



DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS

OECD INVESTMENT POLICY REVIEWS: ISRAEL

Overview

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OVERVIEW

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

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

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

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

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

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

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

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

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

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

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

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

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

sectoral measures largely based on national security considerations, the business regime is generally non-discriminatory for foreign investors.

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

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

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

The increased levels of foreign investments have substantially contributed to Israel's current account deficit financing and enhanced its foreign trade performance. In the case of many acquisitions of Israeli start-ups, the foreign investment has enabled the Israeli companies to have access to international markets and, similarly, Israeli direct investments abroad have permitted access to those

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

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

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

The growth of FDI in Israel has contributed to the financing of its current account deficit and enhanced foreign trade performance. Its concentration in high-tech

markets via existing companies already established in a particular market. The convergence of a number of factors, such as the strong Israeli venture capital industry, the comparatively large amount of resources invested over the years in military research and development and incentives for specific activities have made the high-tech sector attractive to foreign investors. National expenditure on civilian R&D has increased by an average of 12 per cent at constant prices since 1998; of which the high-tech sector is relatively high. As a result, Israel has become a world leader in this industry.

sectors, facilitated by the strong venture capital industry, has enabled Israel to become a world leader in this industry.

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

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

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

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

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

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

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

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