



OECD Economic Surveys ISRAEL

DECEMBER 2011

OVERVIEW



This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Summary

Israel's economy, including its financial sector, passed through the 2008-09 crisis in reasonable shape but is now being affected by the worsening global outlook; geopolitical tensions are high; and the 'tent protests' have added a new dimension to the socio-economic agenda. The Bank of Israel has justifiably switched to a loosening stance in its policy rate.

Analysis for this *Survey* underscores a need for attention to other financial issues:

- There is a risk that a soft landing in the housing market will not be achieved, and further appropriate macro-prudential actions may need to be taken in response.
- The previous downturn revealed weaknesses in the corporate bond market. Stronger regulation should be adopted should the steps taken to increase transparency and improve guidelines fail to substantially strengthen due diligence, which has been clearly insufficient.
- The mandatory pension contribution, now set to reach 17.5%, is ample and plans to encourage life-cycle portfolio adjustment are welcome. But the tax treatment of pensions requires reform, and pension products should be simplified.
- Financial supervision requires close co-ordination among the various regulators, and intensified monitoring of Israel's large business groups. Capital markets, insurance and savings supervision should eventually be moved out of the Ministry of Finance as part of a broader assessment of financial-market oversight to guarantee its actual and perceived independence.

Fiscal policy has been sound, but public debt remains uncomfortably high in relation to GDP:

- Achieving the deficit targets needed to reduce public debt to 60% of GDP by 2020 should remain the top priority, but this level of indebtedness should be viewed only as a milestone.
- The new expenditure rule allows a welcome increase in civilian spending over time compared to its predecessor. However, the 2012 budget should not be re-opened, and beyond that horizon substantially faster growth in outlays than allowed by the rule should be resisted because of the economic costs of raising the necessary revenues.
- Despite the benefits they would have brought, the likely cancellation of the current schedule of cuts in corporate tax and the upper brackets of personal income tax will help revenues meet deficit targets. However, additional revenue-raising measures will be needed, and these should be sought through advantageous tax reforms (*e.g.* pruning base-narrowing exemptions, higher environmental taxes) and VAT. Indeed, calls for preferential rates of VAT should be vehemently opposed.
- The reform of the royalty/tax regime for natural gas and oil is laudable. An independently managed sovereign wealth fund with an appropriately modest drawdown rate should now be established to ring fence the revenues.

Shortfalls in education and social policies contribute to Israel's high rate of poverty, especially among Arab-Israelis and Ultra-orthodox Jews, and the associated substantial socio-economic divides, but they also compromise the development of the economy's skill base:

- Since the in-depth analysis in the previous Survey, there has been progress in education reform, but, in particular, Ultra-orthodox schools still need to be more forcefully encouraged to strengthen their pupils' vocational skills. In labour-market and social policy, reforms should include re-introduction of a private-sector placement

programme and an extension of the recently decided substantial increase in the earned-income tax credit for mothers.

- In-depth review of the housing market in this *Survey* concluded that tax exemptions for homeowners and property investors should be pared back and housing policy focussed more on supporting the rental market and targeted more on low-income households. Legislation that details minimum rights and responsibilities of landlords and tenants should be introduced to encourage development of the rental market.

Although structural policy settings are generally supportive of business activity, the vigour of market competition is rather weak in a number of sectors:

- Proposed measures to streamline administrative processes for land planning and property development are welcome, but checks and balances in planning must not be compromised.
- In the financial sector, the proposed separation of financial institutions from Israel's large business groups would improve corporate governance and reduce the potential for non-transparent cross-subsidisation.
- In the energy sector, stronger policy commitment towards a market-based approach in the electricity sector is needed, starting with an overhaul of the Israel Electricity Corporation.

As elsewhere, key environmental-policy issues, notably greenhouse-gas emissions, relate to energy use:

- Economy-wide instruments should be given greater prominence through greater Israeli involvement in international emissions trading and transforming existing duties on primary fuels into a carbon tax.
- Public transport should be expanded, while at the same time taxes and charges relating to vehicle use should be aligned more closely with environmental externalities.

Assessment and recommendations

Israel's economy passed through the 2008-09 global downturn in relatively good shape but is now suffering alongside others from the continuing effects of the renewed global crisis, and geopolitical tensions have increased. So far there have been no major failures in the financial sector or need for any extraordinary fiscal stimulus. This has helped avoid a substantial increase in public debt. Furthermore, there have been substantial new finds of offshore natural gas, which will strengthen the fiscal position, further decrease dependence on imported fuels and improve options regarding energy security. However, the low interest rates generated by the monetary-policy response to the crisis have contributed to a rapid increase in property prices, which are approaching bubble proportions.

Persistent weaknesses in per capita income growth and a high rate of poverty, especially among certain communities, remain key long-term challenges. In addition, middle-class concerns have surfaced in the form of the recent 'tent protests', with complaints about the cost of housing and price levels in other sectors figuring prominently. These concerns are linked to debate about the level of competition in the economy and the role of Israel's large family-run business groups, which play a significant role in the financial sector and in many non-financial sectors too. As of November 2011, the working groups formed in response to the protests (the Trajtenberg Committee) and concerns over the power of business groups (the Concentration Committee) had delivered their initial recommendations. By the time of writing the tax proposals made by the Trajtenberg Committee had been approved by the government but not yet passed by the Knesset.

This assessment examines the challenges facing macroeconomic policy and progress in structural reform in the light of this complex conjuncture. The rapid rise in house prices has prompted the in-depth review of housing-market developments and policy settings (Chapter 1). Chapter 2 takes stock of Israel's financial sector, which, though it has avoided critical breakdown, has nevertheless displayed a few weaknesses and is an integral part of the debate. Developments and implications of the natural gas finds are discussed in Chapter 3 as part of a wider analysis of economic and environmental issues in the energy sector. The policy analysis in this *Survey* does not cover the territories known as the Gaza Strip, the Golan Heights or the West Bank including East Jerusalem.

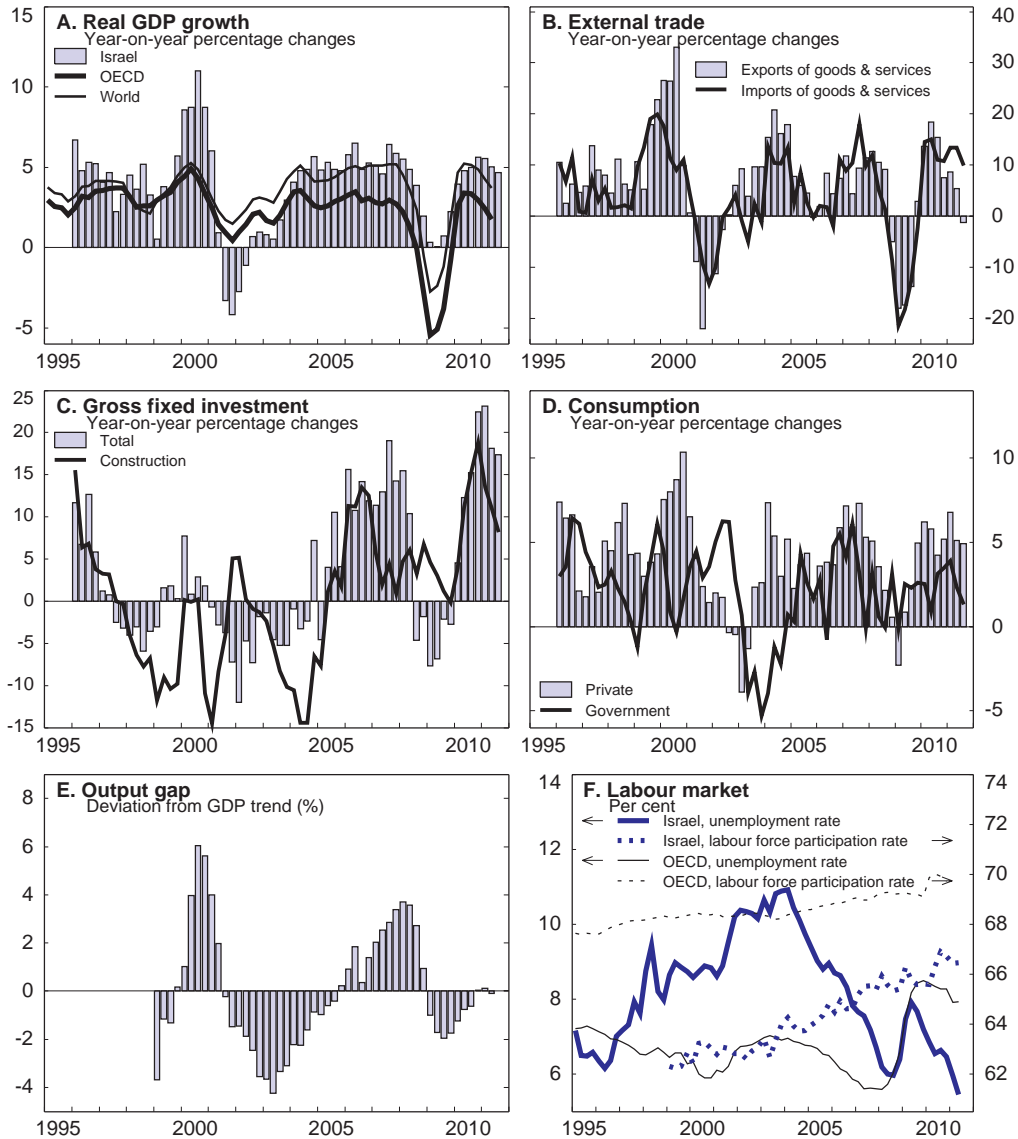
Growth has been relatively strong, but global developments are weakening prospects

Aggregate economic performance remains strong relative to most other OECD economies. The downturn in activity during the 2008-09 global economic crisis was comparatively mild, and output growth recovered rapidly. Indeed, real GDP increased by 4.8% in 2010 (Figure 1; Table 1), with exports, household consumption and, in particular, investment growing strongly. Performance was particularly helped by the absence of any failure in domestic financial institutions during the crisis. Damage from exposure to foreign toxic debt was limited, and there were no domestically driven problems in credit (nor associated house-price booms in need of correction). However, more recently renewed weakness in the global economy is being felt. Annualised quarter-on-quarter real GDP growth was 4.7% in the first quarter but had slowed to 3.4% by the third quarter. Much of the slowdown came from a deceleration in export growth, as world trade slowed significantly. The November 2011 OECD *Economic Outlook 90* has real GDP growth at 4.7% in 2011 but less than 3% in 2012, with a modest rise in unemployment (Table 1). All private expenditure components, domestic and foreign, should contribute to the slowing.

Current uncertainties and risks also influence the outlook beyond 2011. Prior to the deterioration in prospects for the global economy, concern in Israel was strongly focused on the risk of supply constraints. Room for increases in labour input has certainly diminished:

the unemployment rate has already reached a historic low (5.5% in the second quarter of 2011), while the participation rate has also risen. Yet, international comparison suggests that the participation rate could certainly rise further. Nevertheless, given recent developments, the role of these constraints has waned, and with that so have future inflation pressures.

Figure 1. A relatively strong recovery but recent slowing



Source: OECD Economic Outlook 90 database.

Table 1. **Short-term economic outlook**

	2007	2008	2009	2010	2011	2012	2013
	Current prices NIS billion	Percentage changes, volume (2005 prices)					
Real GDP	686.5	4.0	0.8	4.8	4.7	2.9	3.9
Private consumption	388.9	2.8	1.4	5.3	4.9	1.6	3.6
Government consumption	169.5	1.7	1.8	2.5	1.6	1.7	2.6
Gross fixed capital formation	130.1	4.4	-4.9	13.7	17.2	8.0	7.5
Final domestic demand	688.5	2.8	0.4	6.1	6.3	2.9	4.2
Stockbuilding ¹	8.3	-0.7	-0.5	-1.4	0.7	0.3	0.0
Total domestic demand	696.7	2.1	-0.2	4.7	7.2	3.2	4.2
Exports of goods and services	291.3	6.6	-11.9	13.6	4.8	3.9	7.8
Imports of goods and services	301.6	2.2	-14.0	12.8	12.7	5.2	8.3
Net exports ¹	-10.2	1.8	1.0	0.6	-2.7	-0.6	-0.4
<i>Memorandum items:</i>							
GDP deflator	-	1.3	5.0	1.2	1.6	2.5	1.9
Consumer price index	-	4.6	3.3	2.7	3.5	2.0	2.1
Private consumption deflator	-	5.0	2.5	2.9	3.9	2.5	2.0
Unemployment rate	-	6.1	7.6	6.6	5.6	6.0	5.8
General government financial balance ^{2,3}	-	-3.8	-6.4	-5.0	-4.0	-3.8	-3.5
Gross government debt	-	77.0	79.4	76.0	74.6	73.8	72.4
Current account balance ²	-	1.1	3.5	3.0	-0.8	-1.4	-1.7

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

2. As a percentage of GDP.

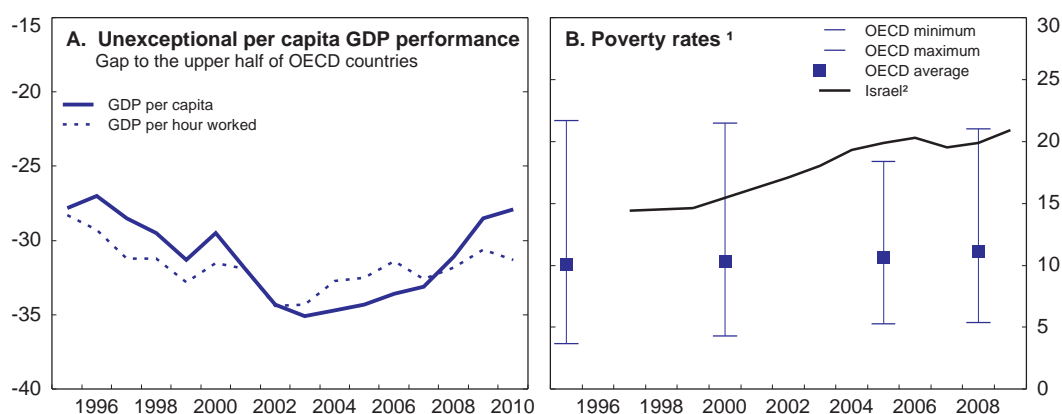
3. Excluding Bank of Israel profits and the implicit costs of CPI indexed government bonds.

