

**Trade Policy Review Body**

**TRADE POLICY REVIEW**

**ISRAEL**

**Report by the Secretariat**

This report, prepared for the Trade Policy Review of Israel, has been drawn up by the WTO Secretariat on its own responsibility. The Secretariat has, as required by the Agreement establishing the Trade Policy Review Mechanism (Annex 3 of the Marrakesh Agreement Establishing the World Trade Organization), sought clarification from the Government of Israel on its trade policies and practices.

Document WT/TPR/G/58 contains the policy statement submitted by the Government of Israel

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Note: This report is subject to restricted circulation and press embargo until the end of the meeting of the Trade Policy Review Body on Israel.



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## SUMMARY OBSERVATIONS

1. Since its previous Trade Policy Review conducted in 1994, Israel has continued to move towards a more open trade policy regime, while, at the same time, Israeli exporters have benefitted from greater market access abroad. The continued liberal and open foreign direct investment regime, with foreigners facing very few restrictions, has also contributed to Israel's economic development. As a result of an increasing number of preferential trade agreements, the actual average customs duty paid has halved since 1993 from an already low level to 1%, in tandem with a reduction of the MFN tariff rates. Israel has demonstrated its commitment to the multilateral trading system through active participation in the WTO. Israel has modernized its customs valuation legislation and its procedures have been streamlined. Another noteworthy development is mandatory standards that are increasingly being aligned with international standards. Competition issues have received increased emphasis as border protection has gone down and privatization has moved ahead. However, the role of the State continues to be extensive in many areas. Israel's state aid system remains complex and costly. Several elements of preferences on government procurement have become subject to regulations since 1994. Some retail prices are still under government control, and parts of the agricultural sector remain subject to government intervention and relatively high import protection.

### (1) ECONOMIC ENVIRONMENT

2. Economic growth in Israel has slowed in recent years, after an impressive performance in 1994-95. While GDP expanded at an annual average rate of 6% during the first half of the 1990s, it grew by only 2% in 1998. Over the same period, the structure of the economy continued to shift towards services, away from agriculture and manufacturing. The slowdown in growth is attributed to several factors, including disciplined financial policies to address rising macroeconomic imbalances, lower export

growth, which was somewhat affected by the slowdown in world growth, and the ebbing of the stimulative effects of the immigration wave of the first half of the 1990s.

3. An expansionary fiscal policy contributed to an overheating of the economy in 1995-96. The current account deficit widened sharply (from 5.5% of GDP in 1994 to 7.4% of GDP in 1995). Initially, monetary policy was the main instrument used to address excess demand, but beginning in 1997 there was progress on the fiscal front, alleviating some pressure on the current account. The financial discipline helped moderate inflation. Recently, against the backdrop of the extension of the Asian financial crisis, private sector flows in the balance of payments (except foreign direct investment) reversed directions to an out-flow in the second half of 1998 and the exchange rate of the Israeli currency, the shekel, depreciated in real terms. While growth remained sluggish and unemployment rose in 1998, progress has been made in reducing macroeconomic imbalances and implementing structural reforms. Preliminary estimates indicate that GDP growth in 1999 will remain at around 2%. Continued pursuit of structural reforms will make the economy more flexible and more attractive to foreign investment. Such reforms could include enhanced efforts to increase competition, including through further privatization, labour market reform and further liberalization of the trade regime, in particular in agriculture. Recent efforts in this direction are positive steps.

4. Foreign trade has continued to play a vital role in Israel. Merchandise trade (exports and imports) is the equivalent of about half of GDP and there is significant trade in commercial services. Israel exports close to US\$10 billion of services a year as well as more than US\$22 billion of goods. The structure of Israel's trade is that of an advanced economy: exports are mainly manufactured goods, while imports show a predominance of intermediate and investment goods. High-tech industries account for an increasing share of total exports. The recent

slowdown in world growth negatively affected Israel's export performance; real exchange rate appreciation, which was maintained until the latter part of 1998, may also have had implications for the competitiveness of exports. Import levels have recently fallen as a result of both a slowdown in domestic demand and a decline in import prices. Foreign investment has also played a role in exposing the Israeli economy to increased competition and transfer of new technology.

