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Boosting competition on Israeli markets

Claude Giorno

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By Claude Giorno

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ABSTRACT/RÉSUMÉ

Boosting competition on Israeli markets

Promoting competition to enhance productivity at the firm level and resulting income and growth improvement and a lower cost of living is an important economic and social challenge in Israel. Consistent evidence shows multiple deficiencies leading to a dual functioning of the economy between exposed and sheltered sectors. Product markets are hampered by regulations that are far from best practice. Because of its geographical and geopolitical situation, Israel is less open to foreign trade than other small OECD countries. Moreover, its product markets feature monopolies in many sectors. Addressing these issues have been high on the policy agenda since the 2011 "tent protests", and the authorities have adopted or launched reforms in many domains since then. However, further increases in foreign trade exposure by lowering non-tariff barriers, making regulation more competition-friendly in network industries, especially electricity, and reducing the oligopolistic structure of the food and banking sectors would still have considerable economic payoffs.

JEL classification: K21, L4, L66, L81, L87, L9, O47, Q18

Keywords: cartel, competition, network industries, parallel imports, agriculture, food industry, banking sector, non-tariff barriers, monopolies, oligopolies, Israel

This Working Paper relates to the 2016 OECD Economic Review of Israel (www.oecd.org/eco/surveys/economic-survey-israel.htm).

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Stimuler la concurrence sur les marchés israéliens

Promouvoir la concurrence pour accroître la productivité dans les entreprises et les gains en résultant pour les revenus et la croissance et abaisser le coût de la vie constitue un enjeu économique et social de taille pour Israël. Certains éléments concordants montrent de multiples déficiences qui mènent à un fonctionnement dual de l'économie, partagée entre secteurs exposés à la concurrence internationale et ceux qui en sont protégés. Les marchés de produits sont entravés par des réglementations qui sont loin de constituer des exemples de bonnes pratiques. De par sa situation géographique et géopolitique, Israël est une économie moins ouverte aux échanges internationaux que d'autres petites économies de l'OCDE. Qui plus est, ses marchés de produits se caractérisent par l'existence de monopoles dans de nombreux secteurs. Les autorités ont fait de ces questions une priorité depuis la « révolte des tentes » de 2011 et ont depuis lors adopté ou engagé des réformes dans de nombreux domaines. Toutefois, une plus forte exposition aux échanges internationaux via une réduction des obstacles non tarifaires, une réglementation plus favorable à la concurrence dans les industries de réseau, en particulier dans le secteur de l'électricité, et une organisation moins oligopolistique du marché de l'alimentation et du marché bancaire, serait grandement payante sur le plan économique.

Classification JEL : K21, L4, L66, L81, L87, L9, O47, Q18

Mots clefs: cartel, concurrence, industrie de réseau, importations parallèles, agriculture, industrie alimentaire, secteur bancaire, barrière non-tarifaires, monopoles oligopoles, Israël

Ce Document de travail se rapporte à l'Étude économique de l'OCDE de l'Israël 2016 (www.oecd.org/fr/eco/etudes/etude-economique-israel.htm).

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BOOSTING COMPETITION ON ISRAELI MARKETS

By Claude Giorno[1]

1. Boosting competition and oiling the wheels of product market performance have ranked high on the Israeli authorities' list of priorities since the 2011 tent protests. There have been several signs of serious shortcomings in these areas. OECD indicators, for example, reveal that product markets are more strictly regulated in Israel than in most other OECD countries. Weak productivity, coupled with the high cost of living, has fuelled social tensions.

2. Market inefficiencies, whose origin lies in a mix of historical, geopolitical and cultural factors, include the presence of many sectors with concentrated market structures. Market liberalisation has, since its beginnings in the mid-1980s, radically transformed and improved many markets, but remains incomplete. The country's remoteness from its main markets restricts trade opportunities, limiting the potential for additional competition from trade openness. And despite its membership of the WTO, Israel remains outside the world's major trading blocs. There are also cultural and religious factors, such as Kashrut – religious dietary laws that apply only to a very small market, unlike other dietary rules such as Halal and Hindu vegetarianism.

3. The authorities have embarked upon wide-ranging reforms of goods and services markets in recent years. The competition watchdog has been given new powers and resources. In late 2013 a bill was passed to reduce the excessive economic influence of major business groups. Other reforms have also been adopted or launched to boost competition, stimulate efficiency and/or cut excessive margins in the postal service, telecommunications, food, ports and banks. Further ambitious, broad-based reforms must be implemented: Israel must not only remedy serious failings in many sectors but also overcome specific barriers that will continue to impact some markets for geopolitical and cultural reasons. Accordingly, this chapter will first analyse the economic consequences of market dysfunction and then assess economic regulations, before reviewing conditions in a few key sectors. Relevant current and pending reforms will be reviewed in order to determine whether additional adjustments would be useful.

Product market shortcomings hurt growth

Significant shortcomings are disrupting many markets

4. Despite free trade and customs tariffs around average for developed countries (Figure 1, Panels A and B), the Israeli market for goods and services is relatively closed, controlling for its small size. Its exposure to international trade is lower than the OECD average and has increased less since the 1990s, especially compared to small countries in the OECD area (Panel C). Foreign trade is also less geographically diverse than that of other Member countries, except Canada and Mexico (Panel D). Most importantly, Israeli presence in global value chains (GVCs) is weakening, even as GVCs are growing more dominant in international trade, and production processes are increasingly broken up between countries

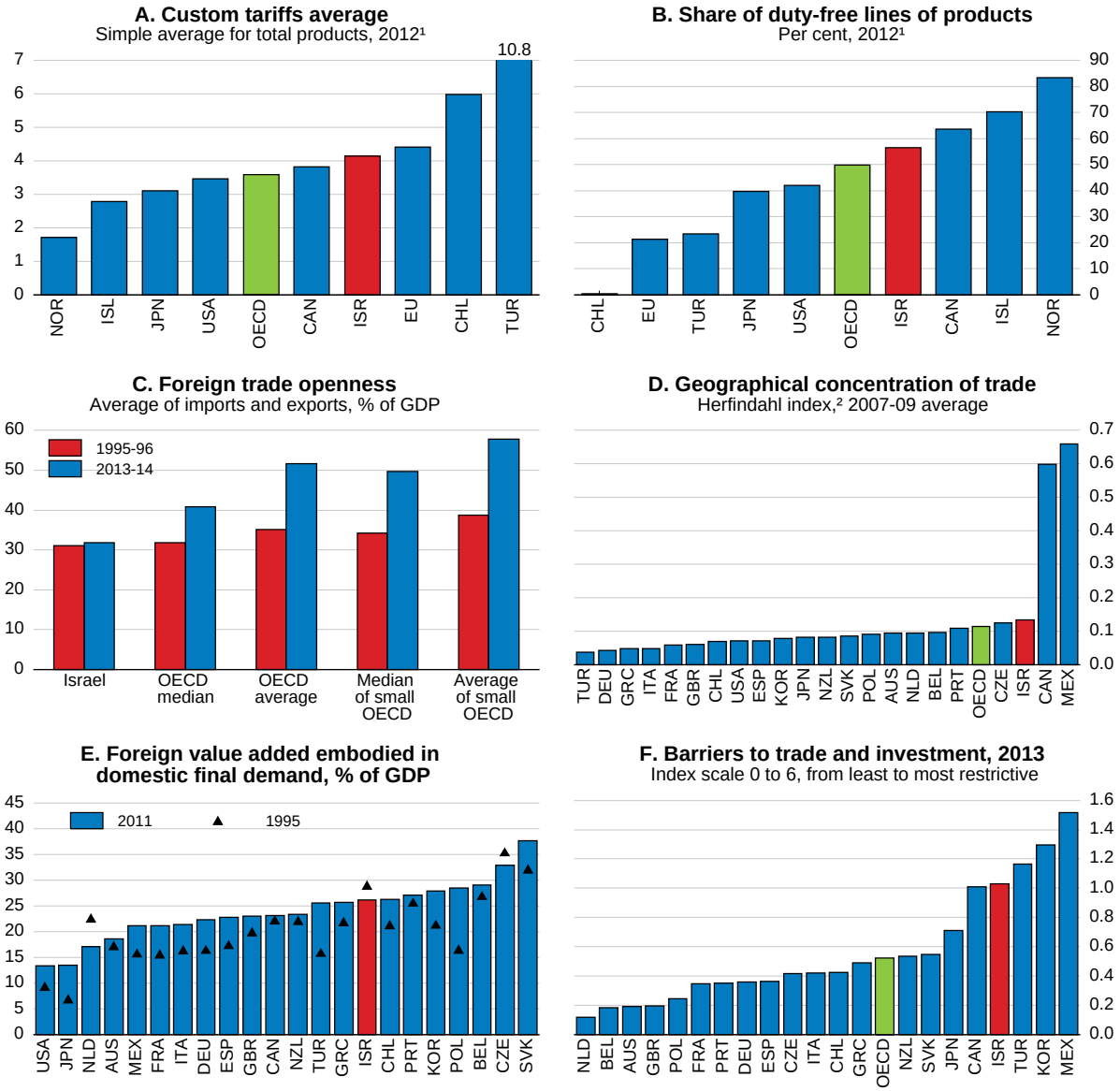
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(Panel E) (OECD, 2013a). This reflects both the country's geopolitical situation and the resulting weakness of its trade with its neighbours, and regulatory barriers to trade (Panel F), which consist of cumbersome import procedures and non-tariff barriers in most sectors, especially food and services. In some agricultural sectors, moreover, foreign competition is restricted by tariff protection and high subsidies (see below).

5. Product markets are also hampered by regulations that are far from best practice (Figure 2, Panel A). Regulatory reform has advanced only slowly in recent years, and Israel has fallen from 30th to 40th place in the World Bank's *Doing Business* ranking since 2008 (World Bank, 2014). The restrictive effects of these regulations reach into many areas. Significant barriers exist in specific sectors, such as retail trade, professional services and several network industries, particularly electricity and rail (Panels B and C). The damage caused by other types of regulation, including the excessively complicated procedures for obtaining licences, is more pervasive, affecting many markets. This is in particular the case of environmental regulation, which is among the least amenable to competition among OECD countries (Kozluk, 2014). In addition, until recently the effectiveness of competition policy was limited as, for example, the reach and accountability of sector regulators was restricted and the antitrust authority's promotion of competition lacked a formal framework (Panel D), although this latter barrier has recently been eased.

6. Monopolies exist in many sectors, and a small number of large business groups that control broad swathes of the economy. The food industry, banking, electricity, gas, cement, rail and sea ports, for example, are all dominated by major public and private enterprises. Despite its small size, therefore, the Israeli economy has an relatively high share of large companies (Figure 3). This also means that at the end of the last decade the five largest Israeli business groups held assets amounting to 63% of GDP, and the ten largest groups represented over 40% of total market capitalisation. This ownership concentration, which is based on complex business pyramids, is substantial. The pyramidal groups, which include major financial businesses, can have damaging effects on competition and the distribution of capital in the economy. The authorities have, however, recently taken steps to gradually reduce their economic weight and prevent large non-financial groups controlling major financial institutions (see below).

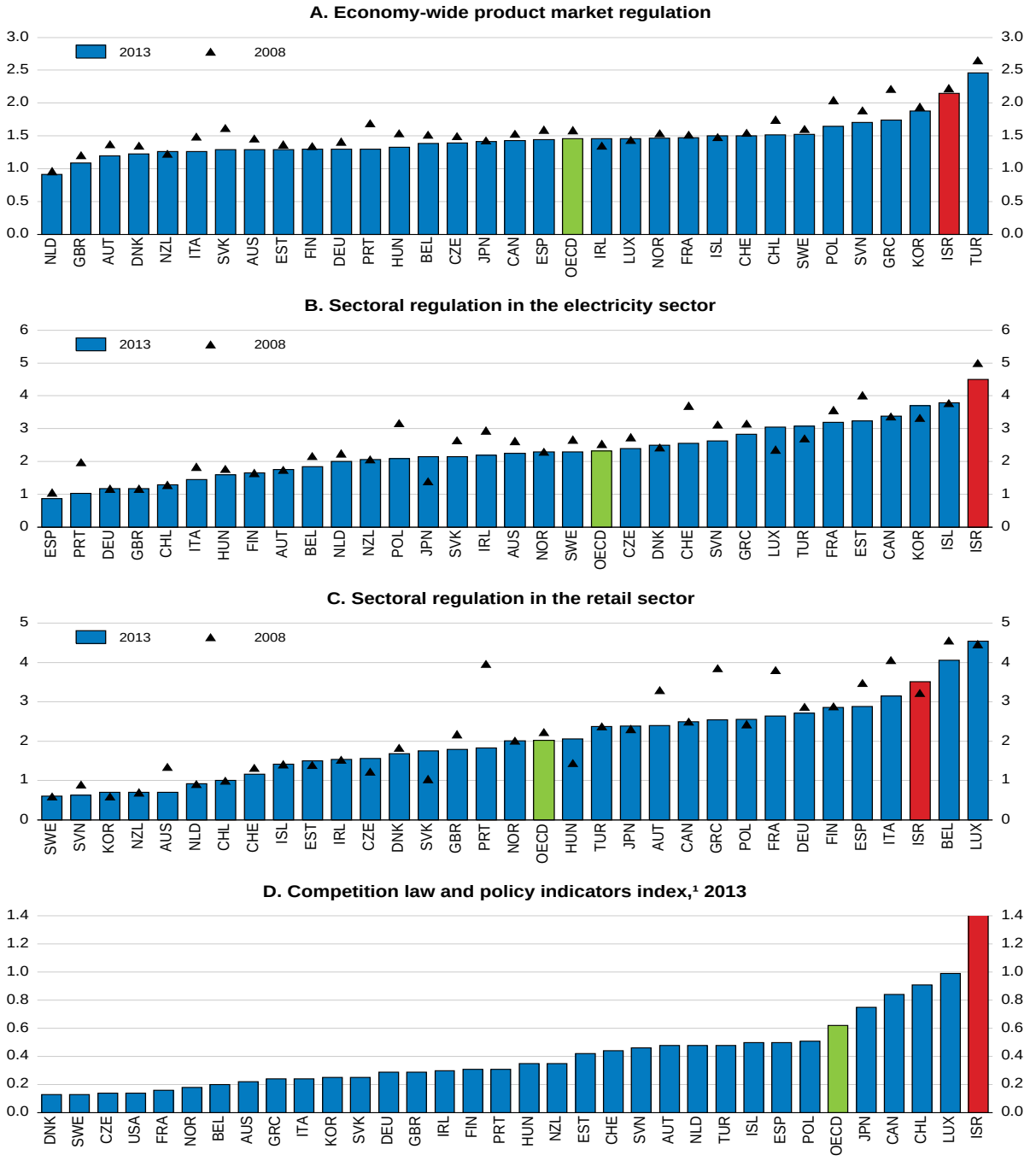
Figure 1. **Foreign trade indicators**



1. 2013 for Turkey.
2. The Herfindahl index of geographical concentration for country A's exports (by harmonised series (HS)) is the sum of the squares of the export shares of each country of destination in the total world exports (by HS) of the country i, i.e.: H = SUM[Xi/SUM Xi]**2, where i = 1...n countries of destination. If each of the n countries of destination received the same export value from that country of dispatch, the Herfindahl index would be equal to: H = 1 / n. The nearer to 1, the more geographically concentrated is its trade.

Source: UNCTAD, Trade Analysis and Information System (TRAINS) database; WB-UNCTAD, World Integrated Trade Solution (WITS) database; OECD, Economic Outlook database, Product Market Regulation database and OECD-WTO Trade in Value Added database.

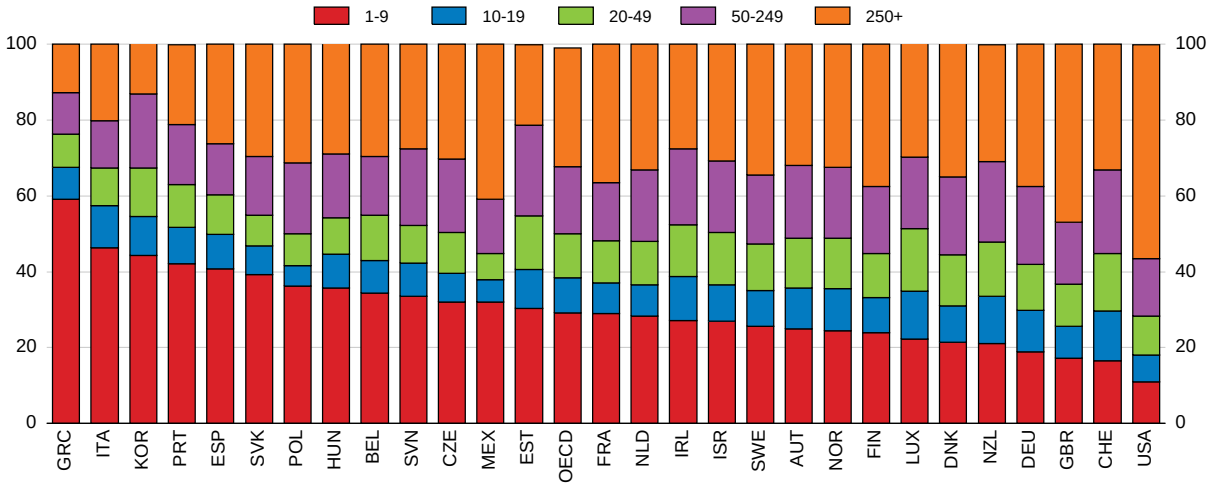
Figure 2. **Product market regulation**
Index scale from 0 (least restrictive) to 6 (most restrictive)



1. The competition law and policy indicators index is the average of four components: scope of action, policy on anticompetitive behaviours, probity of investigation and advocacy.

Source: OECD, Product Market Regulation database and OECD Competition Law and Policy Indicators.

Figure 3. **Employment by enterprise size class**
As a percentage of total employment, 2012[1]



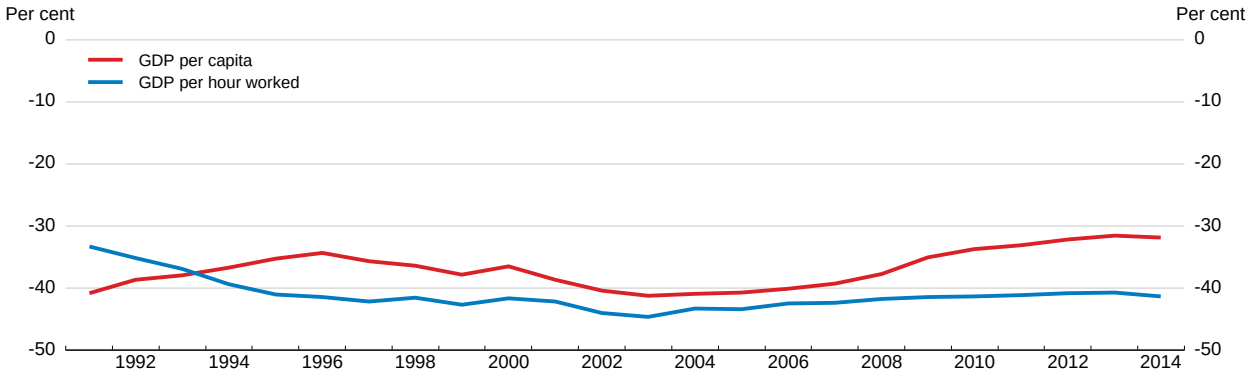
1. Or latest available year.

