand, including compensation of employees, flights on the Sabbath and the high costs of security to the airline.[47]

Licensing of an airline as an Israeli airline is conditional upon at least two thirds of the capital of the company being held by Israeli nationals and at least two thirds of the directors being Israeli nationals. The first measure constitutes an exception to national treatment as indicated in Annex 2.

Maritime transport

Foreign-controlled enterprises established in Israel are entitled to register a vessel in Israel. Registration of a vessel under the Israeli flag is conditional upon the

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holding of over 50 per cent ownership in the licensee company by the State, an Israeli national or a corporation established under Israeli law. Cabotage operations are limited to Israeli vessels and to foreign vessels subject to a reciprocity condition.[48]

Israel has three major ports: Haifa, Ashdod and Eilat. The amount of cargo arriving in Israel by sea has been steadily increasing over the last few years; in 2000 over 43 million tonnes of cargo was handled in the country.[49]

Zim Israel Navigation Limited is Israel's principal shipping company and the subject of a major privatisation transaction that is expected to be completed in 2002. Zim was founded in 1945 and carries out cargo transportation operations in the country's international trade as well as some ancillary services. It was established as a mixed company, with principal shareholders being the Israel Corporation (a public company) holding 48.9 per cent of shares and the State of Israel holding 48.6 per cent. The remaining shares are in private hands. The decision to privatise Zim by selling the State's shares in the company through private sale was taken in August 2000. Agreements were reached with the Israel Corporation Limited as part of the privatisation process.[50]

Roads and rail transport

Israel's road network consists of over 15,000 kilometres of roads and highways that connect Tel Aviv with Haifa, Jerusalem and Beersheva. Upgrading of roads was a priority for infrastructure projects in the 1990s. A number of construction projects to be privately funded, including the Cross-Israel toll highway and the Carmel Tunnel, have been approved. The former, which is under concession, is expected to be completed in 2003. Tenders for both projects were opened to foreign companies. A Canadian company is a partner in the group that won the Cross-Israel toll highway's tender and a Spanish company is a partner in the consortium that won the Carmel Tunnel's tender.[51]

Public transportation lines by bus are operated through licences granted by the Ministry of Transportation. Traditionally, most lines were operated by two co-operatives (namely Egged and Dan). In order to facilitate the entrance of new operators into the market, a decision was taken to operate public transportation lines through operators chosen through tender. To meet this target, the Egged and Dan co-operatives were excluded from tender participation. Some foreign companies were involved in the winning tenders. The Ministry of Transportation aims at establishing a tender process for all transportation lines.

Railways, owned by the State Ports and Rails Authority, link the coastal town of Nahariya in the North with some of Israel's major cities and the Southern region. An inter-governmental committee, headed by the Director General of the Ministry of Transportation, is now reviewing the structural, financial and operative aspects

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of Israel's Railways. It will make recommendations to the Government for future development.

There are two urban mass transportation systems (the light train in Jerusalem and the Tel-Aviv underground) opened to the private sector, including foreign companies. The government intends to open a new tender for the operation of the Tel-Aviv Kfar-Sava railway line. The tender will be open to the participation of consortiums with foreign partners.

Telecommunications

The competitive environment

As a country relying heavily on high-tech industries for its economic development, the availability of modern communications services at reasonable tariffs is of crucial importance. Israel has experienced in the last few years reforms in this area which have profoundly modified the structure and consumption patterns of the industry. Today, Israel has one of the highest degrees of consumption in the world market in mobile phones (80 per cent),[52] multi-channel television (88 per cent – cable and satellite), and internet (55 per cent in the business sector and 42 per cent in total consumption).

International long-distance telephony has been opened to competition since 1999 and the monopoly on local telephony was cancelled in December 2001. Since the year 2000, satellite direct-to-home multi-channel television has provided an alternative to the three regional monopoly cable TV providers, Tevel, Matav and Golden Channels. Cable companies no longer enjoy exclusive rights; they are now subject to an open licensing regime. There are over 70 Internet service providers,[53] mobile operators, cable and satellite broadcasters are increasingly being allowed to compete in one another's traditional markets. A tender for third generation cellular, which will enable broad-band advanced services, has recently been conducted; each of the applicant companies (Pelephone, Cellcom, Partner/Orange) was successful in obtaining a frequency band.

However the transition to an open and free market remains incomplete. Bezeq, Israel Telecommunication Corporation Ltd., the incumbent local exchange carrier remains a *de facto* monopoly in fixed-line domestic telephone services and is controlled up to 54 per cent by the state. Competition is not permitted in telegraph services, which remains a monopoly under the Israel Postal Authority. This is recognised by the Israeli government which in 2001, announced a "new wave of liberalisation" to, *inter alia*, open local fixed telephones services to competition, introduce third generation mobile services and enhance competition in commercial broadcasting. Bezeq is also to be privatised through the sale of over 50 per cent of its shares.[54] At the same time, there is to be a "re-regulation" of

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Figure 10. **Evolution of telecommunication services in Israel**

	1994	1998	1999 and onwards
Mobile Services	– Pelephone (Bezeq)	– Pelephone (Bezeq) – Cellcom – Partner/Orange	– Pelephone (Bezeq) – Cellcom – Partner/Orange – Mirs (2001)
Fixed Services (Infrastructure, Transmission and Telephony)	– Bezeq	– Bezeq	– Bezeq – Companies having affinities to the cable companies providing infrastructure services to license holders of cable broadcasts as well as for access services for Internet providers
International Long Distance Services	– Bezeq	– Bezeq International – Barak – Golden Lines	– Bezeq International – Barak – Golden Lines – Additional Operators (from 2002)

Source: Ministry of Communication (2001), Telecommunications Liberalization Policy, Jerusalem; Ministry of Communications (2002).

the communications sector to give the users greater freedom to determine market developments. According to the government, the communication infrastructure of the future should provide for open and universal access, interconnection, fair competition and public safety and security.

In recent months, the Minister of Communications established a committee to prepare recommendations handling the establishment of an independent Telecommunications Regulatory Authority enabling market restructuring and competition enforcement. A Bill to enable cable TV companies to compete with Bezeq with regard to internet and telephone competition has also been introduced. In addition, amendment 25 to the Communications Law, limiting cross ownership in the media, has recently been approved. Recently companies having affinities with the cable television companies were granted licenses as domestic operators for the providing of infrastructure services to license holders of cable broadcasting for transmission of their broadcasts as well as for access services for internet providers. It should also be noted that the Anti-Trust Commissioner permitted a merger of the cable companies for the purposes of broadcasting and permitted the companies having affinities to the cable companies to merge for the purpose of in-land service, on the condition that the latter companies also supply telephony services within two years upon receiving their in-land license.

The Ministry of Communications is responsible for telecommunications policy and regulation, as well as for spectrum (allocation and assignment is carried out

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Box 3. Main FDI rules in telecommunications

1. *Bezeq Company* (holder of a general licence to provide fixed land-line Bezeq services) – the control in Bezeq Company should be at all times in the hands of an individual that is an Israeli entity, or in the hands of a corporation in which an Israeli entity holds directly at least 20 per cent of each type of controlling means [paragraph 4 to the Telecommunication Order (determination of essential service provided by "Bezeq" the Israel Telecommunication Corp., Limited) 1997, as recently amended ("Bezeq Ordinance"); the term "Israeli entity" is defined in paragraph 1 of the Bezeq Ordinance and means ....)].
2. *Fixed services operators* (holders of domestic operator licences are meant to operate in the activity sectors of Bezeq Company, fully or partially, namely telephony, data communication, transmission and infrastructure); domestic operator licences have recently been issued (companies having affinities to the cable television companies have been granted licenses as domestic operators for the provision of infrastructure services to license holders of cable broadcasting for transmission of their broadcasts as well as for access services for internet providers) – one of the prerequisites to be given the licence is that at least 20 per cent of each type of controlling means in the requester be held directly by an Israeli citizen and a resident of Israel, or by a corporation controlled by an Israeli citizen and resident of Israel [Article 11(*a*)(2) of the Communication Articles (Procedures and conditions for receiving a general licence to provide fixed land-line Bezeq services), 2000 ("Domestic operator articles")].
3. *Mobile operators* (holders of a general licence to provide mobile telephone radio services) – regarding Cellcom, Partner and Mirs companies, it is determined that Israeli citizens and residents will hold at least 26 per cent of each one of the controlling means of the licence holder (paragraph 14.1 of Licences). Regarding Pelephone, no provision was stipulated for this matter in the company licence.
4. *International operators* (namely Bezeq International Company, Golden Lines Company and Barak Company, holders of a general licence to provide international Bezeq services) – it is requisite that Israeli citizens and residents of Israel will hold at least 26 per cent of each one of the controlling means in the licence holder; furthermore a foreign telecom operator is entitled to hold up to 49 per cent (paragraph 13.1 of the Licences, the provision regarding a foreign telecom operator does not apply to Bezeq International Company).
5. *Cable broadcast licence holders* (the licences are awarded by the Council for Cable Broadcasts and Satellite Broadcasts) – regarding the general licences for cable broadcasts, it is determined as a prerequisite that the requester of the licence be an Israeli citizen and resident, or a corporation in which at least 26 per cent of each type of controlling means is held by an Israeli citizen

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Box 3. **Main FDI rules in telecommunications** (*cont.*)

and resident (paragraph 6(i)(2) of the Communications Law (Telecommunications and Broadcast), 1982 ("Communication Law"). Furthermore, it is determined that a general or special licence for cable broadcasts will not be awarded to a requester who is or who is held by a foreign government, though the Minister is entitled to permit the indirect holding of up to 10 per cent by a corporation in which the controlling means are held by a foreign government (paragraph 6(*i*)(3) of the Communication Law).

6. *Licence for satellite broadcasts* – It is determined that at least 26 per cent of each type of controlling means in the requester be held by an Israeli citizen or resident of Israel [Article 13(4) of the Bezeq Articles (Procedures and conditions for giving a licence for satellite broadcasts) 1998 ("Satellite Articles")].

Franchisees of Channel 2, another commercial channel and regional radio – (the franchise is given by the Council of the Second Authority for Television and Radio) – entitled to participate in the tender for franchise is a corporation in which the capability to direct its activities and 51 per cent of all the controlling means in it are held by Israeli citizens and Israeli residents [paragraph 41(*a*) of the Second Authority for Television and Radio Law, 1990 ("Second Authority Law")].

The holding of controlling means in communication operators and in broadcasting entities is subject to the Israeli requirements, as detailed above. It should be stressed that the definition of "holding" includes indirect holding. Furthermore, it is noted that the prerequisites for receiving a licence or franchise, according to issue, must be upheld throughout the period of the licence or franchise.

Below are details of the provisions pertaining to the Israeli requirements regarding position holders in a licence holder or franchise holder, according to issue:

7. *Bezeq Company* – 75 per cent of the board of directors members, position holders and function holders determined in the company licence will be Israeli citizens and residents of Israel, and will have the appropriate security classification (paragraph 13 of the Bezeq Ordinance; Appendix E to the Bezeq Company licence lists in the list of function holders, among others, the chairman of the board, director general, VPs of engineering, operation and finance, and the legal advisor).
8. *Fixed services operators* – the general manager, the director who has been given the executive authority and also the majority of directors requesting the licence should be Israeli citizens and residents of Israel; furthermore, the Minister of Communication is entitled to determine in the domestic operator licence further restrictions regarding the staffing of the positions and appointment of position holders [Articles 11(a)(3) and 13(a) of the Domestic operator articles].

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Box 3. **Main FDI rules in telecommunications** (*cont.*)

9. *Mobile telephone radio operators* – regarding the companies Partner and Mirs it is determined that the managing director and the majority of the directors in the company holding the licence should be Israeli citizens and residents of Israel (paragraph 14.1 of the Licences); in the licence of Cellcom Company a similar provision is included regarding the directors only (paragraph 14.1 of the Licences); in the licence of Pelephone Company there is no provision in this regard.
10. *International operators* – the managing director, the majority of the directors, operating manager and engineering services manager should be Israeli citizens and residents of Israel (paragraph 13.1 of the Licences).
11. *Cable broadcast licence holders* – there are no restrictions in the Communication Law in this matter; licences have not yet been awarded (it is possible that the restrictions will be determined within the framework of the conditions of the licences to be awarded).
12. *Licence for satellite broadcasts* – the managing director of the corporation requesting a licence and at least half of the directors will be Israeli citizens and residents of Israel (Article 13(2) and (3) of the Satellite articles).
13. *Franchisees of* Channel 2, *another commercial channel and regional radio* – there are no restrictions in the Second Authority Law in this regard.
14. In this context it is noted that in some of the general licences to provide Bezeq services, security provisions were determined regarding the mandatory security classification of the certain position holders.

In relation to the requirement that the corporation requesting a licence or franchise, according to issue, will be *registered* in Israel or that the centres of its business will be in Israel, the following provisions were determined:

15. *Bezeq Company* – regarding a corporation held by an Israeli entity (see above), it is determined that it should be a company incorporated in Israel according to the Companies Law [paragraph 4(*a*)(2) of the Bezeq Ordinance]. Furthermore it is determined that the ongoing running of Bezeq Company and the centre of its business will be in Israel, and that the Board of Directors meetings and the general meeting of the shareholders will be held in Israel (paragraph 11 of the Bezeq Ordinance).
16. *Fixed services operators* – the licence requester should be a company lawfully incorporated in Israel [Article 11(*a*)(1) of the Domestic operators articles].
17. *Mobile telephone radio operators* – the licence holder should be a company registered in Israel (paragraph 14.1 of the Licences).
18. *International operators* – the licence holder should be a company registered in Israel (paragraph 13.1 of the Licences).
19. *Cable broadcast licence holders* – the corporation requesting a licence should be a corporation registered in Israel [paragraph 6(*i*)(2)(1) of the Communication Law].

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Box 3. **Main FDI rules in telecommunications** (*cont.*)

20. *Satellite broadcast licence* – should the requester of the licence be a corporation, the corporation will be registered in Israel [paragraph 6(*v*)(1) of the Communication Law]; the centre of the business of the corporation requesting a licence should be in Israel [Article 13(1) of the Satellite articles].
21. *Franchisees of Channel 2, another commercial channel and regional radio* – entitled to participate in the tender to provide a franchise is a corporation registered in Israel [paragraph 41(a) of the Second Authority Law].

It should be noted that the above-mentioned rates may be changed in the future.

by an Inter-governmental Frequency Committee). This entails responsibility for formulating telecommunication policies, regulating communications infrastructures, supervising Bezeq and other telecommunications service providers, supervising the Postal Authority, setting and auditing Bezeq and Postal tariffs, managing spectrum allocations, regulating and supervising cable television services and tariffs and approving usage of telecommunications equipment. The content of the broadcasts is supervised by the Council for Cable and Satellite Broadcasting. The authority to grant cable broadcasting licences has recently been transferred to the Council for Cable and Satellite Broadcasting. However, the Minister of Communications retains the powers to set regulations and orders in the issues dealt within the licences. The Minister may interfere in the Council's decisions for "special reasons".

Foreign investment in the telecommunications sector

The Israeli legislation imposes a number of restrictions regarding the control and management and residency of licence holders. A number of these measures are being recorded by the Israeli authorities as exceptions to National Treatment (see Annex 2).

As a general rule, Israeli investors must hold directly a minimum of 20 per cent in fixed-land operators and 26 per cent in mobile phone operators, international operators, cable broadcast operators and satellite broadcast operators.[55] Foreign operators may not hold more than 51 per cent for the Channel 2, the third channel and the regional radio (the term Foreign Operator refers the operator

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of international services and is irrelevant for commercial channels). There are additional residency/incorporation and local content requirements, in particular for telecommunications suppliers. TV broadcasters must also reserve at least a certain per cent of their transmission time for Hebrew programmes.[56] Below are the details of the provisions regarding Israeli requirements in relation to the holding of controlling means in a licence holder or franchise holder, according to issue. It is to be noted in this context that the term "controlling means" includes the right to vote at the general meeting, the right to appoint a director/CEO, the right to participate in profits of the corporation, or the right to share in the balance of the corporation's assets, after paying off its debts, when being wound up.

Energy

Israel depends largely upon foreign suppliers of oil, coal and gas due to its low level of natural energy resources. Alternative sources of energy, such as solar water heating (of which Israel is the world's largest user per head) have not reduced the country's reliance upon external sources.[57] The fuel market is largely characterised by governmental concessions, although this is beginning to change in some sectors. Privatisation has either been completed or is in the planning stage for government companies operating in the electricity, oil and coal sectors. The recently enacted Natural Gas Law provides for competition in this sector.

The Government decided in 1997 to diversify Israel's "energy basket" of resources, notably by encouraging the use of natural gas, particularly in the generation of electricity. Consequently electricity power plants are to be "Combined Cycle Gas Turbines" that are fuelled principally by natural gas, rather than the traditional power stations fuelled by oil or coal, typically located in coastal areas requiring large areas of land. The use of this new type of power station is expected to facilitate the structural reform of the power generation sector as well as reduce detrimental environmental effects of oil and coal combustion. It is envisaged that natural gas will account for 25 per cent of the total energy basket in 2025.[58] Israel is a participant in several of the International Energy Agency's implementing agreements with regard to energy end-use technologies and renewable energy technologies.[59]

Electricity

The 1996 Electricity Sector Law governs the generation, transmission, distribution and sale of electricity. Holders of licences to transmit, distribute or produce a substantial part of electricity may be subject to nationality or residency requirements. This measure constitutes an exception to the National Treatment instrument as reported in Annex 2.