Source: OECD *Economic Outlook 90* database.

Challenges in long-run productivity performance and poverty remain

While aggregate performance has been impressive, growth in GDP per capita and labour-productivity growth have been less so (Figure 2). However, gaps in income per capita and labour productivity in relation to the top half of the OECD have been narrowing since 2003, which is encouraging and may herald a sustained period of catch-up in the years ahead. Nevertheless, Israel's deep socio-economic cleavages show few signs of narrowing, and the poverty rate, the highest in the OECD area, is again rising (Figure 2; see also, OECD, 2010a; OECD, 2010b; Bank of Israel, 2011, Chapter 8; National Insurance Institute, 2010). The Arab-Israeli population (particularly specific communities, such as the Bedouin) and Ultra-orthodox Jewish communities account for about 60% of poor households. Arab-Israelis make up about 20% of the population and Ultra-orthodox about 10%, but high fertility among both groups means that in combination they account for about half of the children entering primary school. For many observers the problem of high and rising poverty is a cause for significant social concern in itself. However, it also reflects a failure to realise the full potential of human capital resources, and the poverty issue is therefore linked to that of economy-wide catch-up in GDP per capita. Hence, ensuring propitious conditions for a sustained and more inclusive catch-up in per capita outcomes must remain a primary goal of economic policies.

Figure 2. Core challenges for the longer term



1. The poverty rate used here represents the share of individuals with "equivalised" disposable income less than 50% of the median for the entire population where equivalisation is based on the OECD method of weighting household members according to the square root of household size. The values for 1998, 2000 and 2001 are interpolated. The reference years for the OECD poverty rates vary somewhat by country; the data points shown refer to the "mid 1990s", "around 2000", the "mid-2000s" and 2008.
2. Provisional data for 2009.

Source: OECD (2011), *Economic Policy Reforms 2011: Going for growth*; and OECD (2011), *Society at a glance*.

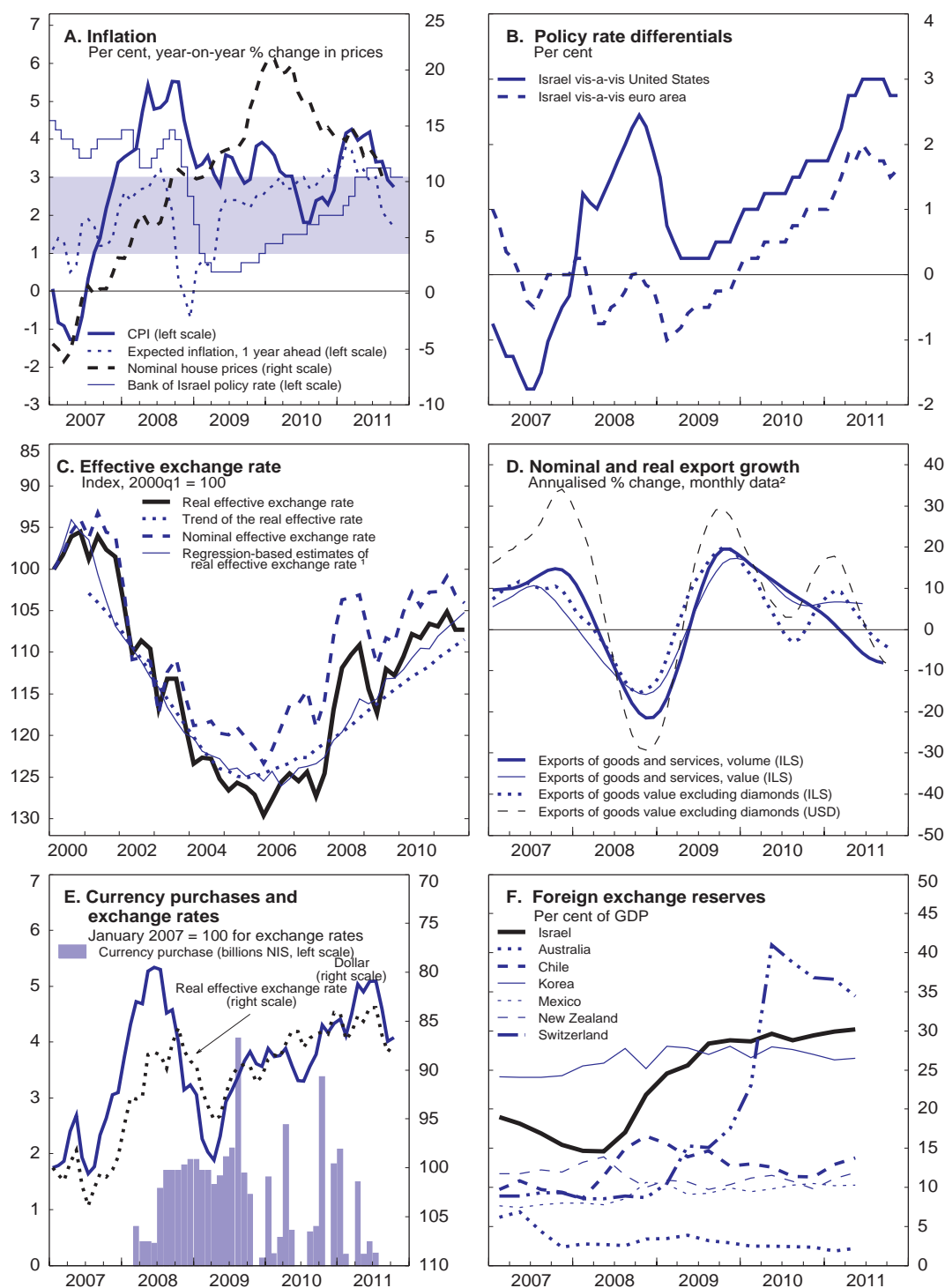
Monetary policy and financial stability

An unusual and difficult conjuncture for monetary policy...

Similar to other small open economies Israeli inflation is subject to substantial variation. Indeed, more often than not outcomes are outside the target band (1-3% growth in the CPI; see Figure 3). In recent quarters, for instance, inflation has been affected by global developments in oil and food prices and by relatively rapid increases in the housing component of inflation, which primarily reflects growth in rents. The latter used to move lockstep with the shekel-dollar exchange rate because the vast majority of rental contracts were specified in US dollars. However, following a wholesale switch to shekel-denominated rents, recent increases reflect the sharp rise in house prices. Price increases have been fuelled by a drop in mortgage interest rates following the deep cuts in the central bank's policy rate to 0.5% in the wake of the global crisis. The rate of increase in house prices has declined from peak values in 2010 and other data point to a more pronounced softening of the market in recent months.

The house price increases, combined with relatively robust real GDP growth, favoured an early start to raising the policy rate towards a more 'normal' range of values (estimated to be between 4 and 5%, Bank of Israel, 2011, p. 113). The first post-crisis rate hike was in September 2009, and by June 2011 the policy rate had reached 3.25% (Figure 3). However, the rate rises encouraged currency appreciation, with the growing interest-rate differential with major currencies playing a key causal role. This raised concerns that the export sector was suffering losses in profit and market share due to unusual circumstances, rather than through fundamentals-driven shifts in the exchange rate, which have themselves been providing a headwind to exporters in recent years. Figure 3, Panel C shows the predicted values of a regression estimated by the Bank of Israel that includes the per capita output gaps of Israel and the United States and the terms of trade. The implications of these forces is most clearly seen in the shekel value of goods exports (excluding diamonds which account for a large share of trade but only a small share of value added), where growth has indeed been relatively weak in recent quarters (Figure 3).

Figure 3. Current issues for monetary policy



1. For details on the regression-based estimates, see main text.
2. Data have been smoothed with Hodrick-Prescott filter. Monthly data for exports of goods and services (value and volume) have been interpolated from quarterly data.

Source: Central Bureau of Statistics; Bank of Israel; IMF International Financial database; OECD (2011), *Going for growth*; and OECD *Economic Outlook 90* database.

... was tackled by combining rate hikes with currency intervention

In an effort to strike a compromise between domestic price pressures and concern for the export sector, the Bank of Israel combined policy-rate rises with interventions in the foreign-exchange market. Regular pre-announced daily foreign-currency purchases were conducted from early 2008 to mid-2009. Since then intervention has been conducted on a discretionary basis. Initially, the Bank stressed that the interventions were to build foreign-currency reserves, but later justifications underscored the role of intervention in shielding the export sector in particular from the exchange-rate impact of heavy short-term capital flows (see Einstein and Friedman, 2011 and Sorezcky, 2010). This can be seen, for instance, by the rise in the share of short-term Bank of Israel securities (*makam*) held by non-residents from 1% at the end of 2008 to 28% at the end of 2010 (Bank of Israel, 2011, Chapter 3). The interventions were accompanied by new reporting requirements on foreign-exchange swaps and derivatives, a reserve requirement on banks against transactions with non-residents in foreign-exchange derivatives, and abolition of a tax exemption for non-resident investors on profits on short-term securities issued by the Bank of Israel and the government.

The currency intervention implies monetary policy became less single-mindedly focussed on hitting the inflation target. Indeed, there were worrying increases in inflation expectations. Notably, from mid-2009 to mid-2011 inflation expectations one year ahead implicit in capital-market outcomes were typically close to or above the upper bound of the 1-3% target band (Figure 3), suggesting declining policy credibility. For small economies, such as Israel, currency intervention has no global implications, and there may be little alternative when foreign monetary policy settings are necessarily extreme. But a number of other countries have also taken unilateral action to affect exchange rates or capital flows. While these measures were introduced to achieve legitimate domestic policy goals, if such policies were to become more generalised, they could collectively have negative spillover effects on global trade and capital allocation.

Intervention should be viewed as a temporary measure to deal with unusual circumstances. Indeed, for Israel currency intervention has become somewhat less relevant recently as reduced growth prospects and falling inflation led the Bank to leave its policy rate unchanged from June to September and lower it for October. And, for the near term at least, rate hikes and therefore further widening of the interest-rate differential no longer seem likely. Indeed, the projection shown in Table 1 is conditional on further monetary loosening in the near term. Monetary-policy relaxation, combined with reaction to other global economic developments, has brought substantial depreciation of the shekel. According to the latest available data, the Bank of Israel has not made foreign-currency purchases since July 2011.

Changes to the Bank of Israel's modus operandi continue

New legislation governing the Bank of Israel came into force in 2010, which has clarified that the Bank's policy objectives include the pursuit of secondary goals in support of government policy (in particular, economic growth and the reduction of social inequalities) as long as this does not impair the primary goal of price stability, nor the efficiency and stability of the financial system. The legislation also laid out a new framework for rate-setting decisions by vote of a monetary-policy committee. This became operational in October 2011. The Monetary Committee comprises the Governor plus two other bank staff and three external members (the Governor has a casting vote). Another new body, the Administrative Council, whose duties, *inter alia*, include approval of the budget and work programme of the Bank, became operational at the same time.

Additional steps are being taken to cool the housing market

Rapidly rising house prices have been not only a factor in rate-setting decisions but also the subject of welcome macro-prudential measures: loan-loss provisions for mortgage

lending have been ramped up, and the variable-rate component of any mortgage limited to one third. In addition, purchasing property for investment purposes has been made more costly through an increase in transactions taxes, while the sale of investment property is being encouraged by a temporary targeted exemption from capital gains tax. In addition to these macro-prudential measures, approval of new housing development has been expedited (see below).

Increases in prices have eased, if not stopped altogether, and warning indicators (such as the price-to-rent ratio, see Chapter 1) have not yet reached what are thought to be critical levels. Furthermore, the macro-prudential measures have added additional margins of safety to already conservative mortgage-lending practises. Nevertheless, there is still a risk that a soft landing may not be achieved and house prices (and loan repayments) in relation to rents and incomes may reach 'bubble' proportions, heightening the risk of a sharp and damaging correction. In this event, further macro-prudential tightening and faster land release by the Israel Land Authority would be warranted. On the other hand, the early signs of weakness may presage an imminent sharper-than-desired decline in prices, which would call for measures in the opposite direction.

There is room to improve financial supervision

The measures taken in reaction to housing-market developments reflect a broader and welcome recognition of the importance of macro-prudential oversight and action. Stress tests in banking are also being made more rigorous, and the authorities aim to publish periodic financial stability reports. However, there is room for improvement:

- Responsibilities in the current three-agency structure are divided along institutional lines (banks, non-banking institutions and capital markets). While this has some advantages, it requires strong co-ordination to ensure that cross-cutting issues are properly covered. The supervisors meet regularly now, but continuing efforts are needed in this area.
- The Capital Markets, Insurance and Savings Division is under the direct authority of the Ministry of Finance. To date, supervision has been good, and the Division appears to enjoy satisfactory autonomy. Indeed, the arrangement has the benefit of allowing it to draw on the considerable clout of the Ministry. While independence has not been compromised, the risk nevertheless remains, and for this reason the Division should eventually be moved out of the Ministry, although this change should be considered as part of an overall assessment of the supervision of the financial system.
- Business groups play a prominent role in the financial sector and in the Israeli economy as a whole (see below). While they are already scrutinised to some extent, a dedicated unit within one of the existing supervisory bodies or a permanent working group comprising representatives from each of the supervisory bodies would help ensure this dimension of financial supervision is comprehensively monitored and not just when a special working group is appointed.