Source: OECD (2015), *Entrepreneurship at a Glance 2015*, Figure 2.5.

Flawed product markets reduce productivity and drive up costs and prices

7. The most serious effects of market dysfunction concern productivity. While productivity does not depend solely on competitive intensity, competition is a powerful driver in encouraging entrepreneurs to take risks, innovate, optimise the use of resources and improve efficiency. Despite the rise in average educational attainment in the workforce and the country's good macroeconomic results in the last decade or so, these measures of productivity have remained poor (Figure 4). Income per capita has gradually been catching up with the most advanced countries since 2003 but has not been matched by a similar convergence in productivity. The productivity deficit has hovered around 40% since 2008, despite strong growth in high added-value hi-tech sectors.

Figure 4. **Per capita GDP and productivity**
Gap relative to the upper half of OECD countries[1]

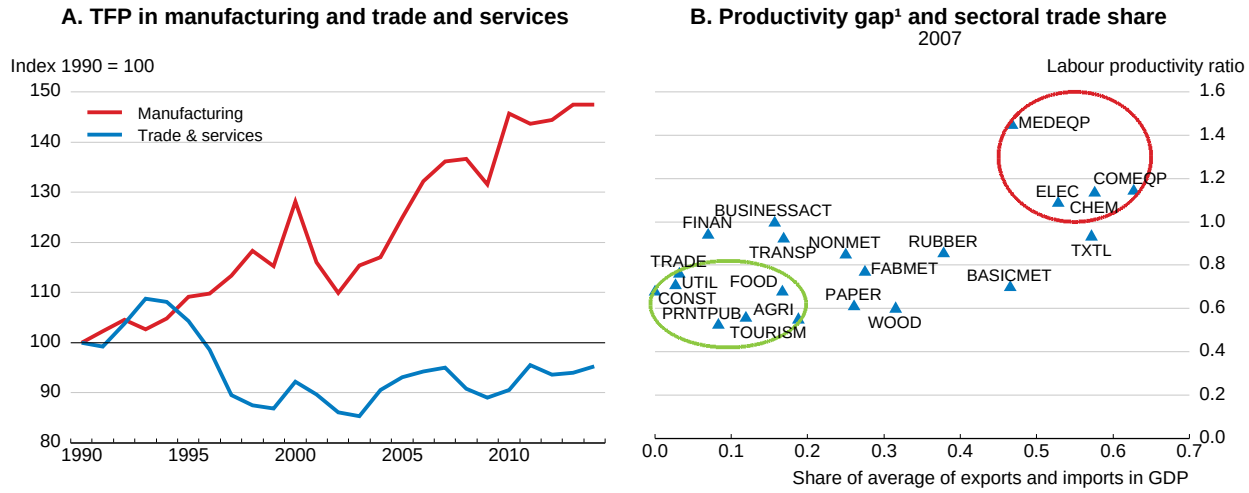


1. Percentage gap with respect to the simple average of the highest 17 OECD countries in terms of GDP per capita and GDP per hour worked (in constant 2010 PPPs).

Source: OECD, National Accounts and Productivity databases.

The reason for this poor productivity performance is the poor efficiency in sectors that are primarily focused on the domestic market. As in other countries, wide gaps have opened up in productivity growth between sectors since the mid-1990s (Figure 5). Differences in productivity by sector between Israel and the OECD average are positively correlated to the sector's integration into global trade based on the average ratio of exports and imports to sector production. Furthermore, these differences in efficiency between exposed and sheltered sectors are wider than the OECD average, with Israel having lower investment rates for almost all sectors except manufacturing (BoI, 2013a and 2014a). Manufacturing's focus on exports promotes investment and innovation, fuelling competitiveness and productivity, with the result that a large share of these exports consists of hi-tech goods. Conversely, in many sectors the efficiency gains brought by globalisation have been limited by a restrictive regulatory framework and a relative lack of openness.

Figure 5. **TFP, productivity gap[1] and sectoral trade share**

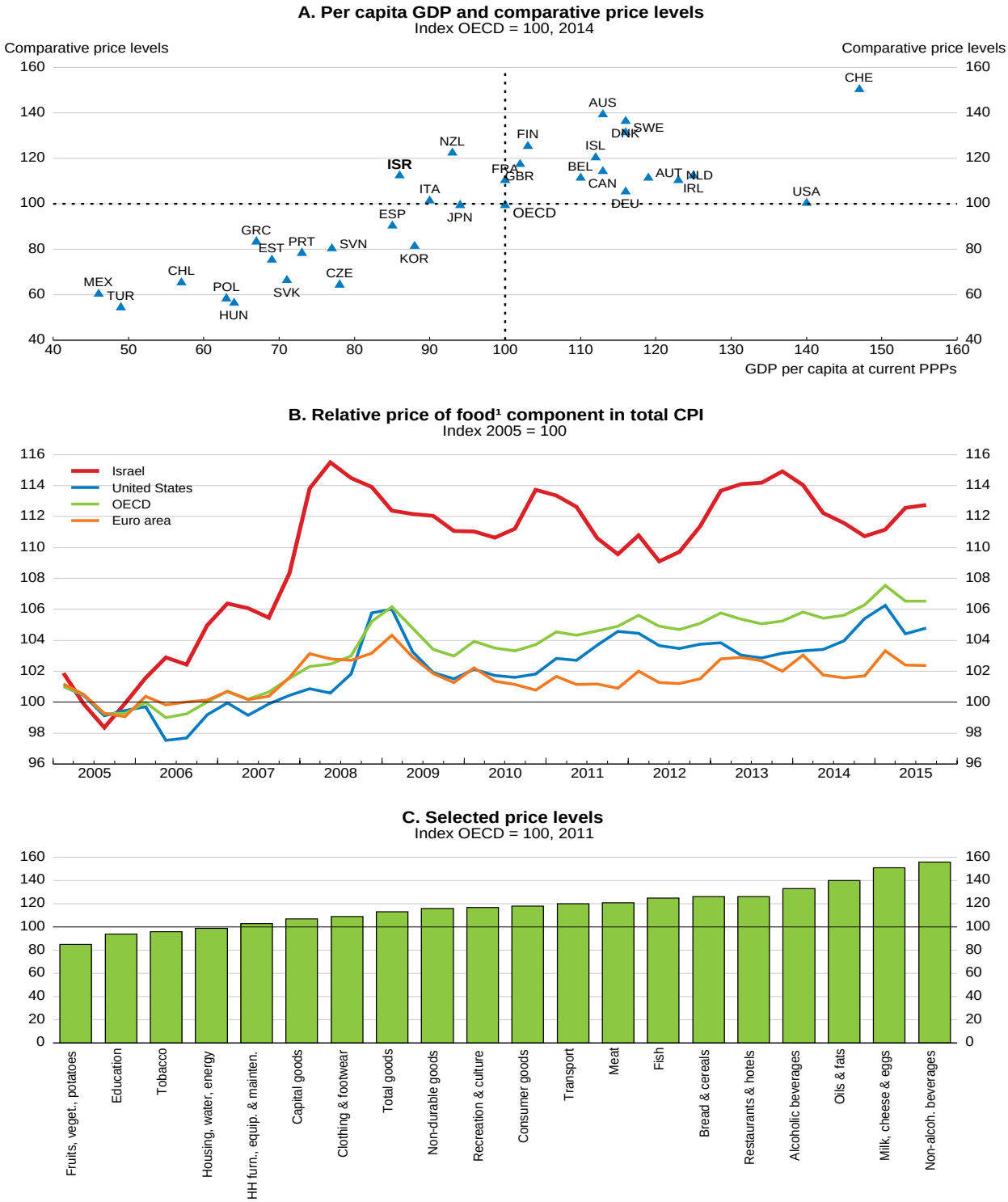


1. Gap between Israel and OECD average.

Source: G. Brand (2015), "The Evolvement of the College Wage Premium in the Israeli Labor Market Supply and Demand Factors" (in Hebrew), Milken Institute; OECD and Central Bureau of Statistics.

8. High prices are another sign of a lack of competition. In 2013 the cost of living was, for instance, respectively 20% and 30% higher than in Spain and Korea, which had a similar per capita GDP as Israel (Figure 6, Panel A). They are also a manifestation of the poor efficiency of the sheltered sector and relative closure to foreign trade. High prices are most pronounced in the food sector, and it was high food prices that triggered the tent protests in 2011. The protest movement prompted the authorities to appoint two Committees, Trajtenberg and Kedmi, with the former responsible for identifying the main thrust of reforms to respond to public anger and the latter for suggesting solutions to the problems specific to the food sector. As pointed out by the Kedmi Committee, food prices (in local currency) have risen faster than the OECD and EU averages since 2005 (Panel B). This, coupled with prices for many products that diverge from the OECD average (Panel C), reflects the food sector's many flaws: high tariff protection on some products, such as milk and meat; non-tariff barriers, including those linked to the application of religious laws requiring the consumption of kosher food; a strict regulatory framework at retail level; and a highly concentrated production and distribution structure. High food prices can only partly be explained by the VAT rate (18% in 2005, 16% in 2011, 18% in 2013 and most recently cut to 17%) being higher than in most other OECD countries, which often apply reduced rates to food.

Figure 6. **Comparative price levels**



1. CPI food excluding restaurants, relative to total CPI.

Source: OECD, Price and Main Economic Indicators databases.

Substantial product market reforms will boost increase productivity and more well-paid jobs

9. The authorities have launched a series of product-market reforms in recent years, and these efforts need to be maintained and intensified. Moving towards a more business-friendly regulatory environment, as represented by the OECD average, would increase GDP by about 3¾ per cent after 5 years and 5¾ per cent after 10 years, i.e. a growth gain of between ½ and ¾ percentage point per year over the period, according to OECD estimates (see Annex below), reflecting productivity gains and more well-paid jobs. These estimated effects, which only provide an order of magnitude of the potential benefits of product market reforms, would reflect for the most part (60%) the direct gains generated in each sector of the more business-friendly regulation of the sector itself, while the remainder (40%) would come from induced indirect gains in downstream sectors. While the size of these benefits seems reasonable when compared with those estimated for other OECD countries (Bourlès et al., 2010, Bouis and Duval, 2011; Anderson et al., 2014), they could however be somewhat overestimated because of the likely staggered nature of product market reforms, which are often spread over time even in the case of ambitious reform agendas and thus take time to fully materialise.

Room for progress on competition laws and their application

10. Since the end of the 1980s, Israel's competition policy has been heavily influenced by a drive to solve the problems related to high concentration in many sectors. The country's limited size –and hence also its markets, the lack of trade relations with its neighbours and the presence of large groups, many of which are privatised state enterprises, have encouraged the development of oligopolies and cartels (OECD, 2011a and 2011b).

11. This situation largely shaped the 1988 Restrictive Trade Practices (RTP) law, which long promoted criminal rather than civil action as the preferred means of combating antitrust behaviour. The implementation of this legislation by the Israel Antitrust Authority (IAA) (Box.1) focused on preventing the emergence of monopolies by strictly controlling mergers. Recently, new measures have, for instance, been aimed at reducing the weight of big conglomerates in the economy. On the other hand, the IAA had long been either less active or less effective in the detection and punishment of abuse of dominance, and in promoting a competition-friendly legal framework. However, this problem has been solved in recent years (see below).

Box 1. Israel's main competition bodies

The Israel Antitrust Authority (IAA) was created in 1994 and is the only government agency responsible for applying the RTP law. In Israel, sector regulators have limited power to enforce competition. They may grant licences and approve some transactions in their field of expertise, while the IAA is focused on the application of competition law and has no consumer protection responsibilities.

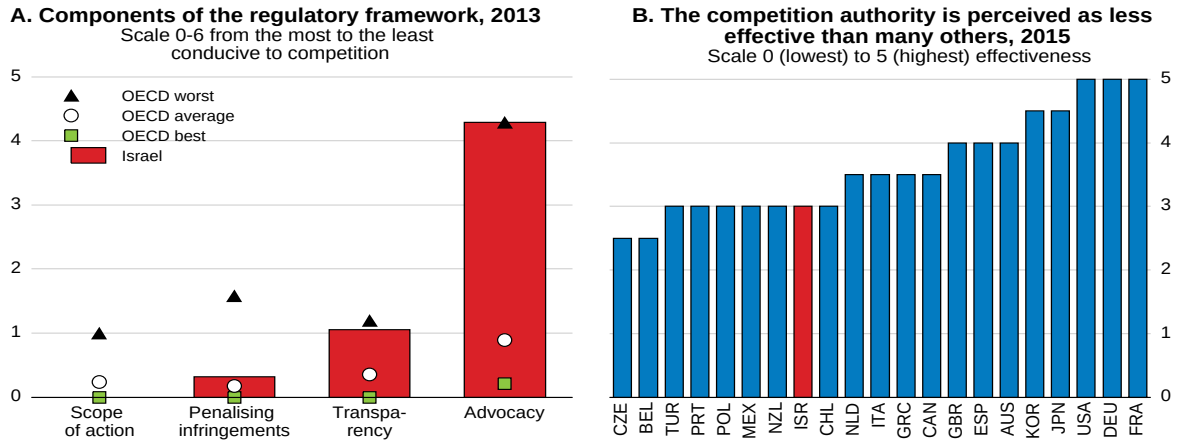
The IAA is assisted in applying this law by an Antitrust Tribunal and the Jerusalem District Court (JDC). For criminal actions against anti-competitive practices the IAA carries out investigations and the JDC is responsible for judgements. The Tribunal has the authority to launch non-criminal proceedings related to competition, if, for example, an appeal is lodged against an IAA merger decision, or to approve, amend or reject the IAA director's administrative penalties and consent decrees to punish companies that have broken the law and would like to avoid criminal charges. Appeals may be lodged against decisions of the Tribunal and JDC in the Supreme Court.

12. In the past few years some reforms have aimed to rebalance the IAA's activities and enhance its effectiveness, based on analyses and internal assessments carried out by the 2006 Goshen Committee and, more recently, the pooling of experience with other OECD countries. Funding and staff levels have both increased since 2011. The number of staff has grown from 83 to 125, with a sharp rise in personnel

responsible for economic analysis. The IAA's resources now fall within the OECD average range, after accounting for size differences between economies. The adaptation of competition policy to best practice has also led to significant progress in several areas, including the application of the RTP law, the management of concentration and monopolies, the effectiveness of antitrust penalties and IAA's role as a competition advocate. The OECD's indicators of the quality of competition law and policy (CLP) may not yet do justice to the most recent successes, but they suggest that further reform is still needed in some respects (Figure 7). Enforcement of the regulatory framework is perceived in particular to be less effective than in many other countries. A more systematic assessment of the competitive effects of regulation and reforming unduly restrictive regulations would be worthwhile. More generally, the government should heighten its attention and response to IAA advocacy for regulatory change.

13. According to the OECD's CLP indicators, Israeli competition law, which covers both private and public enterprises (Figure 7, Panel A), is very broad in scope. In 2013 and 2014, moreover, the authorities extended its reach by limiting sector-specific exemptions in agriculture and in maritime and air transport (see below). The IAA also has various means at its disposal to apply competition law in the economy (Alemani et al., 2013): it can block mergers, instigate criminal proceedings against cartels, impose administrative sanctions in response to competition violations and lift them after negotiating consent decrees with the relevant parties involving the payment of a fine. The RTP law also allows members of the public, businesses and consumer groups to launch proceedings, including class actions, to obtain reparations for any damage caused by anti-competitive actions.

Figure 7. **The competition regulatory framework and its enforcement**



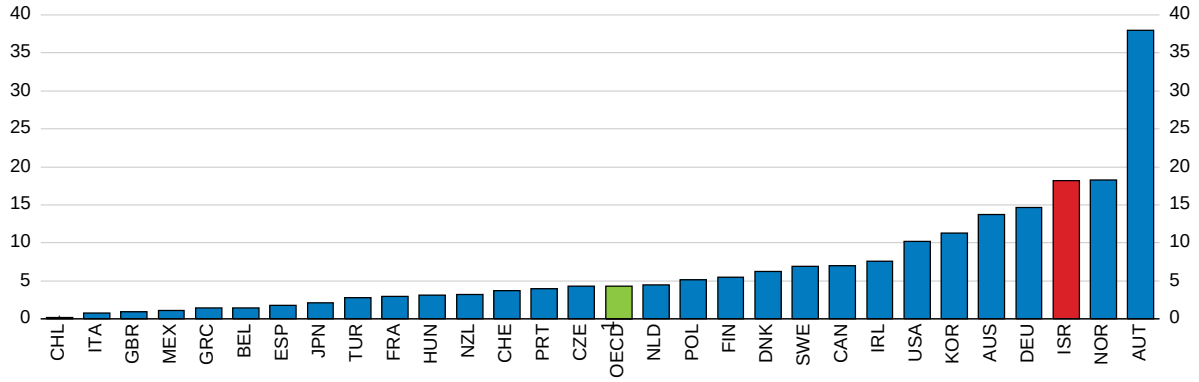
Source: OECD, OECD Competition Law and Policy Indicators; Global Competition Review (2015), *Rating Enforcement 2015*.

Major reforms have been introduced to reduce the high level of economic concentration

14. Generally speaking, however, the authorities have in the past focused their attention on the issue of mergers and acquisitions, using several lines of attack to remedy the resulting damage to the economy. The RTP law, for example, requires businesses to alert the authorities to planned mergers that could threaten competition. Most problems involve mergers that create businesses controlling over 50% of their market, which is a strict criterion requiring the review of a great many transactions without necessarily being a red flag for anti-competitive mergers (OECD, 2011a) (Figure 8). Since 2011, new ways of limiting the influence of oligopolies (or concentrated groups) have been developed following clarification of their definition in the RTP law and the granting of additional powers to the director of the IAA, who can now issue directives to oligopolistic companies and take action to eliminate cross-shareholdings between them (Capobianco and Chiasson, 2015). To promote competition in port services, for example, the IAA declared

that the ports of Haifa and Ashdod constitute an oligopoly and, among other measures, banned them from participating in the management of the new ports to be built.