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Since 1996, the government-owned company Israel Electric Corporation (IEC) no longer has exclusive rights to electricity generation; instead its 70-year concession which expired in that year was replaced by a non-exclusive licensing system that applies to each activity. IEC obtained a ten-year licence in March 1996 for distribution, supply and sale of electricity, as well as separate licences to produce electricity.[60] Additional licences may be granted if the Ministry of National Infrastructures deems necessary. An independent supervisory authority – the Public Utility Authority (Electricity) – has been established along the lines of the United States Public Utility Commission, for the purposes of tariff determination and handling consumer complaints.[61]

The new market structure for the electricity market, determined by the 1999 Inter-Ministerial Committee for the Development of the Future Structure of the Electricity Market, is scheduled to commence in 2006. The national coal supply company, which was established in 1980, had two shareholders: the state of Israel (73 per cent) and the IEC (26 per cent). In February 2001 it was decided that the company would be privatised by the sale of the state's shares in a single bundle to IEC. The privatisation of certain segments of IEC's activities is currently being considered.[62]

A central feature of the restructuring undertaken to date in this sector was the attribution of up to 20 per cent of generating capacity to independent power producers, (IPPs) 10 per cent of which is allocated to foreign suppliers (*i.e.* suppliers operating outside of Israel). Such suppliers have not however been able to access the Israeli market due to the lack of trans-border power transmission interconnections. Until such a network is installed, the 10 per cent share reserved for foreign suppliers is allocated to Israeli producers. IPPs require an operating licence for the generation of activity and a building permit. Parcels of MW capacity are available for tender by IPPs within the framework of the 1999-2005 development plan that envisages 1 333 MW of power supplied by IPPs. Today, IEC supplies over 99 per cent of the country's electricity. There are no restrictions upon foreign participation in IPPs and foreign-controlled IPPs may compete in the tender process on an equal footing with IPPs controlled by nationals.[63]

Oil and gas

Oil is the principal fuel used in Israel. Since 1998, the oil sector has been undergoing significant reform and restructuring, aimed at enhancing efficiency, minimising social and environmental costs, and encouraging foreign and domestic investment in the sector. As a result of the reform process, oil purchases are no longer carried out via long-term contracts between the government and oil-producing countries. Now the sector is open to competition and no limits are imposed on the imports of crude oil and refined products. Areas that remain to be

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addressed for reform are restructuring of the infrastructure and the oil-refining sector and the implementation of the Law to Promote Competition in the Filling Stations sector.[64]

The Israel National Oil Company was privatised in 1997, with all of the State's holdings being divested through private sale to Naphta Israel Petroleum Corporation. All the State's holdings in other oil exploration companies have also been sold to private interests. Crude oil refining is carried out by the Oil Refineries Limited, (ORL) a government-controlled monopoly (with 26 per cent private participation) that has been selected for privatisation. ORL operates pursuant to a concession that is in force until October 2003 for the construction, operation and maintenance of installations and ancillary facilities for the refining of mineral oils. In 2000 it was decided to split the company in two before privatising it.[65] This decision is under review.

Oil and Energy Infrastructures Limited is a state-owned company that operates as a monopoly with regards to specific infrastructure areas. It had been operating under a long-term concession that expired in 2001. An agreement between the State and the company was reached subsequently whereby after the expiration of the concession, the company and its subsidiary will continue to operate in storage and fuel pipelining.

The Ministry of National Infrastructures encourages oil exploration by private-sector actors. Preliminary oil exploration requires a permit and drilling requires a licence. When oil is discovered as a result and in commercial quantities, a lease is granted which entitles the grantee to produce and market the oil, although he may be required to sell it locally and is obliged to pay a 12.5 per cent royalty on the oil produced from the leased area. In 1999 five new licences and eight permits were granted for exploration both on and offshore in Israel.[66] Since 2000, four new leases, fifteen new licences and two new permits have been issued.[67]

The 1999-2005 Development Plan for power generation in Israel envisages the introduction of natural gas in 2002. Following the discovery of significant natural gas reserves off the coast in the southern part of Israel, the government plans to replace some of its oil and coal use with natural gas. It enacted the new Natural Gas Law in December 2001, which regulates the transmission and distribution of gas to the final consumer and issued a tender for the construction and operation of the natural gas infrastructure.[68] There are no restrictions on the involvement of foreign investors in this tender process.

Higher education, audio-visual, academic research, religion and sports

Foreign investment is possible in these sectors although there are a few restrictions. They essentially concern preferential conditions for granting state aid in some of these areas. In addition, the state does not contribute to the budget of

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an affiliate or branch of a foreign academic institution of higher education operating in Israel. These measures have been notified by the Israeli authorities as exceptions to the National Treatment instrument (see Annex 2).

Tourism

Tourism, particularly religious tourism, accounts for 3 per cent of Israel's GDP. It has been one of the sectors most affected by the deterioration in regional security since the fourth trimester of 2000 and, most recently, the spill-overs of the September 11 attacks on the United States and the world economic slowdown. Tourism activity is estimated to have halved since September 2000. Room-occupancy rates are at historical lows, which has led to an increase in Israeli tourists as a result of lower hotel prices. Recent estimates by the Federation of Israeli Chambers of Commerce have calculated the cost to the economy at some US$2 billion.

According to the Tourism Services Law of 1976, the Ministry of Tourism is responsible for supervising the tourism sector, encompassing hotels, travel agencies, camping sites, and listed tourist shops. Restaurants[69] are regulated by the Ministry of Industry and Trade, Tour guides are licensed by the Ministry of Tourism and are required to be Israeli residents. An exception is made for foreign clergy guiding their congregation. Only licensed Tourist Guides may be employed by travel agencies to guide their tours.

Foreign investors' involvement in this sector is not insignificant. Foreign investors control some 20 hotels, accounting for nearly 5 per cent of the total number of hotels, with a preference for the luxury and upscale market. The share of total assets owned by foreigners is estimated to be between 20 and 25 per cent of the entire hotel industry.

There are few restrictions on foreign investment in the tourism sector. Ownership of hotels is not restricted to foreign investors but requires the investor company to be registered in Israel. Investors in tourism are eligible for government incentives under the framework of the Encouragement of Capital Investments Law of 1959. An approved investor may choose between a capital incentive package in the form of a grant equivalent to up to 24 per cent of the investments in fixed assets, and tax exemption and tax deduction, or between an enhanced tax-incentive package; the benefits are contingent on the location and the size of the investment [Chapter III(4)(ii)]. Tourism services, for incoming tourists, are one of the few industries exempt from the flat value-added tax of 17 per cent.

National security measures

The Israeli government has reserved the right in all sectors to deny a foreign investment or an activity of an enterprise in which substantial holdings are held by foreigners to operate in Israel if there is evidence that this investment or activity

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would hinder the maintenance of essential public security interests. There are also a number of provisions based on the same considerations that are applicable to specific sectors. The Ministers' Committee for Privatisation may, in exceptional cases, when setting the conditions for a specific privatisation, decide to limit the level of foreign participation on the basis of essential security considerations.

In defence industries, enterprises may not be granted certain defence procurement contracts where overriding security reasons apply, in some cases due to foreign holdings in the enterprise. Defence corporations may be subject to an order restricting the holdings of means of control by foreign investors. The transfer of defence know-how to a corporation under foreign control is subject to prior approval by the Minister of Defence.

In addition, certain key positions (directors, officers and position holders) in the holders of operating licences in certain sectors may be required to be nationals who are residents of Israel, in some cases with security clearance, and are subject to approval requirements. These sectors are: transmission or distribution of electricity or production of a substantial part of electricity, transmission and distribution, natural gas, domestic fixed-line services, radio and mobile telephone services, satellite broadcasting, international communications services, cable broadcasting, television and radio, national airlines and defence industries.

Monopolies and concessions

In addition to national security measures described above, the Israeli authorities have also notified the existence of *de jure* or *de facto* monopolies and concession regimes (see also Annex 2).

Monopolies can be found in the *communications* sector concerning the inland line operator (telephony, transmission, data communications) and ADSL infrastructure (under the supervision of the Ministry of Communications); the transportation sector regarding civil airfields operation (Airport Authority), ports (excluding ports serving the transportation of energy materials, fuel and coal) (Ports and Railways Authority) and railways (Ports and Railways Authority), the *environment* area with respect to the Israel Nature and National Parks Protection Authority and hazardous waste disposal (Ministry of Environment); *land* owned by the Jewish National Fund; water transportation (Ministry of National Infrastructures and Ministry of Finance); and the production and marketing of *dairy products* (Ministry of Agriculture).

Concessions are allocated for *telecommunications*, to commercial television (Channels 2 and 10), public radio channels (the four channels operated by the Israeli Broadcast Authority and the two channels operated by the IDF) and regional commercial radios (Ministry of Communications); international and domestic *transportation* (Ministry of Transportation and the Council of the Second

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Authority for Television and Radio); D*ead Sea minerals exploitation* (Ministry of Finance); *oil* refinery and *oil* pipeline transport (Ministry of National Infrastructures); *gas* transmission and *oil and gas* storage (Ministry of National Infrastructures). The only licence allocated to *electricity* transmission will expire at the end of 2006 (Ministry of National Infrastructures).

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Notes

1. The information provided in this section draws on The State of Israel, Annex D to the State of Israel's Annual Report on Form 18-K to the UNS Securities and Exchange Commission for the Fiscal Year ended 31 December 2000, 13 June 2001.
2. This section draws on the June 2001 State of Israel Report on Government Companies.
3. There were 57 non-commercially-oriented companies, of which 42 were government companies and 5 were mixed companies. There are also non-profit organisations outside the framework of the government companies such as the Association of Residential Culture and the National Center for the Development of the Holy Places.
4. In 1983, against the backdrop of a stock market crisis, the Government entered into an arrangement called the Bank Shares Arrangement. Under the arrangement, the Government bought shares from the banks' shareholders and it gained a controlling share in five of the six largest Israeli banks. The Government intends to sell the State's controlling interest in these banks.
5. Bank of Israel (1998a).
6. IMF, Israel: 2000 Article IV Consultation – staff report (country report No. 01/133), Washington DC, August 2001; available at *www.imf.org*; page 4.
7. Standard & Poor's, Bank Industry Risk Analysis: State of Israel, London, September 2001; available at *www.standardpoors.com*.
8. WTO, Trade Policy Review – Israel, 1999, available at *www.wto.org*
9. Economist Intelligence Unit, Country Report – Israel, Palestinian Territories, London, January 2002.
10. Bank of Israel, March 2002.
11. Economist Intelligence Unit, Country Report – Israel, Palestinian Territories, London, January 2002.
12. USTR, Country Commercial Guide, Israel, 1999, available at *www.ustr.gov*; Bank of Israel, March 2002.
13. Economist Intelligence Unit, Country Report – Israel, Palestinian Territories, London, January 2002.
14. Bank of Israel, March 2002.
15. Bank of Israel, March 2002.
16. Standard & Poor's, Bank Industry Risk Analysis: State of Israel, London, September 2001; available at *www.standardpoors.com*
17. Standard & Poor's, Bank Industry Risk Analysis: State of Israel, London, September 2001; available at *www.standardpoors.com*

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18. Standard & Poor's, Bank Industry Risk Analysis: State of Israel, London, September 2001; available at *www.standardpoors.com*
19. The Financial Services Annex resulted in an enlarged legal framework for the sector, covering the 2nd and 5th protocols to the GATS, the Decision for the adoption of the protocol and the memorandum of understanding on commitments in Financial Services, acceptance of the latter being optional for members.
20. Israel's GATS schedule, GATS/SC/44.
21. *e.g.* payment and money transmission, guarantees and commitments, trading for one's own account or the account of customers, provision and transfer of financial information, advisory, intermediation and other auxiliary services.
22. See Israel's Final List of Article II (MFN) exemptions; GATS/EL/44: "Financial Services – Banking – A licence may be granted to the establishment of foreign service supplier, to the country of origin of which grants Israeli suppliers access to its market in the form of similar commercial presence" and Chapter 6.
23. Economist Intelligence Unit, Country Report – Israel, Palestinian Territories, London, January 2002; Bank of Israel, March 2002.
24. Economist Intelligence Unit, Country Commerce, Israel, 2000.
25. Economist Intelligence Unit, Country Report – Israel, Palestinian Territories, London, January 2002.
26. Bank of Israel, March 2002.
27. Economist Intelligence Unit, Country Commerce, Israel, 2000; Bank of Israel, State of Israel – exhibit D to the State of Israel's Annual Report on Form 18-K to the US Securities and Exchange Commission, December 2000.
28. Bank of Israel, State of Israel – exhibit D to the State of Israel's Annual Report on Form 18-K to the US Securities and Exchange Commission, December 2000; Ministry of Finance, written submission, January 2002.
29. Israel's GATS schedule, GATS/SC/44.
30. Economist Intelligence Unit, Country Commerce, Israel, 2000.
31. Tel Aviv Stock Exchange, February 2002, see *www.tase.co.il*
32. Tel Aviv Stock Exchange, February 2002, see *www.tase.co.il*
33. WTO, Trade Policy Review – Israel, (WT/TPR/58), 1998.
34. Economist Intelligence Unit, C*ountry Profile – Israel*, London, 2001.
35. WTO, Trade Policy Review – Israel, (WT/TPR/58), 1998.
36. As of January 2003 there will no longer by any restrictions upon investments in foreign securities.
37. WTO, Trade Policy Review – Israel, (WT/TPR/58), 1998.
38. Ministry of Finance, written submission, January 2002.
39. Bank of Israel, State of Israel – exhibit D to the State of Israel's Annual Report on Form 18-K to the US Securities and Exchange Commission, December 2000.
40. Bank of Israel, State of Israel – exhibit D to the State of Israel's Annual Report on Form 18-K to the US Securities and Exchange Commission, December 2000.
41. Economist Intelligence Unit, C*ountry Profile – Israel*, London, 2001.
42. WTO, Trade Policy Review- Israel, (WT/TPR/58), 1998.

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43. Ministry of Finance, written submission, January 2002.
44. Ministry of Finance, written submission, January 2002.
45. Economist Intelligence Unit, Country Report – Israel, Palestinian Territories, London, January 2002.
46. State of Israel, Government Companies Authority, Report on the Government Companies 2000, Report No. 40, Jerusalem, June 2001.
47. See Economist Intelligence Unit, Country Report – Israel, Palestinian Territories, London, January 2002.
48. The Ports and Rails Authority operate Israeli ports. The Ministry of Transportation's current policy aims at improving the efficiency of the ports' activity as well as improving their competitiveness.
49. Economist Intelligence Unit, *Country Profile – Israel*, London, 2001.
50. State of Israel, Government Companies Authority, Report on the Government Companies 2000, Report No. 40, Jerusalem, June 2001.
51. Road congestion remains a problem, particularly in areas of high population density as road development has lagged behind the increase in number of vehicles and number of kilometres travelled (Economist Intelligence Unit, Country Profile – Israel, London, 2001). In order to address this, expenditure in transportation infrastructure has been increased in the 2002 budget, despite spending cuts envisaged for all other ministries. Investments in infrastructure are to be increased by NIS 2 billion ($432 million) to over NIS 6 billion ($1.3 billion), with NIS 3.5 billion of this figure earmarked for roads and highways via private financing initiatives (Economist Intelligence Unit, Country Report – Israel, Palestinian Territories, London, January 2002).
52. Mobile customers are almost twice as numerous as telephone line customers.
53. Only five of them are significant however: Internet-Gold, Netvision, Bezeq-International, Golden lines and Barak.
54. Annual sales of the Bezeq Group exceeded US$2 billion in 2000. It also currently employs 11 000 persons. The government hopes to sell 40 per cent of Bezeq (it still holds 54 per cent) for around 1.65-2.2 billion.
55. This is not true for all international operators however. Bezeq International company does not have any such order in its licence.
56. WTO Trade Policy Review of Israel, 1999.
57. Economist Intelligence Unit, Country Profile – Israel, London, 2001.
58. See the web-site of the Israeli Ministry of National Infrastructures: *www.mni.gov.il*
59. International Energy Organisation web site: *www.iea.org*
60. State of Israel, Government Companies Authority, Report on the Government Companies 2000, Jerusalem, June 2001.
61. This was formerly the responsibility of the then Ministry of Energy (now the Ministry of National Infrastructures).
62. State of Israel, Government Companies Authority, Report on the Government Companies 2000, Jerusalem, June 2001.
63. State of Israel, Ministry of National Infrastructures.
64. See the web-site of the Israeli Ministry of National Infrastructures: *www.mni.gov.il*

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65. State of Israel, Government Companies Authority, Report on the Government Companies 2000, Jerusalem, June 2001.
66. See the web-site of the Israeli Ministry of National Infrastructures: *www.mni.gov.il*
67. Update provided by the Israeli Ministry of Industry and Trade.
68. Economist Intelligence Unit, Country Profile – Israel, London, 2001.
69. Excluding Food-Serving Services in hotels, which is under the auspices of the Ministry of Tourism.

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Chapter 5

Investment Incentives and Promotion

Four decades of experience

The offering of generous investment incentives, estimated at over 8 per cent of GDP,[1] has been from early on an integral part of Israel's economic development policy on both a regional and national level and a major component of its FDI policy. These incentives have taken various forms, including grants, tax reductions, infrastructure support and training. Some have been designed for all types of industrial projects, others for specific industries or activities. They are considered to have helped Israel to become a "Silicon Valley" type of technology centre. The Israeli authorities are nevertheless aware that excessive reliance on investment incentives can create vulnerabilities for the economy and that incentives should not become a substitute for broader policies aimed at establishing a sound enabling regulatory environment for investment. They consider that the incentives programme should aim at correcting the market failures encountered by investors and that their duration should not exceed that of the shortcomings for which they have been established. This is the reason why the Israeli incentives programmes have been modified several times and why they continue to be subject to scrutiny, as is shown in the present chapter.[2] All the incentives given by the Ministry of Industry and Trade are on the basis of risk sharing.

