

## Box 8: Unleashing Israel's competitive advantage

This year, Israel ranks 15th worldwide in the Global Competitiveness Index (GCI), up from 23 last year, making it one of the world's most competitive economies. Its most significant achievements were concentrated in the areas of technological readiness (up 20 places to rank 3), macroeconomic management (up 17 places to rank 50), market efficiency (up seven places to rank 14), and various areas of infrastructure.

Spurred by the global upswing and a concurrent increase in world trade,<sup>1</sup> a recovery of the high-tech sector and an improved internal security situation,<sup>2</sup> the Israeli economy has been improving since 2003, witnessed by an impressive GDP growth rate of 5.2 percent in 2005 (4.3 percent in 2004) and forecasts of growth for 2006 of more than 5 percent, made before the August 2006 hostilities broke out.

The global economic recovery resulted in a sharp upturn in demand for high-tech production, which constitutes some 70 percent of Israel's industrial exports, the highest percentage in the world. In 2005, high-tech exports rose by nearly 10 percent, to US\$18.8 billion. The country also benefited from the rise of the high-tech sectors in India and China and their emergence as increasingly important customers of Israeli products.<sup>3</sup>

In addition to these external global factors, the competitiveness improvements are the culmination of very significant capital market reforms, coupled with fiscal discipline, which have introduced a greater degree of competition and are now clearly bearing fruit. The 2003 New Economics Agenda, pushed through with public consensus during the recession, was based on three main tenets, a reduction in government expenditure, greater fiscal discipline and tax cuts, all of which have done much to create the conditions for higher productivity and growth.

The country's general government expenditure-to-GDP ratio which has been traditionally high 47.3 percent in 2005, compared to the OECD average of 41.8 percent, due to huge defence spending and substantial interest payments on the debt stock was significantly lower in early 2006 than its customary seasonal path. The fiscal consolidation effort aims to bring this ratio down to 34.4 percent of GDP by 2010, increasing the budget by less than the GDP growth rate, namely 1.0 percent in 2006 and 1.7 percent in 2007.

The budget deficit still remains on the high side compared to other western countries, reflected in a rank of 71. But there were signs of improvement, as shown in its jump upwards by 22 ranks over last year, as fiscal consolidation trimmed the deficit/GDP ratio from an average of 4.4 percent during 2001–2004 to around 3 percent in 2005. The current budget is projected to maintain it at this level in the years ahead. The reduction in the budget deficit, brought on by rapid economic growth and financed in part using privatization revenues, has also made it possible to reduce the high debt/GDP ratio, which declined by 3.8 percent to 96.9 percent of GDP in 2005, compared to an OECD country average of 81.2 percent (in 2005).

The reforms have also helped to improve market efficiency. For example, although still high, the extent and effect of taxation ranked 58, an improvement of 17 ranks, following a comprehensive tax reform package approved by the Knesset in July 2005, to be

implemented from 2005 to 2010. This included bringing down the marginal labor tax rate to 44 percent by 2010, a reduction in VAT by one percentage point to 15.5 percent and a gradual decrease in the corporate tax from 31 to 25 percent. Compared to other OECD countries, the maximum tax rates in Israel are no longer high. Moreover, Israel has no estate or inheritance taxes.

The area that saw the most impressive developments was the financial market, highly developed by regional and international standards, as reflected by the country's 13th place under this category, a jump in eight places vis-à-vis last year. This appears to be due, first and foremost, to the recent capital markets reform, led by the Bachar Commission, which tackled the two major problems: the high degree of market concentration resulting from two institutions that accounted for about 70 percent of the asset management industry, and an existing conflict of interest arising from concentrated ownership of funds by banks and their role in the provision of financial retail advice. This was done by separating asset management activities from commercial banking, introducing a substantial degree of competition and professionalism and laying the groundwork for a revolution in the sophistication and independence of asset management.

This has built on a previous round of important reforms that phased out the high-yield guaranteed-rate government bonds held by pension funds mostly public pension funds held by Histadrut, the main labor union in the country and equalized the tax treatment of capital gains between Israeli and foreign securities. Israel ranks 2nd place globally in its excellent access to venture capital, which is channelled to early-stage companies, especially ICT and biotechnology start-ups. The Israeli government continues to play an active role in the development of this market by financing joint public-private venture capital funds to leverage private capital from foreign investors.

Israel ranked 23rd for overall infrastructure quality, up seven places since last year and 31st for railroad infrastructure development, reflecting a jump of ten places. These improvements reflect ongoing reforms concentrated in rail, roads, ports, and electricity supply infrastructure, and have introduced elements of competition. Foremost among the large infrastructure allocations is a multi-year budget of NIS20 billion to Israel Railways, a public corporation since 2004–05. The government also plans to introduce mass transit systems in metropolitan centers, an additional light rail system in Jerusalem, and has allocated approximately NIS 3.3 billion averaging almost 1 percent of GDP for the period 1997–2005 toward road infrastructure development, mainly through build, operate, transfer (BOT) schemes.

Government companies have been established to improve port infrastructure management, maintenance, and development. In 2005, an agreement was reached with unions to begin the privatization process aimed at introducing more competition into the port container market, with the goal of significantly reducing ship waiting times. The Electricity Sector Law, amended in 2003, is focused on reforming the electricity industry by unbundling production activities of the state-owned Israel Electric Corporation, with the aim of lowering prices and improving service.<sup>4</sup>

**Box 8: Unleashing Israel's competitive advantage** *(cont'd.)*

Israel's large-scale fiscal consolidation, will enable future cuts in the tax burden and public debt, thereby freeing up capital market resources for the business sector, lowering the economy's long-term interest rate, and stimulating growth and investment. As long as the macroeconomic targets are met, the combination of consolidation and ambitious capital markets reform is expected to fully unleash the country's competitive potential.

The economic impact of the recent hostilities has been limited. The effects of these events on real activity, on the exchange rate, inflation, and on financial markets has been small and has demonstrated Israel's continued economic resilience in the face of ongoing instability in the region. Over the longer term, much will be gained from securing lasting security arrangements with its neighbors, to remove uncertainties about the political environment and

allow a redirection of resources toward productivity-enhancing areas, such as education and infrastructure. Without doubt, the entire region would greatly benefit from the associated "peace dividend."

**Notes**

- 1 IMF (2006), p. 205; in volume terms, annual growth in world trade has increased from 3.4 percent in 2002 to 7.3 percent in 2005, and is forecast to reach 8 percent in 2006.
- 2 Bank of Israel (2005).
- 3 *BusinessWeek* online, 30 December 2005.
- 4 Government of Israel, Ministry of Finance (2006).