In banking, planned legislation to allow securitisation should proceed cautiously

The loan-loss provisions in mortgage regulation, along with the absence of securitisation, reflect a broadly conservative approach to banking. This certainly helped Israel to avoid the type of problem that contributed to the global financial crisis. Conservative banking is also reducing the risk that the house-price boom could generate an unsustainable and potentially destabilising level of household credit. However, it has meant the financial system lacks some features that can improve market efficiency without boosting risk excessively if properly regulated and supervised. In light of international experience, plans to allow securitisation should nevertheless proceed with a good deal of caution.

Corporate bond markets remain the major concern

Over the past decade, Israeli non-bank credit in the form of corporate bonds has increased markedly; then, during the 2008-09 crisis, the market dried up completely. This drew attention to problems of thin trading volumes, deficient information flows in issuance and risk assessment, and a lack of orderly default processes. In response, new regulations have been introduced to strengthen diligence, especially by institutional fund managers. Such funds, which hold a large share of corporate bonds and manage most household savings and pension plans, are subject to new guidelines on side conditions ('covenants') in bond contracts, for instance. Issuers of company bonds have also been subject to tighter regulation, including new reporting requirements and measures to improve debt-default procedures. However, concerns remain about investment risks remain, particularly in (uncollateralised) corporate-bond financing in the real-estate and construction sectors. Thus far measures have endeavoured to improving transparency and influence behaviour largely through guidelines. A more pro-active approach should be taken if fragilities in the bond market persist.

The framework for saving in institutional funds could be improved

First-pillar pension provisions in Israel are limited, and therefore many households count heavily on the proceeds from their own investments in pension-type products for their retirement income. While the pension system has laudable features, not least a relatively light fiscal burden, there are issues:

- A mandatory minimum pension was introduced in 2008, envisaging a contribution rate of 15% once the scheme was fully operational. In 2010 this was increased to 17.5%, which is high in international comparison (even allowing for the fact that 5 percentage points of the contribution doubles as severance insurance) and implies fairly high replacement rates for those on low incomes. The contribution is therefore ample, and no further hikes in the contribution rate are warranted.
- The mandatory contributions have been introduced without changing the tax benefits to long-term saving, such that employees continue to receive tax breaks on the mandatory component, which is wasteful from a policy perspective. In addition, the tax benefits are regressive and typically of no value to low-income households. This too should be re-examined.
- The provision of tax incentives across a broad range of long-term savings products has merit, but the resulting complexity means that many households probably find it difficult to make well informed choices. Plans to introduce default portfolio guidelines that reduce exposure to risk as the policy holder ages ("life-cycle portfolio adjustment") are therefore welcome. This will help simplify the array of pension products, but additional streamlining and simplification are needed, and removal of access to preferential-rate bonds for some types of pension should be considered.

Box 1. Core recommendations on monetary policy and financial-market regulation

- End intervention in the foreign-currency market, unless needed to counter destabilising capital inflow surges.
- Take further macro-prudential actions should the housing market fail to achieve a soft landing.
- Strengthen co-ordination in financial supervision: establish a specialised unit or permanent working group to scrutinise business groups; and eventually remove the Capital Markets, Insurance and Savings Division from the authority of the Ministry of Finance as part of a broader assessment of financial-market supervision (Chapter 2).
- As regards specific financial products: proceed cautiously with securitisation, adopt more rigorous regulation of bond markets should fragilities persist, reform the taxation of second-pillar pension saving, and do not increase mandatory pension provisions any further beyond currently planned rises (Chapter 2).

Fiscal policy

The absence of bailouts of financial institutions, the relatively mild downturn in economic activity in 2008-09 and the speedy recovery thereafter have helped Israel avoid the challenging fiscal situation facing a number of other OECD economies. Nevertheless, there remain sharp trade-offs in fiscal-policy objectives between debt reduction, spending control and tax reform, which have been heightened by pressures from the recent wave of popular protests.

Debt reduction should remain the top priority

Successive governments had until recently pursued a 'textbook' fiscal strategy of prioritising schedules of income-tax cuts and debt reduction (*via* deficit targets) through a tight lid on spending and increased use of indirect taxation. The returns from this strategy have been significant. The debt-to-GDP ratio has fallen to 76% of GDP, and the overall 'size' of government and level of income taxation have been brought down from high levels (Figure 4).

Nevertheless, further debt reduction is needed. The government's implicit goal of reducing debt to 60% of GDP by 2020 by cutting the deficit to 1% of GDP by 2014 (and holding it at this level thereafter) is sound. However, the 60% target should be regarded as only a milestone in consolidation, and a lower target should be adopted at some point. This would ensure further lowering of interest payments and mean an ample buffer to external shocks and the fiscal impacts of aging. In broad terms the authorities have a good track record in reaching their targets; deficit outcomes have rarely exceeded targets in recent years (Figure 4), although the targets for 2009 and 2010 were revised up significantly and outcomes were substantially above the original targets. Nevertheless, overall fiscal performance over the longer term suggests the authorities are capable of the required fiscal discipline to adhere to the deficit track. Political pressure to relax the deficit target for 2012 contained in the two-year budget in the wake of the tent protests should be strongly resisted.

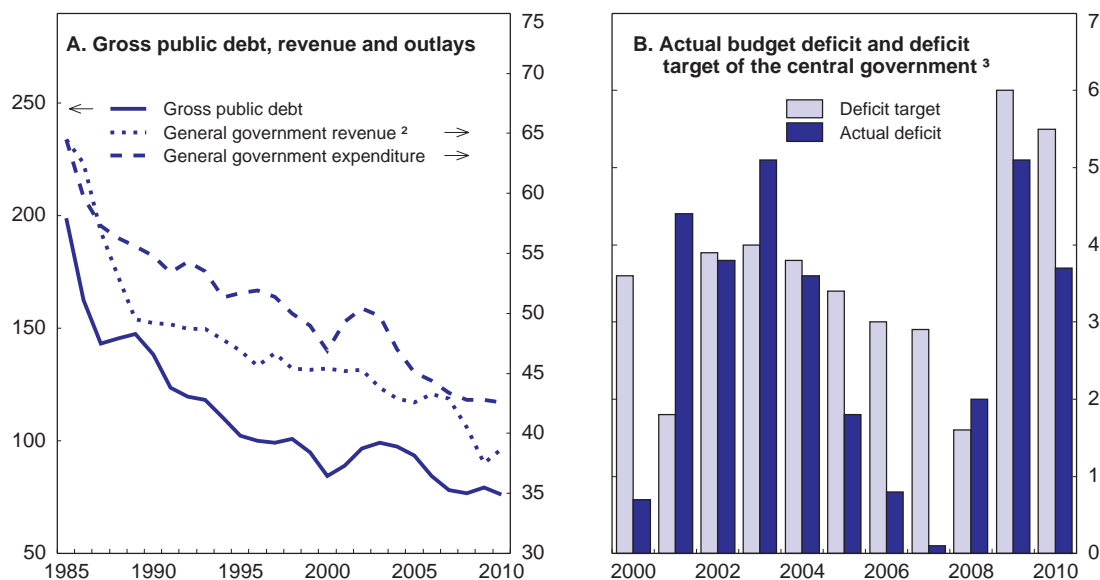
Faster spending growth under the new fiscal rule is welcome

In addition to the deficit targets, budgeting is guided by a fiscal rule that sets the maximum growth rate in central-government spending. Beginning from the 2011-12 budget a new rule was introduced, which anchors spending to the goal of a 60% debt-to-GDP ratio by linking growth in outlays to past GDP increases and the most recent outcome for the public debt. Specifically, the ceiling on spending growth equals average growth in real GDP over the previous ten years multiplied by the ratio of the target debt-to-GDP ratio (60%) to the latest available annual ratio. Importantly, the new rule implies that spending increases will typically be higher than under the old rule, which fixed real spending growth at 1.7% per year. For example, the 2011-12 budget was based on real increases of 2.7% each year. Despite the rule, the authorities have some room for discretion. In particular, one-off expenditure items ("boxes") have often been created that are not included in the ceiling calculation (see OECD, 2010a and Bank of Israel, 2010a).

Government spending has been severely compressed in recent years. Total public spending as a share of GDP has been driven down to close to the OECD average, but primary civilian spending has reached one of the lowest levels in the OECD area, reflecting Israel's large defence needs (Figure 5). Low hanging fruit for efficiency gains and cutbacks in public services have probably been picked; parsimony in transfers is contributing to the high rate of relative poverty, and there is a risk of excessive postponement in the implementation of plans to expand public infrastructure (notably transport). Public-sector pay and conditions in some occupations may have been driven below levels required to adequately retain and motivate existing staff and attract sufficient new entrants.

Figure 4. **Fiscal outcomes¹**

Per cent of GDP



1. The deficit data represent commonly used national definitions of the government's deficit that do not take account of the implied indexing costs from indexed government bonds. The ratio of debt to GDP is the same in the national and the internationally comparable definitions.
2. Including Bank of Israel profits. From 1995, including an expenditure of 1.5% of GDP due to the State Health Law.
3. Excluding net credit.

Source: Bank of Israel (2011), *Annual Report 2010*, Statistical Appendix.

In this light, the higher spending growth under the new rule is welcome, and substantial curtailment of spending growth below that allowed by the ceiling should be avoided. Equally, however, pressures for a substantially faster pace of discretionary spending growth should be resisted. The revenue challenges in meeting the deficit target are already significant (see below) and could be insurmountable at a faster pace of spending increase. Despite pressures arising from the tent protests, there are welcome indications that the authorities intend to maintain the ceiling and are, for instance, investigating channels for economies in the defence budget to create room for additional spending in the social sphere.

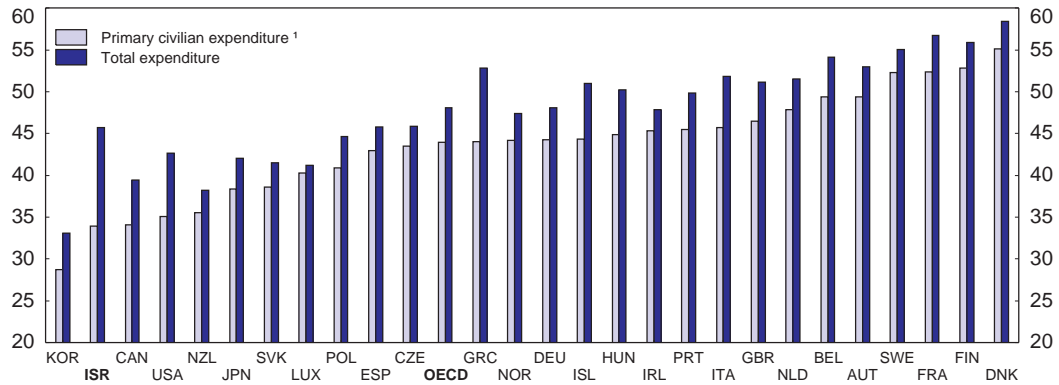
Near-term prospects in fiscal performance have weakened

Near-term prospects in fiscal performance have weakened due to the emerging downturn. When growth prospects were somewhat stronger, the deficit for 2011 was expected to be a good margin below the 3% target in the central-government deficit, despite the reversal of some revenue-raising measures. These included postponement of an increase in excise duty on gasoline and smaller increases in water prices. The decisions followed demonstrations by the public at large in early 2011 about rising living costs and were accompanied by commitments to increase subsidies to public transport and hikes in the minimum wage. With the weakening of growth prospects, the deficit for 2011 is now expected to be close to the 3% target and will probably overshoot the 2% target for 2012. The latest OECD projection (Table 1), for instance indicates only 0.2 percentage point of fiscal consolidation in the general-government deficit in 2012, which is well short of the 1 percentage point that will likely be required to reach the central-government target. On the basis that the current downturn is cyclical, rather than structural, the overshoot should be viewed as reflecting the healthy operation of automatic stabilisers. However, it would

not be advisable to engage in spending measures for 2012 that would exceed those contained in the two-year budget.

Figure 5. **Primary civilian and overall government expenditure**

As a percentage of GDP, 2009 or latest available year



1. Excluding defence and interest payments. Calculation of the primary civilian spending uses an estimate of defence spending for that year.

Source: OECD *Annual national accounts* database and OECD *Economic Outlook 90* database.

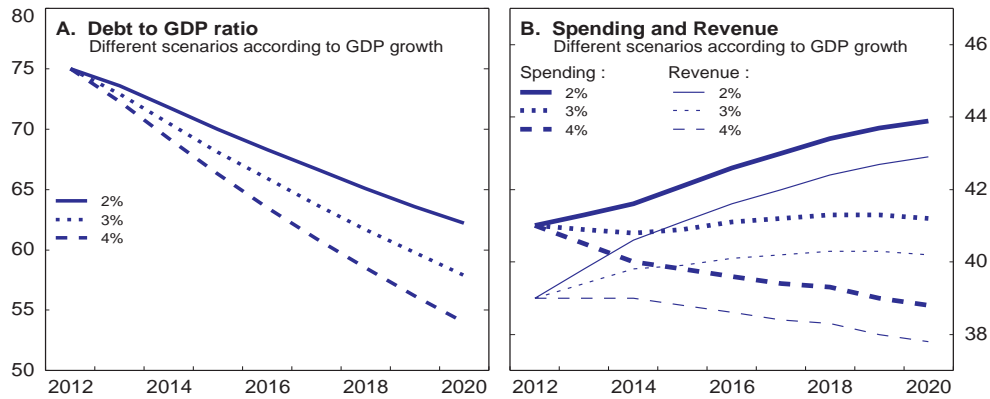
Ensuring revenues remain on track in the longer term remains a core challenge

Medium-term simulations indicate it is likely that the authorities will have to take active measures to increase total revenues as a share of GDP to square their deficit and spending goals. There is little doubt that sticking to the deficit goals will bring the debt-to-GDP to 60% within a reasonable time frame. Assuming 3% average real growth (which approximates historical growth in GDP per capita plus projected population growth), the 60% target will be reached by 2019 and by about 2018 at 4% growth and 2021 at 2% growth (Figure 6). Given the mechanics of the rule, whether spending rises or falls as a share of GDP depends crucially on the pace of growth in relation to its long-run historical average and the debt-to-GDP ratio. Importantly, Figure 6 underscores that at 3% growth spending will remain roughly constant as a share of GDP. Nevertheless an increase in the share of revenue in GDP is required if the goal of a path of declining deficits is to be met. Higher average output growth is required if revenues are to remain constant or fall as a share of GDP.