Israel's investment incentives are generally made available to foreign investors on conditions "no less favourable" than those applying to domestic investors. However, a non-negligible portion of incentives to foreign investors, in the form of tax breaks authorised by the Investment Centre, has been granted to them on "more favourable" terms than those applied to domestic investors. Zero or corporate tax rates varying between 10 and 25 per cent are not unusual, instead of the Israeli normal corporate tax rate of 36 per cent. There is also the possibility for foreign investors to be exempted from capital gains tax in excess of the rate imposed on them in their home countries. These various incentives, combined with the exemption and tax-sparing clauses in Israeli bilateral tax treaties, are generally considered by various international rating agencies to make up an attractive "basket" of benefits.[3]

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All investors seeking incentives under the Law for the Encouragement of Capital must obtain an "Approved Enterprise" status prior to receiving any type of state aid. The Investment Centre at the Ministry of Industry and Trade grants this status on the basis of criteria essentially determined by the needs of the Israeli economy at the time of the application. LawIn some cases, pre-establishment or pre-registration of enterprises may be required for obtaining state aid. Approval may be withheld in areas considered to be "saturated". Effective public support for private R&D is made available under another major Israeli incentives programme, the Law for the Encouragement of Industrial Research and Development, under the same conditions to domestic and foreign investors.

More recently, direct benefits (namely cash grants) have been scaled down in favour of tax concessions as a result of budgetary pressures. There has also been in some cases local dissatisfaction about the large amounts received by foreign investors.[4] The Israeli incentives programme has, in addition, been criticised for being too complex, inefficient and insufficiently sensitive to the needs of small investors. An important tax reform dealing with the taxation of capital markets, real estate, international transactions and investment was disclosed in mid-summer 2000 but this plan has been set aside, at least for the time being.[5] However, another Bill, amending Israel's 16-year-old legislation on research and development to bring it in line with the "Age of Globalisation" and remove existing impediments to investors, has now been submitted to Parliament.[6] A two-year capital gains tax holiday for foreign investment in Israeli venture capital funds was recently adopted.

The present chapter examines Israel's foreign investment incentives/promotion policy as defined by the above-mentioned two major Israeli investment incentives laws – the Law for Encouragement of Capital Investments and the Law for the Encouragement of Industrial Research and Development – and industry-specific investment programmes. Special economic zones and the activities of Israel's Investment Promotion Centre are also reviewed in some detail.

Encouragement of capital investments

Adopted in 1959, the Law for Encouragement of Capital (hereinafter the "ECIL") was the first legislation to introduce a comprehensive investment incentive programme in Israel. It is currently one of Israel's most important regional economic development instruments. The benefits vary depending on the location and the size of the investment. The Law is administered by the Israeli Investment Centre (IIC) at the Ministry of Industry and Trade.

Beneficiaries of the Law must obtain the status of an "approved" enterprise. To receive such a status a company must finance at least 30 per cent of the approved project with capital equity paid in cash. In addition, the project must consist exclusively of fixed assets (such as new equipment and buildings). The

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Table 12. **Investment grants**

	Priority area "A"*	Priority area "B"
Industrial projects (up to 140 million Shekels)	24%	10%
Industrial projects (above 140 million Shekels)	20%	10%
Investments in hotels and other accommodation	24%	10%
Other tourist enterprises	15%	–

* Approved enterprises in priority area A enjoy full tax exemption for the first two years. It should be noted that until the end of 2002 approved projects set up in the northern border towns are entitled to an extra 6 per cent grant over and above Area "A" grants. Furthermore, an additional grant of up to 10 per cent may be available to certain industries in the Negev region and southwards.

Source: *The Israeli Economy at a Glance* 2001, Ministry of Industry and Trade.

investment must be completed within two years of the grant's approval with a possibility of extension of up to five years and at least 40 per cent of the work must be completed within two years. Although foreign investors do not need to benefit from an "approved" enterprise status to invest in Israel, for all practical purpose, most of them do. Of the total approved ECIL programmes 42.2 per cent have had foreign investment involvement and 48 per cent of the sums disbursed have benefited projects with foreign participation. Most of these investments have been made in the electronics and software sector.

The Law provides for two mutually exclusive benefit paths: *a*) the *grant path* and *b*) the *company tax exemption path*. Under the *grant path*, a company opts to receive 1) an investment grant, which is a specified percentage of the company's investment in eligible fixed assets and which varies based on the geographical zone in which the enterprise is located; 2) tax benefits in the form of reduced tax rates and a full tax exemption for the first two years in certain circumstances; and 3) accelerated depreciation on eligible buildings and equipment for the first five years. (See Table 12.)

If the C*ompany tax exemption path* is chosen, the company will receive 1) Zone A – 10-year tax exemption regardless of ownership; 2) Zone B – 6 years of tax exemption and 4 additional years of tax benefits if foreign-owned or 6 years of tax exemption and 1 additional year of tax benefits if domestically-owned; or 3) Zone C – 2 years of tax exemption and 8 additional years of tax benefits if foreign-owned or 2 years of tax exemption and 5 additional years of tax benefits if domestically-owned. The level of benefits for Zones B and C therefore increases with the level of foreign ownership. Tables 13 and 14 illustrate the rates of taxation applicable to foreign investors.[7]

In addition to the tax benefits provided by the ECIL, the Finance Minister has discretionary authority to order partial or full tax refunds to a foreign resident, if the amount of tax paid is greater than the tax credit granted in the foreign resident's home

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Table 13. **Tax holidays**

	Local ownership	Foreign ownership
Priority Area "A"	10 years	10 years
Priority Area "B"	6 years + 1 year benefits	6 years + 4 years benefits
Other Area (Central Israel)	2 years + 5 years benefits	2 years + 8 years benefits

Source: *The Israeli Economy at a Glance* 2001, Ministry of Industry and Trade.

Table 14. **Rates of taxation applicable to approved foreign investors, August 2001**

	Percentage of foreign ownership			
	0-49 (local investor)	49-74	74-90	90-100
Company tax rate	25	20	15	10
Income tax	0	0	0	0
Dividend tax (15% of balance)	11.25	12	12.75	13.5
Total effective tax on distributed income	36.25	32	27.75	23.5

Note: The tax benefits for an "approved" enterprise are granted over a period of seven consecutive years, starting in the first year that the company earned taxable income, provided that 14 years have not passed since the enterprise began operating or 12 years from approval, whichever is earlier.
Source: Ministry of Industry and Trade (August 2001): The Investment Centre (IIC), *Benefits for the Foreign Investor in Israel*.

country on income originating in Israel. The Finance Minister sometimes uses this authority to lower the rate of tax imposed upon capital gains resulting from the realisation of an investment but the resulting Israeli tax rate will usually be at least 25 per cent.

In the case of foreign-based capital funds dedicated to investing in Israeli companies, a 20 per cent tax rate is sometimes obtainable for foreign resident investors of such funds. No further tax is payable at the fund level. An additional exemption has sometimes been granted to investors in such funds if they are tax exempt institutions in their home country (pensions funds) provided the country has a tax treaty with Israel.[8]

Applications are filed in an official form with the Investment Centre. It must be accompanied by a covering letter specifying which benefits programme the investor has chosen, in addition to a detailed feasibility study. The approval process involves an evaluation of economic viability by the Industrial Development Bank of Israel and the appropriate professional division within the Ministry of Industry and Trade. Considerations include the ability to compete in international markets, use of state-of-the-art technology, creation of employment opportunities, high-value-added production and other needs of Israel's economy. Incentives may be withdrawn or reduced if an enterprise does not comply with the conditions of approval.[9]

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A Director and a Board, who possess discretionary powers to grant approval to proposed enterprises, supervise the Investment Centre. Such powers are subject to periodic renewal. The approval process for state aid may take up to between 3 to 6 months. Appeals are made to a special Appeals Committee, composed of five representatives of the public. The Appeals Committee makes a recommendation and submits it to the Ministers of Industry and Trade and Finance for their joint decision. Decisions are normally rendered in 60 days.[10]

The Investment Centre publishes annual reports of its activities. Rough estimates put average subsidisation embodied in the grant path around 20 per cent. According to State Revenues department of the Ministry of Finance tax benefits approached US$300 million in 1997. Since the early 1990s, "approved" investments entitled to capital subsidies accounted for some 31 per cent of total Israeli industrial investments. There are very few studies of the effects of capital subsidisation on the Israeli industry. A study published in 1998 suggests, however, that the Israeli policy may have resulted in production inefficiencies and that such subsidisation may not have been all that necessary. This study did not take into account other potential benefits such as its effects on output and employment growth.[11]

Encouragement of industrial research and development

The Office of the Chief Scientist (OCS), located in the Ministry of Industry and Trade is responsible for implementing government policy regarding the support and encouragement of industrial research and development in Israel. The OCS offers a variety of support programmes that operate on a yearly budget of US$400 million. All the OCS programmes are on a risk-sharing basis. They operate also on a competitive basis, selecting only those projects that merit support on the basis of a ranking system. Foreign-owned companies established in Israel can fully participate in the programme, provided they conduct their research and development within Israel.

The Law for the Encouragement of Industrial Research and Development

While the government's special interest in industrial R&D dates back to the late 1960s, it is the Law for the Encouragement of Industrial Research and Development which has set the parameters of government support in this area since its adoption in 1984. The OCS has been responsible for the administration of the Law. The stated goals of the legislation, which has gone through various amendments, are to develop technology-based and world market-orientated industries, which will promote employment and improve the balance of payments. This is accomplished by sharing with the private sector the financial risks inherent in the development of new products or processes and promoting international co-operation in this field.

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Under the Law, every company registered in Israel – whether big or small – is entitled to receive matching funds up to 50 per cent of its R&D expenses, and up to 66 per cent for start-ups, provided that they are aimed at the discovery of new knowledge, the development of new products or processes, or the substantial improvement of existing products or processes. The approval criteria for new product development includes evaluation of innovation in the development of new technologies; management, production and marketing capabilities of firms, and potential to compete in international markets and gain significant market share.

Grants are disbursed upon the recommendation of the Research Committee of the OCS. The grantees are obliged to: *a*) pay royalties in the case of sales at the rate of 3-5 per cent of the yearly income derived from the project; and *b*) obtain permission before the transfer of manufacturing rights to a third party in Israel or abroad.

The government budget allocation to OCS R&D support in 2000 was around US$439 million, including about US$140 million in royalties. The programme for the Development of New Innovative Products obtained 77 per cent (US$341 million) of the total.

The OCS also supports and administers a wide range of additional programmes, the main ones being *i*) "Magnet" (US$67 million), *ii*) the technological incubators (US$31million) and *iii*) bilateral and multilateral international R&D co-operation programmes. These are described below.

Development of future generic technologies – "Magnet"

Magnet is a programme to encourage pre-competitive generic research by consortia of industrial companies working in co-operation with research institutes. Its purpose is the development of new technologies on which future products could be based. The programme entitles a multi-year R&D support (3 to 5 years) consisting of 66 per cent of the approved R&D budget. There is no obligation to repay the royalties.

A consortium applicant must be comprised of the widest possible group of industrial members operating in a given field together and associate at least one Israeli academic institution doing research in scientific areas relevant to the technological goals of the consortium. To avoid conflict with anti-trust rules, the applicant must pledge not to make the products or services resulting from the joint project available to any interested local party at prices that involve the exercise of monopoly power.

The Magnet programme does not become involved in the commercialisation stage of the products. Like other OCS support programs, it also operates on a competitive basis, which selects only those consortia that merit support on the basis of a ranking system.

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By the end of 2000,[12] there were 18 consortia in operation. These consortia span a wide range of technologies, primarily in communications, microelectronics, biotechnology and energy.

Technological incubators

The objective of the Technological Incubator is to provide a framework and support for nascent companies to develop their innovative technological ideas and form new business ventures that can attract private investors.

The programme was introduced in the early 1990s to exploit the valuable human capital in the large wave of immigrants from the former Soviet Union. The underlying idea is that the technological incubator can significantly enhance the entrepreneur's prospects of raising capital, finding strategic partners and emerging as a viable business.

The programme provides 85 per cent of approved R&D expenses of US$175 000 per year for up to two years to an entrepreneurial team, with the remainder to be raised either by the entrepreneurs themselves or from outside investors. At the conclusion of the two-year period the company may apply to the OCS for further support for R&D grants.

Each incubator is structured so as to handle 10-15 projects simultaneously and provide assistance in determining the technological and marketing applicability of the idea, drawing up an R&D plan and organising the R&D team, raising capital and preparing for marketing, provisions of secretarial and administrative services, maintenance of procurements, accounting and legal advice. As with the regular OCS programmes, the ensuing products have to be manufactured in Israel and if successful, the entrepreneur has to eventually repay the grant through royalties on sales.

The following table provides a breakdown of the grant levels attributed under various OCS programmes as a percentage of the approved budget:

Table 15. **Grant levels as a share of approved budget**

Scope of the project	Share of approved budget
Development of a new product	Up to 50%
Improvement of an existing product	Up to 30%
Project of a start-up company	Up to 66%
Magnet	Up to 66%
Incubators	Up to 85%

Source: *The Israeli Economy at a Glance* 2001, Ministry of Industry and Trade.

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International Co-operation

The conclusion of co-operation agreements with technologically-advanced foreign countries has also been a special (and innovative) feature of Israel's economic diplomacy in recent years. The objective has been to encourage contacts between Israeli and foreign companies leading to joint R&D, manufacturing and marketing. Despite their achievements, particularly in R&D, Israeli firms are disadvantaged by their relative small size and the geographic distance from target markets. Three main mechanisms promote such co-operation, namely *the* R&D *Foundations, the* Bi-N*ational Agreements and the* Fi*fth* R&D F*ramework* P*rogramme of the* E*uropean* U*nion*.

R&D F*oundations* provide funds to identify potential partners for joint projects and award up to 50 per cent of the R&D budgets of the partners involved in the selected projects. If a project succeeds, the Foundation receives royalties – a pre-tax expense to the payer – up to a maximum of 150 per cent of the conditional grant. If not, the companies are exempted from repaying the grants. As indicated in Table 16, Israel has concluded five operational R&D Foundation agreements, namely with the United States, Canada and Singapore.

The B*i*-N*ational* R&D A*greements* also enable Israeli companies to enter into joint R&D projects with companies from technologically-advanced countries signatory to these agreements. In contrast to Bi-National Foundations, however, the project support under this programme must come from parallel funding organisations in the two countries. The implementation of these agreements falls under the responsibility of the Chief Scientist. So far, Israel has concluded bi-lateral R&D co-operation agreements with fourteen countries: Austria; Belgium; Finland;

Table 16. **Foundations in R&D operating in Israel**

Foundation	Countries	Fund size	Established
BIRDF	Israel – United States	Endowment Fund of 110 M US$	1977
CIIRDF	Canada – Israel	CAN$ 10 M Each country contributes 1 000 000 CDN per year for 5 years	1994
SIIRDF	Singapore – Israel	US$6 M for 3 years Grants can reach a ceiling of US$750 000 and not more than US$500 000 in 1 year. Duration of the project is limited to a maximum of 3 years.	1997
BRITECH	Britain – Israel	Endowment of £15.5 million – grants are up to 50% and up to £450k for 3 years.	1999
KORIL	Korea – Israel	$2 million fund. Grants are up to 50%	

Source: *The Israeli Economy at a Glance* 2001, Ministry of Industry and Trade.

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France; Germany; the Netherlands; Ireland; Italy; Portugal; Spain; Sweden; China; Hong Kong, China and India.

Israel is a participant in the *Fifth R&D Framework Programme of the European Union* as an "Associated" State. The programme enables Israeli companies (including universities and public research institutes) to participate jointly, with European partners, in various projects of the programme and to benefit from grants.[13] Foreign-owned companies established in Israel can fully participate in the programme, provided they conduct their research and development within Israel. In addition, Israel is a full participating member (and the only such non-European country) of EUREKA, the pan-European network for the encouragement of co-operative R&D. The network consists of companies from the European Union countries as well as from other nations in Europe. It provides assistance in the location of suitable partners for any given project. Approved programmes may benefit from national funding programmes.

The impact of OCS programmes on the rise of the high-tech sector[14]

Since 1998, national expenditure on civilian R&D has increased by an average of 12 per cent at constant prices. The high-tech component of R&D is relatively high: expenditures on R&D in computer and related activities reached 31 per cent of the total national expenditure on civilian R&D in 2000.[15]

The general view is that the OCS has played a key role in the emergence and development of the Israeli high-tech sector. The positive impact of R&D expenditures on productivity at the firm level is well documented in the economic literature. There is also statistical evidence in Israel that the US$400 million in subsidies (3.6 per cent of GDP) disbursed by the OCS has actually increased the level of R&D conducted by Israeli firms by a significant amount.[16] OCS-funded R&D has also apparently been significantly more productive than privately-financed R&D, irrespective of the "additionality" effect because of OCS's ability to "pick up winners" and/or because the process of application has forced companies to select better projects. An internal OCS study completed in 1999 also identified significant multiplier effects on sales and exports, particularly for smaller firms.[17]

Although the presumption is strong that OCS has been one of the main drivers behind the rise in the high-tech sector, Trajtenberg (2000) has identified the following other positive effects on the development of the Israeli high-tech sector.

- In the manufacturing sector, "advanced industries" such as electronics and electrical industries outperformed the mixed sectors such as construction-related industries and the traditional ones – textiles and apparel in terms of growth, labour productivity, capital stocks and exports – with a particularly high performance in growth and exports (Table 17).

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Table 17. **Performance indicators by type of sector**

Annualised rates of change, 1995-1998

Indicator	Period	Sector		
		Advanced	Mixed	Traditional
Production	1995-96	8.0	6.3	5.9
	1997-98	6.0	0.3	–1.8
Labour Productivity	1995-96	3.5	2.4	4.2
	1997-98	4.5	0.6	2.2
Capital Stock	1995-96	10.7	6.4	9.7
	1997-98	10.0	6.1	6.8
Exports	1995-96	9.0	10.5	2.7
	1997-98	18.5	3.0	–1.4

Source: Bank of Israel, Annual Report for 1998, tables B 10 (page 56).

- Using the number of Israeli patents issued in the United States as a yardstick, the growth in the annual number of Israeli patents has been quite impressive. With a lag of 2-3 years, a close correlation can be observed between industrial R&D (itself promoted by OCS) and the issuance of patents.
- During the 1970-1997 period, Israel has moved up in terms of patents per capita in the forefront of technologically-advanced countries – closely behind the United States and Japan – and the Asian tigers – ahead of Hong Kong, China and Singapore.
- The percentage of patents that belong to Israeli corporations has been rising steadily and stands now at close to 50 per cent.