Figure 8. **Number of mergers filed**
Number of cases per million inhabitants



1. OECD median.

Source: Global Competition Review (2015), *Rating Enforcement 2015*.

15. At the end of 2013 the Knesset also passed an important law to reduce economic concentration. This law signalled a significant change of approach, because previous efforts had aimed at neutralising the negative effects of concentration, rather than preventing them from arising in the first place. The law limits firms' use of pyramidal control structures, which create a disconnect between voting rights and shareholdings. These structures, which are particularly widespread and complex, have allowed a limited number of business groups to control a large proportion of the economy, as mentioned above (Bebchuk, 2012a). Under the law, these groups have until the end of 2018 to reduce the maximum number of levels in these pyramids to two. Another provision restricts the control of major financial institutions by large non-financial enterprises, as is already the case in the United States, Canada and Korea. Such cross-ownership can distort competition between businesses in that access to credit depends on whether they belong to one of these groups (Bebchuk, 2012b). Last, the law requires all government authorities to take competition considerations in account when granting licenses, franchises or selling an asset, which may affect market concentration and, in certain cases, to consult the IAA on the issue. When the licenses, franchises or asset sales concern essential infrastructure areas granted to large-scale or state-owned companies, the IAA must consider the impact of such actions on the concentration in the Israeli economy in consultation with the committee for economic concentration, which is chaired by the IAA's director. These are welcome changes, and they should be supported with increased efforts to detect, penalise and therefore deter anti-competitive practices (GCR, 2014).

Antitrust practices could be better detected and penalised

Some aspects of the leniency programme should be changed

16. In Israel, the detection of anti-competitive practices is based on complaints by the public, but also, more often, on information collected by the IAA's investigators (OECD, 2013b), which has far-reaching powers comparable to those of the police. The IAA director may demand or seize information pertinent to an enquiry; refusal to co-operate can attract a prison sentence. The IAA can also tap telephones and search people's homes with a court warrant. In addition, the authorities have a leniency programme for the detection of cartels, but it is not used very often: only two cartel investigations were started under the programme between 2003 and 2013, compared to 15 conducted by the IAA's investigators.

17. Measures should be considered to promote uptake of the leniency programme. As noted by the authorities, it is likely that cultural factors are partly to blame for its ineffectiveness (OECD, 2011a). The economy is small, and businesses that co-operate with the IAA to expose a cartel are worried about being blacklisted as informers and boycotted by other firms. Some aspects of the programme itself, however, help to explain its underutilisation: for example, there is no recourse to leniency once an investigation has been opened, even if it might speed up and improve results. Neither does the programme offer users full immunity from prosecution on charges indirectly linked to the cartel, such as conspiracy (OECD, 2011a).

Harsher penalties would strengthen compliance

18. Harsher penalties, including fines, would deter cartels and help to promote uptake of the leniency programme. Under Israeli competition law, violations – especially cartels, which are treated as white-collar crime – carry strong penalties of up to five years in prison. But the maximum fine applied under these procedures is only NIS 2.26 million (less than USD 0.6 million). Until now, moreover, nobody has been sentenced to more than nine months in prison for cartel offences, and many sentences have been commuted to community service. Substantially increasing the associated fines should be considered: the courts may be less reluctant to levy heavy financial penalties in these cases than to impose prison terms. The deterrent impact of harsher financial penalties should not be underestimated, as they would reinforce the impact of the relatively recent increase in class action lawsuits. Another welcome suggestion supported by the IAA is increasing potential damages resulting from class actions. In addition to these changes, the IAA expects to see the introduction of tougher prison sentences against cartels, and the Supreme Court wants judges to implement them.

19. A positive development in Israeli law allows the IAA director to impose monetary penalties for competition law infringements since 2012 (including cartel violation, abuse of dominant position or if mergers are carried out without the IAA approval), increasing the options open to the authorities. These new administrative penalties have a useful role to play in the case of minor offences, as criminal charges and prison sentences have not been applicable in practice in these cases, and these violations have rarely been punished, or only very lightly, using consent decrees (OECD, 2011a; GCR, 2014). The first such penalties were recently applied.

There is room for progress in the IAA's advocacy role and competition policy transparency

20. Until 2013, the IAA's power to undertake market analysis and draft opinions on proposals for competition laws was more limited than in other OECD countries (Figure 7, Panel A). Despite this, the IAA has recently been active in the temporary committees responsible for assessing the need for reforms to stimulate competition in some sectors, and has also replied to ministries seeking its opinion on their reform proposals. Its role in promoting competition was institutionalised and consolidated by the new law at the end of 2013. It has also been able to launch market analyses on its own initiative since March 2014 and has produced two detailed reports on the credit card sector and the regional concentration of supermarkets (see below).

21. These are positive changes, and the IAA's action in speedily suggesting measures to support competition in some sectors is to be welcomed and encouraged. This progress could, however, be taken further if the government were legally required to respond to the IAA's opinions and recommendations on proposed new laws and regulations affecting competition or market analysis produced on its own initiative. This would help to promote transparent debate on competition policy and push reforms forward.

22. According to the OECD's indicators, it should also be possible to improve competition policy transparency (Figure 7, Panel A). The Israeli system's shortcomings in this respect are not linked to government interference in the IAA's decisions, which is only possible under exceptional circumstances,

and for strategic or diplomatic reasons. The IAA's political independence seems to be well protected, and it is important to preserve this. However, competition policy transparency could be increased by the more systematic circulation of directives to businesses clarifying the assessment criteria applied to certain practices. Great progress has already been made in this direction: the IAA has issued guidelines on its criteria for assessing horizontal mergers, excessive pricing by monopolies, on violations likely to be punished by monetary penalties and on how it sets these fines. It is worth pursuing these actions, especially those regarding the assessment criteria for vertical agreements.

Making state intervention more effective

It is worth pursuing privatisations and the reform of public enterprises

23. Since the middle of the 1980s the government has pursued reforms to rein in the traditionally interventionist State in several sectors of the economy, leading to a huge programme to privatise state-owned enterprises (SOEs), which are supervised by a special body – the Government Companies Authority (GCA) – that reports to the Finance Ministry. In 1992, SOEs represented almost 17% of GDP, over 4% of jobs and almost 20% of exports; but by 2013 these figures had fallen to 2.2% of GDP, 1.7% of jobs and less than 7% of exports. Reforms have also improved the regulatory framework imposed by the GCA to ensure competitive neutrality between public and private firms in the same market in terms of regulation, financing and taxation (OECD, 2011c).

24. Despite these reforms, the predominance and weak efficiency of SOEs in some key sectors continue to harm the economy. The SOEs' scope for action is greater than in the average OECD country, as they are strongly represented in defence and many network industries – maritime and rail transport, postal services, water management, electricity and other energy-related activities (Figure 9, Panels A and B). These are sectors that are relatively sheltered from competition, with a prevalence of either monopolies or oligopolies. This environment is unlikely to promote efficiency and has fostered the emergence of politicians appointing executives to roles that bear no relationship to their professional qualifications (OECD, 2011c), and also of employees seeking rents. Average SOE pay was 2.9 times the overall average in 2013 (State of Israel, 2014a). Many of these firms are significantly overstaffed, including Israel Military Industries and Israel Post Company, and some, such as Ashdod port, have long favoured relatives of serving staff in recruitment. The quality of some of the services provided is also a frequent source of dissatisfaction: the Israel Post Company, for example, has limited opening times that fail to meet the needs of its consumers, and waiting times are excessively long. These firms incur regular losses, and some are heavily indebted: Israel Electricity Corporation's debt represented almost 7% of GDP at end-2013 (though it has come down since then), and Israel Railways owed almost 13 times the company's annual income.

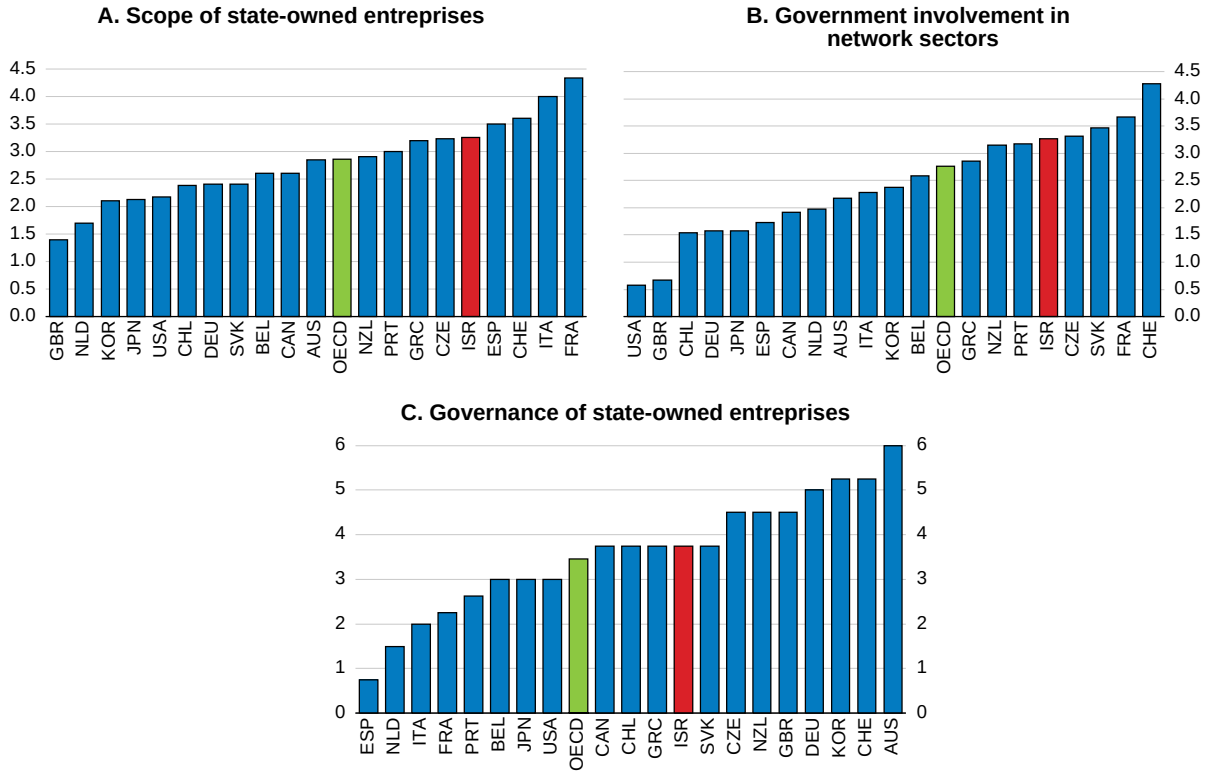
25. This situation has many causes, and the initiatives taken to solve them extend to SOE governance reforms and a new privatisation scheme. The former include measures to boost professional credentials in the boardroom: since late-2013, the appointment of SOE directors has been based on a list of candidates preselected according to their professional skills, with the final decision falling to the responsible minister. This system discourages appointments being made according to purely political criteria, which was a problem in the past (OECD, 2011c). A new three-year privatisation scheme of NIS 20 billion (1.75% of GDP) was recently drawn up, involving the full divestment of some enterprises (including the ports and the postal service), and a series of partial privatisations through IPOs (electricity, water and defence). Besides the public revenue generated, the authorities also expect it to have a positive impact on the firms' management and performance as a result of their increased exposure to market forces and stricter transparency requirements, as the experience of other countries suggests (Megginson, 2011).

26. These are positive changes, but they must be supported by further reform if they are to deliver the best results. The privatisation scheme must be rolled out alongside reforms that introduce more

competition into those fields where it is feasible (see discussion by sector below). And while it is undeniably important to increase the professionalism of those managing public firms, the government still intervenes too much in the control and strategy of public enterprises, as suggested by OECD indicators (Figure 9, Panel C). As a general rule, public enterprises need to have clear objectives and gain sufficient managerial independence and flexibility to reach these objectives, for which their management should be held accountable. Some of the reforms that are being considered to boost the powers of the GCA and give it a more active role as shareholder and in the dismissal of inefficient managers will help to achieve this.

27. The authorities should also review the management of public service obligations that are often imposed on SOEs. These obligations consist, for example, of nationwide price equalisation for electricity, water, telecommunications and postal services, despite regional cost differentials. If justified, public-service obligations should be financed as transparently, for example by granting a specific subsidy for a firm's public service obligations (identified both in the government's budget and in the company's financial statements).

Figure 9. **Restrictiveness of regulation of state-owned enterprises**
Index scale from 0 (least restrictive) to 6 (most restrictive), 2013[1]



1. 2008 data for the United States.

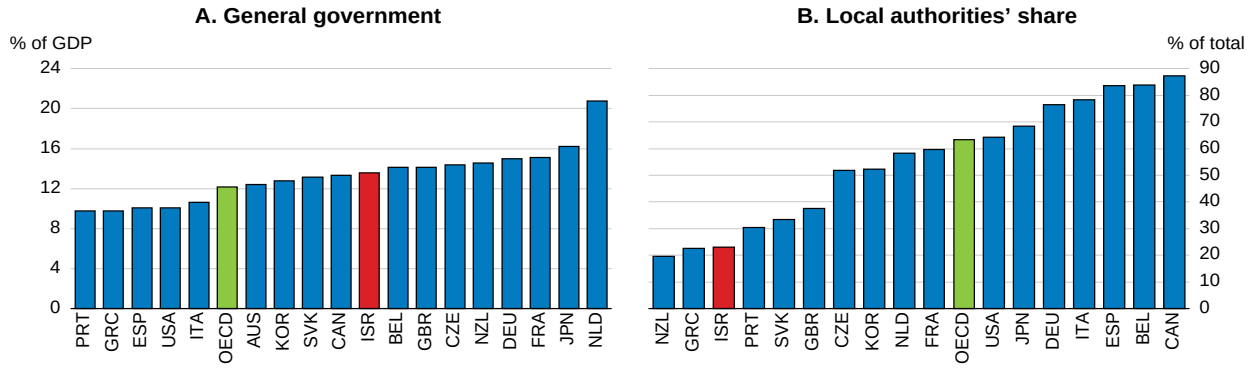
Source: OECD, Product Market Regulation database.

The rationalisation of public procurement management has been too slow

28. Competition has a vital role to play in procurement, given its effects on public finances and the weight of these markets, estimated at 13.5% of GDP (Figure 10, Panel A). Several provisions can help to encourage the efficient management of public procurement in Israel. The legal framework for adjudication

procedures is based on 1992 legislation that enacted a WTO agreement and aims to optimise the use of taxpayer money and to ensure non-discriminatory, fair and transparent contract attribution processes. Public procurement is subject to greater central government control than in other OECD countries, which helps to prevent orders being fragmented into regional portions and undermining economies of scale (Panel B). As elsewhere, Israeli policy does not focus exclusively on obtaining the lowest price or the best quality, but also promotes subsidiary objectives, such as support for small businesses, women's entrepreneurship and improving the environment.

Figure 10. **Size of government procurement**
2013 data



Source: OECD (2015), *Government at a Glance 2015*, Figures 9.1 & 9.2.

29. As in many other OECD countries, a lack of quantitative information makes it hard to judge the efficiency of public procurement. Nonetheless, some of the figures available point to potential efficiency gains in the attribution of contracts. Just 20-30% of total government tenders are subject to open competition; the rest is managed by selective tendering or the direct award of contracts. One reason for this is that, as in other OECD countries, orders worth less than sector-specific thresholds are not subject to calls for tender. Israel's highly centralised government ordering system, however, should limit the effects of this rule somewhat. For its part, defence spending, which is high, is exempt from some procurement rules. The rules do not apply, for example, to the purchase of foreign equipment financed by foreign aid nor to equipment financed by internal resources if there exists only a single Israeli supplier. Defence procurement is, however, subject to Ministry of Finance oversight. Several other exemptions exist for specific goods and services, such as police equipment (ICGL, 2015).

30. Their analysis of public procurement procedures led the authorities to embark on a reform programme to generate efficiency gains and budget savings. The programme, which is based on March 2013 recommendations made by a Governance Committee tasked with assessing various aspects of public management, aims to correct the failing caused by the over-decentralisation of public procurement by specific agencies in the ministries. To this end, the first objective has been to streamline and standardise the working methods of the decentralised procurement units in order to promote information exchange and improve inter-ministerial co-ordination. To support this goal the Department of Public Procurement has launched a review and simplification of the administrative procedures for calls for tender. A second objective is the introduction of a genuinely centralised ordering system based on e-procurement. In recent years the computerisation of adjudication procedures has resulted in the proliferation of different technological platforms in government departments, increasing complexity and inefficiency. To solve this problem, the Department will centralise this infrastructure and promote a standard approach to awarding contracts through framework agreements. A third objective is to encourage the professionalisation of staff responsible for managing public procurement in response to the job's growing complexity – meeting multiple public objectives and mastering new adjudication techniques that require special skills. The new system also cuts contract management costs by eliminating some redundant procedures.

31. These reforms are useful, but their implementation has been limited so far. Just 10% to 15% of total public procurement at the central government level is processed using the new, more standardised and centralised adjudication procedures. These procedures should be extended, as depending on the agency, their utilisation can generate savings of 12-40%.

32. After completing the implementation of the reform programme in central government, the authorities should extend it to local administrations, which are not currently under any obligation to use the new procedures for awarding public contracts, although they may choose to do so. It would also make sense to review all exemptions from competition rules to ensure they are justified. Special attention should be paid to defence spending, given the privatisations underway in this sector. Maintaining exemptions from competitive calls for tender for some kinds of military contracts could, even in the case of partial privatisation, transfer the rent-seeking they engender from the public to the private sector.

33. Steps should also be taken to improve the collection of quantitative information about public procurement, without which there can be no rigorous, regular assessment of current policies. Data as basic as the share of public contracts awarded to foreign firms, for example, are not available. Better information and statistics would be particularly useful in the light of the risk of consistency conflicts between the essential target of the cost-effective management of public procurement and secondary goals that aim, for example, to facilitate access for SMEs (OECD, 2015a). From this point of view, the Israeli authorities should contribute actively to an ongoing OECD project that aims to make up for the widespread lack of data about public procurement in Member countries (OECD, 2014a). The calculation of comparable indicators across countries on efficiency, openness to competition, the transparency of public contract awards, the assessment of contract completion and the professional qualifications of those handling the public contracts would provide valuable information for designing future reforms.