Following the recommendations of the Trajtenberg Committee (Table 2), in October 2011 the government approved a package of tax measures that includes the replacement of scheduled cuts to personal and corporate income tax rates with increases. As well as increasing the burden and progressivity of direct taxation, the package also reduces indirect taxation and provides more support to families. Indeed, it includes all of the Committee proposals, except the increase in employers' social-security contributions. However, at the time of writing the reform had not passed the Knesset, and therefore the final package may depart further from the Trajtenberg recommendations.

Figure 6. Fiscal scenarios with adherence to the deficit targets and new spending rule

As a share of GDP



Source: OECD calculations from *OECD Economic Outlook 90*.

Past cuts in personal and corporate rates have already driven the average tax wedge on labour to a relatively low level in international comparison, and marginal rates (even at twice the average wage) are now close to the OECD average (Figure 7). These developments, combined with the fact that the proposed tax-rate increases are relatively modest, suggest that any erosion of competitiveness will be small. However, substantial additional hikes in direct taxation (or social contributions) over and above those proposed by the Trajtenberg Committee, as called for in some quarters, should be avoided. High rates of personal-income tax (or employee social contributions) on top earners can be problematic because they can prompt tax evasion and elicit little in the way of additional revenues. Indeed, this is one reason why the authorities decided to reduce the ceiling on social-security contributions as part of the package. Furthermore, large additional increases in direct taxation would risk significant damage to growth outcomes through harmful impacts on competitiveness and labour supply.

The Trajtenberg Committee also made recommendations that have implications for public spending (Table 2). Proposals include increased support for families (particularly those with at least one worker). In addition, there are a number of proposals to lower housing costs and increase integration of minorities into the workforce. As of November 2011, there was only limited progress in gaining government and parliamentary approval of these measures, and the timing and scale of related additional spending is uncertain. Finally, the Committee proposed partly funding the additional spending associated with these programmes by cuts in defence outlays (these have been approved by the government in principle) and recommended ways of achieving efficiency gains and savings in public spending.

Implementation of the Trajtenberg Committee's recommendations will not diminish the risks to achieving the fiscal targets. The Committee was mandated to remain within the spending limit, and did so, which is welcome. In addition, for 2013 onwards its recommendations would result in a net increase in revenues equivalent to the impact of the cancellation of the scheduled tax cuts on the revenue baseline (for instance this would amount to NIS 11 billion by 2016). However, under prudent economic growth assumptions, these increased revenues are probably not enough to ensure the deficit (and debt) targets are met if spending is to increase according to the new rule (Bank of Israel, 2010b). Hence, unless average growth in the coming years outperforms the historical average then, the authorities will require additional revenue measures.

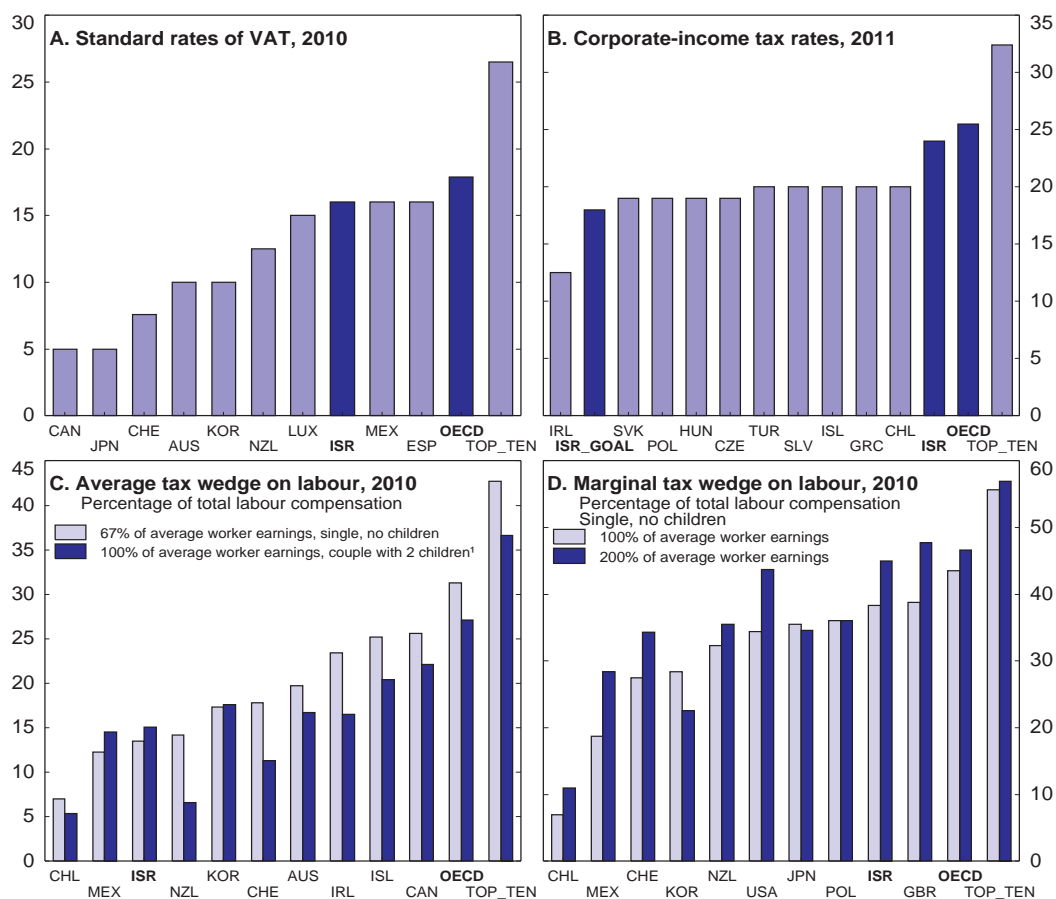
Table 2. Key features of the Trajtenberg Committee's recommendations

Revenue-related measures	Budgetary impact (annual), NIS billion ¹
Cancellation of scheduled income-tax rate cuts	
<ul style="list-style-type: none"> The rate of corporate tax was due to fall from its current value of 24% to 18%, and, for example, the top rate of personal income tax was to be cut from the present value 45% to 39%, both by 2016. 	+2.5
Increases in top personal-income tax rates	
<ul style="list-style-type: none"> Increase in the top rate from 44 to 48% (the rate applies to taxable monthly income of more than NIS 40 231, which is around five times the average wage). 	+0.7
<ul style="list-style-type: none"> Imposition of an additional 2% tax on those with income over NIS 1 million per year (<i>i.e.</i> NIS 83 333 per month equivalent, which is around ten times the average wage). 	+0.4
Changes to social-security contributions	
<ul style="list-style-type: none"> Reversion of the ceiling on employee social-security contributions to five times the average wage (the ceiling had been increased to nine times the average wage as a temporary measure in the wake of the 2008-09 downturn). 	-0.8
<ul style="list-style-type: none"> Increase in employers' national-insurance contribution rate for those earning above 60% of the average wage from 5.68% to 7.5%. 	+2.5
Increases in corporate-income and capital-gains taxation	
<ul style="list-style-type: none"> Increase in corporate-income tax from 24 to 25% (and possibly later to 26%). 	+1.4
<ul style="list-style-type: none"> Increase in capital-gains tax from 20 to 25%. 	+1.3
Changes to indirect tax	
<ul style="list-style-type: none"> Cancellation of a scheduled increase in excises on gasoline and diesel. 	-2.5
<ul style="list-style-type: none"> Commitment to a scheduled cut in import duties, except on cars and agricultural produce. 	-1.5
<ul style="list-style-type: none"> Cancellation of the scheduled cut in VAT from 16 to 15.5%. 	+2.5
Additional tax breaks for families	
<ul style="list-style-type: none"> Extension of child tax credits to fathers (previously only mothers were eligible). 	-1.0
<ul style="list-style-type: none"> A 50% increase in the earned-income tax credit for mothers. 	-0.8
<i>Net budget impact of revenue-related measures (excluding increase in the employers' social-security contribution)</i>	+2.2
Measures requiring additional public spending	
Expansion of child care and early childhood education	
<ul style="list-style-type: none"> Increase in public spending on daycare services for children aged up to 3 years; introduction of free compulsory education from age 3 to 5; additional after-school services; reduction in school fees. 	-4.0 (approximate)
Targeted schemes for minorities	
<ul style="list-style-type: none"> A number of schemes are proposed, all of which aim to encourage the integration of minorities into the workforce, particularly Arab-Israeli women and Ultra-orthodox men. 	<i>n.a.</i>
Additional measures to lower housing costs	
<ul style="list-style-type: none"> Several schemes are proposed, for instance affordable long-term rental housing units, increased rent subsidies, increase in property tax on empty apartments. 	<i>n.a.</i>
<i>Total budget impact of additional public spending (based on a figure of NIS 30 billion for the first five years)</i>	6 (approximate)
Economies in public spending	
<ul style="list-style-type: none"> Annual defence spending cuts of NIS 2.5 billion (from baseline) for five years. 	+2.5
<ul style="list-style-type: none"> Privatisation of public services with a view to efficiency gains and cost savings. 	<i>n.a.</i>
<ul style="list-style-type: none"> Greater efforts to ensure efficiency and co-ordination in policy planning and implementation. 	<i>n.a.</i>
<i>Total budget impact of economies in public spending</i>	+2.5

1. Estimates by the Trajtenberg Committee.

Figure 7. Tax indicators

Comparison with bottom ten OECD countries



1. Average of three situations regarding the wage of the second earner (0%, 33% and 67%).

Source: Bank of Israel, Statistical Annex of the *Bank of Israel Annual Report* (2010); OECD tax database; and OECD taxing wages database.

As regards direct taxation, competitiveness concerns limit the scope for significant new revenue-raising measures in addition to those already in the Trajtenberg proposals. This said, there are avenues for changes to income or capital-gains tax that provide a double dividend in terms of revenues and structural reform. For instance, the in-depth examination of the housing sector for this survey identifies excessive exemptions of capital gains.

Indirect taxes can also play a role in ensuring adequate revenues. Here too there are opportunities for double-dividend reforms. For example, in the energy sector existing excise tax on primary fuels could be increased to reflect environmental externalities and greater recourse made to taxes and charges relating to car use (in terms of fuel excise, the government's adoption of the Trajtenberg Committee's recommendations implies, unfortunately, the abandonment of moves in this direction, see Table 2). Indeed, "green taxation" in general may well provide a number of modest win-win revenue options. However, where exemptions cannot be justified on economic grounds, then indirect tax should, in general, be made more uniform. For instance, although not strictly a tax reform, the Trajtenberg Committee has made welcome recommendations to reduce import tariffs on electrical goods and foodstuffs.

Turning to VAT, the tent protests have generated calls to widen exemptions (or introduce preferential rates) for some goods and services. Addressing social concerns in this way is expensive because all households benefit, including those on high incomes. Exemptions also run counter to the principle of uniformity that minimises distortions in consumer choice. Delineating between categories of goods and services can throw up awkward anomalies in VAT treatment and invites pressure from business interests. To date Israel's single-rate VAT system has had admirably few exemptions compared with other countries. Indeed, albeit relatively minor, existing VAT exemptions could be removed (exemptions currently apply to the tourist resort of Eilat, fruit and vegetables and certain tourist services). Thankfully, further exemptions do not feature in the recommendations of the Trajtenberg Committee, and the government should continue to oppose any proposals for further base narrowing through additional exemptions or the introduction of multiple rates.

Contrary to what many may believe, in several respects an increase in the VAT rate is potentially the least economically damaging way of ensuring revenues adequately meet deficit and spending goals in the wake of the Trajtenberg Committee recommendations. At 16%, the rate of VAT is considerably lower than that in quite a number of OECD countries (Figure 7). While higher rates are often accompanied by wide exemptions in OECD countries, there is room for some adjustment in the Israeli rate. In a welcome move the government approved the Trajtenberg Committee proposal to not reduce VAT from 16% to 15.5% as was previously scheduled (the rate of VAT was increased by 1 percentage point during the 2008-09 financial crisis as a temporary measure. It has since been reduced to 16% and was due to fall to 15.5% in January 2013). A modest increase in addition to this should be considered as a means achieving fiscal goals. True, VAT increases are regressive (although less so than often thought when looked at in a life-cycle context) and therefore should be combined with offsetting measures. For example, a VAT increase could be combined with increased transfers to low-income households (for example, by a hike in the earned-income tax credit; see below).

An innovative shift to a two-year budget cycle

The Ministry of Finance has used a 'full' two-year (biennial) budget process since 2009, *i.e.* the legislative discussion and the budget are on a two-year basis. This is an extremely unusual approach. Indeed, it has hitherto been used regularly only in some US states and mostly in a 'rolling' format (*i.e.* the budget process is annual, but each budget spans two years). However, biennial budgeting by central government is certainly not without merit and may prove worth adopting on a permanent basis. Two-year budgets can potentially lead to less resource-intensive and better policymaking through savings in administrative overheads. In addition, a two-year budget lengthens the "hard" budget horizon and therefore more forcefully extends fiscal planning than do many medium-term budgeting mechanisms.

But there are downsides to biennial budgeting. It places a heavy demand on revenue and spending projections, and worthwhile reforms that require related budget measures may be delayed by the two-year cycle. There are political considerations too. The budget cycle is a key forum for debate on economic policy, and therefore some may oppose lowering the budget frequency on the grounds that it may compromise the democratic process. In Israel, the new two-year cycle arguably places more power in the hands of the Ministry of Finance, because it can make substantial reallocations of public spending within the two-year budget cycle (subject to the overall spending limit and approval of the Knesset Finance Committee). In sum, there are clearly important uncertainties surrounding the impact of biennial budgeting on fiscal planning and economic reform, and the authorities should closely monitor its impact. Furthermore, the biennial approach is not a full substitute for improving more typical medium-term budgeting mechanisms, as these are anyway desirable as a means of extending the planning horizon beyond the budget cycle.