Despite these achievements, Trajtenberg (2000) has also identified a number of shortcomings in Israel's R&D policy. The "demand" for R&D support seems to exceed largely the government-allocated budget. The growth of OCS resources has not followed that of the high-tech sector. It may be desirable to replace the present system based on the principle of neutrality by a ranking system similar to that found in the MAGNET programme. Some promising sectors such as biotechnology may deserve greater budgetary allocations. There may also be room for reducing the rate of support to large firms in favour of smaller companies. In view of the shortages of highly skilled personnel in cutting-edge technologies, the government may need to shift the focus of its present policy away from subsidisation of R&D – which stimulates further the high demand for scientists and engineers – to programmes that would directly encourage the supply of newly trained qualified manpower.[18] Finally, the royalty system presents a number of shortcomings.

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A Bill amending Israel's 16-year-old legislation on research and development (R&D) has recently been submitted to the Parliament. The Bill, approved by the government in July 2001, will allow multinational companies with an Israeli base to benefit from state support for R&D, even if they locate some of their manufacturing facilities abroad. At the same time, it could scale down the possible level of state support for R&D ventures from 20 to 50 per cent of R&D. Various other alterations which take into account changes in technology since the Law was first introduced in 1985 have also been included in the Bill.[19]

Industry-specific incentives

Israel provides in addition special advantages for investment in certain sectors or activities. These include investment in real estate assets, tourism projects – and film production companies if foreign-currency revenues account for at least 30 per cent of total revenues or if the foreign-investment portion of the project is at least 70 per cent. Oil exploration is also subject to a special regime. These advantages may range from tax holidays, reduced tax rates on distributed and undistributed income, reduced withholding tax on dividends, tax reduction on income from additional investment and accelerated depreciation.

Special economic zones[20]

With the objective of promoting production, the Government of Israel has established a free-trade zone in Eilat, a free-port area in Eilat, and free-processing zones (none in existence as of February 2002). Companies established within one of these areas enjoy a wide range of tax concessions and, for the free-trade zone in Eilat, a refund of a part of the wages paid to the employees.

Free-trade zones

The purpose of the Eilat Free Trade Zone Law of 1985 is to encourage the development of the city of Eilat. The Law provides for several tax concessions and other benefits. Most products (imported or domestically produced) purchased in Eilat are exempt from value-added tax. This tax benefit is available to Eilat residents and companies, for products consumed in Eilat. Employers receive refunds for employees of up to 20 per cent of gross wages paid to employees. Resident individuals receive tax credits of up to 10 per cent of their taxable income from employment in Eilat.

Free-port zones

The Free-Port Zone Law of 1969 establishes the framework of operations and practices of the free ports in Israel. Currently, there is one port operating in

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accordance with the Law (Port of Eilat).[21] Enterprises operating in this port qualify for incentives including, *inter alia*: *i*) exemption from income tax for seven years, and thereafter to a maximum tax rate of 30 per cent; *ii*) a tax of 15 per cent (compared with the usual tax rate of 36 per cent) on dividends paid out of the above income with no stipulated time limit; *iii*) no capital gains tax on inflationary gains, and no capital gains tax to foreign shareholders on selling their share in the enterprise, when the shares are purchased in foreign currency; and *iv*) exemption from property tax.

Free-processing zones

In 1994 the Israeli Parliament passed legislation authorising the creation of free-processing zones (FPZs) (the Free Export-Processing Zone Law of 1994). Companies operating in the zones are exempt from direct taxation for twenty years, and imported inputs are not subject to import duties or most licensing requirements in effect in Israel, regardless of whether the processing is for the domestic or the export market. Such companies are also exempt from collective bargaining and minimum wage requirements, although arrangements regarding working hours, annual leave and severance pay require ministerial approval. As of February 2002, there were no FPZs in operation.

Qualifying Industrial Zone (QIZ)

In order to foster economic co-operation with Jordan and attract investment, in March 1998 Israel and Jordan in collaboration with the United States designated Irbid as the first Qualifying Industrial Zone (QIZ). The Irbid Zone, which is located on the Jordanian side of the border between Israel and Jordan, entitles products originating in the zone, duty- and quota-free access to the United States market. In 1999, four additional QIZs were established and an additional 5 in 2000. The granting of duty-free access through the QIZ, is a unilateral act of the United States and does not require reciprocity or trade concessions from Jordan.

The Jordanian-Israeli Agreement establishes that a product produced in a QIZ zone must reflect "substantial economic co-operation" between the two countries. This can be done in two ways: at least 35 per cent of the value must be shared by Jordanians and Israelis. Of the 35 per cent minimum content, at least 11.7 per cent must be provided by the manufacturer located within the QIZ. A minimum of 8 per cent must be provided by Israeli manufacturers, and the remainder may be provided by Jordan, the United States, the Palestinians or Israel. Alternatively, both the Jordanian and the Israeli manufacturers must each contribute at least 20 per cent of the total production inputs.

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The Investment Information-Promotion Centre[22]

In addition to its various investment incentives schemes, Israel has put in place an Investment Information-Promotion Centre located in the Israeli Ministry of Industry and Trade whose role is to provide a full-service customised "first stop shop" for foreign-based companies interested in investigating direct investment opportunities and joint ventures in Israel. The main activities of this "marketing agency" of Israel are arranging business visits to Israel, providing prospective foreign investors with briefing material about their sectors of interest, identifying potential strategic partners and establishing contacts with relevant authorities. The Promotion Centre also conducts public relations to promote Israel as an investment location by organising seminars and conventions for foreign business people, keeping active channels of communication with the foreign media and maintaining an Internet site catering for domestic and international community interest in expanding business ties with Israel. The Promotion Centre plays an independent and complementary role to the incentive-oriented activities of the Investment Centre.

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Table 18. **Key features of the Israeli state aid programmes, January 2002**

	Scheme	Eligibility	Incentives	Direct cost
1.	Regional aid programme (Capital Investment Law of 1959)	Manufacturing and tourism	– Grant up to 24% of investment cost, tax exemption up to two years, tax deduction up to five years or tax exemption up to ten years or – Enhanced tax incentive package	Direct cost of NIS 1 453 million in 2001 NIS 1 362 million in 2000 NIS 1 133 million in 1998 NIS 1 240 million in 1994
2.	Structural adjustment fund programme	Companies affected by unilateral trade liberalisation	– Grant up to 20% of investment cost – Information advisory services	NIS 4.1 million in 2001 NIS 5.2 million in 2000 NIS 1.57 million in 1998 NIS 6.01million in 1994
3.	Research and development programme			
	a. Main programme	R&D-oriented projects in all sectors	– Grant of 30-66% (standard of 50%) of the cost	NIS 1 327 million in 2001 NIS 1 017 million in 2000 NIS 1 140 million in 1998 NIS 793 million in 1994
	b. Joint ventures between entrepreneurs and established business entities	Entrepreneurs in need of experienced companies[1]	– Grant of 66% of approved R&D expenditures (maximum US$300 000) per year up to two years	Included in *a*) above
	c. Generic technologies (Magnet programme)	Advanced generic technology projects	– Grant of 66-80% of approved R&D expenditures	NIS 304 million in 2001 NIS 245 million in 2000 NIS 227 million in 1998 NIS 31 million in 1994
	d. Incubators programme	Start-up companies (focus on scientist and inventors among new immigrants)	– Grant of 85% of approved R&D expenditures (maximum NIS 560 000) per year up to two years	NIS 126 million in 2001 NIS 107 million in 2000 NIS 112 million in 1998 NIS 85 million in 1994
	e. Beta sites (*) *Note* : this programme cancelled as of Jan. 2002	Companies ready to establish beta sites	– Grant of 50% (30%) of approved expenditures to companies with a turnover of up to US$6 (US$30) million for the previous three years; maximum budget is US$600 000	NIS 21 million in 2001 NIS 15 million in 2000 NIS 15 million in 1998 NIS 9 million in 1994
	f. Feasibility studies	Feasibility studies	– Grant of up to 50% of a maximum budget of US$25 000 for market feasibility studies and US$30 00 for survey involving more than two continents	Included in *a*) above

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Table 18. **Key features of the Israeli state aid programmes, January 2002** (*cont.*)

	Scheme	Eligibility	Incentives	Direct cost
	g. Bi-national industrial research	Joint ventures between Israel and several countries[2]	– Grant of generally 50% over three years	Included in *a*) above
	h. The EU's Fifth Framework Programme	Co-operative projects with EU member countries	– Grant normally 50% of project cost (larger subsidies available for small or medium-sized enterprises)	Data on membership payment not available
	i. Eureka	Cross-border co-operation in advanced technological projects	– Assistance to firms and research institutes to find methods for collaboration in high-technology, market oriented co-operative R&D ventures	NIS 153 million in 2001 NIS 173 million in 2000 Not budgeted
	j. US-Israel Science and Technology Commission:			
	– joint venture programme for high risk technology joint ventures between US and Israeli companies	High risk technology projects	Not available	No longer budgeted US$3 million in 1997
	– impediments reduction and infrastructure building programme	Infrastructure building activities	Not available	No longer budgeted US$0.4 million in 1998 US$0.1 million in 1994
4.	Tax concessions [Encouragement of Industry (Taxes) Law of 1969]	Not available	– Amortisation of patents and know-how at 12.5% per year – Expenses for the registration and issue of shares on a stock exchange are tax deductible over three years – A group of industrial companies may file a consolidated tax return – No tax paid on income derived as a result of a merger; mergers are also exempted from land appreciation tax, and transfer fee, registration fee, capital fee and stamp fee	No direct cost

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Table 18. **Key features of the Israeli state aid programmes, January 2002** (*cont.*)

	Scheme	Eligibility	Incentives	Direct cost
5.	Capital intensive investments [Encouragement of Investments (Capital Intensive Companies) Law of 1990]	Company of paid-up capital of no less than US$30 million[3]	– Real capital gains from the sale of shares of fixed assets (including real estates) which were used in qualifying activities are taxed at 25% – Revenue income of company derived from these activities is taxed at 25% – Revenue income which the company derives from dividends paid from a "qualified investment" is taxed at 15%	No direct cost
6.	Small and medium-sized companies (Small Business Authority)	Business with up to 100 employees and an annual turnover of US$50 million	– Professional guidance and assistance	NIS 26.6 million in 2001 NIS 16.8 million in 2000 NIS 12 million in 1998
7.	Employment and training programme			
	a. Business tutorial	Small and medium-sized businesses (up to 100 employees) in disadvantaged areas	– Grants of up to 75% of the expenses of tutorial programme for 6-12 months	NIS 27 million in 2001 NIS 14 million in 2000 NIS 16.5 million in 1998 NIS 13.2 million in 1994
	b. Advanced managerial systems	Medium-sized manufactures	– Grants of up to 50% of the consultancy fee, up to a ceiling of 400 hours of consultancy	Not available 2001/2000 NIS 2 million in 1998 NIS 0.4 million in 1994
	c. On the job training of new employees	Employers hiring employees	– Grants of up to NIS 1 700 per employee in disadvantaged areas[4]	Not available
	d. Re-training of unemployed graduates	Unemployed university graduates	– Grants of up to NIS 2 600 per employee for up to six months	Not available
	e. Newly released soldiers	Newly released soldiers who work in high demand jobs	– Grants of NIS 7687 per employee (January 2001)[5] – Grants of NIS 7004 per employee (January 2000) – Grants of NIS 6,603 per employee (January 1998)[6]	NIS 110 million in 2001 NIS 121 million in 2000 NIS 120 million in 1998 NIS 50 million in 1994

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Table 18. **Key features of the Israeli state aid programmes, January 2002** (*cont.*)

	Scheme	Eligibility	Incentives	Direct cost
8.	Environment *Note*: this programme is no longer budgeted	Investment aimed at the reduction of environmental hazards at existing industrial plants	– Grants of up to 35% of the cost of the approved investments for the new installation (but not more than NIS 1.125 million)	NIS 28 million until 1998
9.	Income Tax Law (Adjustments for Inflation) of 1985	Not available	Not available	No direct cost

1. With an accumulated turnover of at least US$5 million over the last three years and/or holding companies with a portfolio in excess of US$12 million.
2. Israel has research agreements with Canada, France, India, Netherlands, Portugal, Singapore, Spain and the United States, while funds with the United Kingdom and Korea have been established during 1999; the principal being the Israel-United States Bilateral Industrial Research and Development Fund (BIRD).
3. Share ownership restricted to non-residents, and the aim is either to conduct business in Israel in areas of activity that have been designated as "qualified activities" or invest in Israeli companies whose primary activities are qualifying activities.
4. An additional NIS 850 for new employees who are new immigrants, women, or above the age of 45.
5. Article 8.2 (c)(ii) of the WTO Agreement on Subsidies and Countervailing Measures stipulates that assistance is limited to 20 per cent of the cost of adaptation.
6. The grant is determined as half of the unemployment payment (s)he would have received if working for the average wage in the market.

NB. The exchange rate (of the NIS against the US$ has changed since 1998.

Note: Estimates on foreign revenue associated with the programmes are not available.

Source: WTO Secretariat, based and updated on information provided by the Israeli authorities.

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Notes

1. This figure dates back to 1996 and may need to be updated. See WTO Trade Policy Review, 1999.
2. A typical example of this policy is the creation of the government venture capital fund Yozma in the early 1990s. Yozma has since been privatised as it was considered to have fulfilled its initial objectives. In fact, exit provisions were included in the original articles of association of the Fund.
3. According to a recent study by Ernst and Young, the overall tax burden on an individual United States investor in Israel – Israel's major economic partner – can turn out to be in several instances less than the tax burden on investments within the United States. See Kost, Forer and Gabbay, Ernst and Young International, Incentives or Investment in Israel.
4. The Economist reports that in 1996 the cost of the subsidy to the United States microchip producer cost the government $608 million. See Country Commerce, Israel, October 2000, page 15.
5. For a comprehensive overview see Kost, Forer and Gabbay, Ernst and Young International, Incentives or Investment in Israel.
6. See New Year's Message of Chief Scientist Carmel Vernia, *www.moit.gov.il*
7. Boundaries of the National Priority Regions (also known as Development Regions) are determined by the Ministers, with the authorisation of the Knesset Finance Committee. These Regions are determined for the purpose of encouraging investment in industry as separate from those regions designated for the encouragement of investments in the tourism industry. Region A includes Upper Galilee, the Golan Heights, the Jordan Valley, the Bet Shean Valley and the Southern Negev and also a number of industrial regions in Lower Galilee, Yoqneam, Carmiel, Afula and Atarot (near Jerusalem). Some of these geographical regions or towns are defined as "temporary" National Priority Regions, a status which is extended periodically. Jerusalem is considered as Region A with respect to science and technology-based or skill-intensive enterprises. Region B includes Lower Galilee and the Northern Negev, as well as Or Akiva and Ashkelon.
8. The following additional advantages may be noted. Interest on loans from a recognised financial institution abroad that finances projects in Israel's macroeconomic interest may be granted a withholding tax rate of 15 per cent on interest exceeding the LIBOR rate on the date of payment. In other cases, lenders who can prove that they receive financing abroad for the purpose of granting the loan, may request (or be required) to pay tax only on the interest profit margin at the regular company tax rate of 36 per cent, *i.e.* on the difference between loan interest received and the cost of financing the loan. Income received by a foreign resident from dividends or interest on debentures (with a

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12 year term or more) or on securities traded on the Tel-Aviv stock exchange will be exempt from taxation if the foreign resident receives no tax credit in his home country for taxes paid in Israel. Interest received by foreign residents on non-residents' foreign currency bank deposits at a bank in Israel is tax exempt, if the foreign resident does not have a business in Israel.

9. See Country Commerce Israel, The Economist Intelligence Unit, October 2000.
10. See Kost, Forer and Gabbay, Ernst and Young International, Incentives or Investment in Israel.
11. In the sense that subsidised firms have generally earned higher rates of return on their total physical capital (including the portion which was subsidised) than firms that were not subsidised. See Arie Bregman, Melvyn Fuss, and Hail Regev, "The Effects of Capital Subsidisation on Israeli Industry", Working Paper Number UT-ECIPA-FUSS-98-01, Department of Economics and Institute for Policy Analysis, University of Toronto.
12. See Manuel Trajtenberg, R&D Policy in Israel, An Overview and Reassessment, NBER Working Paper Series 7930, October 2000.
13. Discussions are currently being held in the European Union on the establishment of the Sixth Framework Programme (starting in 2003). The Programme's projected framework consists of a total budget of 17.5 billion euros.
14. See Trajtenberg. It should be kept in mind however that the statistics used in this study do not always correspond to OCS classifications.
15. State of Israel, Central Bureau of Statistics, National Expenditure on Civilian Research and Development 1989-2000, Publication No. 1167, Jerusalem, October 2001.
16. A recent survey by Feldman and Kelley (2000) has found *prima facie* evidence of "additionality" between beneficiaries of OCS subsidies and a control group that did not. Another study by Lach (2000) has found that OCS programmes stimulated long-run company-financed R&D expenditures by some 41 per cent. Griliches and Regev (1999) came to the conclusion that government-funded R&D appears to be significantly more productive than privately-financed R&D irrespective of an "additionality" effect. An internal OCS study commissioned by the OCS itself examined the contribution of OCS grants to sales, exports and other variables relying on detailed data from the OCS and on an extensive survey of firms. See Trajtenberg.
17. In his New Year's Message letter for 2002, Chief Scientist Carmel Vernia reiterates that the spill-over effects on the economy justify the government's continued support and encouragement of R&D.
18. See also Roomer 2000.
19. In his annual statement earlier this year, Carmel Vernia also points to a number of recent procedural improvements. He mentions the new requirement that all proposals from any given company be submitted at one time and for budgets in excess of $5 million, at a predetermined date. He also refers to an update of the procedures for grant applications.
20. This section is extracted from The 1999 WTO Trade Policy Review of Israel, Report by the Secretariat, WT/TPR/S/58.
21. This status was terminated for the ports of Haifa in 1996 and Ashdod in 1997.
22. This section is based on The Israeli Economy at a Glance, Ministry of Industry and Trade of Israel, 2001.