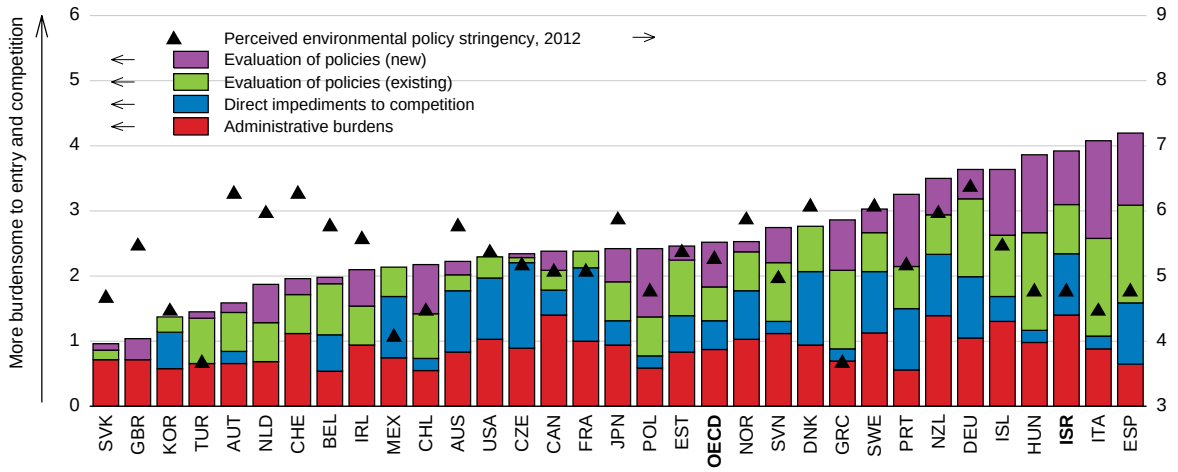
Regulations should be made more competition-friendly, including in the environmental domain

34. As stressed by the business sector and recognised by the authorities, the regulatory burden needs to be substantially reduced to promote a more business-friendly environment. To address this issue, in October 2014 the government adopted an ambitious plan to reduce the administrative and compliance costs associated with the existing bureaucratic burden of regulation. This plan includes two central components. The first aims to lower the cost of existing regulations in all ministries by 25% by 2019. The second requires carrying out an assessment of the expected impact of regulation before formulating new regulatory texts as from 2016. This policy initiative, which relies on the OECD recommendations on regulatory policy and governance, is welcome. However, making progress will depend crucially on the implementation and quality of regulatory impact assessments (RIAs). The decision of the authorities to consult with the business sector to formulate their action plan was thus important. Since the task of reducing the regulatory burden will be assigned to each ministry, it would also be desirable to ensure that a team well-trained in the domain of RIA closely assists and checks the quality the work performed at least until departments become more familiar with these new procedures.

35. Environmental regulation illustrates this excessive burden issue. Recent OECD indicators analysing its cost show that it creates unnecessary barriers to entry and distorts competition in product markets (Figure 11). This is due to heavy administrative procedures, such as absence of single contact points, single applications or integrated permits. Vintage-differentiated regulation and tax/subsidy measures are also common and tend to discriminate between new entrants and incumbents. Procedures and requirements for policy evaluation should also become more effective. There is thus ample room to pursue environmental targets in a way that is more amenable to competition (Kozluk, 2014). The need for streamlining existing environmental permits into one integrated permit and creating one unified and simplified approval procedure ("green licencing") has been recognised by the Israeli government. In April 2014 the authorities thus approved a draft reform based the European Union's Integrated Pollution

Prevention and Control (IPPC) methodology. However, Knesset approval of this text was postponed by the early elections of March 2015.

Figure 11. **Burdens on the economy due to environmental policies and their perceived stringency**



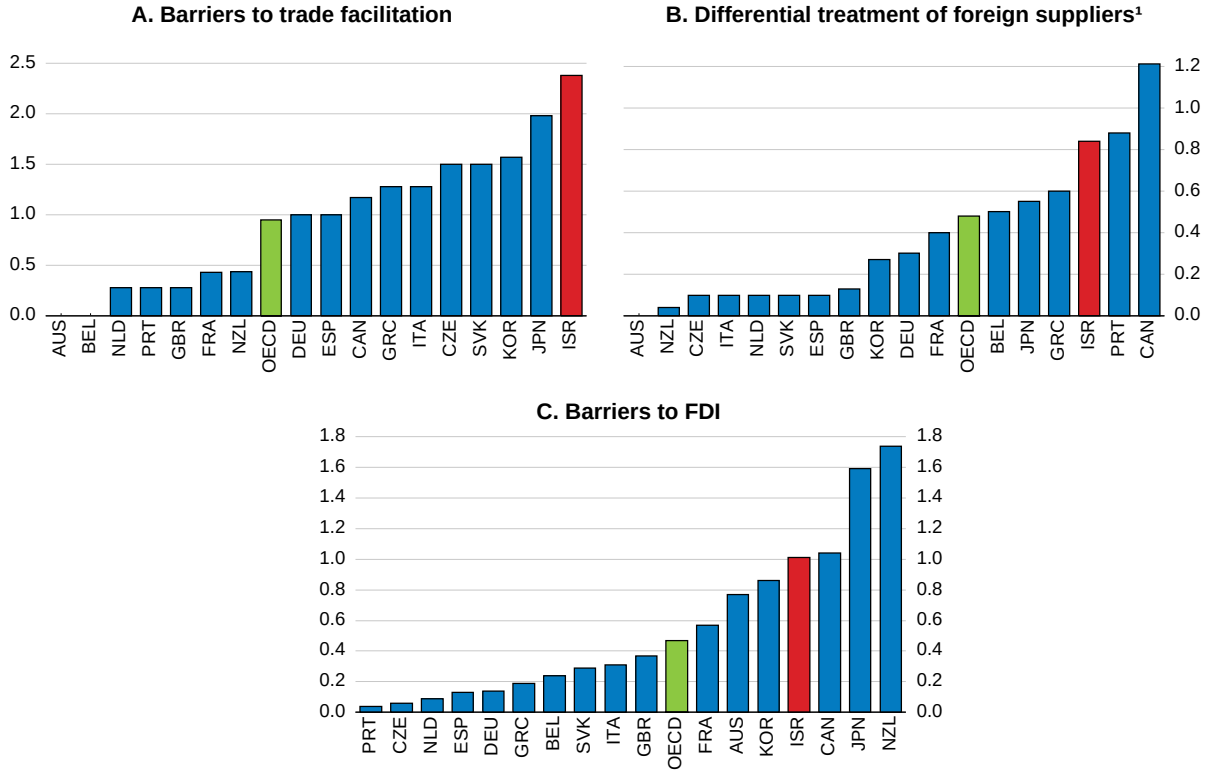
Source: T. Kozluk (2014), "The Indicators of the Economic Burdens of Environmental Policy Design - Results from the OECD Questionnaire", *OECD Economics Department Working Papers*, No. 1178, OECD Publishing; and OECD calculations.

Lowering import barriers would boost competition from abroad

36. The Trajtenberg and Kedmi Committees highlighted the significant barriers facing imports, even though average customs tariffs, at around 4% in 2012, were fairly low and declined in 2013 (WTO, 2014). However, non-tariff barriers are more restrictive than average for OECD countries (Figure 12). Laborious, complex and costly procedures require importers to file applications for prior authorisation and check that foreign products comply with Israeli standards and technical obligations before commercialisation. These standards often differ from their international counterparts, generating additional costs. They are issued by 37 different bodies, and they are therefore heterogeneous and often applied arbitrarily, depending on the sensitivity of the particular product being imported. Transparency is also low; standards are relatively hard for the public and commercial entities to access, hampering the growth of parallel imports that can compete with exclusive importers of foreign products, who dominate in several sectors, and who often adopt practices that may be legal but deter retailers from buying from their rivals by abusing their dominant position (State of Israel, 2014b).

37. These regulatory barriers to trade affect services as well. When 18 sectors were measured against the OECD's Services Trade Restrictiveness Index, they were on average far more restrictive than in other OECD countries, because of both general and sector-specific restrictions (Figure 13). These restrictions act as a brake on the entry into Israel of foreign workers and discourage foreign services companies from opening operations there, with restrictions that were tighter than the OECD average in 14 of the 18 sectors evaluated. This distorts competition between foreign and local services providers in fields such as rail freight, air transport, telecoms and some professional services.

Figure 12. **Non-tariff barriers to trade and investment**
Index scale from 0 (least restrictive) to 6 (most restrictive), 2013



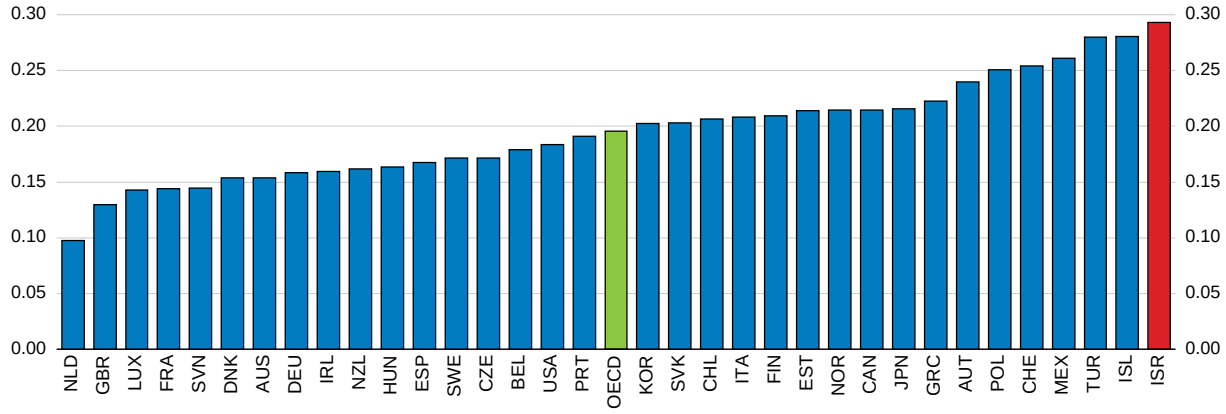
1. Discrimination against foreign firms in taxes and subsidies, public procurement, entry regulation and appeal procedures.
Source: OECD, Product Market Regulation database.

38. The authorities have embarked on regulatory reform by appointing a Committee (chaired by Amit Lang) to recommend ways of lowering import barriers. In December 2014, the government accepted its recommendations, which included the following measures (State of Israel, 2014b):

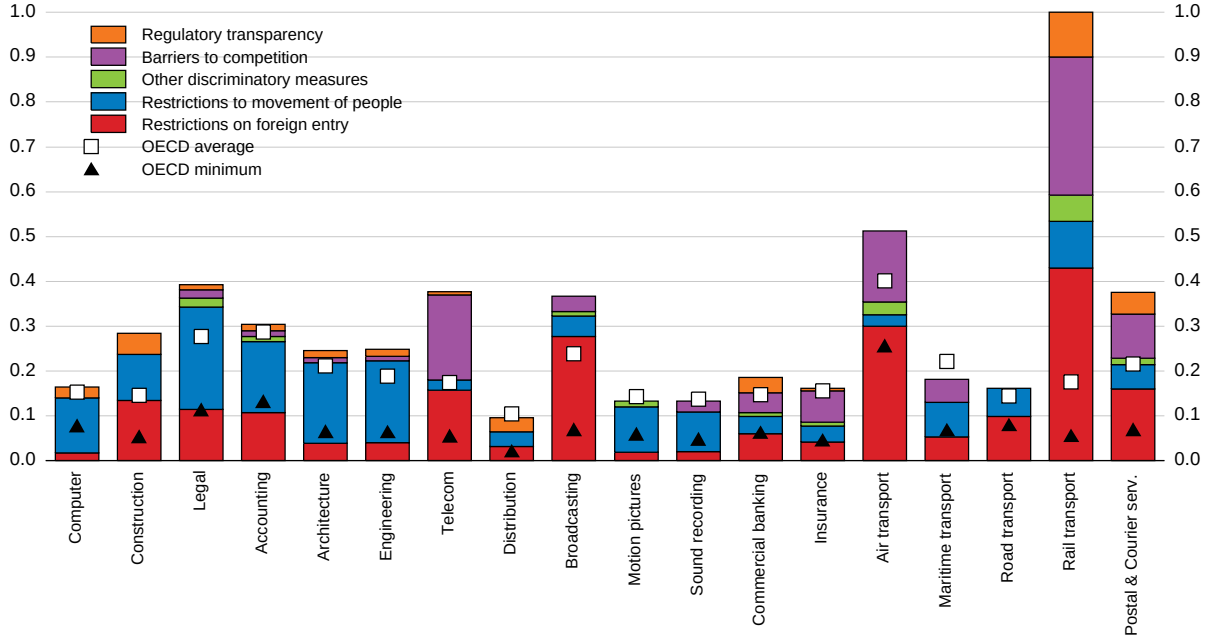
- Simplification of import procedures, and switching from *ex ante* to *ex post* checks for compliance with the standards required of foreign products. Shifting responsibility for the enforcement of standards and obligations from the government to firms will be offset by heavier penalties for violations.
- A review of the standards applied to imported products to ensure their compatibility with those in force in other advanced economies.
- Increased transparency and importers' accessibility to regulatory procedures and obligations, and the creation of a website allowing exchanges among importers, customs and other public bodies.
- Reform and centralisation of the institutions responsible for drafting import regulations in order to rationalise and standardise their operation across different sectors.
- Careful examination of competition law in order to boost the IAA's regulatory tools and counter practices that restrict competition among importers.

Figure 13. **Services trade restrictiveness index**
Index from 0 (open) to 1 (closed), 2015

A. Average restrictiveness index in 18 sectors



B. STRI by sector and policy area



Source: OECD, Services Trade Restrictiveness Index database.

39. Some of the Lang Committee's recommendations for increasing import competition by facilitating overseas consumer shopping for personal use were also implemented in 2014. They included raising the threshold for exempting overseas Internet orders from customs duties from USD 325 to USD 500. Other recommendations are still in progress as part of a wide plan in all relevant ministries and regulatory agencies. The authorities have also pursued their efforts to establish new trade agreements with emerging market countries and to extend their field of application to the reduction of non-tariff barriers. One such agreement was signed with Colombia in 2013 and included lower customs tariffs and regulatory barriers. Similar negotiations are underway with India.

40. These changes adopted in response to the Lang Committee's recommendations are positive steps. The promotion of new free-trade agreements and their extension to non-tariff issues are also very welcome. The authorities could, however, be more ambitious and implement unilateral reductions of many customs

tariffs, given their positive impact on the economy, both in terms of lower consumer prices and the increased competition among businesses fuelled by lower costs for intermediate consumption. Like other OECD countries, Israel should also work harder to sign multilateral trade agreements. As international trade is increasingly dominated by global value chains and production processes that are increasingly dispersed among countries, maintaining a competitive economy and business sector will depend on reliable, easy and affordable access to imported inputs (OECD, 2013a).

41. The authorities should also reduce Israel's restrictions on foreign services providers by revising some general provisions that limit their activity, such as the maximum twelve-month limit on initial residency visas for independent and contract workers and those working on secondment for foreign companies. This mobility restriction is an obstacle to foreign services providers. It would also make sense to lower the restrictions on property acquisition by foreigners and to review the residency conditions CEOs have to meet in many services sectors. Specific barriers to competition in sectors such as rail freight and air transport should also be lifted.

Strengthening competition in the food sector

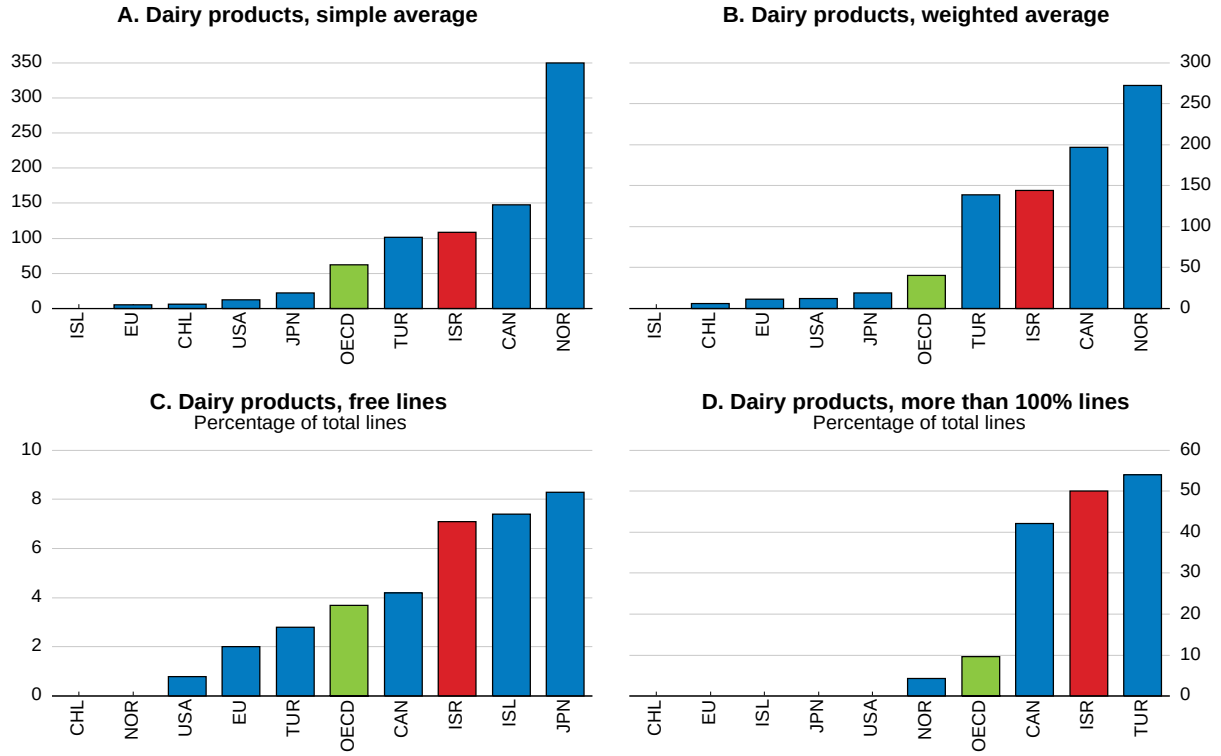
42. For several years discussion of Israel's economy has been dominated by competition matters and high prices in the food sector. Issues related to this sector range from the external angle, given the import barriers for food products related to agricultural policy, non-tariff barriers and specific religious dietary rules that affect the market, to regulatory and competition problems generated by the high level of concentration in the production and retail distribution of food products. These obstacles hamper the functioning and efficiency of the food and retail sectors, which is in turn contributing to the weaker economy-wide productivity growth in Israel compared with the OECD-country average (Regev and Brand, 2015). Several actions have been recently taken or are underway to address these issues in this field, but, as discussed in this section, further reforms would be desirable.

Reducing tariff barriers and speeding up agricultural policy reform

43. Behind the lack of foreign competition in the food sector lie both regulatory difficulties and problems with some customs tariffs. International benchmarks do not point to a high average level of tariffs, but taxes on imported agricultural products are more heterogeneous than the OECD average (Figure 14, Panels A-C). High tariff protection mainly concerns dairy, eggs and meat. Half the imported eggs and dairy product lines are subject to tax rates over 100%, whereas this kind of tariff applies only to 10% of these products on average in the OECD (Panel D). Average meat tariffs are also higher than the Member country average, and meat imports are also restricted by procedures for kosher certification.