And a significant improvement in the fiscal treatment of hydrocarbon resources

Natural gas production from offshore fields began in the early 2000s and is set to increase substantially in the coming years following the discovery of new deposits, notably the Leviathan field in 2010. In total, these finds sum to around 700 billion cubic metres of natural gas, which amounts to resource wealth of about USD 15 000 per capita at current prices. While the discoveries to date are not on the same scale as those in very hydrocarbon-rich countries, there is a reasonable chance that more gas will be found, and possibly oil too. The resources imply additional fiscal revenues, not only from regular corporate taxation, but also from royalties.

In a welcome move, the authorities have brought the previously generous fiscal treatment of oil and gas resources much closer to levels typical elsewhere. Previously, the ‘government take’ from natural gas fields was about 30 to 40%, depending on the size of field. It now ranges from 50 to 60%. The increase derives from a special profits levy that is triggered when the ratio of revenues to outlays reaches a certain level (the “R-ratio”). The initial proposal already included provisions lightening the burden for existing and upcoming developments, and further minor concessions were made before the legislation was finalised. However, these are not considered to have overly compromised the design of the new system.

The legislation requires the government to come forth with a proposal to channel fiscal revenues from the natural gas fields into an independently managed sovereign wealth fund (SWF), and this is indeed probably the best option. Such revenues should accrue widely to both current and future generations, because they represent the proceeds from the sale of a publicly owned asset. Allowing the proceeds to flow into general government revenues (or an earmarked fund for specific areas of spending) should be avoided because it would put excessive focus on the well-being of current generations. An SWF invested entirely in foreign assets would mitigate so-called Dutch disease, which would negatively affect competitiveness and employment. Given the reasonable chance of further finds, an SWF would insulate the deficit from fiscal leakage, so long as the share of the fund made available for spending is kept low. A drawdown of something like 4 or 5% – in line with real returns – would probably be best. The administrative framework for a fund should be established as soon as possible, before political commitments to use the revenues on current spending items take hold.

In general, pressures to subsidise downstream investment in gas export facilities or infrastructure for additional domestic demand should be resisted. Under a business-as-usual scenario, it is reckoned that domestic demand can absorb up to 10 billion cubic metres of gas per year, but production prospects are far in excess of this, and, as yet, there is no infrastructure for export. A degree of government involvement in the development of domestic demand and export is unavoidable because of energy security issues and the fact that electricity supply remains dominated by a single state-owned enterprise. However, involvement beyond these legitimate concerns should be avoided; there is little or no economic justification for state financial support or intervention in developing domestic demand or indeed influencing whether and how the gas is exported, which should remain a market-based decision.

Box 2. Core recommendations on fiscal policy

- Continue placing top priority on achieving the deficit targets and set spending increases according to the new rule.
- Avoid further rate increases in personal-income and corporate tax over and above those recommended by the Trajtenberg Committee. Exploit opportunities for double-dividend reforms in direct and indirect taxation (e.g. pruning exemptions, increasing environmental taxation).
- Do not narrow the VAT base in an attempt to resolve redistributive issues through exemptions; instead, aim for more uniform indirect tax overall and tackle redistribution through other channels. Indeed, use increases in VAT as a means of meeting deficit and spending goals.
- Closely monitor the impact of two-year budgeting while also strengthening regular medium-term budgeting mechanisms.
- Establish an independently managed sovereign wealth fund for holding fiscal revenues from hydrocarbon resources, invest it in foreign assets and keep the drawdown rate from the fund low (Chapter 3).

Education, labour and social policies

Israel's profound challenges in education, labour and social policies were the subject of in-depth analysis in the previous *Survey*. Increasing rates of relative poverty in the Arab-Israeli and Ultra-orthodox communities remains a core issue with low earnings capacity, weak labour-force attachment and problems in the education system all playing a role (Figure 8). These problems are likely to increase in importance over time as the share of the population of the two communities is expected to rise due to their high fertility rates. Still, even though these groups already total around 30% of the population, some 40% of those in poverty are in other segments of the population. Therefore, while programmes targeting specific communities are justified, general policies with wide eligibility should do much of the heavy lifting in improving outcomes.

Some good news in the latest PISA results and reasonable progress in education reform

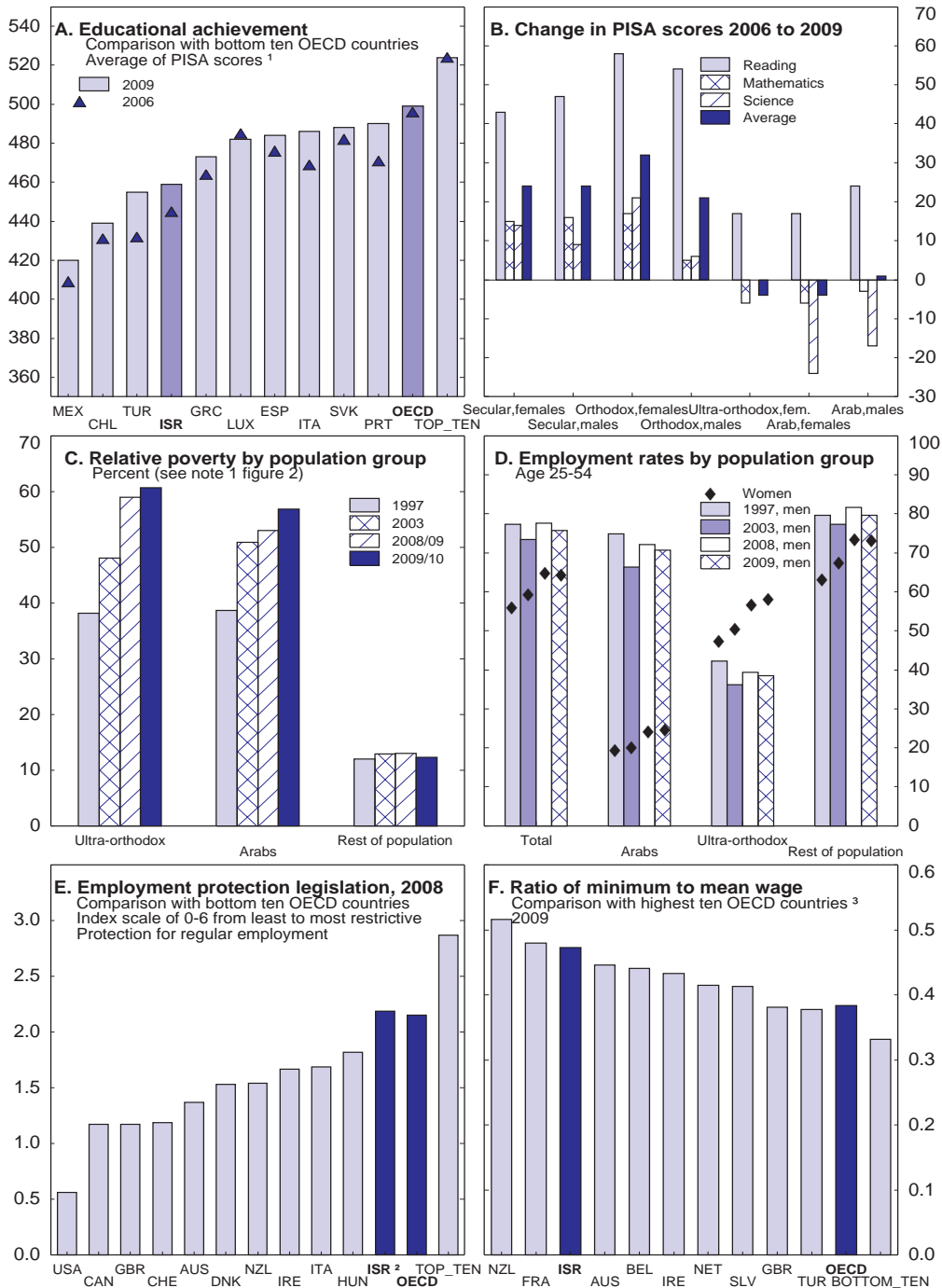
As discussed in the previous *Survey*, average educational attainment in the working-age population is fairly high in international comparison, but the results of PISA and other international tests point to weak core skills at secondary level. The latest PISA tests (conducted in 2009 and published in 2010) saw improvement in Israel's aggregate score, largely driven by better performance in the reading component. Somewhat worryingly, however, science and maths scores among Arab students actually fell compared with the previous results (Figure 8), as did maths scores for Ultra-orthodox girls (they did not participate in the science tests, and, as in previous PISA tests, an insufficient number of Ultra-orthodox boys participated in all the PISA tests to generate statistically reliable results).

There has been welcome progress in reforming compulsory education. Most notably, the upper-secondary teaching union has struck a deal with the government, similar to that agreed previously in lower-secondary education, involving substantial pay increases alongside additional teaching hours and other reforms (see Annex). However, much remains to be done, particularly as regards Arab-Israeli and Ultra-orthodox education. Arab-Israeli classes remain comparatively large, although efforts are underway to rectify this. The Ultra-orthodox community should be more forcefully encouraged to strengthen the vocational skills of its youth, in part by stronger curriculum requirements for the receipt of state funding.

Proposals to reform tertiary education are being revived since a failed push for the changes recommended by the Shochat Committee in 2008. This latest initiative comprises a substantial six-year plan whose main goals are to increase staff recruitment, raise the population of Arab and Ultra-orthodox students, boost spending on competitive research

funds, upgrade teaching and research infrastructure and reform budgeting, such that it links inputs more closely to outputs.

Figure 8. Education and labour-market indicators



1. Reading, mathematics and science.
2. Israel has the sixteenth rank.
3. Data for only 22 countries are available. OECD calculations for Israel.

Source: Bank of Israel (2011), *Annual Report 2010*, OECD (2011), *Economic Policy Reforms 2011: Going for Growth*, OECD.Stat., Labour database.

A lack of progress in making employment and social policies more effective

Progress towards a more effective employment-oriented social policy has been disappointing. A promising pilot scheme of private placement services (dubbed the Wisconsin programme) came to an end in spring 2010. The authorities should nevertheless revive the approach, drawing on lessons from the pilot scheme, particularly as regards competition among providers. Yet, in a welcome move, the earned-income tax credit has been expanded to cover the whole of the country. Furthermore, the Trajtenberg Committee has recommended a 50% increase in the credit for working mothers (along with substantial expansion of daycare support and early-childhood education), which is a step in the right direction. On other fronts, little progress has been made along the lines recommended by the previous *Survey* and other OECD work (see Annex). In particular, general income support remains meagre, and there have been no initiatives to economise on universal child allowances. In spring 2011 trade-union pressure led to exceptional increases in the minimum wage, thus pushing ratio of the minimum to the average wage even higher (Figure 8). At the same time, labour law and minimum employment conditions remain inadequately enforced, which particularly affects vulnerable low-income workers. Greater infrastructure investment in Arab localities (such as that provided in five-year development plan for the minority sector) is welcome, but has to be “joined up” with broader education, employment, social and business policies.

In housing, tax settings excessively favour home ownership...

In-depth review for this *Survey* finds that policies in Israel generally favour home ownership, and around 70% of households are owner occupiers. Such high rates of home ownership can limit labour mobility, since renters are more willing to relocate in response to changing job-market opportunities – although Israel’s relatively high population density means this issue is less significant than in some other OECD countries. In addition, the incentives for owner occupation typically distort consumption and saving behaviour, and represent a ‘back-door’ tax benefit for middle- and upper-income earners. Thus, in broad terms, policy should aim for more balanced incentives to own or rent property.

Home ownership is partly encouraged through the various taxes and other policy settings that affect the purchase, ownership and sale of property, even if mortgage regulation has long encouraged low loan-to-value ratios. The treatment of capital gains from the sale of property is unusually generous. As in many countries, there is exemption from regular capital gains tax on primary residences but also, to some extent, on property owned by private households for investment purposes (although this has recently been pared back). At a minimum these exemptions should be reduced to cover only primary residences. However, in other respects the tax treatment of housing is in good shape: transactions taxes and charges (which are highly distorting) are light; the tax treatment for homeowners follows a reasonable compromise (implicit rental income is not taxed, but mortgage interest deductibility is not allowed); and property taxation is more fully exploited than in many other OECD countries. Indeed, the latter should be pursued further.

... and housing support schemes extend well beyond assistance to low-income households

Home ownership is also promoted through grants and mortgage assistance, typically for specific population groups and not always confined to low-income households. This is symptomatic of housing support as a whole and reflects an attempt to combine social-welfare goals with other policy objectives. Most notably, a large share of spending on housing support goes to those who have recently settled in Israel, as part of a broad programme for encouraging and integrating immigrants. Furthermore, most schemes are in one way or another more generous for households in peripheral areas (typically based on the system of National Priority Areas, NPAs), and special consideration is often given to those who have completed military service.

The diverse policy agenda means that significant support is provided to households that are not necessarily indigent. True, the housing policy does provide support for low-income households through means-tested public housing and rental subsidies. But, in addition for instance, all recent immigrants receive rent support for five years, irrespective of income, seemingly an inefficient use of public funds. Also, access to the general scheme for mortgage support is governed by a somewhat unusual points system (which, for example, includes points for the number of siblings of the applicants) that does not directly take into account household income and strongly favours large families. Furthermore, highly targeted schemes continue to feature on the policy agenda. In 2011 a new programme, initiated by politicians representing certain communities, has been providing mortgage support to 28 designated towns. Its effectiveness should be closely monitored, particularly as to the risk that support is captured by property developers through price hikes.