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Chapter 6

International Relations

An active economic diplomacy

Israel is party to several international agreements, which commit the economy to open trade in goods and services and open capital accounts. Israel is a founding member of the WTO (1995), and was a member of its predecessor, the GATT, from 1962. It adhered to the IMF (1954) and was granted Article VIII status in 1998. It has been a member of WIPO and its various agreements since 1970.[1, 2]

Israel has also concluded a network of free trade agreements with its two major trading partners, the EU (1976, 1995) and the United States (1985), as well as with the European Free Trade Association (1993), Canada (1997), the Czech Republic (1997), the Slovak Republic (1997), Turkey (1997), Hungary (1998), Poland (1998), Slovenia (1998), Mexico (2000), Romania (2001), and Bulgaria (2002), which together secure market access for over 70 per cent of its commerce. Israel and Jordan concluded a preferential trade agreement in 1995. Economic relations with Palestine are governed by the 1995 Interim Framework Accord providing for the free movement of goods between Israel and the Palestinian Authority under one external customs envelope. In November 1995, Israel concluded an Association Agreement with the EU.

Israel's adherence to these economic agreements has served to anchor domestic reforms into long-term international legally binding commitments and help it overcome a difficult regional economic environment. International investment has not escaped this logic. Since the early 1980s, Israel has entered into some 35 Agreements for the Promotion and Protection of Investments[3] and some 34 Agreements for the Avoidance of Double Taxation largely based on OECD models. Parties to these agreements do not only include Israel's major economic partners or sources of inward investment but also a wide range of non-OECD countries from Northern and Central Europe, former Soviet Union, Latin America, Asia and even Africa, where Israel has started to invest. Israel's principal international commitments in the matter of FDI also derive from the United States and EU Agreements, the 1995 WTO Agreements, adherence to major investment dispute settlement mechanisms of ICSID (1983) and UNCITRAL (1966), and membership of MIGA (1988). They can be seen as part of, intertwined with, or reinforced by, an

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elaborated network of interactive trade, economic or more specialised agreements (see Table at the end of this chapter).

The remainder of this chapter examines the nature and extent of Israel's commitments toward foreign investment as defined by bilateral investment treaties (BITs), bilateral trade or economic agreements and the WTO Agreements. Co-operation on R&D agreements was examined in Chapter 6.

Bilateral investment treaties

Israel has concluded bilateral investment treaties (BITs) with 32 countries; 21 of them have already entered into force; 11 other treaties are awaiting ratification.

Table 19. **Bilateral investment and economic treaties: a comparison with FDI flows**

OECD countries	BIT	Other agreement covering FDI issues	FDI from OECD countries to Israel (outflows in US$ million) 1999	FDI from Israel to OECD (inflows in US$ million) 1999
Australia			...	...
Austria		EU agr	1.07	–2.13
Belgium-Luxembourg		EU agr	23.24	30.03
Canada		FTA	...	...
Czech Republic	1997/99		...	23.73
Denmark		EU agr	14.33	0.00
Finland		EU agr	...	...
Germany	1976/80 (temporarily into force)	EU agr	80.78	14.88
Greece		EU agr	...	...
Hungary	1991/92		0.01	0.96
Iceland		FTA	...	–0.10
Ireland		EU agr	...	...
Italy		EU agr	1.10	4.95
Japan			1.76	1.76
Korea	1999 not ratified by Israel yet		...	...
Mexico			...	0.00
Netherlands		EU agr	...	...
New Zealand			...	...
Norway		EU agr	...	0.00
Poland	1991/92		0.90	0.00
Portugal		EU agr	0.00	0.00
Slovak Republic			...	...
Spain		EU agr	5.33	–30.91
Sweden		EU agr	2.30	0.24
Switzerland		FTA	17.13	23.73
Turkey	1996/98		...	1.00
United Kingdom		EU agr	...	...
United States		US agr	1 050.00	387.00

Source: OECD.

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Seven BITs concern OECD countries: the Czech Republic, Germany, Hungary, Poland, Turkey, Korea and the Slovak Republic (see Table 19).[4]

Main characteristics

A closer look at Israel's Bilateral Treaties for the Reciprocal Promotion and Protection of Foreign Investment (BITs) shows that the "Abs-Shawcross Draft Convention on the Protection of Foreign Property" of 1962, or the so-called OECD draft model Convention, has been used as the base for the definition and content of these agreements.[5] Israeli BITs provide foreign investors with basic security and protection rights, including repatriation of investments and returns, no expropriation or nationalisation other than for public purposes and against prompt, adequate and effective compensation, and no less favourable treatment of foreign investors as compared to local or third country investors.

The ***standard promotion clause*** commits Israel to encourage as well as protect investments by (Art. 2):

- according fair and equitable treatment to the investments made by investors of the other Contracting Parties (this is the general standard of treatment that has been developed under customary international law);

Table 20. **Bilateral investment agreements in force as of May 2001**

	Date of signature	Entry into force
Albania	29.01.96	18.02.97
Argentina	23.07.95	10.04.97
Bulgaria	06.12.93	17.12.96
Czech Republic	23.09.97	16.03.99
Estonia	14.03.94	23.05.95
Georgia	19.06.95	18.02.97
Germany	24.06.76	28.08.80 Temporarily in force
Hungary	14.05.91	14.09.92
India	29.01.96	18.02.97
Kazakhstan	27.12.95	19.02.97
Latvia	27.02.94	09.05.95
Lithuania	02.10.94	11.07.96
Moldova	22.06.97	16.03.99
Poland	22.05.91	06.04.92
Romania	02.09.91	26.08.92
Slovak Republic	08.09.99	23.05.00
Slovenia	13.05.98	02.10.99
Turkey	14.03.96	27.08.98
Turkmenistan	24.05.95	17.03.97
Ukraine	16.06.94	18.02.97
Uzbekistan	04.07.94	18.02.97

Source: Israeli government.

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Table 21. **Bilateral investment agreements that were officially signed, but not yet ratified**

	Date of signature	Comments
Armenia	19.01.00	02.04.01 – Ratified by Armenia
Belarus	11.04.00	24.05.01 – Ratified by Belarus
China	10.04.95	12.07.96 – Ratified by China
Croatia	01.08.00	05.12.00 – Ratified by Croatia
Cyprus	13.10.98	19.12.00 – Ratified by Cyprus
El Salvador	03.04.00	10.00 – Ratified by El-Salvador
Korea	07.02.99	02.04.99 – Ratified by Korea
Peru	11.12.96	Initials
Poland (amendment)	27.06.97	27.10.99 – Ratified by Poland
Romania (amendment)	03.08.98	05.05.99 – Ratified by Romania
Thailand	18.02.00	Pending ratification in both countries
Uruguay	30.03.98	07.06.98 – Ratified by Israel
Zaire	14.05.85	Not ratified yet

Source: Israeli government.

- guaranteeing them full protection and security in its territory, without damaging by unreasonable or discriminatory measures the management, maintenance, use, enjoyment or disposal of their investments in its territory.

The ***compensation for losses*** clause (Art. 4) which requires Israel to:

- compensate for the losses suffered by the other Contracting Party due to war, armed conflicts, revolution, a state of national emergency, revolt, insurrection, riot or other such similar events happening in its territory;
- ensure that such compensation shall be as favourable as that accorded to Israeli investors or to investors of any third state;
- ensure that payments resulting from the accorded restitution or adequate compensation shall be freely transferable.

The ***provision on nationalisation, expropriation and other types of dispossession*** (Art. 5), restating the international law principle ruling that a State shall:

- take measures with effects equivalent to nationalisation or expropriation only where justified by a public purpose related to internal needs;
- on a non-discriminatory basis, with judicial review;
- and against prompt, adequate and effective compensation amounting to the market value of the expropriated investment.

The Israeli standard of compensation in case of expropriation follows the so-called German prototype, under which the compensation shall be equivalent to

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the market value of the expropriated investment immediately before the date of expropriation or nationalisation was publicly announced. Moreover, the payment of compensation is required to be without delay, fully realisable and freely transferable.

The Provisions on Repatriation of Investments and Returns (Art. 6) according to which Israel shall:

- guarantee an unrestricted transfer of their investment and returns, which shall be effected without delay and in freely convertible currency.

The ***Principle of National Treatment and the MFN Clause*** (Art. 3) according to which Israel shall not, in its territory,

- subject investments or returns of investors of the other Contracting Party to treatment less favourable than that which it accords to investments or returns of its own investors or to investments or returns of investors of any third State;
- subject investors of the other Contracting Party, as regards their management, maintenance, use, enjoyment or disposal of their investments, to treatment less favourable than that which it accords to its own investors or to investors of any third State;

with the exception that such provisions shall not (Art. 7)

- oblige one Contracting party to extend to the investors of the other the benefit of any treatment, preference or privilege resulting from any international agreement such as customs unions, regional economic organisation, free trade area agreement, or any similar international agreement;
- as well as any international agreement or arrangement, and domestic legislation relating wholly or mainly to taxation.

The ***Dispute Settlement clause*** (Art. 8), holds that if any dispute arising between an investor of one Contracting Party and the other Contracting Party in connection with an investment made in the territory of the latter cannot be settled through negotiations between the parties, within a period of six months from notification of the dispute, the investor shall be entitled to submit the dispute either to:

- a court of competent jurisdiction of the Contracting Party in whose territory the investment was made;
- the International Centre for the settlement of Investment Disputes (ICSID);
- an arbitrator or international *ad hoc* tribunal.

Although the main features of Israeli BITs are very similar, there are also some minor differences which, by and large, can be explained by the evolution in the economic and policy environment which prevailed at the time of the negotiation of the first agreements (Germany – 1976 and France – 1985) and that of more recent

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negotiations with transition economies such as Estonia, Hungary and Romania. In particular, differences may be observed:

- Regarding the *application* of the agreement. While in the case of Germany, France or Latvia, the agreement also applies to investments made prior to the entry into force of the agreement (Art. 9), the BITs signed with Hungary, Romania, and Estonia set more restrictive temporary time limits.[6]
- Concerning the *duration* and *termination* of the bilateral investment treaty. According to the general framework, the provisions of the agreement shall continue in effect, with respect to the investments made while the agreement is in force, for a period of ten years after the date of termination. This is the case for Romania, Latvia and Estonia. The agreed duration in the BITs with Germany, France and Hungary is 10 years. Yet, Investments that were made during this period enjoy the protection of the agreements during the period of the 20 years following their entry into force.
- With respect to the *transfer of investments and returns*, in principle investors should be able to transfer freely and without limitations all payments relating to their investments. This is the case of treaties signed with Germany and France. However, some BITs concluded at the beginning of the 1990s, such as those with Romania and Hungary, allow certain *restrictions* on the free transfer of currency by both parties. In the bilateral investment treaties signed during the mid-1990s such limitations have been removed but at the same time some guarantee-clauses have been added.

The Israeli authorities consider that their bilateral investment treaties have provided a good framework for creating a healthy atmosphere for foreign investment. An important motivation for the newly negotiated agreements with transition and emerging market economies is the protection that they offer to Israeli investors increasingly active in these countries. The dispute settlement provisions of the agreements have never been invoked.

Free trade agreements

While the principal focus of Israel's FTAs and other economic agreements is trade, they also give rise in some instances to international obligations on FDI. The Association Agreement with the EU is particularly important for the large majority of member states (all but France and Germany) which have not yet concluded a BIT with Israel. A *contrario*, the BITs involving EU accession applicants (the Czech Republic, Hungary, Poland and Slovenia) provide a basis for wider commitments (and benefits) for the future. In some cases, the commitments can be seen as a substitute for (in the case of the United States) or a supplement to existing BITs (the case of France and Germany). In other cases, they amount to "best

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endeavour" undertakings. Israel's main commitments under such agreements can be summarised as follows:

Association Agreement with the EU

The Euro-Mediterranean agreement establishing an association between the European Communities and their Member States, on the one part, and the State of Israel on the other part, and superceding the Free Trade Agreement of 1975, came into being in June 2000. The parties agreed:

- to widen the scope of the Agreement in order to cover the *right of establishment of firms of one* Party *in the territory of another* Party and the liberalisation of the provision of services by one Party's firms to consumers of services in the other. Under the Agreement, the Parties, in the form of the Association Council shall make recommendations for the implementation of such objectives, taking into account the past experience of implementation of the reciprocal most-favoured-nation treatment and of the obligations of each Party under Art. V of the GATS. (Title III – Art. 29);
- not to impose *any restrictions on the movement of capital* and *discrimination* based on the nationality, or on the place of residence of their nationals, or on the place where such capital is invested. Therefore, all current payments connected with the movement of capital involving direct investment within the framework of such Agreement shall be free of all restrictions (Title IV – arts. 31 and 32).

In addition to the Association Agreement with the EU, Israel is also engaged in the Euromed initiative for the liberalisation of trade in services in the Euro-Mediterranean region. The EFTA Agreement

Article 29 commits the Parties to gradually *deepen and broaden their co-operation* in order to achieve a *progressive liberalisation and mutual opening of markets for investments*. Under the Agreement, the Parties will also endeavour to accord *a treatment to the other* Party's *investors no less favourable than that granted to domestic and foreign operators in its territories on condition that a balance of rights and obligations exists between the parties*.[7]

The FTA *with the* United States[8]

Under Art. 13 of the Agreement dating back to 1985, the Parties are committed *not to impose, as a condition of establishment, expansion or maintenance of investments* by nationals or companies of the other Party, requirements to *export* any amount of production resulting from such investments or to purchase locally-produced goods and services. Moreover, no requirements shall be imposed on investors to *purchase locally produced goods* and services as a condition for receiving any type of governmental incentives.[9]

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The FTA *with Canada*

This Agreement does not contain legal obligations relating to FDI. But according to Chapter One, the Agreement aims to eliminate barriers to trade in, and facilitate the movement of, goods between the territories of the Parties, and thereby to promote conditions of fair competition and *increase substantially investment opportunities* in the free trade area.

The FTA *with Mexico*

Israel has concluded a FTA with Mexico, which does not have a chapter on FDI. A separate agreement on investment is under negotiation.

WTO agreements

What follows represents the situation as of 1997. Israel is taking part in the services negotiations and is prepared to take on additional commitments in the framework of these negotiations.

Foreign investment-related issues are dealt with in a number of WTO Agreements: particularly the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs), and the Agreement on Trade-Related Investment Measures (TRIMs). As a member of the WTO, Israel will participate in post-Doha work on the relationship between trade and investment.[10]

Israel's commitments under the GATS

Israel's GATS commitments provide legal security for market access and national treatment in the form of assurances not to increase the level of restrictions listed in its GATS schedules.[11] Its schedule of commitments (which details Israel's liberalisation undertakings or coverage of existing non-conforming measures) provides for specific commitments in 49 activities (compared with an average of 23 for developing and 93 for developed countries) out of a total of 161.[12] A large number of these commitments pertain to Mode Three, namely the provision of services through established presence in a foreign territory, and some others, to Mode Four on the presence of natural persons in a foreign territory.[13]

The horizontal section of Israel's schedule refers to the following requirements applicable to all sectors (where commitments have been taken). A public corporation must have on its board of directors at least two directors representing the public at large and be Israeli residents. Also, a foreign company must maintain in Israel a place of business, or an office for registration or transfer of shares to register as a foreign company and pay the requisite fees. A partnership formed outside Israel may only carry on business in Israel if it is registered in the Israel

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register of partnerships. In the case of a limited partnership, registration has to be sanctioned by the Minister of Justice who may at his discretion authorise or refuse the registration. Israeli authorities have indicated that this description may be revised in accordance with the New Company Law (1999) that came into effect in February 2000. Mode 4 commitments were undertaken in the horizontal section as well. See description below.

With regard to **M*ode of supply three*** (commercial presence) (which is the most relevant mode of delivery in relation to the OECD National Treatment instrument) Israel has made the following entries:

In the **sector of business services**, Israel undertook to apply no limitations either on market access or on national treatment for both the *sub-sectors of computer and related services*, and of some *other business services* (*e.g.* management consulting, advertising, market research, etc). However, in the case of the *professional services sub-sector* of legal services, it maintained the provision according to which a restriction regarding Israeli residents or citizen may exist in the establishment of commercial presence. In addition, it excluded completely R&D services, real estate services and rental/leading services without operators from its schedule of commitments.

In the **sector of communication services** Israel has undertaken significant commitments, including additional commitments through the adoption of the reference paper. Under its schedule of commitments, Israel permits 74 per cent foreign ownership in international service providers and 80 per cent foreign ownership in wireless service providers. With regard to the *audio-visual services sub-sector*, in the motion picture and videotape production, only investments involving an Israeli participation of 25 per cent are entitled to a grant.

The **sector of environmental services** (sewage and refuse disposal services) has no limitations. However it is noted that it a common practice to require a local representative

In the **sector of financial services**, only the *sub-sector of insurance and insurance-related services* has no limitations. Following the adoption of the Financial Services Annex, to the General Agreement on Trade in Services (GATS), concluded at the end of 1997, Israel has scheduled a number of activities as unbound for service providers not recognised as banking institutions: acceptance of deposits and other repayable funds from the public; lending of all types; and financial leasing. There are no limitations on market access or national treatment for banking institutions wishing to offer these services. Similarly, there are no limitations for a range of other banking services supplied by a foreign-controlled bank established in Israel. In accordance with the general note included in the 1997 financial services commitments, for prudential reasons Israel applies, *inter alia*, measures requiring juridical form of establishment, or residence of natural persons in Israel,

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for the supply of Financial Services. In addition, Israel has taken a most favoured nation (MFN) exemption in relation to banking services by maintaining the possibility of invoking a reciprocity condition on the granting of banking licences to foreign entities. To date no licence has been refused because of this reciprocity condition to foreign entities.

Within the **tourism and travel-related services sector** only *food-serving services* have no limitations while owners of *hotels, and travel agencies*, must be Israeli-registered companies, and travel agencies must employ at least one Israel-licensed travel expert. T*ourist guide services and tour operators* may be restricted to Israeli resident or citizens.