44. These barriers raise prices on certain foodstuffs and are linked to Israel's agricultural policies. These policies have three main goals: to ensure the self-sufficiency of domestic production of dairy, meat and eggs; to increase fruit and vegetable exports; and to maintain the population in peripheral areas (OECD, 2013c). Achieving these goals is not as costly in terms of resources as elsewhere or as in the past, since total agricultural support in 2012-14 came to around 8% of agricultural production, or around half the OECD average and less than half the level of the mid-1990s (Figure 15, Panel A). The composition of support is nevertheless based more heavily on instruments that generate distortions in production and trade than in other countries. Public intervention with a direct impact on prices or agricultural production represented over 80% of the total, compared to around 25% in the United States and the European Union (Panel C). Most of this support is consumer-funded. Altogether, it adds an average 7% to domestic production prices compared to international prices, which is higher than in the European Union and the United States (Panel D). In the case of the most protected products, like milk and beef, the gap between domestic production prices and international prices came to an average 37% and 73%, respectively, between 2011 and 2013.

Figure 14. **Tariffs on dairy products**
2012[1] data



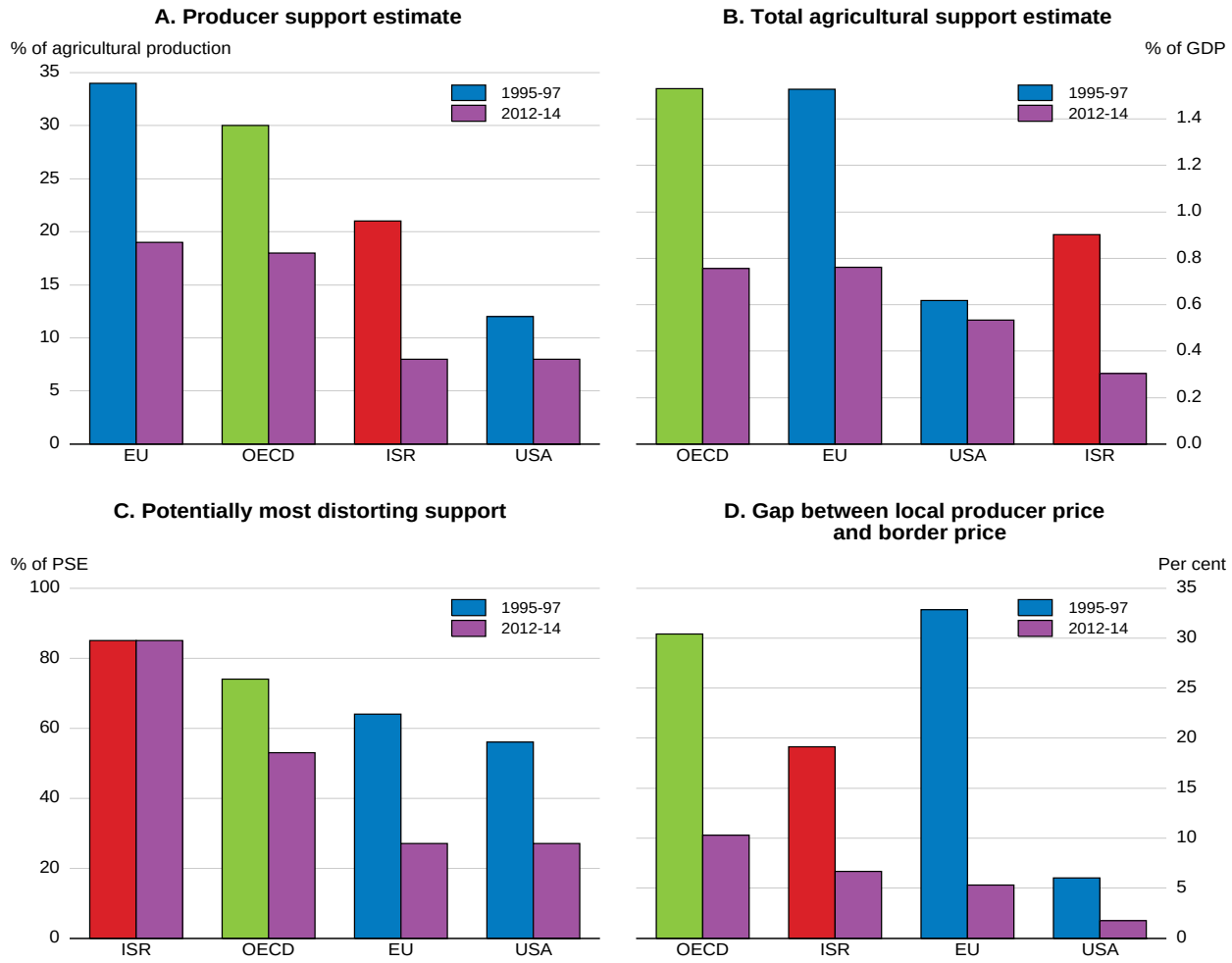
1. 2013 for Turkey.

Source: UNCTAD, Trade Analysis and Information System (TRAINS) database.

45. The authorities' efforts in the last several years to rein in agricultural subsidies should now shift to reducing their distortive effects and costs to the consumer. Despite the government's commitment to gradually increase duty-free quota on a range of staples, especially dairy products, as recommended by the Kedmi Committee, faster progress would be desirable (OECD, 2014b and 2015b). Israel should follow the example of many other OECD countries and reduce its market intervention (quotas, guaranteed prices, customs tariffs) – replacing it when necessary with direct payments to farmers. Measures going in this direction in the goat dairy industry recently announced by the government should be extended to other farm sectors. These changes should be supported with reforms that boost farmers' productivity by improving the operation of the domestic market. More generally, it is also essential to relax the government's tight control over the distribution of the main inputs – land, water and foreign labour – among producers, 80% of which are kibbutz or *moshav* (another form of co-operative settlement) (OECD, 2010). A first step would be to reduce the red tape involved in agricultural land and tenant farmer transactions (OECD, 2014b).

46. The authorities have also recently pursued initiatives to reduce non-tariff phytosanitary barriers to food imports. Under the current rules, importers must give the Health Ministry an exhaustive list of the ingredients in their products, which must be subjected to a battery of lab tests, the results of which must also be provided to obtain prior import authorisation. These costs encourage the emergence of monopolies. A Committee chaired by Harel Locker was tasked with examining these regulations and suggesting simplifications to the government, which accepted them in May 2014.

Figure 15. **Main characteristics of agricultural support**



Source: OECD (2015), *Agricultural Policy Monitoring and Evaluation 2015*.

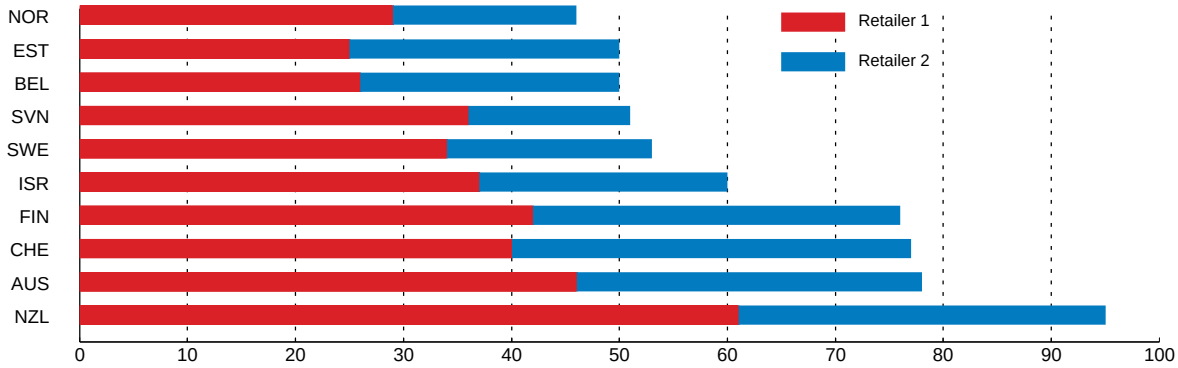
47. The Locker Committee's recommendations were based on a distinction between "sensitive" and "non-sensitive" products (i.e. those presenting a low health risk) and were to cut some of the red tape around import procedures for the latter category. It also recommended that Israel adopt the health rules in force for non-sensitive products in other developed countries, in order to eliminate testing for these products. Import procedures will no longer require prior authorisation, but only a statement by the importer declaring their compliance with the standards in force. These products will be monitored *ex post*, and the information to be provided in the event of an inspection will be simplified to facilitate parallel imports. This reform should be supported and fast-tracked by the Knesset.

48. The health rules governing sensitive products also need review. It certainly makes sense to distinguish between sensitive and non-sensitive products insofar as some products require additional attention, especially during transport, and higher health standards. But the list of sensitive products, which represents over half of total imported foodstuffs, includes dairy, eggs, meat, honey, bottled water and baby food – goods that are traded internationally every day, within the European Union, for example, without such cumbersome and costly procedures as those currently in force in Israel. EU or similar standards could be adopted with *ex post* verification, as is planned for non-sensitive products.

Reducing concentration and regulation in the agrifood chain

49. Concentration is high throughout the Israeli agrifood value chain. Just three companies control 40% of production in this sector (GAIN, 2014), and far higher concentration exists for some products. Recently declared a monopoly by the IAA, the company Tnuva controls 70-90% of sales in several dairy products. The IAA has also declared another firm – Strauss – a monopoly in other dairy products and confectionery, and Coca Cola Israel in carbonated drinks. Moreover, the government initiated grants in order to support the development of small or medium-sized firms in concentrated food markets. Concentration is also high in retail: supermarket chains increased their weight from 50% to 60% of spending on food between 2003 and 2011, and almost 60% of outlets belong to one of two networks (Shufersal and Mega) (Figure 16). Although recent financial difficulties of the Mega chain may lead to a change in the retail food market, this concentration in food retailing is high relative to other countries and is even more visible at the local level (IAA, 2014a). Another feature of this sector is the absence of foreign competition, despite the increasing internationalisation of this activity (Wrigley and Lowe, 2010). This situation is reflected in the high level of supermarket profitability that was recorded a few years ago (OECD, 2013d). More recently it seems that retail food margins have fallen back, but the problem has shifted to food producers and importers.

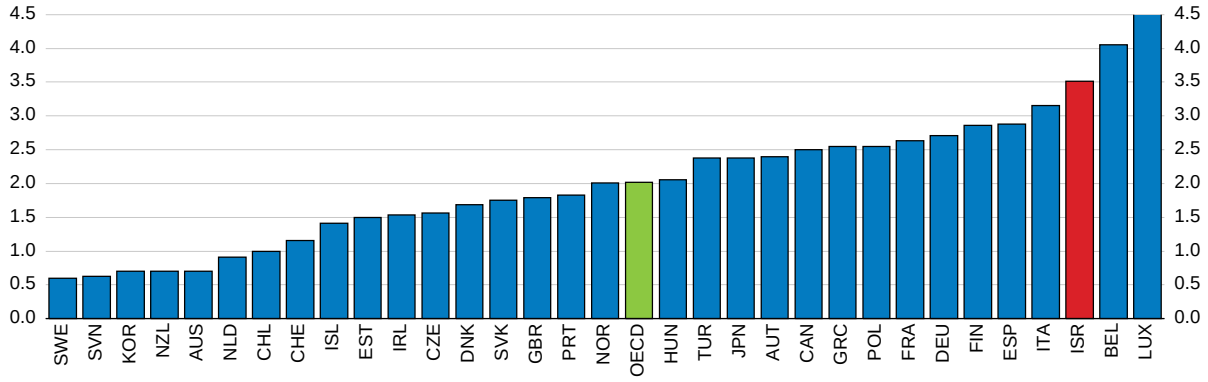
Figure 16. **Ten most concentrated countries for grocery retailing within OECD**
Two-firm concentration ratio in per cent, 2009[1]



1. 2008 for Denmark, Finland, New Zealand and Norway and 2007 for Estonia.
Source: OECD (2013),"Roundtable on Competition Issues in Food Chain Industry", DAF/COMP/WD(2013)116.

50. Commercial distribution is also more heavily regulated than in most other OECD countries (Figure 17). Authorisation requirements for opening shops are comparatively strict. Regulations protect established businesses, allowing their representative bodies to intervene in the approval of new outlets and supermarkets, a practise that has long been known to lead to self-serving behaviour in France (OECD, 2015c). Supermarkets are, moreover, subject to specific regulations. Price controls and/or supervision are also relatively extensive, affecting almost 20% of the CPI food basket (2.4% of the total). As in other OECD countries, these controls are partly the result of regulations on some public services such as electricity, water and public transport. In several fields, however, such as dairy products and eggs, they are used to solve competition problems.

Figure 17. **Regulation in retail trade**
Index scale from 0 (least restrictive) to 6 (most restrictive), 2013



Source: OECD, Product Market Regulation database.

51. The authorities recently adopted two reforms designed to improve the retail food market. The first is the IAA's initiative to remove the blanket exemption of the wholesale market for agricultural products from competition rules. This reform was passed by the Knesset in 2014, and only wholesalers who are also farmers and agricultural producers themselves now qualify for exemption. The second reform is a law to promote competition, which enshrines the main conclusions of the Kedmi Committee. It introduces improvements in three areas:

- *Boosting local competition among retailers*. Supermarket chains with over 30% of sales in a given zone will no longer be able to open new outlets in that zone without the IAA director's agreement. If a chain's market share is over 50%, with at least three established shops, the IAA director may ask the Antitrust Tribunal to force the sale of some supermarket outlets to a competitor.
- *Improving the regulation of relations between suppliers and retailers*. To limit the pressure exerted on retail outlets by major suppliers, the new law prevents suppliers intervening in decisions concerning the organisation of supermarket shelving and taking up more than half the shelving space. Slotting allowances and other bonuses, sometimes used by producers to persuade retailers to accept higher prices to the detriment of the consumer, are also banned, as are recommended prices.
- *Increasing price transparency*. The main retail networks must now post the prices of all products sold in their outlets on their websites in real time, to promote the development of mobile applications that help consumers compare prices among outlets.

52. Increased competition can reduce margins and so lower prices. A recent Israeli survey found that the margins of supermarkets in a given region fall by around 4.5% when a rival moves into that region (Avner, 2012). The new law limits the expansion of the two main retail networks who therefore have to apply for IAA authorisation to open new outlets in zones covering around 79% and 21% of the Israeli population, respectively (where they exceed the aforementioned 30% threshold)[1] (IAA, 2014a). And a non-negligible proportion of Israeli supermarkets (about 5%) could be forcibly sold if the law is applied to the letter, i.e. when the chain's market share is above 50% with at least three established shops. In practice, the law's effectiveness will depend on its implementation, and the authorities should therefore assess its impact after an appropriate delay.

53. Nevertheless, further efforts could liberalise the retail food market, especially by reducing the red tape surrounding the opening of shops and the protection given to existing establishments. The authorities should proceed with their recent project to end the exemption to the poultry sector from anti-monopoly

legislation and systematically screen anti-competitive provisions in the regulation of other sectors, possibly using the methodology of the OECD Competition Assessment Toolkit. The authorities must also resist the temptation to extend price controls, which they almost did recently in response to problems detected on certain markets, such as frozen vegetables or yoghurt (Ben-Israel, 2014). In fact, they should strive to reduce such controls by carrying out the requisite reforms beforehand. Once in place, price controls delay the fundamental reforms needed to improve market efficiency, strengthen competition and improve the distribution of resources. In free markets prices play a regulating role that is more efficient than distortive frameworks such as that in Israel's dairy industry, which features producer price controls, quotas and both tariff and non-tariff barriers, as well as consumer price controls, with the result that the consumer pays high prices and economic resources are wasted.

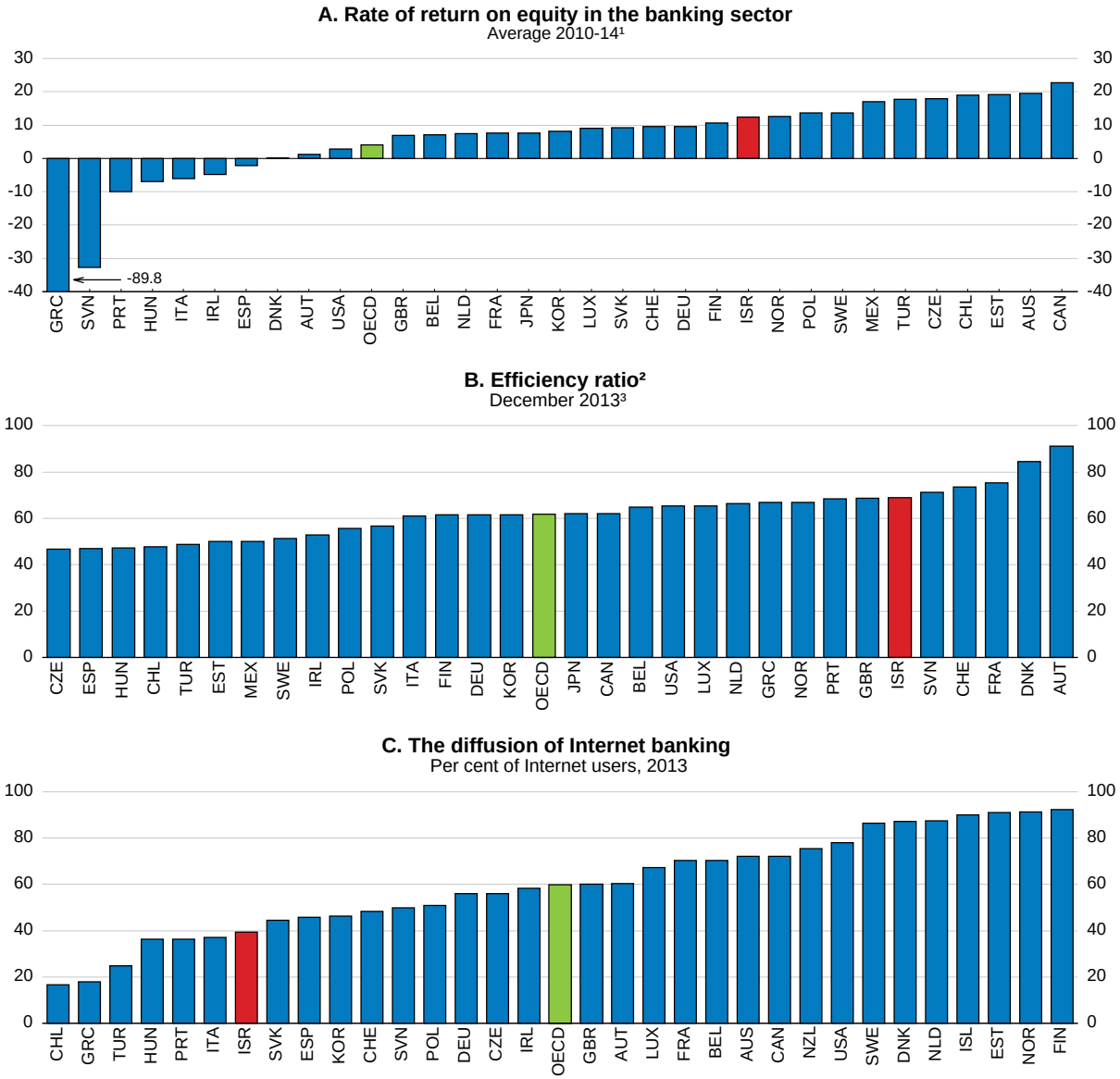
The economy would also benefit from greater competition in banking

54. The Israeli banking system saw out the financial crisis of 2008-09 without any bail-outs or bankruptcies. While strong and stable with adequate profit (Figure 18, Panel A), it is also structured in such a way as to discourage competition. It is more concentrated than in most OECD countries, and in some activities is oligopolistic. Five establishments hold 94% of bank assets, with the two largest having 57% (Figure 19, Panel A). No foreign banks are active in retail or online banking, and the sector's main players are closely interconnected: some banks have a shared ownership structure. For example, one bank may buy another's IT department, and the major banks share the management of credit card systems (see below) (IAA, 2012a). This kind of market organisation fosters rent-seeking by the banks and reduces efficiency (Lin et al., 2010). Banks have high operating expenses (especially salaries) in relation to income (Figure 18, Panel B), implying a lower level of efficiency in Israel than in the average OECD country. They are also relatively slow to adopt innovation, such as online banking services (Panel C).