Unlike many other OECD countries, Israel has no special legislation regarding rental contracts, and this may well be discouraging the development of the rental market. There is no specific legal framework defining the rights and responsibilities of landlords and tenants. For instance, there is no legislation governing deposits, notice periods, contract renewals. All such details are left to be entirely determined by whatever contract is signed between landlord and tenant. The introduction of some modest minimum legal criteria should be considered, so as to set some boundaries on acceptable outcomes.

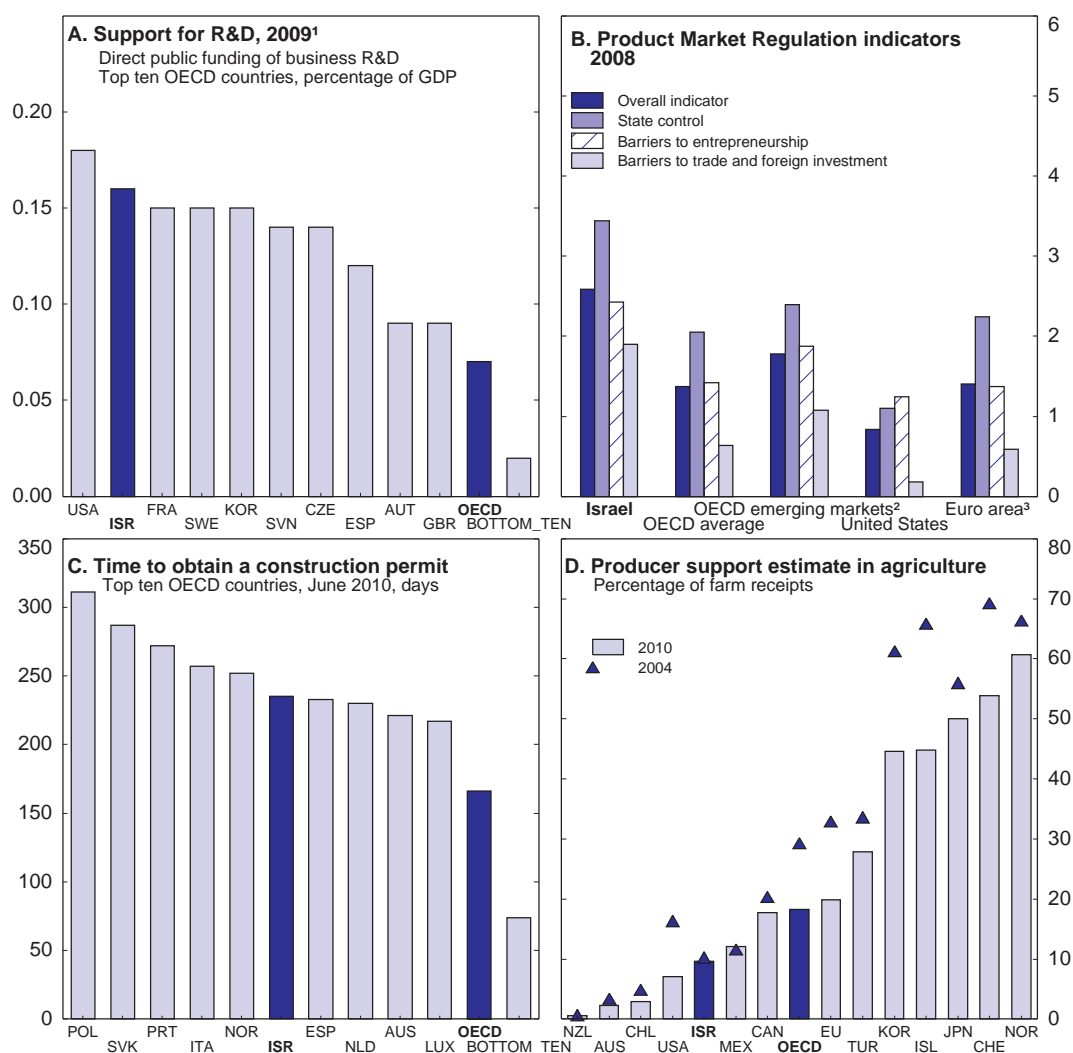
Box 3. Core recommendations on education, labour and social policies

- Press on with general reforms to state primary and secondary education and targeted policies, particularly those to improve education for Arab-Israelis. More forcefully encourage the Ultra-orthodox community to strengthen vocational skills as part of a wider strategy to increase labour-market participation and income from earnings.
- Make work pay. Re-introduce a welfare-to-work programme along the lines of the cancelled 'Wisconsin' programme, and increase the value of the earned-income tax credit. Consider increases in general welfare benefit. Combine strengthened enforcement of the minimum wage and labour regulation in general with gradual erosion of the value of the minimum wage in relation to the average wage.
- As regards socio-economic issues relating to housing: (Chapter 1):
 - Pare back tax exemptions for homeowners and property investors.
 - Focus housing support more strongly on low-income households.
 - Introduce legislation that details the rights and responsibilities of landlords and tenants with a view to providing more certainty and continuity in rental contracts.

Progress in improving the business environment

In broad terms Israeli economic policies have long been geared to improving the environment for business. The establishment of low, single-digit inflation and reductions in the overall "size" of government have been crucial. Also, targeted support programmes (such as that for greenfield investment and small and medium-sized enterprises) is strongly tilted towards the high-tech sector and research activity (Figure 9), and this has undoubtedly contributed to Israel's widely recognised strengths in these fields. Nevertheless, as underscored in the previous *Survey*, strong frameworks for assessing, modifying and, where necessary, pruning programmes are important. Reducing the red tape facing businesses is necessary too. A one-stop-shop system for business permits and other administration is being established, though the latest World Bank indicator suggests the fruits of this reform have yet to emerge (Figure 9).

Figure 9. Indicators of business policy



1. Or latest available year.
2. Czech Republic, Hungary, Korea, Mexico, Poland, Slovak Republic, Turkey.
3. Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Portugal, Spain.

Source: World Bank *Doing business* (2011), dealing with construction permits; OECD (2011), *OECD Science, Technology and Industry Scoreboard 2011*. OECD.stat, PMR database; OECD.stat, Producer and Consumer support estimates.

In a similar vein, the examination of housing policies for this *Survey* reveals that planning approval for housing construction is extremely slow. As regards competition issues, past OECD reviews have found little technical fault with general competition legislation and oversight but have in particular identified unfinished business in network industry reform and broad concerns about the competition effects of Israel's business groups. Moreover, the recent social protests focused on the impact of weak competition in a number of sectors on the general price level.

In the housing sector reforms to planning regulation are underway

Israel's relatively high population density limits somewhat the capacity for a rapid supply response in housing and property development; dense populations require fairly

extensive planning regulations and procedures due to the prevalence of complex urban environments. However, it is widely accepted that there is scope for a more nimble planning system in Israel. As one of several measures to cool the housing market, the authorities have already sped up the approval of new housing projects within the current system. Housing starts have been increasing since early 2010, and in 2011 there will have been some 44 000 starts per year. This figure compares with only 30 000 to 35 000 starts per year between 2001 and 2009 and exceeds the annual increase in the number of households of around 39 000. In addition, property developments representing some 51 000 new dwellings have been identified in a first list of candidates for a proposed temporary 'fast-track' approval process.

There has also been progress in permanent reform to planning and land-ownership systems. Since most land is owned by state or quasi-state bodies, the authorities naturally have strong powers in deciding the location and type of new property development. Indeed, most homeowners in Israel are technically in fact leaseholders. Following the 2009 Land Reform Bill, leaseholders in selected areas are being given the opportunity to switch to full ownership of their property, which is broadly welcome and should be pursued further. This will provide an important building block in reducing the role of central government in the housing market.

The Land Reform Bill also paved the way for significant changes in planning administration. The current agency, the Israeli Lands Authority (ILA), was slated to be replaced by a new body operating within a faster and simpler planning system. The reforms notably envisage decentralisation of responsibilities to municipalities and property developers. However, implementation has been slow. Furthermore, concerns have been raised that the proposals do not adequately ensure checks and balances in municipal-level planning. Clearly, if there are such difficulties, they need to be addressed in the reform.

In the energy sector, sluggish reform in electricity and concerns about competition in natural gas

Analysis of the energy sector in this review underscores Israel's slow progress in reforming the electricity supply chain. An independent regulator (the Public Utilities Authority – Electricity) was established in 1996, and some private-sector generation is due to come on stream shortly. But even when this is up and running, the state-owned incumbent (the Israel Electricity Corporation, IEC) will continue to produce the lion's share of electricity and remain the sole provider at all other stages of the supply chain. The reform process is in stalemate, with permanent friction between the authorities, management and unions. Furthermore, IEC's financial position is precarious. Policy commitment giving greater certainty about the process and timing of a shift towards a market-based model is required. In addition, the reform programme needs to resolve the IEC's financial difficulties as well as generating capacity problems.

Although the gas sector has been set up along market-based lines, there are concerns about the level of competition. The exploration and development of offshore natural gas is being largely conducted by a single consortium, and the industry has come under the scrutiny of the competition authority. Furthermore, the imports of natural gas from Egypt have provided a useful counterweight to the offshore fields, but in light of recent disruptions this may diminish. Multiple sources of supply are especially important for energy-security reasons. There is also a concern about the institutional framework of the sector. Although the supervisory body (the Gas Authority) has many features of an independent regulator, it operates in the same premises as the Ministry of National Infrastructures and is legally defined as being "in" the Ministry. A clearer separation of the Authority from the Ministry should be sought to ensure regulatory decisions and policymaking are independent for clearer accountability.

Competition issues in the financial sector remain a subject of debate

Issues in competition are not confined to network industries, and this *Survey* highlights particular concerns relating to the financial sector (Chapter 2). The degree of competition in retail banking has long attracted attention, with service fees being a common target of complaint by the public at large. Direct regulation of fee levels has been avoided as a response, which is welcome. Instead, transparency has been increased by rationalising and harmonising the definition of fees and by ramping up disclosure requirements. Similar reforms to fees in institutional savings vehicles have been proposed, which would be welcome too.

Furthermore, the structure, conduct and performance of Israel's financial entities are inexorably linked to a broad debate about corporate governance, because most of the major financial institutions are controlled by large domestically owned business groups. Debate about the relative benefits of these groups has intensified recently, with two issues pertaining to the financial sector. First, the presence of financial institutions in company groups typically amplifies their advantages and disadvantages. In-group financial institutions facilitate efficient financial intermediation but can also provide more opportunities for appropriation and self-dealing by controlling shareholders. Second, there are issues of prudence and systemic risk: the stability of financial entities may depend on the stability of their parent company groups, which may in themselves pose systemic risks. With a number of such institutions that are "too big to fail", there is a public interest in preventing them from giving preferential treatment to related non-financial entities.

Similar to most other countries, attempts to limit the downsides of company groups have to date operated primarily through regular corporate law and antitrust regulation. This has been boosted recently by new legislation (the Concentration Law) that gives the antitrust authority stronger powers to operate in markets with relatively high levels of concentration. In addition, a high-level committee was set up by the Prime Minister to examine avenues for improving corporate governance in the business groups, released its preliminary recommendations in September 2011. These entail some deep and innovative reforms to corporate governance rules and will in principle significantly reduce the scope for inappropriate corporate behaviour. The proposal to force separation of ownership between financial and non-financial entities in particular should be implemented. Analysis in Chapter 2 suggests that, in addition to these reforms, the authorities should establish a permanent body charged with monitoring role of the business groups with regard to market competition. The latter could be combined with the establishment of a specialised unit within one of the existing supervisory agencies for assessing the groups in relation to their effects on financial stability. Chapter 2 also underscores the importance of promoting a greater foreign presence in the financial sector (and in company groups), as a means of diversifying ownership.

Public debate about price levels and the strength of competition in supply chains for household goods has intensified. Recent protest was sparked by outrage over the price of cottage cheese, but attention has widened to other sectors, and the issue has been a central theme of the tent protesters. Given the size of the Israeli economy, there are often points in supply chains where economies of scale mean there can be only a limited number of domestic operators. While this indeed potentially generates monopoly profits (and high prices), some policies and regulations are also causing problems. Food prices are affected by a host of restrictions, and tariffs on imports as part of efforts to protect domestic agricultural production (OECD, 2010c). As well, until recently, vehicles could be bought only from domestic dealerships that generally have exclusive rights to the sale of each car brand. Hence, it appears that much work could be done to expose domestic supply chains to stronger foreign competition. Progress on this front could also obviate the need for some of the price regulation currently in place that aims to counter excessive supply-chain profits.

Box 4. Core recommendations on the business environment

- In broad terms, pursue general efforts to reduce red-tape facing business, closely monitor targeted business support (with a view to pruning), and pay greater attention to competition in network industries and the wider economy.
- Proceed with efforts to encourage the supply of housing, but nevertheless act with some caution in streamlining and decentralising planning regulation (Chapter 1).
- Strengthen policy commitment to reforming the poorly performing electricity sector and the IEC in particular (Chapter 3).
- Implement the proposals of the Concentration Committee, particularly the recommendation forcing business groups to divest themselves of controlling shareholdings in financial institutions. Promote greater foreign presence in the financial sector (Chapter 2).

Environmental issues

Many of Israel's environmental challenges are strongly connected with its rapid growth in population and economic activity. Environmental issues arising from the production and use of energy are prominent (and are discussed in Chapter 3 of this *Survey*). Water and waste management are high on the agenda too, with Israel's dry climate adding to the challenges. In addition, Israel's geographic position means it has a high level of biodiversity and is an important route for many migratory species.

