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Israel's economic strategy



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Interview with **Yuval Steinitz**, Minister of Finance, Israel

A year ago, at the 2010 OECD Ministerial Council Meeting, Israel was formally invited to become a member of the OECD, following three years of accession negotiations. Israel duly became the organisation's 33rd member country a few months later, in September 2010. The OECD Observer asked the minister of finance, Yuval Steinitz, to outline his views on the country's economic challenges.

OECD Observer: What main economic challenges does Israel now face?

Yuval Steinitz: Our key challenges include the rising competition to Israeli exports, the unsatisfactory performances of the education system and relatively high level of income inequality. The 2011-2012 budget strives to improve education, health and social welfare. In addition, it sets out to promote the high-tech industry, support higher growth and increase the integration of Ultra-orthodox (Haredim) Jews and Israeli Arabs into the workforce. Government expenditure is expected to increase by 2.6% in 2011 and 2012 alike, as dictated by the new fiscal rules.

What attributes would you highlight?

Our focus continues to be on promoting significant economic growth, increasing participation in the labour market, improving education and reducing the income inequality between the centre and

periphery. In addition, we are working to develop a long-term and strategic fiscal planning based on:

- education, which is Israel's long-term growth engine;
- encouraging the Ultra-orthodox and Arabs to participate in the labour market by providing skills and job opportunities;
- promoting business in Israel by cutting red tape and streamlining regulations;
- investing billions of shekels in transport infrastructure, including roads and rail, with a focus on connecting the Galilee and the Negev.

How important has joining the OECD been for Israel and what can membership bring your country?

Becoming a member country of the OECD has already led to economic improvements and enhanced Israel's economic image, as well as improved the functioning of various sectors in Israel's society and economy, including environment, education and employment. The improvement and upgrading process is continuing as part of the government's commitment to ongoing peer review by the organisation and to adjust its regulation policy to OECD standards.

The process of joining the OECD has already encouraged us to adopt a variety of reforms and norms. We are building on the experience of the OECD member countries in forming government policy and implementing reforms, such as on the environment. OECD membership is a driving force for continual improvement of government efficiency through annual reports, peer reviews and the organisation's wealth of expertise. We plan on taking full advantage of what the OECD has to offer us. The OECD is also a unique forum in which we can discuss national experience and best practices, and find solutions to common problems.

The OECD is celebrating its 50th anniversary. What contribution do you think Israel can make to the organisation in the years ahead?

Israel shares the basic values of an open market economy and democratic pluralism. It ranks among the world's leading countries with respect to the number of scientists, engineers and high-tech start-ups per capita, as well as in R&D spending per capita. Due to its achievements in information technology, water management, industrial biotechnology and knowledge-based agriculture, Israel can contribute to improving standards of living through innovation. Moreover, we believe our fiscal frameworks—including the new “two-year budget model”—are modern and innovative, and can be examined by other member countries.

We look forward to contributing to OECD working groups on a variety of topics.

How do you see the economic challenges facing the world more widely?

In the short term, downside risks remain a concern. We are particularly concerned with the deterioration of global fiscal positions, the uncertainty related to a premature exit from expansionary fiscal and monetary policies, and the potential for inflation and rise in commodity prices. We are also monitoring the stress remaining in the financial sector and the imbalances in the global economy.

This article first appeared in OECD Observer No 284 Q1 2011.

For more on Israel's accession to the OECD, see www.oecd.org/mcm2010 and www.oecd.org/accession

Visit www.finance.gov.il

A profile of the economy

In many respects Israel's short but dramatic history has created a combination of economic, social, demographic and political circumstances without close parallel with any other OECD member country. Some of these characteristics are outlined here, and are explored in more depth in the OECD's first Economic Survey of Israel, published in 2010.