55. The weakness of competitive pressures in this sector – much discussed in Israel in recent years – hits households and small businesses hardest. The banks exploit these customers' lack of mobility between banking establishments, a natural consequence of the cumbersome procedures involved in changing banks and of the poor transparency of financial services, which makes it hard to compare different offerings (BoI, 2012). Households and small businesses cannot rely on the growing competition in credit between non-banking institutions, which manage pension funds and concentrate on large corporations, fuelling high margins on loans to small businesses. Margins are more compressed on mortgage loans due to competition between banks which are required to provide a written offer each potential client who requests one. Moreover, although bank charges paid by households seem comparatively low (Van Dijk, 2013), those levied on retailers for the use of credit cards are high, and this indirectly affects consumers. The IAA has therefore proposed regulatory and legal changes that have been approved by the authorities (Box 2).

56. In 2013, the authorities embarked on a reform programme to implement the recommendations of the Zaken Committee, which was charged with boosting competition in the banking sector. This programme has two main objectives: (i) increasing the number of competitors offering retail banking services, and (ii) stimulating competition among the current players on the market by providing households and small businesses with good information on banking fees and cutting the cost of switching banks. The Committee also recommended closer supervision and possibly even price controls for some financial services, in cases where effective competition is difficult to create.

Figure 18. **Banking sector: efficiency, profitability and diffusion of Internet banking**



1. Average of the Q4 data (Q1 for Japan). For 2014, it is the latest available quarter.
2. Ratio of total operating expenses to total net interest and non-interest income.
3. Or latest available data.

Source: IMF, Financial Soundness Indicators database; OECD (2014), *Measuring the Digital Economy: A New Perspective* and ICT database; Eurostat, Information Society Statistics and national sources.

57. These recommendations have been partially implemented by the Bank of Israel (BoI):

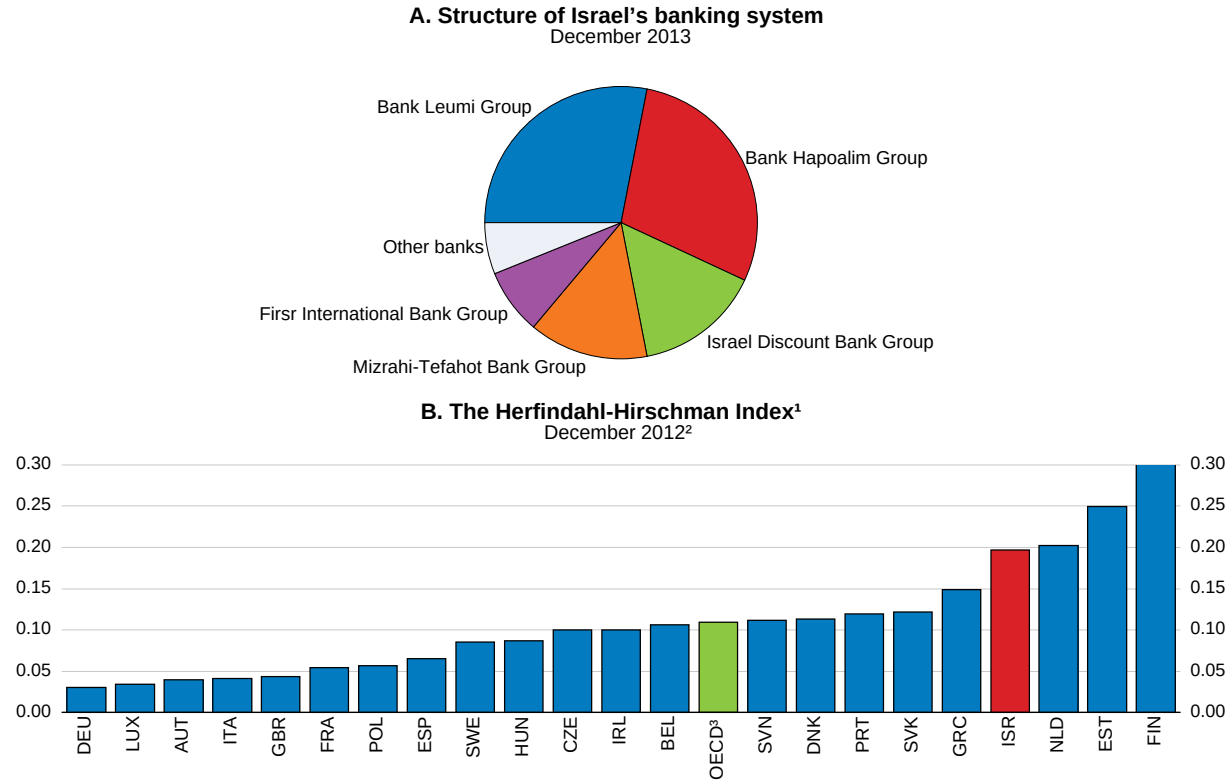
- The BoI has issued directives to simplify the process of changing banks, especially transferring standing orders between accounts. Opening an account online has also been made easier (BoI, 2013b and 2014b).
- In order to increase price transparency, since the beginning of 2015 banks have been required to keep customers informed of the cost of their securities transactions compared to those billed by other banks. Since April 2014, they have also been obliged to offer their customers a flat-rate payment for a

standard basket of transactions, which makes prices easier to compare than when billed per transaction. The BoI has, moreover, capped the price of the basic basket of financial services at NIS 10 per month, and banned billing considered abusive for some banking operations.

- To encourage new entry, the regulation of co-operative banks has been clarified and simplified.

- More fundamentally, the BoI is working on the creation of bank identity numbers and an extended credit rating system to share financial information on households in order to reduce the information handicap suffered by new nonbank financial institutions and smaller banks compared to their established rivals, and to permit clients to obtain multiple competitive offers for a loan or other credit product. The current framework allows the credit bureaux to circulate information about banks' customers without their consent only if that information is negative. The aim is therefore to ensure that both positive and negative information about banks' customers can be shared without violating people's privacy. This credit rating system should begin operation in 2018, subject to the completion on the necessary legislative process.

Figure 19. **Structure and concentration in the banking sector**



1. The Herfindahl-Hirschman Index (HHI) is a measure of the size of firms in relation to the industry and an indicator of the amount of competition among them. It is defined as the sum of squares of the market shares of the largest firms within the industry, where market shares are expressed as fractions. It can range from 0 to 1. Increases in the HHI generally indicate an increase of the concentration ratio. For this chart, the HHI calculation is based on total assets of the commercial banks.
2. For Israel, data is for December 2013. It is based on the total assets of the commercial banks and doesn't include activity of foreign banks while for the other countries, data include activity of foreign banks.
3. Average of the countries shown.

Source: Published financial statements for Israel and European Central Bank for all other countries.

58. Additional measures being considered by another committee (Strum Committee) set up after the 2015 elections include the creation of a deposit insurance system, which will help strengthen the smaller

banks, and the entry of institutional and non-banking entities into the retail and SME credit segment, which will however have to be supervised in prudential and consumer protection areas. Separating the credit card companies from the two largest banks is also envisaged, with new credit card companies issuing bonds to finance their business (BoI, 2015b). A third committee (Baris Committee) recently defined the regulatory framework for non-banking credit institutions, and the needed legal changes had already been subjected to public consultation prior to the cabinet approval before submission to the Knesset. A decision over who will be the supervisor has not yet been made.

59. These measures should improve the balance between the objectives of maintaining the stability of the banking sector and increasing its efficiency. The implementation of some of these recommendations (such as simplifying the process of changing banks and increasing price transparency) have already yielded some initial positive results, such as a large drop in banking fees paid by households (Avissar, 2015). Giving households and small businesses more leverage in negotiating with banks will fuel competition, and the improvements currently being made to the credit reporting system should bring further benefits by encouraging new players to enter banking; they should be finalised and applied as soon as possible. By reducing the cost of accessing bank information, they will encourage the growth of retail banking services in non-banking institutions and increase Israel's attractiveness to Internet banks and leading international financial institutions (Tsai et al., 2011). Reducing the information imbalance among banks by pooling credit data is also likely to intensify competition among established banks and improve the allocation of credit in the economy (Lin et al., 2010).

Box 2. **The organisation of the payment card market has encouraged rent-seeking by the financial institutions**

The payment card market is organised in such a way as to reward rent-seeking by the major banks. The market leaders control the sole three firms that operate in this sector and the card network management system that collects and approves transactions. In the last few years, the Israeli Antitrust Authority (IAA) has taken several steps to reduce the cost of using payment cards and eliminate barriers to competition on this market, notably by:

- Adjusting the calculation of interchange fees, cutting them from 1.25% to 0.875% in 2010, then gradually to 0.7% in July 2014.
- Ordering the company Shva, which oversees the operation of the card network, to bring its system into line with international standards in 2013 and to remove all technical obstacles to new entry (IAA, 2014b).
- Carrying out a survey in 2014, which showed that the banks were exploiting several provisions that reduced the attractiveness of direct debit cards compared to deferred debit cards (IAA, 2014c), which dominate the market in Israel. Despite their lower credit risk, direct debit cards are not subject to lower interchange fees than deferred debit cards. Nor are retailers credited immediately with sale proceeds, whereas the consumer's account is debited immediately. According to the IAA, these regulatory anomalies are generating revenue for the financial institutions estimated at around NIS 450 million a year, compared to a scenario in which direct debit transactions would grow from practically zero to 35% of total transactions. This revenue is apparently generated by an unjustified level of interchange fees for direct debit cards and the financial institutions' profits on the financing of cash loans to retailers to cover the delayed settlement of their sales.

These findings led the authorities to commit to adjusting the law to correct the anomalies. In the meantime, the Bank of Israel (BoI) has set out directives for the distribution of direct debit cards at a lower cost and with lower fees than deferred debit cards in the course of 2016, with an immediate accounting of their transactions (BoI, 2015a).

60. To further increase competition, the authorities should consider extending the activities of the post office's bank. This state-controlled body is regulated by the Ministry of Communications and has a dense nationwide network of agencies reaching into the remotest regions. Current legislation allows it to offer its customers only a limited number of banking services, including deposit-taking, the management of current accounts, and international transfers, but excluding deposit remuneration and consumer credit. The postal network could be better exploited, as in many other OECD countries. Small banks or non-banking financial institutions could be allowed to access the post office's network of agencies to distribute credit. Over a longer-term horizon the capacity of the postal bank should be further enhanced in order to allow it

to play a more effective role in ensuring effective competition for a wider range of financial services (again, subject to appropriate prudential supervision).

Network industries can be made to work better

Improving postal services, telecoms, maritime freight and air transport

Reforms have progressed

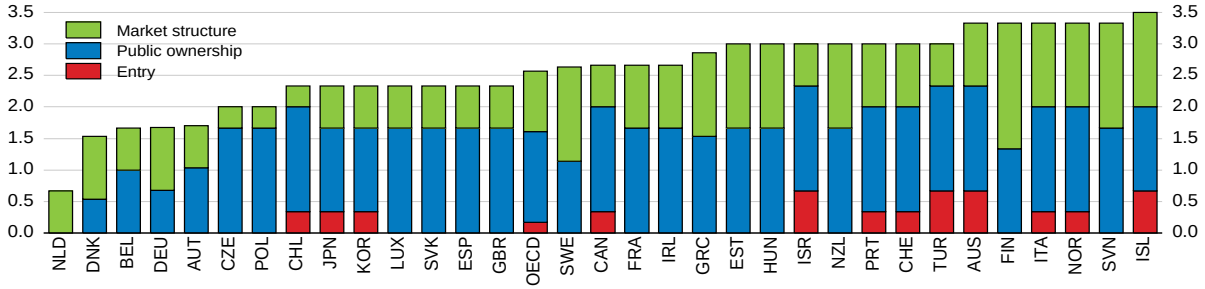
61. The authorities have adopted or recently launched several reforms in network industries, including postal services, telecommunications, maritime freight and air transport, to strengthen the effectiveness and improve the provision of their services. These sectors, notably because of their oligopolistic structure, needed an overhaul. The postal sector has to adapt to the development of the Internet, which has led to a decline in the postage of letters and newspapers, while the rise of e-commerce has fuelled demand for parcel delivery, but the sector's organisation and greater-than-average regulatory restrictiveness have not allowed it to keep pace with market changes (Figure 20, Panel A). After the large price declines in mobile telephony following the reforms introduced from 2008 onwards (BoI, 2013a), it is also important to improve the provision of broadband internet services from fixed networks, which is less favourable than in many OECD countries (Panel B). The lack of competition and the segmentation of the maritime freight between the two public companies managing the ports of Ashdod and Haifa have hurt the quality of their services compared with other OECD countries (Panel C). In air transport, the government's desire to create a strong national airline until the middle of the 2000s penalised the evolution of relative prices and demand in this sector for many years (OECD, 2014c) (Panels D and E).

62. The main objective of the reforms has been to increase the number of firms in these markets:

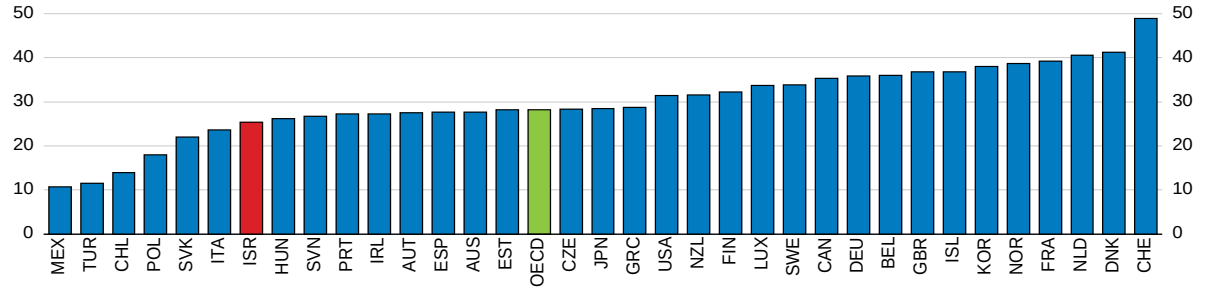
- The privatisation of El Al in 2005 was followed by a liberalisation of the sector, following open skies agreements signed with the United States in 2010 and the European Union in 2013.
- To boost competition in maritime freight, in 2013 the authorities launched the construction of two new ports to be managed by separate private operators with plans to partially privatise the existing ports.
- To stimulate competition in fixed broadband Internet, in November 2014 the authorities decided to open up access to the two existing networks by unbundling their local loop. In addition, the development of fourth generation (4G) mobile networks has led the authorities to modify the regulation of these services and enable network and spectrum sharing to maintain a sufficient number of competitors, as the OECD recommends (OECD, 2014d). For technical reasons, only three bands of the frequencies needed to roll out 4G networks are available in Israel, which is insufficient for separate networks for five operators.
- Since late 2014, following the recommendations of the Reich Committee, the postal market has been more widely opened to private companies. The management autonomy of the public operator, Israel Postal Company (IPC), has also been increased, and IPC is to be partially privatised in 2016. The reform plan also provides for an adjustment of public service obligations, with a reduced frequency of mail delivery and improved parcel delivery services (State of Israel, 2014c).

Figure 20. **Product market indicators in postal services, telecom, ports and air transport**

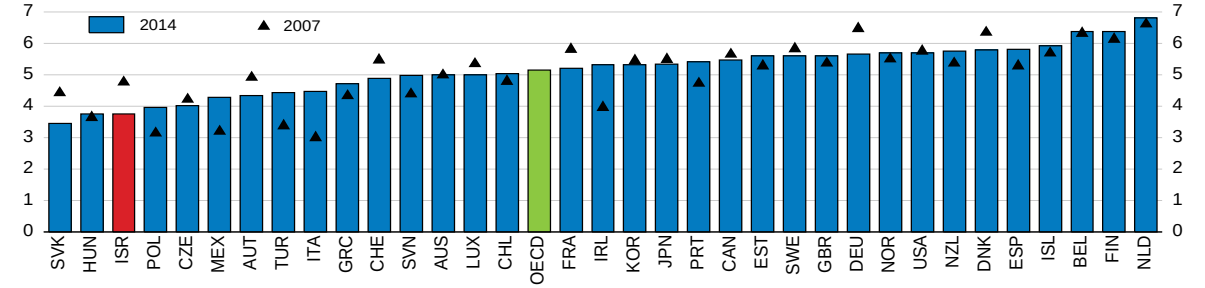
A. Regulation in the postal market
Index scale from 0 (least restrictive) to 6 (most restrictive), 2013



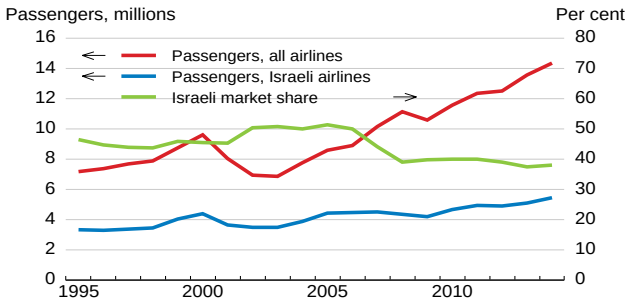
B. OECD fixed broadband subscriptions per 100 inhabitants, all technologies
December 2014



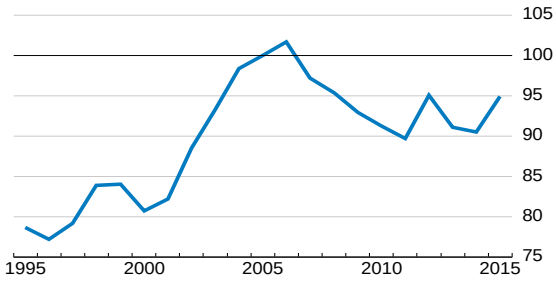
C. Perceived quality of port infrastructure
Score from 1 to 7 (best)



D. International airline traffic development
Number of passengers, millions



E. Relative price of air travel[1]
Index 2005 = 100



1. CPI of expenditures for travel abroad and local flights over total CPI. Data for 2015 refer to the first nine months only.