Supply* Mode *four (temporary presence of natural persons in order to supply a service) is unbound *for all sectors* except providing for the temporary entry of service providers in the sectors where commitments were undertaken as intra-corporate transfers in the categories of executives and managers where Israel is committed to allow temporary entry without requiring compliance with labour market tests.

In addition, Israel has listed *most favourable nation* (MFN) *exemptions* under Article II of the GATS in the areas of *i*) film, video and television programme co-production and distribution, and *ii*) banking. In the former, differential treatment is granted to persons of countries with which Israel may have co-production arrangements, as well as persons engaged in film and video distribution. In the latter, Israel retains the right to grant licences to suppliers from a country that grants Israeli suppliers similar access.

Israel's GATS schedule does not contain any entry in regard to construction and related engineering services, distribution services, education services, health-related and social services, recreational, cultural and sporting services and transport services. This means that Israel was not prepared to undertake any binding commitments for trade in these sectors. This does not exclude the possibility that they will be included in future negotiations.

Israel's commitments under the TRIMs

According to the TRIMs provision (Art.2) Israel is committed not to apply any TRIM inconsistent with Articles III (national treatment) and IX (prohibition of quantitative restrictions) of the GATT. More particularly, measures requiring particular levels of local procurement by an enterprise, or restricting the volume or value of imports that an enterprise can purchase or use to an amount related to the level of products it exports would be inconsistent with the above-mentioned articles. Israel has no measures contrary to this Agreement.[14]

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***Israel's commitments under the* TRIPs**

According to the TRIPs, Israel shall accord to the nationals of other Members treatment no less favourable than the one it accords to its own nationals with regard to the protection of intellectual property (Art.3 – National Treatment Clause). Moreover, Israel shall accord immediately and unconditionally to the nationals of all other Members any advantage, favour, privilege or immunity granted to the nationals of any other country (Art.4 – Most-Favoured Nation Treatment Clause).

Israel notified its implementing legislation to the TRIPs Council at the end of the developing countries' transitional period in 2000, after invoking developing-country status in 1995. The TRIPs Council reviewed Israel as part of the reviews of Developing countries' legislation in 2000-2001 where it was found to be in conformity with the substantive requirements of the TRIPs Agreement.

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Table 22. **International agreements**

Free trade area agreements	Protection of investments	Avoidance of double taxation	Agreements on R&D	MFN trade agreements with non-WTO members
Canada	Albania	Austria	***Funds***	China
Mexico	Argentina	Belarus	Canada	Kazakhstan
United States	Armenia***	Belgium	Singapore	Russian Federtion
	Belarus***	Canada	South Korea	Ukraine
EU	Bulgaria	China	United Kingdom	Uzbekistan
Austria	China***	Czech Republic	*United States.*	Vietnam*
Belgium	Croatia***	Denmark		
Denmark	Cyprus***	Finland		
Finland	Czech Republic	France	***Co-operation***	
France	El Salvador***	Germany	Belgium	
Germany	Estonia	Greece	China	
Greece	Georgia	Hungary	France	
Ireland	Germany	India	Hong Kong	Standardisation and Product Certification
Italy	Hungary	Ireland	India	Jordan
Luxembourg	India	Italy	Ireland	Russian Federation
Netherlands	Kazakhstan	Jamaica	Netherlands	Ukraine
Portugal	Latvia	Japan	Portugal	
Spain	Lithuania	Netherlands	Spain	
Sweden	Moldova	Norway	Fifth Framework	
United Kingdom	Poland	Philippines	EU	
	Romania	Poland	Germany	
EFTA	Slovenia***	Romania	Italy	
Iceland	South Korea***	Russian Federation	Finland	
Liechtenstein	Thailand***	Singapore	Sweden	
Norway	Turkey	Slovak Republic		
Switzerland	Ukraine	South Africa		
		South Korea		
Bulgaria***	Uruguay***	Spain		
Czech Republic				
Hungary	Zaire***	Thailand		
Poland	Turkmenistan	Turkey		
Romania	Slovak Republic	United Kingdom		
Slovak Republic	Peru***	*United States*		
Slovenia		Uzbekistan		
Turkey				

* Under negotiation.
** Initialled.
*** To be ratified.
Source: From State of Israel, Ministry of Industry and Trade *www.tamas.gov.il*

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Notes

1. Israel is a member of the Madrid Arrangement for the prevention of false indications of origin, Nice Arrangement for the International Classification of Goods, and Lisbon Arrangement for the Protection of Appellations of Origin, Universal Copyright Convention, European Conventions, Strasbourg Agreement, Patent co-operation Treaty.
2. Israel joined the Paris Convention for the Protection of Industrial Property and the Bern Convention for the Protection of Literary and Artistic Works in 1950.
3. A Bilateral Investment Treaty with France was signed in 1983, but expired in 1995 and is no longer in force.
4. OECD FDI outflows to Israel mainly originate from the United States, Germany, France, Belgium-Luxembourg and Switzerland. FDI inflows to OECD coming from Israel are primarily directed to the United States, Belgium-Luxembourg, Switzerland, Germany and France.
5. Although the OECD draft Agreement was never adopted as a convention, it has been recommended by the OECD Council of Ministers to its member States as a model for the preparation of bilateral investment treaties.
6. In the case of Hungary, the treaty applies to investments made after 1 January 1973; in the case of Romania 31 December 1989, and in the case of Estonia, 4 September 1991.
7. It should be noted that the Israel/EFTA Agreement was concluded before the WTO GATS Agreement and the TRIMs Agreement.
8. The FTA Agreement with the United States also contains offset provisions on government procurement which are beneficial to investors originating from the parties to the agreement. This matter is dealt with in Chapter 3.
9. Article 13 does not go beyond the commitments of the WTO TRIMs Agreement.
10. As defined by paragraphs 20-22 of the Doha Ministerial Declaration of 14 November 2001. See *www.wto.org*
11. There is no formal process under the GATS according to which a "developing country" status would be granted. Such designation is normally by self-election. There has not so far been any occasion in which Israel has pronounced itself on that matter under the GATS.
12. The Results of the Uruguay Round of Multilateral Trade Negotiations, GATS, Geneva, 1995.
13. The General Agreement on Trade in Services (GATS) prescribes important obligations regarding the provision of services. It does so by defining four modes of supplying services internationally covered by the agreement, one of which, Mode three, consists of the provision of services through established presence in a foreign territory. This may take place, for example, through the establishment of a branch office or a subsidiary of the foreign company. Moreover, given that directors, managers, specialists and other

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key personnel often need to be deployed abroad, at least initially, in order to manage a foreign operation, the services trade via this mode often takes place in conjunction with the fourth mode of supply. The latter refers to the supply of a service through the presence of natural persons in a foreign territory.

14. 1999 WTO Trade Policy Review of Israel, page 80.

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Annex 1

Summary of the Main Provisions of the OECD Declaration on International Investment and Multinational Enterprises

Adherence to the OECD Declaration on International Investment and Multinational Enterprises implies acceptance of all its components as well as the related Decisions and Recommendations. The OECD Declaration on International Investment and Multinational Enterprises is a political agreement among Adherent countries for co-operation on a wide range of investment issues. The Declaration contains four related elements: the National Treatment instrument, the Guidelines for Multinational Enterprises, an instrument on incentives and disincentives to international investment, and an instrument on conflicting requirements. It is supplemented by legally binding Council Decisions on implementation procedures, and by Recommendations to Adherents to encourage pursuit of its objectives, notably with regard to National Treatment.

National Treatment

The National Treatment Instrument provides that Adherents should, consistent with their needs to maintain public order, to protect their essential security interests and to fulfil commitments relating to international peace and security, accord to enterprises operating in their territories and owned or controlled by nationals of another Member country treatment under their laws, regulations and administrative practices consistent with international law and no less favourable than that accorded in like situations to domestic enterprises.

Under the Third Revised Decision of the Council on National Treatment, Adherents to the Declaration must notify the Organisation of all measures constituting exceptions to the National Treatment principle within 60 days of their adoption and of any other measures which have a bearing on this principle (the so-called "transparency measures"). These measures are periodically reviewed by the CIME, the goal being the gradual removal of measures that do not conform to this principle.

Exceptions to National Treatment fall into five categories: investments by established foreign-controlled companies, official aids and subsidies, tax obligations, access to local bank credit and the capital market, and government procurement.

Transparency measures include measures based on public order and national security interests, restrictions on activities in areas covered by monopolies, public aids and subsidies granted to government-owned enterprises by the state as a share.

The National Treatment Instrument is solely concerned with discriminatory measures that apply to established foreign-controlled enterprises. This includes established branches, except for the category of "investment by established foreign-controlled enterprises".

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Areas of existing public, private or mixed monopolies are to be recorded for the purpose of transparency since foreign-controlled and domestic private enterprises are subject to the same restrictions. The undertaking to apply National Treatment comes into force as and when areas previously under monopoly are opened up. In such cases, access to these areas should be provided on a non-discriminatory basis. If restrictions prohibit or impede in any way the participation of foreign-controlled enterprises *vis-à-vis* their domestic counterparts, then these restrictions are to be reported as exceptions to National Treatment. The objective is to ensure access to formerly closed sectors on an equal basis.

The 1991 Review confirmed the understanding reached in 1988 by the Committee on International Investment and Multinational Enterprises on a standstill on National Treatment measures. This understanding provides that Adherents should avoid the introduction of new measures and practices, which constitute exceptions to the present National Treatment Instrument. Particular attention is to be given to this question in the Committee's work.

A number of Recommendations of the Council have also been addressed to Adherents in the context of earlier horizontal examinations. Most of these recommendations were made to individual countries, but a number of them were of a general character. Concerning investment by established foreign-controlled enterprises, Adherents should give priority to removing exceptions where most Adherents do not find it necessary to maintain restrictions. In introducing new regulations in the services sectors, Adherents should ensure that these measures do not result in the introduction of new exceptions to National Treatment. Adherents should also give particular attention to ensuring that moves towards privatisation result in increasing the investment opportunities of both domestic and foreign-controlled enterprises so as to extend the application of the National Treatment Instrument.

In the area of official aids and subsidies, Adherents should give priority attention to limiting the scope and application of measures which may have important distorting effects or which may significantly jeopardise the ability of foreign-controlled enterprises to compete on an equal footing with their domestic counterparts.

Finally, with regard to measures motivated by public order and essential security interests, Adherents are encouraged to practice restraint and to circumscribe them to the areas where public order and essential considerations are predominant. Where motivations are mixed (*e.g.* partly commercial, partly national security), the measures concerned should be covered by exceptions rather than merely recorded for transparency purposes.

Guidelines for Multinational Enterprises

The Guidelines for Multinational Enterprises are recommendations jointly addressed by Adherent governments to multinational enterprises operating in their territories. While their observance is voluntary and not legally enforceable, they represent the collective expectations of these governments concerning the behaviour and activities of multinational enterprises.

They also provide standards by which multinational enterprises can ensure that their operations are in harmony with the national policies of their host countries. The areas covered include disclosure, employment and industrial relations, environment, combating bribery, consumer interests, science and technology, competition, and taxation.

Adherent governments must set up national contact points (NCPs) to deal with the implementation of the Guidelines. The purpose of NCPs is to undertake promotional activities, handle inquiries and foster discussions with the parties concerned on all matters covered by the Guidelines so that they can contribute to the solution of problems which may arise in this connection, taking due account of the Procedural Guidance.

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NCPs in different countries shall co-operate if such need arises, on any matter covered by the Guidelines relevant to their activities. NCPs shall also meet annually to share experiences and report to the CIME.

The Committee on Investment and Multinational Enterprises is responsible for periodically, or at the request of an adhering country, holding exchanges of views on matters covered by the Guidelines, and it periodically invites the Business and Industry Advisory Committee to the OECD (BIAC), the Trade Union Advisory Committee to the OECD (TUAC) ("the advisory bodies"), and other non-governmental organisations as well as representatives of non-adhering countries to express their views on matters covered by the Guidelines.

The Committee is also responsible for clarification of the Guidelines and for exchanging views on the activities of National Contact Points, and periodically reports to the Council on matters related to the Guidelines.

Incentives and Disincentives

The Instrument on Investment Incentives and Disincentives recognises that Adherents may be affected by this type of measure and stresses the need to strengthen international co-operation in this area. It first encourages them to make such measures as transparent as possible so that their scale and purpose can be easily determined. The Instrument also provides for consultations and review procedures to make co-operation between Adherents more effective. A considerable part of the work undertaken in this area is analytical, two studies having been undertaken in the 1980s. Adherents may therefore be called upon to participate in studies on trends in and effects of incentives and disincentives on FDI and to provide information on their policies.

Conflicting Requirements

The Instrument on Conflicting Requirements provides that Adherents should co-operate with a view to avoiding or minimising the imposition of conflicting requirements on multinational enterprises. In doing so, they shall take into account the general considerations and practical approaches recently annexed to the Declaration. This co-operative approach includes consultations on potential problems and giving due consideration to other countries' interests in regulating their own economic affairs.

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Annex 2

Israel's Position Under the OECD Declaration of International Investment and Multinational Enterprises

A. Exceptions Under the National Treatment Instrument

Adherents to the Declaration have the obligation to notify their exceptions to National Treatment. The exceptions notified by Israel are as follows:

I. *Investment by established foreign-controlled enterprises*

Land and real estate

Acquisitions of rights to use land and real estate by foreign nationals or companies controlled by foreign nationals are subject to the prior approval of the Israel Land Administration Council.*

Authority: Israel Land Law (1960) and Israel Land Administration decision number 342.

Air transport

The licensing of an airline as an Israeli airline is conditional upon the holding of at least two-thirds of the capital by Israeli nationals.

Cabotage operations may only be conducted by Israeli airlines.

Authority: Aviation Law (1927); Licensing of Aviation Services Law (1963).

Maritime transport

Cabotage operations are limited to Israeli vessels or to foreign licensed vessels from countries having reciprocity with Israel.

Authority: Ministry of Transport; legislation pending.

Communications

- Domestic fixed-line operator

The control of a domestic licensed communications company must be held by an Israeli individual or a corporation incorporated in Israel in which an Israeli individual holds at least a 20 per cent interest.

* The legal regime regarding land and real estate rights is currently under reform.

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- Mobile services; satellite broadcasting

At least 26 per cent of the control in a licensee must be held by nationals who are residents of Israel.

- International communications services

At least 26 per cent of the control in a licensee must be held by nationals who are residents of Israel. A foreign operator may hold up to 49 per cent of the control of a licensee.

- Cable broadcasting

i) At least 26 per cent of the control in the licensee must be held by nationals who are residents of Israel.

ii) A licence shall not be granted to an applicant in which a foreign government holds shares, but the Minister of Communications may authorise an indirect holding in the licensee of up to 10 per cent by such a corporation.

- Commercial television and regional radio

At least 51 per cent of the control in the concession must be held by nationals who are residents of Israel.

Authority: Communications Law (Telecommunication and Broadcast) 1982; Second Authority for Television and Radio Law (1990).

Electricity

An applicant for a licence to transmit, distribute or produce a substantial part of electricity may be required to fulfil the following conditions:

i) The control of the licensee shall be held by a national who is a resident of Israel.

ii) The maximum proportion of control in the licensee to be held, directly or indirectly, by a non-resident of Israel, is subject to a determination by the Minister of National Infrastructures.

Authority: Electricity Sector Law (1996).

Education services

Co-operation between an affiliate of a foreign university and equivalent Israeli institutions is subject to the approval of the Council for Higher Education.

Authority: The Council for Higher Education Law (1959).

II. *Official aids and subsidies*

Films, education, religion, academic research, arts and sports

i) The Government may set conditions for granting state aid in the above-mentioned sectors.

ii) The State does not contribute to the budget of an affiliate or branch of a foreign institution of higher education operating in Israel.

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Authority: The Film Law (1999); Foundation of Budget Law (1985); The Council for Higher Education Law (1959).

III. *Tax obligations*

None.

IV. *Government purchasing*

None.

V. *Access to local finance*

None.

B. Measures reported for transparency under the National Treatment Instrument

I. *Measures based on public order and essential security considerations*

All sectors

The Israeli government reserves the right to deny a foreign investment or an activity of an enterprise in which substantial holdings are held by foreigners if there is evidence that this investment or activity would hinder the maintenance of essential public security interests and if other laws are insufficient to deal with this risk.

Defence

i) Enterprises may not be granted certain defence procurement contracts, where overriding security reasons apply, in some cases due to foreign holdings.

ii) Defence corporations may be subject to an order restricting the holdings of means of control by foreign investors.

iii) The transfer of defence know-how to a corporation under foreign control is subject to prior approval by the Minister of Defence.

Privatisation

The Ministers' Committee for Privatisation shall decide the process and the conditions for privatisation.

Authority: The Israeli Government Companies Law (1975).

Corporate organisation

Certain directors, officers and position holders in the licence-holder or in a corporation may be required to be nationals who are residents of Israel in some cases with security clearance and are subject to approval in the following activities:

- Transmission or distribution of electricity or production of a substantial part of electricity.
- Natural gas operator.
- Domestic fixed-line operator.
- Radio and mobile telephone services operators.

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- Satellite broadcasting operator.
- International communications services operator.
- Cable broadcasting operator.
- Television and radio operator
- Israeli airline
- Defence corporations

Authority: Bezeq (communication) Law, Second Authority for Television and Radio Law (1990); Natural Gas Law (1999), Electricity Economy Law (1996), and Licensing of Aviation Services Law (1963).

II. *Monopolies and concessions*

1. *Monopolies*

In accordance with special laws, the following activities or state-owned enterprises are in a *de jure* or *de facto* monopoly *situation*:

- Land: Jewish National Fund (Keren Kayemeth LeIsreael)
- Communication:
  - Inlandline operator (telephony, transmission data, data communication, infrastructure)
  - ADSL infrastructure
- Transportation
  - Civil airfields operation
  - Ports (excluding the ports for transporting energy materials – fuel and coal)
  - Railway
- Environment
  - Israel nature and national parks protection authority
  - Hazardous waste disposal
- Water transmission
- Production and marketing of dairy products

2. *Concessions*

- Satellite TV
- Public radio channels and regional radio
- International and domestic aviation
- Dead Sea mineral exploitation
- Oil pipe transport.