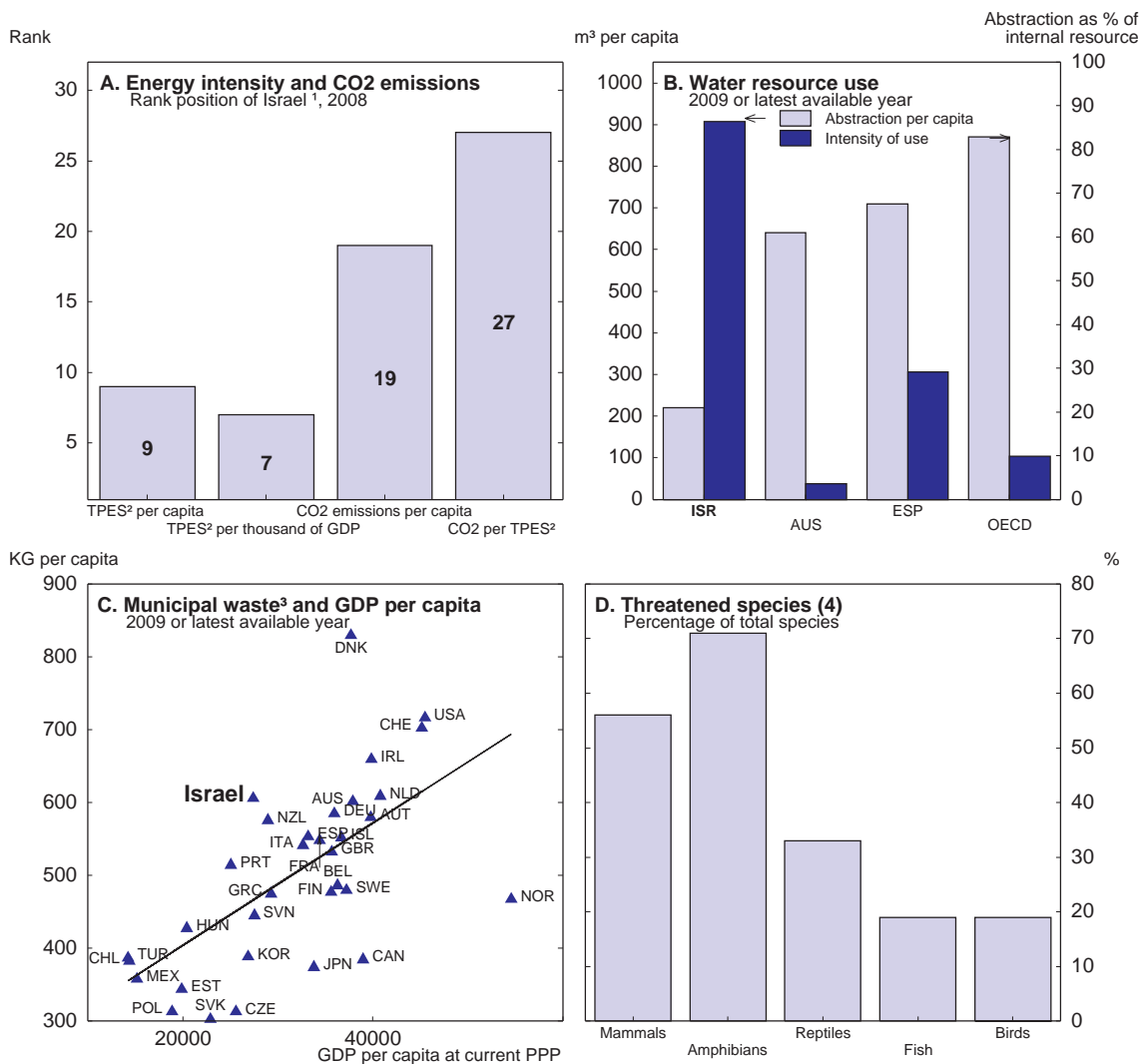
Plans for GHG-emission reduction focus on the electricity sector

Israel's greenhouse-gas emissions and related air pollutants are largely the result of electricity production and energy use in transportation. Electricity supply is entirely domestic and generated almost entirely by hydrocarbon fuels. As a result, although energy intensity is relatively low, emissions per capita or per unit of GDP are relatively high (Figure 10). Supplies of natural gas *via* pipeline from Egypt and increasingly from the offshore fields are allowing a shift away from oil- and coal-based generation, but concerns for supply flexibility and security mean there is a limit to further substitution. Indeed, repeated disruptions to Egyptian supplies in 2011 have served as a reminder of Israel's vulnerability on this front. The picture in renewable energy is mixed. Regulations introduced in the 1980s have meant the vast majority of domestic water heating has long been *via* solar panels, a renewable source of energy. However, only about 1% of electricity is currently generated from renewable sources.

Environmental policy reform has gathered momentum in recent years. An explicit target representing a 20% (22 Mt CO₂-eq) reduction from a baseline GHG-emissions calculation by 2020 has been developed through a practical 'bottom-up' approach based on feasible emissions-reduction measures. Because population growth and economic development are expected to drive a fairly steep baseline, GHG emissions are nevertheless estimated to rise by 16.5% by 2020, even if the target is reached. The plan is for most of the emissions reduction to come from the electricity sector, and subsidiary goals in energy efficiency and renewable energy production have been set. Though the target-setting exercise represents an admirable step forward, it should be followed up with monitoring and a system of dynamic targeting that looks beyond 2020. There should also be a commitment to an independent technical assessment of progress toward the target.

Significant emissions reductions are expected from an energy-efficiency programme. A large number of measures have been laid out in strategy documents, some of which have been approved by the government, including subsidies for scrapping household refrigerators and air conditioners. Though the programme is already commendably comprehensive, there is room for other measures, particularly as regards buildings. Mandatory green building standards could be introduced alongside the current voluntary system, and compulsory energy-efficiency certification should be considered.

Figure 10. Environmental indicators



1. Out of 32 OECD countries. Low rank indicates lower energy intensity or emissions.
2. Total primary energy supply.
3. Household waste only for Australia and Canada.
4. International Union for Conservation of Nature (IUCN) categories "critically endangered", "endangered", or "vulnerable" species in per cent of known species.

Source: OECD.stat and OECD (2011), *Environmental Performance Review of Israel*, Paris.

Plans are also being implemented that aim to raise the contribution of renewable electricity generation to 10% of aggregate supply, principally through thermo-solar, photovoltaic and wind power. While a significant number of tenders for production and quotas for feed-in tariffs have been allocated, further regulatory hurdles remain before production can begin, most notably planning regulations. The authorities should work to overcome any such obstacles to renewables development as they arise. As with renewable-energy schemes in many countries, the feed-in tariffs are likely to pass through to end-user prices, but the levels of the tariffs is difficult to justify on the basis of a simple calculation of the implied price of carbon. Thus, as elsewhere, policymakers are implicitly appealing to other arguments, such as supporting demand so as to spur further technological advance.

At present the emissions-reduction plans do not include economy-wide instruments, but these should be included in further developing plans. Although perhaps a distant prospect, greater participation in international trading should remain a strategic goal so as to ensure that the costs of emissions reduction are minimised. Also, a 'carbon tax' based on existing excise duties imposed on primary fuels (oil, coal and natural gas) would be beneficial in order to equalise marginal costs of climate-change mitigation across sectors. This would be particularly effective, given the substantial share of GHG emissions derived from such fuels in Israel.

A need for better public transport and further development of vehicle taxation

Achieving GHG-emissions reduction and resolving urban congestion and other transport-related externalities importantly requires improved options for alternatives to private-vehicle use. To date public transport has largely comprised state-subsidised bus transport. Concrete progress in expanding the currently limited rail network has been slow. Following various long delays, a light rail network is now finally running in Jerusalem, and construction of another in Tel Aviv has recently begun after many years of delay. In 2011 a long-term plan for inter-city rail and road development was approved by the central government, and implementation should be given a high priority.

Taxes and charges influencing car use could also be improved. The introduction in 2009 of a scheme differentiating purchase taxes on cars according to environmental criteria is welcome. However, the basic rate of purchase tax (83%) distorts consumption behaviour and on this basis should be lowered further. For most environmental issues it anyway makes more sense to target car use more directly. In particular, in order to internalise the external costs of congestion and other localised externalities road pricing and other schemes targeting car use should be more fully exploited, for instance by expanding use of toll systems such as the one recently introduced on one lane of the main highway into Tel Aviv. The tax treatment of company cars should also be made less generous, and the inclusion of car allowances in employee remuneration in some sectors (notably the public sector) should be reconsidered.

Box 5. Core recommendations on energy-related environmental policies

- Follow up the one-off GHG-emissions-reduction targeting exercise with comprehensive monitoring, including revaluation of baseline emissions and the establishment of targets going beyond 2020.
- Work towards economy-wide instruments: envisage greater involvement in international emissions trading, and consider using existing duties imposed on primary fuels as a basis for a 'carbon tax'.
- Improve the options for alternatives to private-vehicle use.
- Align taxes and charges relating to vehicle use more with environmental externalities. Reduce taxes at the point of sale (notably the purchase tax), and raise those influencing use; scale back tax breaks for company cars; and discourage the inclusion of car allowances in pay packages.

Issues in water and waste management, and biodiversity

In 2011 the OECD undertook its first Environmental Performance Review of Israel (OECD, 2011) Israel has substantial expertise in water technologies, and this is likely to remain a source of "eco-innovation". Also, some dimensions of the economics of water management are in good shape. Practically all water consumption is metered (and is priced on a block-tariff system), the use of "smart metering" is growing, and full-cost recovery in water pricing overall has been achieved. As well, wastewater management is highly effective, as over 80% is re-used, since that is much cheaper than desalination. However, cross-subsidisation from households to the agricultural and industrial sectors should be reduced as planned and targets for domestic water consumption established. In addition,

the use of economic instruments could be broadened. For instance, the pollution tax could be expanded to cover effluent discharges into fresh water and aquifers.

Municipal waste generation is among the highest in the OECD area on a per capita basis and is principally deposited in landfills. Recent policy initiatives notably include a landfill levy. However, the waste-collection component of the municipal property tax should be increased, as it does not fully reflect service costs, and volume- or weight-based waste disposal schemes should be gradually introduced. Recycling remains underdeveloped, and there is a need to roll out programmes for the separate collection of waste and related treatment infrastructure, including wider use of waste-to-energy solutions.

Israel has a high degree of biological diversity, largely due to its location at the interface of Africa, Asia and Europe. In this regard it is particularly significant as a migratory route for birds and marine species. More work is required to establish the extent and value of ecosystems and biodiversity and the pressures on them. Measureable biodiversity targets need to be established, conservation strengthened and steps taken to reduce the inflow of invasive alien species. Market-based instruments should be expanded, such as fees for ecosystem services in housing and infrastructure development. Also, opportunities for private-sector participation in biodiversity protection should be exploited (e.g. eco-tourism).

Bibliography

- Bank of Israel (2010a), *Annual Report, 2009*, Bank of Israel, Jerusalem.
- Bank of Israel (2010b), "Analysis of the 2011 and 2012 Draft Budget in view of Budget Targets and from a Long-term Perspective", Public Sector Analysis Unit, Research Department.
- Bank of Israel (2011), *Annual Report, 2010*, Bank of Israel, Jerusalem.
- Eckstein, Z. and A. Friedman (2011), "The Equilibrium Exchange Rate for Israel", *Bank for International Settlements*, Basel, forthcoming.
- National Insurance Institute (2010), *Poverty and Social Gaps, Annual Report 2009*, Research and Planning Administration, Jerusalem.
- OECD (2010a), *OECD Economic Surveys, Israel*, OECD Publishing, Paris.
- OECD (2010b), *OECD Reviews of Labour Market and Social Policies, Israel*, OECD Publishing, Paris.
- OECD (2010c), *A Review of Agricultural Policies in Israel*, OECD Publishing, Paris.
- OECD (2011), *Environmental Performance Review of Israel 2011*, OECD Publishing, Paris.
- Sorezcky, A. (2010), "Did the Bank of Israel Influence the Exchange Rate?", *Bank of Israel Research Department Discussion Paper*, No. 2010.10, 17 October.

Annex

Progress with structural reforms

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

Recommendations	Measures taken since 2009
EDUCATION (2010 SURVEY)	
Regular primary and secondary education (i.e. the supervised sector)	
<ul style="list-style-type: none"> • Fully implement the New Horizon (Ofek Hadash) programme in lower-secondary education. 	<ul style="list-style-type: none"> • In the 2011-12 school year New Horizon will be fully implemented in primary education with further coverage in kindergartens and lower-secondary education schools.
<ul style="list-style-type: none"> • The stakeholders in upper-secondary education should be encouraged to strike a similar deal. 	<ul style="list-style-type: none"> • An agreement for upper-secondary education was reached in August 2011. The "Courage to Change" Reform will raise pay by about 50%, on average, in exchange for an increase in working hours from 24 to 40 hours per week and a range of other pedagogical, professional and administrative reforms. Implementation began in the 2011-12 school year.
<ul style="list-style-type: none"> • As regards the other general reforms: <ul style="list-style-type: none"> – Continue implementing the extension of compulsory education and the caps on class size as planned. 	<ul style="list-style-type: none"> • In the 2011-12 school year compulsory education to Grades 11 and 12 will increase to apply to 35% of students. The budget to fund the cap in class size has been increased (in 2010-11 it was NIS 200 million).
<ul style="list-style-type: none"> – Continue with efforts to shift away from rote learning. 	<ul style="list-style-type: none"> • A number of programmes aim, inter alia, at reducing rote learning.
<ul style="list-style-type: none"> – Alter budgeting so that the Strauss index (or something similar) allocates most, or all, of education budgets. 	<ul style="list-style-type: none"> • The Strauss index continues to determine only a small share of education funding.
<ul style="list-style-type: none"> • Consider the following additional general reforms: <ul style="list-style-type: none"> – Take further measures to reduce the dominance of teachers who teach as a lifetime career, along the lines of the recent "Academics for Teaching" programme and similar initiatives. 	<ul style="list-style-type: none"> • The Academics for Teaching programme has proceeded as planned and four additional new teacher recruiting programmes were introduced in 2010-11.
<ul style="list-style-type: none"> – Introduce an individual a bonus for teachers linked to student performance, similar to that used in the one of the pilot projects in the early 2000s. 	<ul style="list-style-type: none"> • Teacher bonuses – The "Courage to Change" reform anticipates bonuses for schools and outstanding teachers.
<ul style="list-style-type: none"> – Pursue further reform of the Bagrut system, in particular so that it provides better information on student capabilities for entrance to tertiary education. 	<ul style="list-style-type: none"> • Several other initiatives have been launched including programmes to increase independence of schools (self management of schools) and provide a greater role for parental preferences. In addition steps have been taken to strengthen vocational training. Efforts are also being made to improve budget transparency.
<ul style="list-style-type: none"> • Make more strenuous efforts in affirmative action, particularly as regards Arab-Israeli students: <ul style="list-style-type: none"> – Evaluate and, if necessary, reform the relevant targeted programmes. 	<ul style="list-style-type: none"> • The five-year programme in the Arab-Israeli sector has this year become more targeted, focussing on three areas: Arabic language, mathematics and sciences.