Source: OECD, Product Market Regulation database; Broadband Statistics; World Economic Forum (2014), *The Global Competitiveness Report 2014-2015;* Central Bureau of Statistics.

63. Benefits for consumers and the economy as a whole of some of these reforms are already visible. Air transport prices have dropped significantly and demand has increased since 2005, which has boosted tourism. Like air transport, efficient maritime freight services operating in a competitive market will raise external trade and the openness of the economy to foreign competition. Changes in operating the postal sector will also help meet consumer demand for a better quality of services and rationalise their management.

64. Free third-party access to fixed telecom networks should also bring further benefits. So far, accessing fixed high-speed Internet involved taking out two separate subscriptions – to the infrastructure network and the Internet service provider. With the end of such segmentation, the market should be stimulated by the aggressive competition that already exists among Internet service providers. For instance, the announcement in early 2015 by one of the mobile operators that it was developing a "triple-play" package, including Internet access, network connection and television, heightened competition in almost all telecom segments.

65. To complete the reform process, the Ministry of Communication needs to create independent regulators for both postal and telecom services, with well-defined mandates. Moreover, it would be important for these regulators, like other industry regulators, to be run by a CEO on a non-renewable contract, to limit the risk of their wishing to curry favour with the authorities to obtain a second term. These regulators lack the transparency and independence of their counterparts elsewhere in the OECD:

- In the telecom case the Israeli regulator is not required to publish much information about its activities and the reasons for its decisions. It does not produce an annual report, for example. Nor does it report to any authority other than the government, on which it depends. This dependence on the executive does not seem to have caused any particular problems in the past, because there were no public enterprises involved, and so no doubts were raised about the impartial application of regulation. Moreover, the regulator's task has also been made easier by the organisation of the market, in which the separation of network infrastructure operation between fixed and mobile operators limits the risk of legal disputes. Now, however, with shared networks, the risk of disputes will increase. Clearer differentiation is therefore needed between the task of designing regulation, overseen by the Ministry, and applying regulation, which ought to depend on an independent, transparent entity (OECD, 2014e).
- For postal services the dependence of the regulator on the Ministry of Communication generates a conflict of interest, since IPC belongs to the government. The potential pressure on the Ministry caused by the high degree of unionisation may also affect the decisions of the postal regulator, if its independence is not further secured (OECD, 2014e). An independent regulator with sufficient resources would help to safeguard non-discriminatory access to postal infrastructure and ensure that the IPC does not attempt, for instance, to eliminate competition using predatory pricing for non-regulated services.

66. Beyond these governance reforms, it might be worth considering some additional specific measures to enhance the functioning of maritime freight, air transport, postal services and telecoms:

- In maritime freight some modernisation of the old ports might be required to enable them to compete with the new players. Contrary to the new ports, the old ones will not benefit from deep-water capacity and may thus face an important competitive disadvantage that might weaken competition in the sector.
- In air transport there is room to improve regulation and reduce obstacles to foreign providers offering services in Israel, notably by relaxing the regulations governing the allocation of take-off and landing slots (allowing airlines to swap them, for example).

- In the postal sector the authorities could consider financing the universal service obligations on the basis of a compensation fund paid for by all postal operators, in line with best practice for this sector (OECD, 2001). The cost of universal service obligations is likely to rise over time, if demand for postal deliveries continues to fall and if competition from the private sector further erodes IPC's revenues by creaming off the most profitable market segments.

Regulatory reform and the extension of the rail network would improve land transport

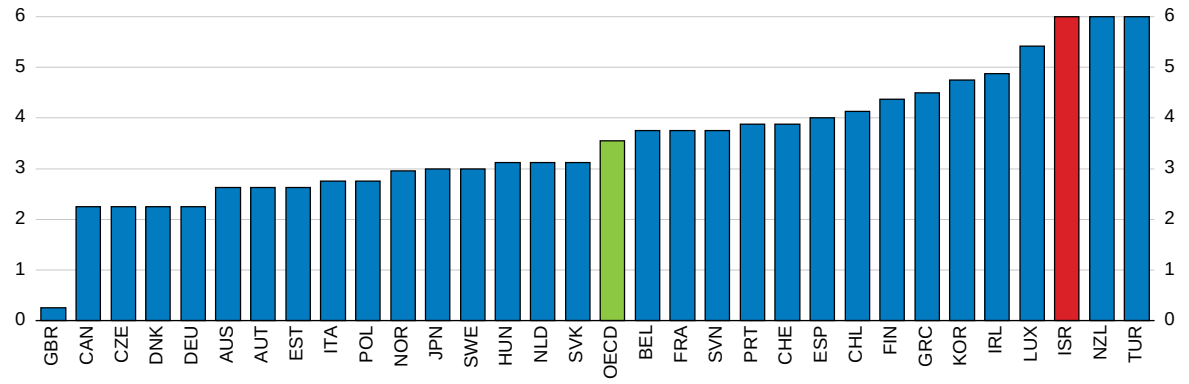
67. The Israeli public transport system, which is essentially based on bus and coach networks, does not fully meet the needs of the country's highly urbanised population. According to the Ministry of Transport, rail lines account for only 6% of public passenger transport, compared to 30-60% in many OECD countries, and less than 6% of freight. In urban areas this sector is struggling with an infrastructure shortage estimated at around NIS 250 billion (25% of GDP) in 2012 (Sharaby et al., 2012). And despite subsidies to ensure reduced rates for children and the elderly and affordable service reaches most parts of the country, take-up of urban and inter-city public transport is low. It is used for less than a quarter of journeys in cities, compared to 30-50% in other countries, largely because it is slow (Sharaby et al., 2012). The resulting heavy and growing use of private cars is causing serious road congestion, with important economic and environmental costs. The former was reckoned at an annual NIS 15 billion (1.5% of GDP) in 2012, mainly because of the loss of productivity due to the time wasted in traffic jams, which is estimated on average per day at more than 60 minutes per vehicle traveller, and could reach NIS 25 billion in 2030 (Sharaby et al., 2012).

68. In response to this situation, the authorities have prioritised transport policy changes in the last 15 years: a special ministry to deal with the issue was set up in 2000, and transport networks, especially in rail, were developed, albeit too slowly. New investment led to the opening of a rail link between Ben Gurion airport and Tel Aviv in 2005, the fast Metronit bus line in Haifa in 2007, and the light rail line in Jerusalem in 2011. An express rail link between Jerusalem and Tel Aviv should open in 2018 and a light metro line in Tel Aviv in 2021. There are also plans to upgrade the inter-city rail network, with the replacement of diesel by electric locomotives.

69. To get the most out of these infrastructure improvements, however, the authorities will need to back them up with regulations that stimulate efficiency and service quality. Israel's rail regulation is among the most restrictive in the OECD (Figure 21), and, with the exception of Jerusalem's light rail, this sector is managed by the publicly owned and vertically integrated Israel Railways Ltd. This monopoly, despite its subsidies, is highly indebted and has posted repeated losses in the past. To improve its results and stimulate efficiency reforms were made in 2012 and 2013. Some maintenance activities, affecting 30% of rolling stock, were opened up to competition through a subcontracting system, and a subsidiary was set up to handle rail freight, with the authorities signalling their intention to privatise it at least partially. In 2014 Israel Railways made a profit for the first time since it was founded in 2003.

70. These measures take the sector in the right direction, but more ambitious reforms would be welcome. Maintenance activities could be more widely opened to competition. Most urgently, the management of the network's infrastructure should be separated from the operation of passenger rail services, as is already the case in many OECD countries. This separation has, in practice, already been made for freight. Unlike other countries' rail networks, Israel's is far too small to allow multiple operators to operate simultaneously on the same lines, and this kind of competition would not be very valuable in light of competition from road transport. The rights to operate rail services could, however, be allocated on the basis of regular tenders, as for public road transport where such reforms have had positive effects (Shiftan and Sharaby, 2006). Such procedures, similar to those used for the Jerusalem light rail line and planned for its Tel Aviv counterpart, would stimulate efficiency and cut operating costs for these services.

Figure 21. **Indicators of railway transport regulation**
Index scale from 0 (least restrictive) to 6 (most restrictive), 2013



Source: OECD, Product Market Regulation database.

Resuming the reform of the electricity sector

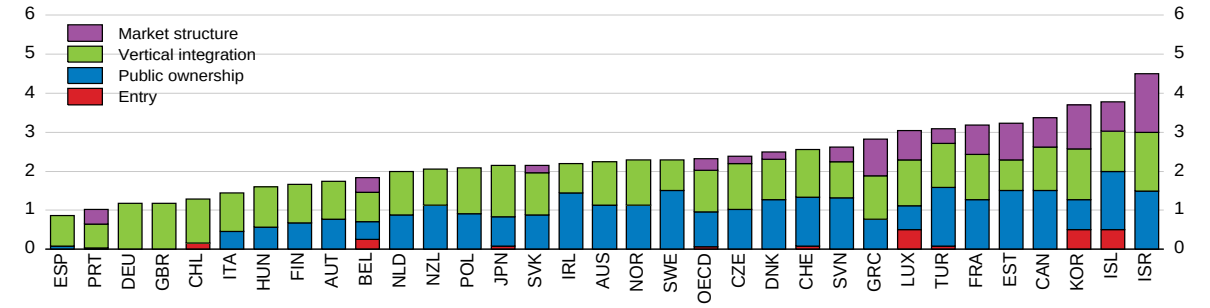
71. The Israeli electricity market is more strictly regulated than in many other OECD countries (Figure 22, Panel A), and Israel is one of the rare countries in which electricity is still largely managed by a publicly owned, vertically integrated company – the Israel Electricity Corporation (IEC). The IEC is responsible for operating the national grid and controls over 75% of generation, the entire transmission infrastructure and most of the distribution and supply to end users. Despite its monopolistic position, however, it is also financially weak, because its high debt is squeezing operating margins. The IEC does not set its prices, which are fixed by an independent regulator, and its investment plans have to be approved by its responsible Ministry. On a wide range of issues, including staff mobility, appointments to managerial positions, disciplinary procedures, redundancies and some calls for tender, the company's decisions are taken equally by management and workers' committees. All this keeps costs high, especially payroll. The workforce is bloated, with the surplus generally reckoned to be around 20%, and the highly unionised staff is paid more than is average in other SOEs and enjoys generous pension provision and other benefits, such as free electricity.

72. Reforms for the electricity sector were identified several years ago, but despite the authorities' repeated efforts to improve the sector by introducing market forces, progress has been slow. Several attempts at introducing change have failed, such as the most recent, led by the 2013-14 Yogev Committee, because of the unions' exorbitant demands for compensation in exchange for an agreement on structural adjustments. Key provisions of the Electricity Sector Law adopted in 1996 to encourage competition by separating generation, transmission and distribution have not yet been implemented, although it did set up an independent regulator, the Public Utilities Authority (PUA) – Electricity, which is responsible for setting electricity rates after examining the relevant costs, defining and upholding service quality standards, and granting production licences. The IEC's vertical integration is highly detrimental to transparency and impedes the evaluation and tracking of costs in its various activities (PUA, 2014a), which in turn hampers efforts to detect cross-subsidisation between generation, transmission and distribution, which is illegal.

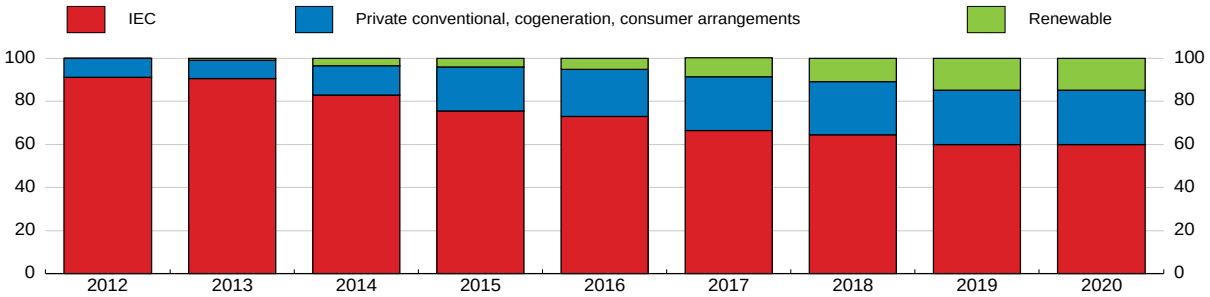
73. Although competition from independent private producers (IPPs) of electricity has been permitted since 1996, its emergence has been slow, delayed by the drafting of the requisite technical regulations to govern their operation and, from 2010, by supply problems with Egyptian gas (OECD, 2011b). It was not until the recent entry into production of the Tamar gas field that the IPPs'

Figure 22. **Electricity sector indicators**

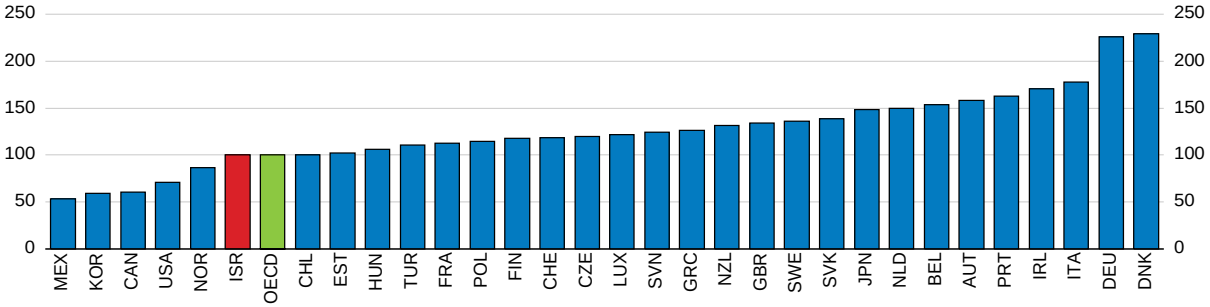
A. Regulation in the electricity sector
Index scale from 0 (least restrictive) to 6 (most restrictive), 2013



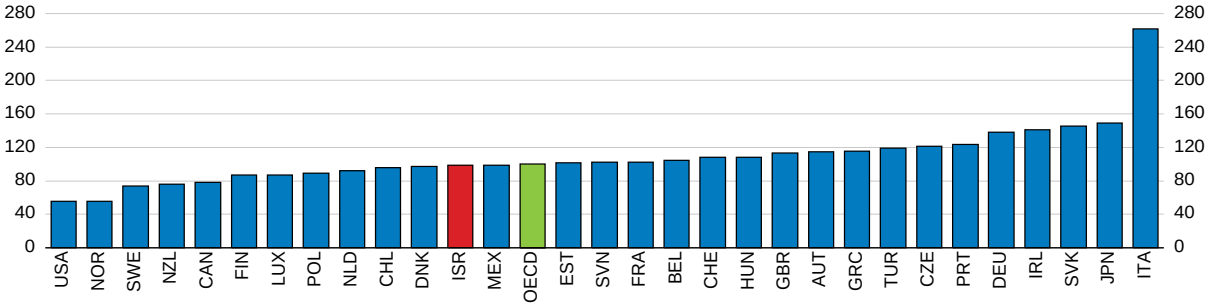
B. Installed and projected electric production capacities by type
Per cent of total production



C. Electricity price paid by households
Total price in USD/MWh, index OECD = 100, 2013



D. Electricity price paid by industry
Total price in USD/MWh, index OECD = 100, 2013



Source: Israel Public Utilities Authority - Electricity; IEA, Energy Prices and Taxes database; OECD, Product Market Regulation database

market share reached still modest 17% of output in 2014 (Figure 22, Panel B). Private competition still faces many obstacles, such as the uncertainty generated by the IEC's control of the grid. IPPs' expansion is also being curbed by the long-term contracts in the gas market, with take or pay clauses that require customers to buy gas in large quantities, which must be fully paid for, even if not fully consumed, and hence constitute a financial barrier to the development of competition.

74. Attempts to reform the electricity sector, and IEC in particular, should be urgently resumed, notwithstanding the 2013-14 failure. The gradual rise of competition from IPPs and increased production from renewable sources will inevitably reduce IEC's market share and results. According to some scenarios, it should see its share of electricity production fall to 60% by 2020 (Figure 22, Panel B). Therefore, the risk of further deterioration in its financial position should not be underestimated, and further delaying reform would increase the adjustment costs imposed on the public purse. Moreover, it is important to avoid any backtracking on past reforms, especially a weakening of the PUA's independence, as planned by the Economic Arrangements bill associated with the 2015-16 budget, which aims to subordinate the regulator to the Ministry of National Infrastructure and Energy.

75. In the light of past difficulties in reforming the electricity sector, the authorities could opt for sequential change that aims first to increase the transparency of IEC's management and reduce its financial fragility. To obtain this transparency, which is a *sine qua non* for assessing the need to rationalise the different segments of the market, it would be useful to restructure IEC into a holding company with several separate subsidiaries (for power station construction, electricity generation, transmission and distribution), as suggested by the PUA (PUA, 2014a). This would also facilitate monitoring the company's costs in its different activities and the detection of cross subsidies. IEC's corporate governance must also be reviewed to improve its financial position, which will call for a reduction of workers' committees' influence on management to secure the required rationalisation.

76. Necessary changes to the electricity sector also involve separating generation, transmission and distribution of electricity, with the creation of an independent operator for the national grid. The use of Take or Pay contracts on the gas market might be reduced and/or a secondary market could be established to allow electricity producers to resell the gas bought on the primary market and not consumed. The authorities should boost competition on the supply side by introducing a wholesale electricity market (Joskow, 2008). Such reforms, if well designed, can be successful in small economies, as shown by the examples of some regions of Australia, New Zealand and Northern Europe. To work properly, wholesale electricity markets need, for example, a sufficient number of electricity producers, none of which enjoys a dominant position. IEC would therefore have to divest some power stations.