C. Implementation of the OECD Guidelines for Multinational Enterprises

With regard to the implementation of the Guidelines for Multinational Enterprises, Israel considers that the Guidelines are an important element in the promotion of corporate social responsibilities at home and abroad. In accordance with the Decision of the OECD Council of

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June 2000, the Israeli government will establish a National Contact Point (NCP) to help implement and promote the Guidelines and make them better known to businesses, labour representatives and other interested parties. In the setting-up of a National Contact Point, Israel intends to follow the Procedural Guidance for institutional arrangements attached to the above-mentioned Decision, as well as its guidance on any issues related to implementation matters. The government of Israel is committed to the implementation of the Guidelines.

The Israeli NCP will be located at the Foreign Trade Administration of the Ministry of Industry and Trade, which will be responsible for co-ordinating and leading activities related to the Declaration, including the publication of the Guidelines, the preparation of Israel's annual report and its presentation at the annual OECD meeting of NCPs, the organisation of activities to promote the Guidelines among those concerned. The Israeli NCP will also act as a focal point for inquiries.

Alongside the Israeli NCP, an NCP Advisory Committee will be established whose members will consist of representatives of the Ministry of Finance, the Ministry of Foreign Affairs, the Ministry of the Environment, the Ministry of Labour and the Ministry of Justice. The Chairman of the NCP Advisory Committee will be a representative of the Ministry of Industry and Trade.

Issues that arise relating to implementation of the Guidelines in specific instances shall be submitted to the Israeli NCP and referred to the NCP Advisory Committee which will be responsible for analysing these issues. Following the preparation of the annual report, the NCP shall present it to the NCP Advisory Committee for approval. The Israeli NCP Advisory Committee will also hold bi-annual consultations with the business community, NGOs and labour and trade unions, and other interested parties.

In order to ensure their wide dissemination and promotion, the Guidelines will also be translated into Hebrew and Arabic and made available on the website of the Ministry of Industry and Trade and through other means. The Israeli government also intends to engage in promotional activities with interested partners and the general public. This effort will include raising the awareness of Israeli companies operating abroad of the recommendations of the Guidelines.

Finally, prior to the launching of the CIME FDI policy review of Israel, the Israeli government solicited comments from the business community including the Manufacturer's Association, the Federation of Economic Organisations, the Israel Export Institute as well as from the Histadrut (Israel's major labour union). Some of these bodies expressed their interest and willingness to maintain active relations with the envisaged NCP-Advisory Committee.

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Annex 3

Israel's FDI Data Collection, Methodology and Sources

General

Foreign exchange control was gradually abolished during the 1990s. During that period FDI statistics were mostly based on the investments approval system. Along with the liberalisation process, and as part of it, new reporting systems were introduced.

Two main reporting systems are used for compiling FDI statistics: Direct Reporting System (DRS) which is based, mostly, on reports by enterprises, and the Transactions Reporting System (TRS) which is based, mostly, on reports by the banking system.

- DRS – these systems comprise reports received on a monthly and quarterly basis from individuals, enterprises and other institutions. The information received is based mostly on a transaction-by-transaction basis and enables considerable classifications and various breakdowns of transactions (*i.e.* by type, by country, by economic branch, etc…)
- TRS – this system is based on two weekly reporting subsystems (on a daily basis):
  - Aggregate reporting (classified by transaction type) of all payments and receipts executed through the banking system.
  - Transaction-by-transaction reporting of payments and receipts executed through the banking system of all transactions over a threshold of US$50,000.

These two systems, along with other reporting systems, are the infrastructure for the FDI statistics as well as the BOP and IIP statistics.

The methodology for FDI statistics (as well as BOP and IIP statistics) is based on the IMF's Balance of Payments Manual (BMP5).

FDI outward collection model

FDI outflows statistics are based on the following DRS reports:

- Each investment above US$m5.0 (or that increases the total assets of the investor abroad over this amount) should be reported immediately to BOI (details of transaction).
- Quarterly reports by residents (enterprises and individuals) that have assets abroad over a threshold of US$m5.0. (Mainly assets and liabilities abroad).
- Monthly reports of big enterprises regarding activity abroad (mainly through foreign bank accounts).
- Annual reports of enterprises and individuals regarding assets and liabilities abroad (mainly change of capital and inter-company transactions).

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Complementary sources:

- The TRS provided the FDI data for small transactions. The detailed reports (transaction by transaction) enable data comparison with DRS data.
- Custodians' reports of foreign tradable stocks that are held by Israeli residents.

FDI inward collection model

FDI inflows statistics are based on the following sources:

- Reports by Israeli enterprises that issued stocks abroad
  - Report on each issue
  - Quarterly reports regarding major shareholders
- Reports from large Israeli enterprises – data on major shareholders and on reinvested earnings.
- Monthly reports from Israel Securities Authorities (ISA) regarding major shareholders in stocks traded on the Tel-Aviv Stock Exchange.

Complementary sources:

- The TRS provided the FDI data for small transactions.
- Custodians' reports of Israeli tradable stocks that are held by non-residents.
- Reports regarding investments in venture capital funds.
- Registry of Israeli enterprises.

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Annex 4

Foreign Direct Investment Statistics in Adherent Countries to the OECD Declaration on International Investment and Multinational Enterprises

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Table 1. FDI Inflows in Adherents to OECD Declaration on International Investment and Multinational Enterprises

Million US dollars

	Cumulative Flows		1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
	1981-1991	1992-2001										
Australia	36 085.5	69 571.6	5 719.8	4 281.7	5 024.6	11 963.2	6 111.0	7 633.4	6 100.0	5 685.1	11 932.5	5 120.5
Austria	3 286.8	35 920.8	1 432.7	1 136.5	2 102.9	1 904.2	4 428.6	2 655.6	4 534.1	2 974.6	8 841.3	5 910.2
Belgium-Luxembourg	27 538.7	422 349.3	10 957.3	10 467.8	8 313.2	10 803.6	14 054.1	12 100.2	22 724.3	38 664.2	243 259.3	51 005.1
Canada	33 390.0	186 748.8	4 721.6	4 730.3	8 204.1	9 255.4	9 632.6	11 522.0	22 573.6	25 153.8	63 335.1	27 620.1
Czech Republic	..	26 757.4	..	653.5	868.5	2 562.2	1 428.4	1 300.4	3 717.9	6 324.0	4 986.3	4 916.2
Denmark	3 542.3	48 464.1	1 014.7	1 669.0	4 897.6	4 179.8	768.0	2 801.3	7 735.7	6 801.0	14 503.2	4 093.7
Finland	2 050.5	36 338.8	406.2	864.4	1 577.7	1 062.9	1 109.0	2 115.8	12 140.7	4 610.2	8 835.6	3 616.3
France	54 676.9	292 301.7	17 849.2	16 442.7	15 574.7	23 678.1	21 959.5	23 170.4	30 984.5	47 072.2	42 938.4	52 632.0
Germany	17 636.7	342 602.3	– 2 088.9	368.3	7 133.9	12 025.4	6 572.8	12 243.4	24 596.7	54 753.7	195 158.1	31 839.0
Greece	1 006.0	9 432.7	1 144.0	977.0	981.0	1 053.0	1 058.0	984.0	..	567.3	1 083.4	1 585.0
Hungary	..	22 056.2	1 479.2	2 349.7	1 144.1	4 518.6	2 274.1	2 167.0	2 037.1	1 997.3	1 644.1	2 445.0
Iceland	74.8	764.5	– 11.1	– 0.3	–	12.0	82.5	145.6	146.1	61.1	157.3	171.3
Ireland	1 861.1	64 311.9	376.7	381.4	309.6	376.2	575.0	580.6	8 856.5	18 956.8	24 121.8	9 777.1
Italy	24 992.8	60 639.3	3 163.1	3 750.3	2 235.8	4 816.4	3 534.5	3 697.6	4 279.8	6 911.4	13 377.3	14 873.4
Japan	15 454.0	106 148.9	4 084.0	3 078.0	4 155.0	3 930.1	7 082.3	5 605.0	10 240.7	21 066.8	28 979.0	17 928.1
Korea	3 940.3	38 491.5	803.3	728.2	991.5	1 357.1	2 309.0	3 086.0	5 222.6	10 659.8	10 136.0	3 198.0
Mexico	34 119.2	127 287.1	8 093.7	6 715.0	15 040.9	9 552.2	9 937.5	14 043.9	11 932.9	12 534.4	14 706.0	24 730.6
Netherlands	27 816.1	238 298.0	6 796.7	7 673.3	5 539.3	11 400.3	14 604.2	12 603.9	37 934.3	31 924.1	54 259.1	55 562.7
New Zealand	3 236.2	21 954.7	1 089.2	2 211.6	2 615.7	2 849.7	3 922.0	1 917.2	1 825.5	940.4	1 344.4	3 238.9
Norway	4 180.6	34 006.8	810.4	1 460.7	1 235.7	2 463.9	3 991.5	4 251.0	4 032.7	7 512.2	6 015.3	2 233.4
Poland	..	47 156.0	678.0	1 715.0	1 875.0	3 659.0	4 498.0	4 908.2	6 364.9	7 269.6	9 342.3	6 846.0
Portugal	5 636.0	23 385.1	1 904.0	1 516.0	1 254.2	660.1	1 488.5	2 478.8	3 143.5	1 233.5	6 448.9	3 257.6
Slovak Republic	..	4 921.2	..	179.7	273.0	229.6	361.5	212.9	526.8	395.6	2 148.0	593.9
Spain	47 292.1	138 563.6	13 350.7	9 573.1	9 275.6	6 283.9	6 820.1	6 386.7	11 800.1	15 758.6	37 530.2	21 784.6
Sweden	8 868.2	157 412.4	– 41.0	3 844.9	6 349.9	14 447.7	5 076.1	10 968.0	19 570.7	60 850.4	23 400.6	12 945.3
Switzerland	14 068.1	62 577.7	411.2	– 83.3	3 368.4	2 223.2	3 078.2	6 641.8	8 941.2	11 714.0	16 293.1	9 989.9
Turkey	..	11 754.0	911.0	746.0	636.0	934.0	914.0	852.0	953.0	813.0	1 707.0	3 288.0
United Kingdom	113 006.8	444 381.3	15 534.5	14 809.3	9 254.6	19 971.6	24 441.3	33 244.9	70 613.0	82 941.3	119 741.1	53 829.8
United States	368 447.0	1 274 229.0	19 823.0	51 362.0	46 121.0	57 776.0	86 502.0	105 603.0	179 045.0	289 454.0	307 747.0	130 796.0
Total OECD	**852 206.7**	**4 348 826.6**	**120 413.0**	**153 601.9**	**166 353.6**	**225 949.4**	**248 614.6**	**295 920.4**	**522 573.8**	**775 600.4**	**1 273 971.9**	**565 827.7**
Argentina	2 351.3	75 520.0	4 433.0	2 791.0	3 635.0	5 610.0	6 949.0	9 161.0	7 292.0	23 984.0	11 665.0	..
Brazil	17 584.8	158 037.7	2 061.0	1 292.0	3 072.0	4 859.0	11 200.0	19 650.0	31 913.0	28 576.0	32 779.0	22 635.7
Chile	2 330.1	34 896.5	935.1	1 034.3	2 583.1	2 957.0	4 634.0	5 219.0	4 638.0	9 221.0	3 675.0	..
Estonia	..	2 884.9	82.3	162.2	214.4	201.5	150.2	266.2	580.5	305.2	387.3	535.0
Israel	237.5	18 084.7	588.5	604.9	441.6	1 349.1	1 387.1	1 627.8	1 760.3	2 889.2	4 392.4	3 043.8
Latvia*	..	2 683.9	29.4	45.1	214.5	179.6	381.7	521.1	356.9	347.6	407.4	200.7
Lithuania	..	2 617.0	..	30.2	31.3	72.6	152.4	354.5	925.5	486.5	378.9	185.2
Slovenia	..	2 144.7	111.0	112.6	128.1	177.4	194.0	375.2	247.9	181.2	175.5	441.8
Total	**874 710.4**	**4 645 696.0**	**128 653.3**	**159 674.3**	**176 673.6**	**241 355.5**	**273 663.0**	**333 095.2**	**570 287.9**	**841 591.0**	**1 327 832.4**	**592 869.9**

Note: Data are converted using the yearly average exchange rates.

* Latvia's application to adhere to the Declaration on International Investment and Multinational Enterprises is under review.

Source: OECD Foreign Direct Investment database – Based on national sources of OECD Member countries; IMF International Financial Statistics for Non-Member Adherents.

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Table 2. **FDI Outflows from Adherents to OECD Declaration on International Investment and Multinational Enterprises**

Million US dollars

	Cumulative Flows		1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
	1981-1991	1992-2001										
Australia	25 291.0	49 634.8	5 266.9	1 947.0	2 816.5	3 281.8	7 087.6	6 427.9	3 364.9	2 996.1	5 056.0	11 390.0
Austria	4 027.8	23 947.8	1 697.5	1 190.5	1 257.2	1 130.6	1 935.0	1 988.2	2 745.2	3 300.7	5 741.0	2 962.1
Belgium-Luxembourg	20 787.3	414 050.6	10 955.9	3 850.5	1 205.4	11 704.8	8 063.4	7 274.1	28 456.3	34 038.5	241 182.3	67 319.4
Canada	42 352.7	200 231.7	3 589.2	5 699.9	9 293.5	11 462.3	13 094.3	23 059.2	34 583.1	18 417.4	44 047.5	36 985.3
Czech Republic	..	780.6	..	90.2	119.6	36.6	152.9	25.2	127.2	89.8	42.9	96.2
Denmark	6 686.1	41 497.6	2 236.0	1 260.5	3 955.1	3 063.5	2 519.1	4 209.5	4 480.2	7 044.5	6 589.8	6 139.4
Finland	11 478.0	71 904.4	– 751.7	1 407.1	4 297.8	1 497.3	3 596.5	5 291.7	18 641.5	6 615.5	24 034.7	7 274.0
France	101 426.3	583 869.7	30 406.3	19 736.1	24 372.3	15 758.1	30 418.6	35 579.6	48 612.7	120 620.1	175 535.4	82 830.5
Germany	91 382.8	477 654.9	18 595.1	17 196.1	18 857.8	39 051.6	50 806.3	41 794.1	88 837.2	109 449.6	49 801.8	43 265.2
Greece	..	..	..	..	..	..	..	..	..	542.3	2 098.5	611.0
Hungary	..	2 175.3	0.2	10.7	49.0	43.1	3.7	433.3	478.0	254.4	563.5	339.5
Iceland	15.6	1 070.5	4.1	12.2	22.6	23.6	62.5	50.0	79.4	117.0	381.8	317.3
Ireland	..	22 119.0	215.3	219.8	437.8	819.9	726.6	1 008.7	3 902.0	5 418.5	3 973.5	5 396.9
Italy	28 054.4	97 706.0	5 955.2	7 232.4	5 108.4	5 732.1	6 464.8	10 619.5	16 077.6	6 721.7	12 318.5	21 475.9
Japan	274 290.0	455 867.4	34 138.0	36 025.0	41 051.0	52 692.7	49 709.6	54 734.7	39 857.1	65 317.4	49 786.7	32 555.2
Korea	2 463.5	25 732.3	1 219.4	1 261.6	2 299.5	2 759.0	3 560.0	2 994.0	3 418.0	2 144.0	3 477.0	2 599.8
Mexico	..	..	..	..	..	..	..	..	..	..	..	3 708.0
Netherlands	51 404.8	319 139.8	13 945.9	11 782.7	16 786.8	19 415.0	31 685.1	28 815.6	38 831.5	41 472.4	71 992.3	44 412.5
New Zealand	3 956.5	2 804.4	391.4	– 1 388.7	2 008.2	1 783.5	– 1 239.7	– 1 565.5	401.4	1 072.5	608.7	732.6
Norway	6 310.1	32 976.8	394.2	933.0	2 262.6	3 141.1	5 947.9	4 993.3	2 514.7	5 520.9	8 254.6	– 985.5
Poland	..	631.5	13.0	18.0	29.0	42.0	53.0	45.0	316.0	31.3	17.2	67.0
Portugal	429.0	24 207.0	684.0	107.0	283.0	684.6	785.4	1 926.2	3 845.9	3 168.4	7 656.8	5 065.7
Slovak Republic	..	41.0	..	12.8	17.7	41.8	56.5	94.3	138.4	– 396.6	18.3	57.8
Spain	10 799.3	175 271.7	2 171.0	3 174.9	4 109.9	4 158.1	5 592.1	12 547.3	18 938.8	42 085.0	54 684.6	27 809.9
Sweden	48 598.2	130 304.0	408.7	1 357.7	6 701.4	11 215.0	4 664.3	12 648.1	24 377.3	21 927.2	40 636.6	6 367.8
Switzerland	33 555.2	182 762.9	6 058.5	8 765.4	10 798.0	12 213.9	16 150.8	17 747.9	18 768.8	33 264.3	42 669.9	16 325.4
Turkey	..	3 384.0	66.0	65.0	50.0	114.0	133.0	272.0	396.0	655.0	1 029.0	604.0
United Kingdom	176 468.4	834 141.7	17 740.9	25 316.8	29 605.1	43 566.9	34 055.9	61 620.0	121 834.0	205 795.2	255 122.6	39 484.4
United States	174 909.0	1 145 500.0	48 266.0	83 950.0	80 167.0	98 750.0	91 885.0	104 803.0	142 644.0	188 901.0	178 294.0	127 840.0
Total OECD	**1 114 686.0**	**5 319 407.4**	**203 667.0**	**231 234.3**	**267 962.1**	**344 182.7**	**367 970.2**	**439 436.9**	**666 667.2**	**926 584.1**	**1 285 615.4**	**593 047.2**
Argentina	500.8	14 432.0	1 170.0	705.0	1 013.0	1 498.0	1 600.0	3 653.0	2 326.0	1 354.0	1 113.0	..
Brazil	615.8	8 056.0	137.0	491.0	1 037.0	1 384.0	– 467.0	1 042.0	2 721.0	1 690.0	2 280.0	– 2 259.0
Chile	– 11.5	17 977.7	397.8	434.2	910.7	752.0	1 188.0	1 865.0	2 798.0	4 855.0	4 777.0	..
Estonia	..	525.5	1.9	6.2	2.4	2.5	40.1	136.6	6.3	82.9	63.4	183.3
Israel	62.8	10 365.1	579.5	615.4	741.6	733.2	1 042.2	794.9	1 063.2	805.8	2 801.7	1 187.6
Latvia*	..	– 35.6	2.1	– 4.5	– 64.6	– 65.0	3.0	6.1	54.0	17.0	9.4	6.9
Lithuania	..	51.6	..	..	..	1.0	0.1	26.9	4.2	8.6	3.7	7.1
Slovenia	..	239.7	– 1.8	1.3	– 2.9	– 5.1	6.3	35.7	– 1.7	37.7	66.0	104.2
Total	**1 115 853.9**	**5 371 019.4**	**205 953.5**	**233 482.9**	**271 599.3**	**348 483.3**	**371 382.9**	**446 997.0**	**675 638.2**	**935 435.2**	**1 296 729.6**	**592 277.3**

Note: Data are converted using the yearly average exchange rates.