## **(2) TRADE POLICY FRAMEWORK**

5. Since Israel's previous Review, the institutional and legal structures for trade policy formulation and implementation in Israel have remained broadly the same. The main changes in trade and related legislation since 1994 have been pertinent to Israel's implementation of its WTO commitments. To bring legislation into conformity with the obligations it took under the Uruguay Round, Israel has amended legislation in areas such as customs valuation and standards. Other legislative changes are in the process of being implemented or are expected to be soon considered. Israel's commitments under the General Agreement on Trade in Services (GATS), which are quite extensive particularly in the financial services area, provide legal security for market access in the form of assurances not to increase the level of restrictions covered by the GATS Schedule. Israel is a party to the 1997 Agreement on Telecommunications Services (the Fourth Protocol), the 1997 Information Technology Agreement (ITA), and the 1997 Agreement on Financial Services (the Fifth Protocol). During the period under review, Israel also disinvoked the GATT 1994 provisions on the use of import restrictions for balance-of-payments reasons. Israel is in the process of amending its laws to comply with its obligations under the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs); it has invoked developing-country status with respect to the TRIPs Agreement, which means a transition period up to 1 January 2000 to bring its legislation into conformity. Adequate enforcement of

legislation in this area has been a matter of concern to some of Israel's trading partners. Israel is a signatory to the WTO Government Procurement Agreement (GPA); in government procurement it maintains off-set provisions of up to 35% of the contract, which are to decline to 20% in January 2005.

6. Israel's continued moves towards a liberal and open foreign direct investment regime, in tandem with its well educated work force, have been important factors in attracting foreign investment. During the period under review, the amount of foreign direct investment into Israel has steadily increased. Israel maintains its longstanding policy of encouraging foreign direct investment. Most sectors are open to foreign investors. The exceptions include the defence industry, international telecommunications (up to 74% foreign equity participation is allowed), wireless telecommunications services (up to 80% foreign equity participation), and tourism (ownership of hotels, travel agencies and tour operators is restricted to Israeli-registered companies, while tourist guide services are restricted to Israeli residents or citizens). The Government encourages foreign investment by providing generous incentives which are positively related to the percentage of foreign participation. Incentive schemes can be costly not only from a fiscal point of view, but may also introduce considerable distortions in the economy, and are thus under review in Israel.

## **(3) TRADE AND TRADE-RELATED MEASURES**

### **(i) Border measures**

7. Since its previous Review, Israel has continued to move, slowly but steadily, towards a more open trade policy regime. Further efforts in this direction, as well as an increase in the transparency of its tariff system, would enhance economic efficiency and attract foreign investment. MFN tariffs have been lowered from an average of 8.3% in 1993 to 7.6% in 1999 (excluding ad valorem equivalents) according to a pre-announced

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unilateral trade liberalization programme. However, as a result of the "tariffication process", MFN tariff protection for agricultural products has risen more than two and a half times over the same period. The dispersion of applied MFN tariffs has broadened since the previous review, possibly increasing their distortionary effects on the allocation of resources. The coverage of the additional tariff - called the "safeguard levy", has been substantially reduced from the equivalent of 2.7% of the tariff lines in 1992 to 0.8% in 1999. While increases in the MFN tariff require approval by the Parliament, the imposition of the safeguard levy does not, adding a possible element of uncertainty to tariff protection. As a result of the Uruguay Round and the more recently concluded Information Technology Agreement (ITA), Israel bound the rates on just over half of its tariff lines. The bound rates are often above the applied MFN rates, giving Israel the flexibility to unilaterally raise its applied tariffs, but introducing an element of uncertainty for importers and investors. The predictability of Israel's tariff regime might well be enhanced by narrowing the gap between bound and applied rates, as well as by increasing the coverage of tariff bindings.

8. In practice, most importers do not pay the MFN applied tariff. Only about a quarter of Israel's total imports are subject to MFN applied rates. Israel's major trading partners, the European Union and the United States, as well as many other countries, receive duty-free status for their exports onto the Israeli market under a number of trade agreements. Preferences under these agreements mainly concern industrial products. The importance of preferential trade is also indicated by the difference between the average applied tariff and the collection duty rate (i.e. customs duty revenue divided by imports); while the simple average applied 1999 MFN rate (including ad valorem equivalents) is 8.8%, the collection rate was 1% in 1998. This difference is also partly a reflection of various tariff concessions and exemptions.