77. These reforms should deliver efficiency gains and lower electricity costs and prices, although these effects might be felt only in the longer term. In the short term heightened competition will not only generate efficiency gains but will also force IEC to rationalise its management and reduce its debt, which could push prices higher if they are artificially low, as some studies suggest (World Bank, 2010). Despite a rise of 30% between 2011 and 2013 caused by the Egyptian gas supply crisis, most of this was reversed in 2015, and prices are again low compared to the OECD (Figure 22, Panels C and D).

Establishing an efficient natural gas market

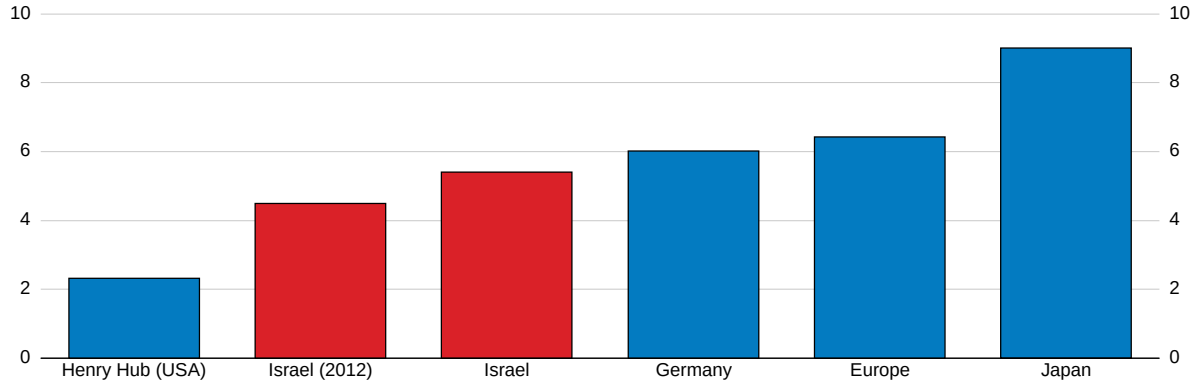
78. The natural gas market has only recently taken off in Israel, with major offshore reserves of natural gas discovered in its exclusive economic area in 2009 and 2010. These reserves, currently estimated at over 900 billion cubic metres, are enough to supply the country for several decades, based on annual consumption of around 8 billion cubic metres in 2013. However, provisions governing the natural gas sector are not conducive to competition, as supply is under the effective control of a consortium of private companies, Noble-Delek, with a monopoly position. The consortium holds most of the recoverable resources identified, especially the two big fields of Tamar (305 billion cubic metres) and Leviathan

(470 billion cubic metres). Tamar meets over 95% of the country's current demand, while Leviathan and some other smaller fields (Karish and Tanin) still have to be developed.

79. On the demand side, the market is also small and not very dynamic, with the electricity sector using about 80% and big industrial companies the other 20%. Moreover, there is a lack of distribution infrastructure, which the authorities are attempting to remedy. The development of regional distribution networks has been slow, however, and small businesses face many bureaucratic hurdles in accessing natural gas, such as complexities linked to land settlement, problems defining and applying safety standards, a lack of co-ordination among public players and the under-resourcing of the bodies charged with expanding the gas distribution network (Cohen, 2015). In early 2015, just eight firms that are not in the business of producing electricity were connected to the natural gas network out of a potential market of around 2000. There are no plans for residential gas connections in the immediate future, and the country has yet to start exporting. In June 2013 the authorities decided to cap gas exports at around 40% of available reserves, keeping 540 billion cubic metres for the domestic market in order to secure the country's long-term energy future (State of Israel, 2012). However, the government has recently launched a reform in order to expedite connection of commercial users to natural gas. This reform is expected to have a large positive effect on productivity, especially in traditional industry.

80. Despite relatively low gas prices by international standards (Figure 23), the contracts with Noble-Delek to supply Tamar gas to Israeli electricity producers seem unbalanced and costly to the economy (PUA, 2014b). Gas prices are higher than those of other countries self-sufficient in gas, exceed those paid by Israel until 2012, when some gas was still imported from Egypt, and their indexation formula depends on aggregate consumer prices in Israel and the United States, taking no account of world energy prices (for crude oil, for example), and without a cap, as is customary for this sector. As a result, the IAA has endeavoured to promote new producers and stimulate competition, requesting that new exploration and drilling licences be granted to firms other than the current licensees (OECD, 2011a). It has declared the Noble-Delek consortium to be a monopoly on the Israeli market and required it to change some contracts with Israeli customers in order to ensure that they leave enough long-term demand for gas in the market to justify the development of new fields (IAA, 2012b and 2012c). More importantly, the IAA considered challenging the legality of the Leviathan partnership between Noble and Delek and, therefore, the possibility of forcing the consortium to sell either Tamar or Leviathan to another operator.

Figure 23. **Natural gas price**
USD/MMBtu, October 2015



Source: www.quandl.com, Natural Gas Prices and Charts; Interfax, Global Gas Analytics.

81. However, the government felt that the IAA's position to overhaul the natural gas sector entailed excessive costs. It would jeopardise the development of the Leviathan field, because of lengthy court proceedings resulting from Noble-Delek opposition to IAA's decision, and so reduce tax revenues and

limit gas export contracts with the Palestinian Authority, Jordan and Egypt, despite their considerable economic and geopolitical importance. Delays in developing Leviathan were also likely to slow that of other smaller reservoirs and discourage new exploration and drilling licences because of the export constraints and a local market too small to attract foreign investors. The government thus decided to use a clause in the competition law granting veto powers to the Minister of Economy on issues with sensitive strategic or diplomatic implications, which eventually led to the resignation of the IAA's director in summer 2015.

82. In the meantime the authorities also negotiated a compromise agreement with Noble-Delek in order to avoid undesirable delays in developing Leviathan, to lower the local price of gas, to partly lift the constraints on exports, and to gradually develop a more competitive structure of gas supply over time. The compromise agreed in August 2015 aims to increase the number of suppliers in the market: the smaller Karish and Tanin reservoirs would be sold to third parties within 14 months and Delek's holding in the Tamar field within six years, and Noble-Delek would develop the Leviathan field by 2019. According to the compromise, Tamar will be able to export part of its production. The gas price will also be regulated in the local market over the next six years with a new formula implying a fall from USD 5.4 per mmbtu to USD 4.7 per mmbtu by early 2016 for the new contracts and the renewal of the existing ones by 2020. Finally, it was agreed that, if the commitment of Noble and Delek to develop the Leviathan is fulfilled, there would be no change on the key points of this agreement over the next decade so as to stabilise the sector's regulatory framework.

83. This compromise agreement should be implemented. In the short term there is only limited room for effectively boosting competition without the entry of new competitors and the development of new gas fields. Temporary price regulation is also needed until there is sufficient competition in the local gas market. However, the authorities should ensure that this price control does not become permanent and that the infrastructure required for a competitive market (such as sufficient pipeline capacity or storage facilities) are properly developed. Geologists believe that more significant gas and probably oil reserves remain to be discovered, although their scale is hard to gauge. Real investment opportunities exist, and they should not be thwarted by dissuasive price controls and uncertain regulation, given investors' need to count on clear profitability prospects in return for committing costly investments over the long term. Lifting the obstacles limiting the demand for natural gas would also be useful. From this perspective, the measures recently announced for developing the gas distribution network and simplifying the regulatory procedures to allow local firms to rapidly access this network are welcome. Moreover, gas export regulation should be carefully assessed to make sure that they are not slowing market development. According to the Tzemach Committee, Israel's export restrictions are stricter than those in force in most other countries (State of Israel, 2012). The arrival of new foreign investors is to be encouraged for developing the country's natural gas resources, because Israel lacks skills in this field, and foreign investment depends on these investors being allowed to export.

84. However, there are also plenty of other prospective new sources of fossil fuels around the world, which, together with the likelihood that such energy will be subject to carbon taxes, could affect the incentives to invest in Israel under any regulatory regime. A case in point is the recent discovery of the Zohr gas field in Egyptian waters, which seems about 40% larger than Leviathan. The development of this reservoir could thus have important ramifications for Israeli gas development by potentially reducing its export options and increasing regional competition in this sector. On the other hand, the discovery of this new gas field could favour closer regional cooperation in the gas sector, with a view to facilitating the joint financing of the needed export infrastructure.

Recommendations for improving competition in the economy

Improving the legal framework and applying competition law

- Improve the leniency programme and increase financial penalties for criminal cases.
- Create independent regulators in telecoms, postal services and gas, with well-defined mandates.
- Ensure that the planned cut in the regulatory burden relies on high-quality regulatory impact assessments.

Making government intervention more effective

- Pursue state-owned enterprise reform and privatisation with a view to enhancing competition.
- Increase the transparency of the cost of state-owned enterprise public service obligations in public and business accounts.
- Increase the pace of public procurement reform in order to rationalise and standardise purchasing procedures, centralise orders and promote e-procurement take-up. Extend this reform to local government.

Lifting import barriers

- Further cut customs tariffs and fast-track implementation of the Lang Committee's recommendations to lower non-tariff barriers: simplify import procedures and align the standards applied to imports with those in force in other developed economies.
- Lift the barriers to foreign services providers: extend the maximum initial visa for workers on secondment from foreign companies; relax restrictions on foreigners buying property; and abolish the residency conditions widely applied to business leaders.

Strengthening competition in foodstuffs

Reform agricultural policy, and lower trade barriers facing food

- Replace quotas, guaranteed prices and customs tariffs with direct payments to farmers.
- Lessen State control over the distribution of production factors, starting with the reduction of red tape around the buying and selling of agricultural land and tenant farms.
- Further cut customs tariffs and non-tariff barriers, in particular by adopting the EU import procedures on non-sensitive foodstuffs as well as EU standards for sensitive agricultural goods.

Solve the concentration and regulation problems in the agri-food chain

- Rigorously apply the law on the promotion of competition in the food sector at local level, and assess it when sufficient time has passed.
- Eliminate regulatory constraints on opening new shops, the protection enjoyed by existing companies and specific restrictions applied to opening new supermarkets. Consider screening the anti-competitive provisions in the food sector, possibly using the OECD competition assessment toolkit.

Boosting competition in the banking sector

- Promote the entry of new competitors in retail banking, including by non-banking credit entities, with appropriate prudential and consumer protection regulation.
- Finalise the improvements to the credit reporting system. Make the changes required to increase uptake of direct debit cards. Separate the credit card companies from the two largest banks. Create a deposit insurance system.

Improving the efficiency of network industries

Modernise the postal service

- Pursue the postal reforms to open it more widely to private competitors, to enhance the management autonomy of the public operator, Israel Postal Company, and partially privatise it.
- Introduce a financing mechanism for the universal service obligation based on a compensation fund financed by all postal operators.

Improve transport regulation, especially in rail

- Allow more competition in maintenance activities for railway rolling stock. Separate the management of track infrastructure from the operation of rail services. Allocate the rights to operate rail services through regular calls for tender.
- Relax the rules governing airport take-off and landing slot allocation, and allow swapping among airlines.

Pursue electricity sector reform

- Turn IEC into a holding company with distinct subsidiaries for different activities, and create a separate infrastructure operator.
- Create a wholesale electricity market with a number of producers, making sure that none has a dominant position. Sell or privatise IEC power plants if necessary.

Create the right conditions for the development of an efficient natural gas market

- Implement the compromise agreement negotiated between the government and the private companies Noble-Delek, to ensure the development of the Leviathan gas fields and of the infrastructure needed to introduce competition in this market in the future. Avoid introducing permanent price controls in natural gas.
- Speed up the development of regional gas distribution networks to promote domestic demand by clarifying the standards applicable and improving co-ordination among the responsible agencies. Create an independent sectoral regulator. Consider relaxing export restrictions.

NOTES

1. The 79% and 21% estimates of the Israeli population where the market share of supermarket chains is above 30% is an upper bound because it covers areas where both retailers have stores where concentration is above 30% (these areas are thus counted twice).

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ANNEX: QUANTIFICATION OF THE IMPACT OF PRODUCT MARKET REFORMS IN ISRAEL

85. A competitive product market environment that allows new firms to challenge incumbents, efficient firms to grow and inefficient ones to exit helps improve the allocation of resources and boost economic growth and living standards. A key policy ingredient for a growth-enhancing competition environment is for product market regulation to be set in a business-friendly way. Empirical studies have shown that greater competition and better regulation can raise overall output per capita by increasing investment and by encouraging companies to be more innovative and efficient, thereby lifting productivity (e.g. Conway et al., 2006; Bourlès et al., 2013).

86. This annex provides methodological information on the quantification of the macroeconomic effects of reforms that would increase competition. This quantitative assessment is based on a similar methodology as in previous work by the OECD for the G20. First, the scale and scope of a set of reform measures are evaluated in terms of OECD Product Market Regulation (PMR) indicators. Then the quantitative changes in the PMR indicator expected from each group of reform measures are associated with productivity growth at the sectoral level based on the empirical findings in past OECD studies. Finally, such sectoral productivity growth is aggregated into an economy-wide effect on GDP using each sector's value-added share as its weight.

The scenario simulated

87. The reform scenario envisaged in the main paper corresponds to a change in the overall product market regulations towards a more business-friendly regulatory environment that would prevail in an average OECD country. This corresponds to the case where Israel's PMR indicator converges to the average level of the indicator among the OECD countries, which represents a reduction of 33% from the level observed in 2013. Such a change is larger than the average progress observed in the past two decades among the reforming countries and therefore constitutes an ambitious reform programme. However, several countries have managed to adopt product market reforms on a similar or even larger scale over a shorter time period. This was the case for Greece, Hungary, Italy, Netherlands, Poland, Portugal and the Slovak Republic, which have all improved their overall product market regulation indicator by between 30% and more than 40% over a 10-year period.

Quantification method of the simulated change in product market regulation reforms

88. The exercise exploits the framework of Bourlès et al. (2010), who estimate the economic impact of the PMR reforms on multifactor productivity at a sectoral level. According to this approach, multifactor productivity (MFP) is assumed to follow a model of the form:

$$\Delta \ln MFP_{i,j,t} = a_0 \Delta \ln MFP_{F,j,t} + a_1 gap_{i,j,t-1} + a_2 REG_{i,j,t-1} + a_3 REG_{i,j,t-1} \times gap_{i,j,t-1} + f_i + f_{j,t},$$

where $MFP_{i,j,t}$ is the MFP level of a non-frontier country-sector pair i,j in year t, $MFP_{F,j,t}$ is the MFP level at the technological frontier F for sector i in year t, $REG_{i,j,t}$ is the OECD's regulatory impact indicator – which measures regulatory burdens stemming from anti-competitive product market regulations in the various sectors of the economy – in each country/sector/year triplet, and $gap_{i,j,t}$ is the country-sector distance from the sector frontier in year t, while f_i and $f_{j,t}$ denote respectively sector and country-year fixed effects.

$REG_{i,j,t}$ is calculated for each country by using total input-output coefficients as follows:

$$REG_{j,t} = \sum_k R_{k,t} \times w_{k,j},$$

where $R_{k,t}$ is the OECD indicator of anti-competitive regulation in sector *k* in year *t* and the weight $w_{k,j}$ (lying between 0 and 1) is the total input requirement of sector *j* for intermediate inputs from sector *k*. Depending on whether the intra-sector consumption is taken into account or not in the calculation of the weight $w_{k,j}$, the regulatory impact indicator $REG_{i,j,t}$ will account or not for the gains of an improved regulation in sector k on the sector itself. By including or not the intra-sector consumption of the input-output matrix, it is thus possible to decompose the impact of a set of reforms on the whole economy between their direct and indirect effects, with, in this latter case, the effects of sectoral reforms being only captured on downstream sectors.

Finally, $gap_{i,j,t}$ is defined as:

$$gap_{i,j,t} = \ln\left(\frac{MFP_{F,j,t}}{MFP_{i,j,t}}\right).$$

89. Estimates of this set of equations over the 1995-2007 period for 24 OECD countries indicate that the leader country's MFP growth in a particular sector has a positive impact on MFP growth in that same sector in less productive countries (technological pass-through effect), with $a_0 = 0.122$ (with a standard deviation of 0.019), while the gap variable also has a significant and positive effect on MFP growth (technology catch-up effect), with $a_1 = 0.032$ (0.005). Importantly, the indicator of regulatory burden has a negative influence on MFP growth ($a_2 = -0.124$ (0.062)). This effect is found to be even more negative for country/sector/period triplets close to the technological frontier, as suggested by the positive coefficient on the interaction term ($a_3 = 0.132$ (0.054)).

90. Although the methodology used by Bourlès et al. (2010) was intended to assess the impact of less stringent regulations in non-manufacturing upstream sectors (mainly network industries) on the rest of the economy, given the extent of regulatory obstacles to competition affecting the product markets in Israel, including non-upstream sectors, like food, this approach has been extended to all sectors of the economy.

91. Due to unavailability of adequate Israeli sectoral MFP data for this exercise, the productivity time series of three countries having some similarities with Israel (Korea, Spain and Portugal) were used as a proxy. The interaction between sectors through the utilisation of intermediate inputs and the calculation of the regulatory impact indicator for each sector has been estimated with Israel's 2011 input/output matrix. Once the impact on sectoral MFP of regulatory changes has been estimated using this set of equations, the overall effect on GDP is calculated using the economy's sectoral value-added decomposition.

Discussion of the results

92. As mentioned in the main text, moving towards a more business-friendly regulatory environment, as represented by the OECD average, would increase Israel's MFP level, and thus GDP, by about 3¾ per cent after 5 years and 5¾ per cent after 10 years. This quantification does not aim to provide more than an order of magnitude of the potential benefits of product market structural reforms. It indeed relies on a not-very-up-to-date set of equations, which are also used somewhat beyond the scope of analysis for which they were designed. Moreover, this quantification is based on a number of assumptions regarding, for instance, Israeli MFP development at the industry level. However, the estimated impact of reforms is little affected by the choice of either Korea's, Portugal's or Spain's MFP time series proxy for sectoral productivity change in Israel.

93. As expected, the quantification of the impact of reforms when it is restricted to the downstream sectors is significantly smaller than when it is calculated for the whole economy, since the estimated output gains reach only 1½ per cent after 5 years and 2½ per cent after 10 years (i.e. about 40% of the total effect). Overall, the order of magnitude of these output gains seems reasonable when compared with similar exercises performed for other OECD countries (Bourlès et al., 2010; Bouis and Duval, 2011; Anderson et al., 2014). Yet, it could be somewhat overestimated because of the likely staggered nature of

product market reforms, which are often spread over time even in the case of ambitious reform agendas and thus take time to fully materialise.

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