Recommendations	Measures taken since 2009
<ul style="list-style-type: none"> – Ensure general reforms also work towards reducing inequalities in education. – Adopt equity targets in key dimensions of inputs and outcomes in education. 	<ul style="list-style-type: none"> • New targeted initiatives include: additional teaching hours in Grades 3 and 4 in Arabic, mathematics and science; reading test in Grade 1 to identify and assist weak students; Shalhevet Program – incorporating language comprehension and expression across subjects; upgrading the quality of teacher intake; and improved adaptation of the Arabic language curriculum to international tests. • Many general programmes are being implemented in such a way as to reduce inequalities. For example, in the programme to cap class size, 67% of the programme budget for primary schools was allocated to the non-Jewish sector, which is much greater than the share of pupils (which is around 33%). The budget for this programme in lower secondary education has been similarly allocated.
Ultra-orthodox education	
<ul style="list-style-type: none"> • Encourage the community to strengthen vocational skills as part of wider efforts to increase employment rates, particularly among men: <ul style="list-style-type: none"> – Existing curriculum requirements on grants for teaching services in primary education need to be more stringently enforced. Similar conditions should be applied to secondary schools and other sources of state funding, such as infrastructure grants. Consider introducing core curricula for all schools, <i>i.e.</i> universal curricula requirements. – In areas where schools choose not to accept the conditions for state funding consider subsidising optional out-of-school private-sector education and training. 	<ul style="list-style-type: none"> • Fourteen additional superintendants were appointed in 2011, with the aim of tightening supervision over Ultra-orthodox schools in relation to the teaching of core subjects. • The Ministry has withheld funding based on the percentage of core curriculum taught. • Efforts have been made to increase opportunities for Ultra-orthodox boys in the field of vocational education.
Tertiary education	
<ul style="list-style-type: none"> • Pursue the Shochat reforms. Indeed, go further on some fronts: give providers greater leeway in setting fees, while ensuring access through student loans and grants. Make staff pay and progression more transparent and flexible. 	<ul style="list-style-type: none"> • A six-year reform plan has been developed that notably reforms the system of state transfers to tertiary education providers. However, the reform does not propose reform of student fees.
Lifelong learning	
<ul style="list-style-type: none"> • As regards special education support for conscripts, ensure that the equivalent post-school support is also available for Arab-Israeli students. 	<ul style="list-style-type: none"> • No significant reform.

LABOUR-MARKET, SOCIAL AND WELFARE POLICY (2010 SURVEY)

Tax breaks and benefit payouts	
<ul style="list-style-type: none"> • Make more use of the EITC: expand coverage to the whole of the country, and consider increases in the credit rate and greater differentiation according to the number of children. • Increase payout in Income Support, and bring in new levels of benefit for those with more than two children. Refrain from further increases in universal child allowances beyond those already scheduled. Indeed, consider making economies, for instance through wider application of the lower rates that currently apply only to children born after May 2003. 	<ul style="list-style-type: none"> • The EITC is now available nationwide; however, the size of the credit has only been increased for working mothers. • No significant reform of Income Support payouts. Child allowance increases are being increased as described in 2010 Survey (p. 110).

Recommendations	Measures taken since 2009
<ul style="list-style-type: none"> Reform other tax credits. For instance, consider reducing the regular (<i>i.e.</i> wasteable) tax credits, (especially if combined with an increase in EITC). However, on the grounds of equal treatment, the same credit should be applied to men and women. The extra credits for children should be made claimable by either fathers or mothers and not just the latter. 	<ul style="list-style-type: none"> No significant reform on other tax credits.
	<p>Other</p> <ul style="list-style-type: none"> The ceiling for National Insurance Contributions was temporarily raised from five times to ten times the average wage.
Entitlement conditions and employment services	
<ul style="list-style-type: none"> Ease the prohibition on car ownership and access to a car in the means test for Income Support and related benefits and conduct a general investigation of eligibility with a view to widening coverage. 	<ul style="list-style-type: none"> No significant widening of eligibility. Among various minor adjustments, the definition of a child for benefit purposes has been increased from 22 to 24 years for those who have not yet completed army service. This may be of particular significance to Ultra-orthodox and Arab families.
<ul style="list-style-type: none"> Nationwide adoption of the Light for Employment programme should proceed, but it is important to define the future role of the Employment Service before doing so. 	<ul style="list-style-type: none"> Light for Employment programme was cancelled in spring 2010. A replacement plan has been mooted, but no concrete proposal has been made as yet.
<ul style="list-style-type: none"> The moves to lighten employment rules for disability-benefit recipients should be followed by removal of rules allowing labour-market conditions to have a bearing on eligibility and a general review of the eligibility procedure. Also, a shift in the approach of medical assessment from general disability to capacity for work should be considered. 	<ul style="list-style-type: none"> No significant reform of disability benefit.
Childcare services	
<ul style="list-style-type: none"> Support for childcare services is moving in the right direction; daycare services for Arab-Israeli children warrant particular attention. 	<ul style="list-style-type: none"> No significant reform.
Labour regulation	
<ul style="list-style-type: none"> Efforts to increase the enforcement of labour regulation should be intensified but combined with lowering the value of the minimum wage relative to average earnings. 	<ul style="list-style-type: none"> Exceptional increases in the minimum wage were agreed in early 2011. It was raised from NIS 3 850 to NIS 3 950 in April and will be increased to NIS 4 300 in October 2012.
<ul style="list-style-type: none"> In sectors dominated by foreign workers increased enforcement of labour regulation should be accompanied by measures to limit rent-seeking in the permit system. 	<ul style="list-style-type: none"> Enforcement has been ramped to counter rent-seeking in work permits. Reductions in quota numbers for temporary worker are planned but as in the past may only be partially implemented.
Pensions	
<ul style="list-style-type: none"> For first-pillar pensions, as with regular Income Support, eligibility rules to the Income Supplement should be reviewed with a view to widening coverage. 	<ul style="list-style-type: none"> No significant reform.
<ul style="list-style-type: none"> Increases in women's retirement age for eligibility for state pensions should be extended beyond 2017 so as to eventually equalise with that of men. 	<ul style="list-style-type: none"> A bill is passing through parliament that rejects increasing women's pension age beyond 62 years.
<ul style="list-style-type: none"> Tax breaks on pensions should be pruned. The credits on long-term saving should apply only to savings that are over and above mandatory levels and credits in pension payouts reduced. Credits might also be made "non-wasteable" to boost their value to those on low incomes. 	<ul style="list-style-type: none"> Reforms to the tax treatment of pensions are under discussion along with measures to encourage life-cycle adjustment of the risk profile of pensions savings.

Recommendations	Measures taken since 2009
	<p>Other measures</p> <ul style="list-style-type: none"> • Agreement has been reached for further increase in mandatory second-pillar contributions. Increases were supposed end in 2013 (at 15%) but will be increased to 17.5% in 2014. • Proposals for life-cycle portfolio adjustment in second-pillar pensions are under discussion.
POLICY TOWARDS BUSINESS (2010 SURVEY)	
Business support	
<ul style="list-style-type: none"> • In general, ensure there are good processes for pruning, modifying and innovating within the various menus of support measures. • Given regional-policy objectives, re-balance investment incentives to better cater for the skill base of the peripheral regions that are targeted by these programmes. • Consider paring back targeted support for business in exchange for significant reductions in the rate of corporate taxation. • Reduce support for agriculture and make it less distorting, for instance through further reduction of trade barriers on agricultural products and further simplification of the current highly complex tariff profile, as well as through cuts in support payments based on input use. 	<ul style="list-style-type: none"> • Core legislation governing business support (the Law for the Encouragement of Capital Investment) has been revised, and includes some simplification of processes. • Business support for innovation has been ramped up on several fronts, including: doubling of the budget of the Israel Science Foundation; establishment of a programme for developing alternative fuels; and guarantees to institutional funds investing in venture capital (August 2010).
Competition policy and network industry regulation	
<ul style="list-style-type: none"> • As regards the Israel Antitrust Authority, consider authorising civil penalties, increasing the budget to deal with staff-retention problems and making the IAA's advocacy and regulatory roles more explicit. • In the electricity sector, continue to press for a solution in the deadlock on reform of the Israeli Electricity Corporation. • In telecommunications, follow through on plans to introduce an independent regulator, and continue to push for market opening, notably through unbundling of the local loop. • Press on with efforts to privatise and introduce or strengthen competition for services in post, sea ports and water. • Explore whether there is any justification for the state's "golden" shares having unusually strong rights, as is suggested by the OECD's product-market regulation data. • Give continued policy attention to underdeveloped road infrastructure and rail service. Consider establishing a national transport authority and giving local authorities a bigger role in planning, financing and operating public transport systems and road networks. 	<ul style="list-style-type: none"> • The subsidy agreement for Israel Railways has been revised. • Steps aimed at strengthening competition in the telecoms sector include: regulation to force reduction in the cost of international cell-phone calls, reduction of interconnection tariffs, a tender for a new cellular operator issued. • Reform of port tariffs approved, including phasing out of cross-subsidy between exports and imports. • Provisions have been adopted that allow the direct import of cars from foreign dealers and the export of used cars to Arab countries. • Concentration Groups Law approved that gives the antitrust commissioner powers to declare a "concentration group" and to operate against it. • Long-term plan for rail and road development agreed ("Netivei Israel" programme).

Chapter summaries

Chapter 1. How to improve the economic policy framework for the housing market

Israeli house prices have risen by over 50% over the past three years. In part this reflects the fact that for several years housing construction had not kept pace with increases in the number of households. In response to these developments, hitherto sluggish planning-approval processes are being speeded up. However, in addition low interest rates have been boosting demand, and there are concerns that prices have already been driven to bubble levels. Efforts have been made to subdue demand, and the market has cooled off somewhat, but there remains a risk of a hard landing with a sharp downward price correction and a contraction in construction activity. Recent price developments are not the only economic issue in Israeli housing. As in a number of other OECD countries, housing policies favour home ownership through tax settings and subsidies for house purchase, potentially raising issues of labour mobility. More generally, housing support (public housing and rent support as well as subsidies for purchase) endeavours to fulfil an unusually wide policy agenda that goes beyond simply assisting low-income households with their housing needs.

Chapter 2. Issues in private-sector finance

The 2008-09 global financial crisis did not result in the failure of any major financial institution in Israel, but it did reveal vulnerabilities in the non-banking sector – particularly in the corporate-bond market. Conservative regulation of the banking sector helped this segment avoid a financial meltdown, and low loan-to-value ratios in mortgage lending are undoubtedly helping limit the pace of house-price increases. Nevertheless, as elsewhere, capital requirements and stress tests for banks have been ramped up. Also the identification and monitoring of systemic risks and macro-prudential problems has intensified. In the Israeli context somewhat unusual issues arise from the control of most of Israel's major financial institutions by family-based business groups that have significant interests in non-financial sectors of the economy. This close link between the financial and non-financial sectors generates potential risks to financial stability, and it is a key issue in a wider debate about the relative merits of the business groups in terms of competition and control in the economy.

Chapter 3. Addressing challenges in the energy sector

Offshore natural-gas discoveries have released Israel from complete reliance on imported primary fuels and are allowing for a cleaner energy mix. Furthermore, additional production will soon come on stream, and there is a reasonable chance of new commercially viable gas finds, and possibly of oil too. The authorities have overhauled the system of royalties and taxes, although how best to use the resulting revenues remains the subject of debate. Concerns about competition in the gas sector have risen following the disruption of imports via the pipeline from Egypt, which has strengthened the market position of the lead consortium developing the offshore fields. Competition concerns in the electricity sector have been longstanding due to sluggish reform away from monopoly provision by the state-owned incumbent. As elsewhere, energy use has important environmental side-effects. A comprehensive plan for reducing greenhouse-gas emissions has been developed recently, which relies primarily on energy-efficiency measures and an increase in the share of renewable-electricity production.

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

The economic situation and policies of Israel were reviewed by the Committee on 2 November 2011. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 18 November 2011.

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

The previous Survey of Israel was issued in January 2010.

Further information

For further information regarding this overview, please *contact*

Peter Jarrett, e-mail: peter.jarrett@oecd.org;

tel.: +33 1 45 24 86 97; or

Philip Hemmings, e-mail: philip.hemmings@oecd.org;

tel.: +33 1 45 24 76 69

See also <http://www.oecd.org/eco/surveys/Israel>.

How to obtain this book

This *Survey* can be purchased from our online bookshop:

www.oecd.org/bookshop.

OECD publications and statistical databases are also available via our online library: www.oecdilibrary.org.

Related reading

OECD Economic Surveys: *OECD Economic Surveys* review the economies of member countries and, from time to time, selected non-members. Approximately 18 Surveys are published each year. They are available individually or by subscription. For more information, consult the Periodicals section of the OECD online Bookshop at www.oecd.org/bookshop.

OECD Economic Outlook: More information about this publication can be found on the OECD's website at www.oecd.org/eco/Economic_Outlook.

Economic Policy Reforms: Going for Growth: More information about this publication can be found on the OECD's website at www.oecd.org/economics/goingforgrowth.

Additional Information: More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's website at www.oecd.org/eco.

Economics Department Working Papers:
www.oecd.org/eco/workingpapers

OECD work on Israel: www.oecd.org/Israel