9. Seasonal tariffs and (MFN and preferential) tariff quotas have been introduced in Israel in recent years, somewhat detracting from transparency as does a wide range of end-use provisions (granting tariff reduction for specified end-users). At the same time, with respect to some of the MFN tariff quotas, the concessional rate is higher than the applied MFN rate, thereby making them effectively redundant.

10. Progress has been made in reducing the incidence of non-tariff measures on imports, over the past years. Remaining measures, such as import licensing which covers 8.5% of the tariff lines, are mainly related to safety and security concerns. Israel has not been an active user of its anti-dumping legislation, nor has any countervailing or safeguard measures been taken during the period under Review.

11. Within the framework of its WTO commitments, Israel has modernized its customs valuation legislation since its previous Review. The customs valuation method has been changed from the Brussels Definition of Value to the transaction value method. Israel has also abolished the "harama" system, which in the past increased the value of most imports by 2 to 10% before tariffs were imposed. Clearance procedures for imports have also been improved.

#### (ii) *Internal measures*

12. Changes in a number of internal measures have the potential of facilitating foreign trade in Israel. A noteworthy development is mandatory standards that are increasingly being aligned with international standards. Currently, about one-quarter of the mandatory standards are equivalent to international standards. Competition issues have received increased emphasis as border protection has been reduced and privatization has moved ahead. An independent anti-trust authority has been established, while the legislation has been amended to deal with the abuse of dominant position and provisions on private class action have been enacted.

13. The privatization programme has gained momentum with notable recent progress in the banking and telecommunications sectors. Nevertheless, the role of the State continues to be extensive in many areas. Israel's state aid system, of mainly tax exemptions and grants, remains complex and costly, amounting to some 8.4% of GDP. Another area of state intervention is prices. Retail prices, constituting some 18% of the consumer price index, remain under government control. Moreover, several preferences (to domestic industries, certain regions, and local sub-contracting) and a requirement of business co-operation on government procurement have become subject to regulations since 1994; these requirements do not apply to tenders under the GPA.

14. Most imports, as are domestic products, are subject to purchase and value-added taxes, while certain items (such as fuels and tobacco) are subject to additional taxes. The purchase tax on imported goods is usually calculated on an average mark-up (called TAMA), which is an estimate of the difference between the import and wholesale price. An optional system, under which an importer can declare the wholesale price, has been available since 1991. However, few importers have used it.

#### **(4) SECTORAL POLICIES**

##### **(i) Services**

15. Services have continued to be the most dynamic sector of the Israeli economy. Since Israel's last Review, the structure of the economy has further shifted slowly towards services, away from agriculture and manufacturing. The overall growth of the sector has been underpinned by rapid expansion of activities in the area of personal, finance and business services. This development reflects recent deregulation and privatization achievements, which have improved the private sector environment, as well as Israel's high human capital stock.

16. Barriers to foreign firms in the services sector are generally being removed, but some sub-sectors remain monopolized, insulated from foreign competition, or largely controlled by government-owned companies. However, significant headway has been made in liberalizing the telecommunications sector and turning it from a monopolistic to a more competitive structure. While the majority government-controlled company Bezeq operates as the exclusive provider of local telephone services, private investors in joint-ventures with foreign equity up to 74% provide international services. Most value-added services are also open to foreign investors. As a result of increased competition, Israeli consumers have benefited from a sharp drop in prices of international telephone and cellular services. Substantial progress has also recently been made in liberalizing the financial sector. Nevertheless, banking remains marked by a high degree of concentration and the Government owns most of the assets. The Israeli Government is undertaking a comprehensive reform of the banking sector, to enhance competition and improve the regulatory framework. Other sub-sectors (such as insurance, air and maritime transportation, and tourism) are generally open to foreign competition. Israel's commitments in its GATS Schedule, which covers a wide range of services, provide legal security for market access in the form of assurances not to increase the level of restrictions covered by the Schedule.