* Latvia's application to adhere to the Declaration on International Investment and Multinational Enterprises is under review.

Source: OECD Foreign Direct Investment database – Based on national sources of OECD Member countries; IMF International Financial Statistics for Non-Member Adherents.

Table 3. **Foreign Direct Investment in Adherents to the OECD Declaration on International Investment and Multinational Enterprises: Inflows**

As a percentage of GDP

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Argentina	0.44	0.75	1.01	1.39	1.12	1.51	1.73	7.07	1.96
Australia	1.79	2.05	1.21	1.37	2.36	2.02	1.74	1.81	1.86
Austria	0.49	0.53	0.66	0.81	1.91	1.29	2.15	1.42	4.97
Belgium-Luxembourg	4.55	4.56	3.34	3.66	4.88	4.60	8.42	14.29	35.83
Brazil	0.82	0.96	1.09	1.32	1.26	1.64	3.26	2.71	3.36
Canada	0.83	0.85	1.47	1.59	1.59	1.87	3.57	3.88	8.96
Chile	0.49	1.04	4.49	3.24	3.90	4.13	2.84	8.73	2.43
Czech Republic	3.38	1.87	2.11	4.92	2.48	2.45	6.53	11.58	9.05
Denmark	0.69	1.20	3.23	2.32	0.42	1.66	3.74	6.55	9.81
Estonia	..	0.00	0.00	0.35	0.13	0.90	6.29	4.13	5.39
Finland	0.37	1.00	1.58	0.82	0.87	1.73	9.41	3.59	7.31
France	1.33	1.29	1.15	1.52	1.41	1.65	1.93	2.39	3.41
Germany	0.13	0.10	0.09	0.56	0.24	0.58	1.13	2.66	9.44
Greece	1.02	..	..	..	..	..	..	..	..
Hungary	..	..	..	..	..	..	..	4.16	3.65
Iceland	–0.16	0.00	0.00	0.17	1.13	1.97	1.79	0.71	1.84
Ireland	0.70	0.76	0.57	0.57	0.79	0.73	10.24	19.99	21.73
Israel	0.87	0.51	0.48	0.56	0.53	0.08	1.41	0.65	1.21
Italy	0.26	0.38	0.22	0.44	0.29	0.32	0.22	0.59	1.25
Japan	0.11	0.07	0.09	0.07	0.15	0.13	0.26	0.47	0.61
Korea	0.26	0.21	0.25	0.28	0.44	0.65	1.65	2.63	2.22
Latvia*	0.00	0.00	0.00	0.37	0.15	0.62	6.05	1.61	1.64
Lithuania	–1.87	0.52	0.05	0.10	0.02	0.14	0.43	0.70	3.11
Mexico	2.23	1.67	2.94	3.33	2.98	3.45	2.76	2.49	2.29
Netherlands	2.03	2.36	1.59	2.75	3.55	3.34	9.64	8.02	14.69
New Zealand	2.69	5.02	5.20	4.42	5.53	2.78	4.02	1.68	2.68
Norway	0.64	1.26	1.01	1.68	2.53	2.74	2.73	4.89	3.72
Poland	..	1.29	1.11	2.88	3.13	3.41	4.00	4.69	5.92
Portugal	1.95	1.76	1.39	0.62	1.32	2.32	2.79	0.98	5.89
Slovenia	..	1.02	0.45	0.58	0.54	1.06	0.94	0.76	1.11
Spain	2.22	1.91	1.84	1.08	1.12	1.14	2.01	2.62	6.53
Sweden	–0.02	2.00	3.07	6.01	1.94	4.59	8.17	25.08	10.22
Switzerland	0.17	–0.04	1.29	0.72	1.04	2.60	3.41	4.40	7.22
Turkey	0.57	0.41	0.49	0.55	0.50	0.45	0.48	0.44	0.85
United Kingdom	1.45	1.54	0.89	1.76	2.05	2.51	4.96	5.69	9.00
United States	0.31	0.77	0.64	0.80	1.09	1.25	2.00	3.20	2.87

Notes: Data are converted using the yearly average exchange rates.
The GDP in million US dollars for the OECD countries are from the Statistics Department of the OECD (SNA database).
The GDP in million US dollars for the non-OECD member countries are from the International Financial Statistics Yearbook, IMF 2001.

* Latvia's application to adhere to the Declaration on International Investment and Multinational Enterprises is under review.

Source: OECD Foreign Direct Investment database – Based on national sources of OECD member countries.

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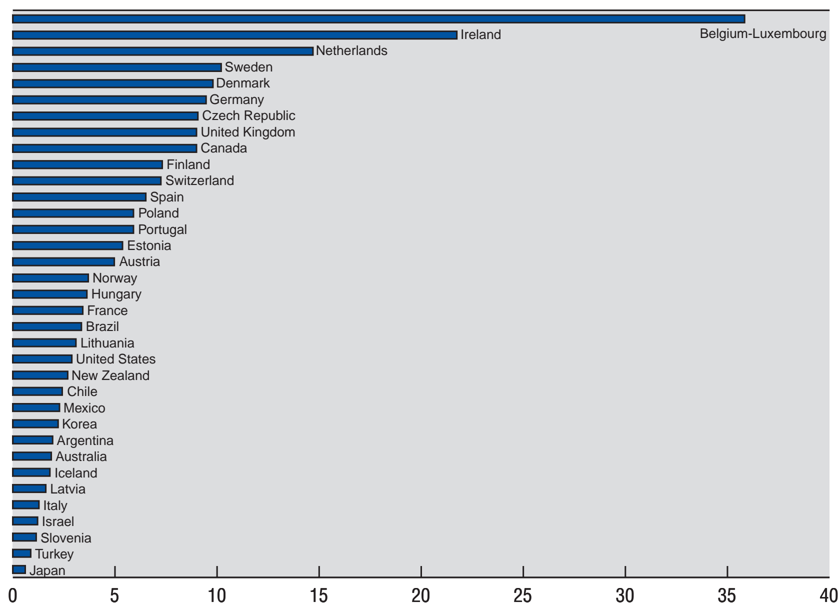
Graph 1. **Foreign Direct Investment in Adherents* to the OECD Declaration on International Investment and Multinational Enterprises: Inflows**

As a percentage of GDP: 2000



* Latvia's application to adhere to the Declaration on International Investment and Multinational Enterprises is under review.

Source: OECD.

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Table 4. **Foreign Direct Investment from Adherents to the OECD Declaration on International Investment and Multinational Enterprises: Outflows**

As a percentage of GDP

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Argentina	0.00	–0.02	0.01	0.18	0.09	0.02	0.05	–0.02	0.02
Australia	1.04	1.31	0.75	0.62	1.57	1.15	1.26	0.38	0.22
Austria	0.98	0.79	0.60	0.48	0.84	0.97	1.30	1.58	1.77
Belgium-Luxembourg	4.55	1.68	0.48	3.97	2.80	2.77	10.54	12.58	34.87
Brazil	0.02	0.06	0.01	0.02	–0.01	0.04	–0.02	0.06	0.05
Canada	0.63	1.02	1.67	1.97	2.16	3.58	5.15	2.76	5.93
Chile	0.04	–0.05	0.01	–0.01	0.04	0.05	0.06	–0.09	–0.01
Czech Republic	..	0.26	0.29	0.08	0.27	0.05	0.22	0.16	0.23
Denmark	1.52	0.91	2.61	1.70	1.38	2.49	2.25	7.22	5.33
Estonia	..	0.00	0.00	0.00	0.00	–0.03	0.00	0.00	0.26
Finland	–0.69	1.63	4.30	1.16	2.82	4.32	14.45	5.15	19.88
France	2.26	1.55	1.80	1.01	1.96	2.53	2.79	7.07	13.34
Germany	0.97	0.78	0.82	1.58	2.13	1.98	4.13	5.22	2.60
Greece	..	..	..	..	..	..	..	..	..
Hungary	..	..	..	..	..	..	..	0.53	1.22
Iceland	0.06	0.20	0.36	0.34	0.86	0.68	0.97	1.36	4.46
Ireland	..	..	..	..	..	..	4.51	5.71	2.78
Israel	–0.12	0.88	0.49	0.02	–0.01	0.45	0.62	0.43	0.72
Italy	0.48	0.73	0.50	0.52	0.52	0.91	1.01	0.57	1.15
Japan	0.90	0.82	0.85	1.00	1.06	1.27	1.01	1.45	1.04
Korea	0.39	0.36	0.57	0.56	0.68	0.63	1.08	0.53	0.76
Latvia*	0.00	0.02	0.00	0.00	0.00	–0.01	–0.02	–0.02	0.01
Lithuania	0.00	0.01	0.00	0.00	0.01	0.03	0.00	0.00	0.01
Mexico	..	..	..	..	..	..	..	..	..
Netherlands	4.17	3.62	4.82	4.68	7.69	7.65	9.87	10.42	19.49
New Zealand	0.97	–3.15	3.89	2.87	–1.89	–2.43	0.69	1.91	1.11
Norway	0.31	0.80	1.84	2.14	3.77	3.22	1.70	3.60	5.10
Poland	..	0.02	0.02	0.03	0.04	0.03	0.20	0.02	0.01
Portugal	0.70	0.12	0.31	0.64	0.70	1.81	3.41	2.73	6.72
Slovenia	..	0.17	–0.02	–0.04	–0.05	–0.07	–0.05	0.14	0.58
Spain	0.36	0.64	0.81	0.71	0.92	2.23	3.22	6.99	9.58
Sweden	0.16	0.71	3.24	4.67	1.78	5.29	10.17	9.04	17.74
Switzerland	2.48	3.70	4.13	3.98	5.46	6.94	7.16	13.89	17.26
Turkey	..	..	..	..	..	..	..	0.35	0.51
United Kingdom	1.65	2.63	2.84	3.84	2.86	4.64	8.55	14.11	17.48
United States	0.68	1.19	1.05	1.25	1.09	1.16	1.50	1.55	1.42

Notes: Data are converted using the yearly average exchange rates.
The GDP in million US dollars for the OECD countries are from the Statistics Department of the OECD (SNA database).
The GDP in million US dollars for the non-OECD member countries are from the International Financial Statistics Yearbook, IMF 2001.

* Latvia's application to adhere to the Declaration on International Investment and Multinational Enterprises is under review.

Source: OECD Foreign Direct Investment database – Based on national sources of OECD member countries.

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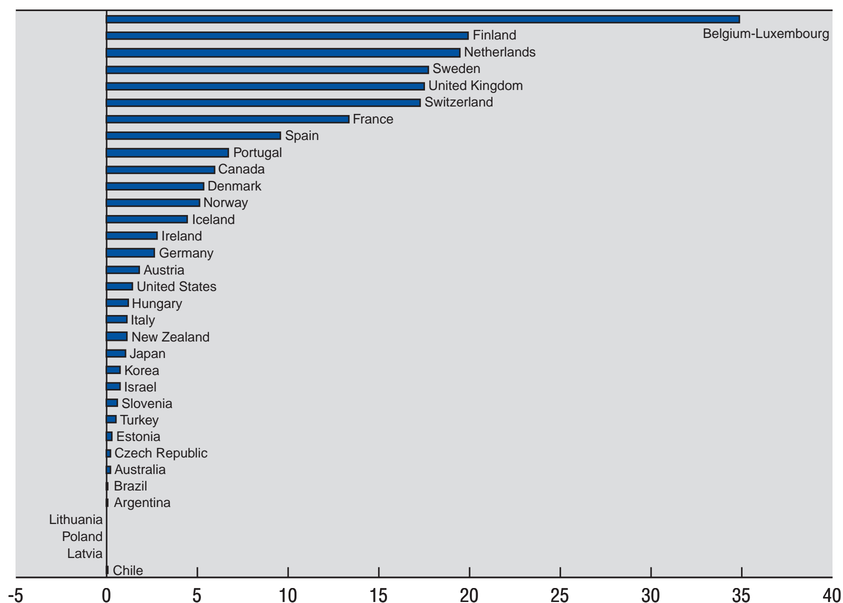
Graph 2. **Foreign Direct Investment from Adherents* to the OECD Declaration on International Investment and Multinational Enterprises: Outflows**

As a percentage of GDP: 2000



* Latvia's application to adhere to the Declaration on International Investment and Multinational Enterprises is under review.

Source: OECD.

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Table 5. **Foreign Direct Investment from and in OECD Countries: Inward and Outward positions at year-end**
Million US dollars

	Inward							Outward						
	1995	1996	1997	1998	1999	2000	2001	1995	1996	1997	1998	1999	2000	2001
Australia	104 074	116 797	101 089	105 811	122 656	113 227	111 391	53 009	66 858	71 968	77 038	87 212	80 932	87 890
Austria	19 721	19 629	19 522	23 565	23 472	30 431	34 370	11 832	13 060	14 011	17 468	19 127	24 820	26 351
Belgium-Luxembourg	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Canada	123 182	132 970	135 936	143 349	172 267	201 513	201 463	118 106	132 322	152 959	171 785	196 249	226 888	244 461
Czech Republic	7 350	8 572	9 234	14 375	17 552	21 644	26 764	345	498	548	804	698	738	832
Denmark	..	22 337	..	31 179	41 236	64 408	..	0	27 602	0	34 859	44 859	64 046	..
Finland	8 465	8 797	9 530	16 455	18 320	24 272	26 267	14 993	17 666	20 297	29 406	33 850	52 109	56 055
France	143 669	143 939	141 138	169 540	150 090	257 804	..	184 379	192 967	189 684	229 222	279 873	432 657	..
Germany	192 897	197 492	192 146	255 363	299 705	449 066	..	258 141	274 878	286 526	351 615	400 054	470 578	..
Greece	..	..	..	13 088	15 533	12 479	..	..	..	..	2 792	3 218	5 852	..
Hungary	9 355	9 714	10 047	10 805	10 393	10 304	..	..	..	887	1 273	1 484	1 925	2 205
Iceland	149	197	332	457	476	482	631	177	240	275	361	452	649	887
Ireland	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Italy	63 453	72 482	81 082	108 835	108 701	113 046	107 921	97 038	107 441	124 977	176 985	181 858	180 276	182 375
Japan	..	29 938	27 076	26 066	46 117	50 322	50 320	0	258 618	271 895	270 053	248 786	278 438	300 117
Korea	..	..	..	..	..	42 342	..	10 232	13 792	16 786	20 204	22 348	25 816	..
Mexico	41 130	46 912	55 810	63 610	78 060	97 170	..	..	..	..	..	..	..	..
Netherlands	121 972	131 139	127 424	168 867	186 854	238 329	..	178 464	203 238	209 577	230 769	257 062	309 708	..
New Zealand	25 728	34 744	31 365	33 170	32 861	28 070	20 888	7 676	9 293	5 646	5 491	7 006	6 065	6 860
Norway	19 836	20 624	20 704	26 081	28 841	30 363	..	22 521	25 439	27 494	31 578	..	..	..
Poland	7 843	11 463	14 587	22 479	26 075	33 603	..	539	735	678	1 165	1 024	1 025	..
Portugal	18 162	19 861	19 306	24 466	23 519	28 161	29 958	4 406	3 954	5 414	9 622	10 331	17 781	22 095
Slovak Republic	1 155	1 497	1 720	2 220	2 306	3 795	4 213	110	165	220	395	307	322	365
Spain	109 245	107 908	99 993	118 073	116 667	144 507	158 404	36 259	40 555	50 304	70 146	112 660	165 871	185 952
Sweden	30 489	34 202	41 894	51 605	74 368	82 855	81 084	71 941	70 878	75 154	90 184	101 699	120 088	120 172
Switzerland	57 064	53 917	59 515	71 997	76 000	81 888	90 324	142 481	141 587	165 354	184 237	194 599	227 675	236 469
Turkey	..	..	..	..	..	..	..	..	..	..	..	..	..	..
United Kingdom	199 772	228 642	252 959	305 325	375 438	456 613	497 097	304 865	330 432	360 796	491 924	651 361	910 839	943 541
United States	535 553	598 021	681 842	778 418	965 632	1 238 627	..	699 015	795 195	871 316	1 000 703	1 130 789	1 244 654	..
Total OECD	**1 840 262**	**2 051 796**	**2 134 251**	**2 585 200**	**3 013 140**	**3 855 319**	..	**2 216 530**	**2 727 411**	**2 922 771**	**3 500 080**	**3 986 905**	**4 849 752**	..

Note: Data are converted using the yearly average exchange rates.
Source: OECD Foreign Direct Investment database – Based on national sources of OECD Member countries.

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