##### **(ii) Manufacturing**

17. While services have prospered, manufacturing has somewhat contracted in recent years. The economic performance of manufacturing sub-sectors has, however, been uneven as the high-tech sectors - such as computers, communications and medical equipment - have steadily expanded, while the traditional labour-intensive industries have shrunk, with the lowering of trade barriers exposing a certain lack of competitiveness; an additional factor has been the slowing of demand as the immigration wave, and its demand for products from traditional sectors,

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of the early 1990's became fully absorbed. The good performance of the high-tech industries has only partly compensated for the strong decline in the traditional industries.

18. The Israeli manufacturing sector is relatively more open to import competition. As a result of many free-trade agreements concluded by Israel with its main trading partners, most manufacturing imports enter Israel under preferential (mostly duty-free) rates. For manufacturing imports from other sources, the overall tariff protection is moderate (simple MFN average, including ad valorem equivalents, of 6.6% for non-agricultural goods). Above average tariff protection is granted to sectors such as food, beverages, clothing and footwear. Israel has a number of other measures affecting trade and production of manufactured products, including strict enforcement of technical regulations (mandatory standards covering most imports of food, beverages and tobacco; and textiles, clothing and leather products), government procurement preferences (all industries), licensing requirements (concentrated in transport equipment; leather products; and other food products and animal feeds), price regulations (electricity, refrigerators and gas, oil and fuels for domestic use) and a generous state-aid system (mainly benefiting the electronic and electrical industries).

### (iii) Agriculture

19. Agriculture's share in the economy has continued to decline steadily over the period under review. Farming accounts for less than 2% of GDP and employs around 3% of the labour force. Israel is, however, self-sufficient in some agricultural products (such as foodstuffs), and competes successfully in export markets for some items (including cotton, avocados, flowers and citrus). With most of its production destined for export markets, the sector contributed to about 6% of merchandise exports in 1997. The agricultural sector makes extensive use of research and development, contributing to its export success. A major constraint for

agricultural production is the lack of rainfall and other water resources. About half of the cultivated area has to be irrigated.

20. Farming remains subject to a high degree of government intervention and depends on subsidies, cheap water and protected markets for products such as dairy fruits and vegetables. However, in 1997, for the third consecutive year, subsidies - expressed in terms of direct subsidies, and open and direct transfer payments - to farming output declined in real terms, to slightly over half their 1994 level. Taking into account the subsidy for the cost of capital in the water system, as well as the subsidy implicit in the protection of domestic produce against competing imports, the number could be higher. In some cases, such as dairy (in particular milk and cheese) and poultry meat production, domestic support measures provided by the Government are compounded by the impact of relatively high levels of tariff protection and import quotas. On the other hand, export subsidies appear to have been reduced and were granted only to one product (cut flowers) in 1997/98.

### (5) TRADE POLICIES AND FOREIGN TRADE PARTNERS

21. Israel's broad direction and objectives of its trade and investment policies have not changed during the period under review. Israel continues to maintain an orientation towards an open and liberal policy framework. Trade liberalization measures have been implemented, either on an MFN basis or through preferential trade agreements. During the period, the share of imports entering at preferential rates has increased. The bulk of Israel's trade continues to be conducted within the framework of free-trade agreements, which account for an increasing share of total trade (about three-quarters of merchandise trade by 1998). Since the previous review, Israel has continued to expand its network of preferential trade agreements (Canada, the Czech Republic, Hungary, Jordan, Poland, the Slovak Republic, Slovenia and Turkey), while

*continuing liberalization within the framework of trade agreements with its two main trading partners, the European Union and the United States. Israel also maintains a free trade agreement with EFTA countries since 1993. The coverage of the recently concluded trade agreements is wide; in addition to trade preferences, they also contain provisions on trade-related aspects such as competition, state aid, intellectual property rights, safeguard, government procurement, and dispute settlement.*

22. *Israel's large number of preferential trade agreements is not per se contradictory to its participation in, and commitment to, the multilateral trading system. It is, however, important to avoid any risks of trade diversion away from most efficient import sources. In this connection, Israel's active participation in a broader multilateral trade liberalization, as envisaged in the forthcoming new trade negotiations in the WTO, would create an enhanced competitive environment in Israel and ensure a better resource allocation.*