Consider the market-oriented reforms since the mid-1980s, for instance. Israel's initial decades of economic management saw a corporatist approach, with widespread public ownership, strong trade unions and severe trade restrictions. Energy and telecommunications sectors were entirely operated by state-owned enterprises, and government had significant holdings and influence in many other sectors. Although trade-union power has diminished substantially since the mid-1980s, it is still considerable. In recent years the unions and employers' representatives have increasingly presented a common front on policies.

Macroeconomic policy reached a turning point in 1985 with a radical stabilisation programme designed to tackle hyperinflation and put the debt-to-GDP ratio on a downward path. The anti-inflation measures were particularly successful and were followed up by the implementation of an inflation-targeting approach to monetary policy in the early 1990s. Indeed, inflation has typically been well below 5% annually since the late 1990s. The 1990s also saw extensive structural reform. As in many OECD countries, this included privatisation and regulatory reforms to encourage product market competition.

In addition to this dramatic switch in economic management, Israel's economy has experienced rather more shocks (both positive and negative) than most, even during the relatively stable post-1980s era.

Mass immigration from the former Soviet Union in the early 1990s, the dot.com bubble, the Second Intifada, which began in autumn 2000, and the recent global economic downturn have all generated considerable cyclical effects on output and employment.

The strong influence of the 1990s dot.com bubble on Israel's economy highlights the prominent role high-tech activities have played in growth, attracting much interest from outside. Innovation policy has played a role in this, notably featuring a system of competitively awarded research grants and additional

Building a good environment for stronger, more inclusive long-term economic performance must remain a core goal for both macroeconomic and microeconomic policies

support for firms located in special business parks (business incubators). Other factors contributing to Israel's impressive profile in high-tech and R&D activity include: a fairly large defence industry; training with sophisticated technologies during military service; a large pool of researchers in the Jewish diaspora; and engineering and science skills brought by the wave of immigrants in the early 1990s. Aside from defence industries, the main high-tech activities are computer component manufacturing, software engineering, medical technologies and pharmaceuticals. In fact, the world's largest generic pharmaceutical company, Teva, is headquartered in Israel.

Outside the high-tech sectors, Israel plays an important role in the world diamond industry, though the sector accounts for only a small share of the economy. Agriculture now accounts for around 2% of GDP, though related experience in managing scarce water resources has developed into another area of high-tech expertise.

Policies have been favourable towards business for some time to draw investors in and anchor them down. Still, the country arguably has some outright disadvantages as far as some investors are concerned: it is further from major markets than many competing business locations and the politics of the region probably puts some off. Retaining a reputation for excellence in high-tech and research activities also presents challenges because of the global mobility of these sectors.

Substantial security costs

While the substantial resources devoted to the military and security services have some positive benefits for civilian economic development, this also incurs considerable costs. Government spending on defence equipment and personnel is now well below previous peaks, but it is nevertheless still comparatively high at around 8% of GDP. About 1.5 percentage points of that is accounted for by military aid from the United States. But even when this is taken on board, this spending still represents a fiscal burden and also has implications for human resources.

Compulsory military service (three years for men, two years for women, followed by reserve-service requirements) affects education and the labour market, and also contributes to divisions within society. Ultra-Orthodox Jews and Arab-Israelis are exempt, freeing them from the downsides of service but excluding them from a range of subsequent fringe benefits and other support; this exclusion contributes to lower labour market participation and income levels. In addition, there is little doubt that a greater share of resources is devoted to civilian security arrangements than in most OECD countries. Checks on entry to government offices are tight; transport networks, offices, shops, restaurants and bars are often manned by private security guards; and scanning devices similar to those used in airports are often found on larger premises.

Israel's history and the geopolitics of the region have additional economic implications. The country is described by some as an "island economy". Although trade and investment flows are substantial with the wider world, those with neighbouring economies in the Middle East are relatively small, while cross-border movement of labour is also limited. This has prompted a widening of channels to temporary foreign workers from further afield (such as the Philippines and Thailand), who now account for about

three-quarters of the non-Israeli workforce. Meanwhile, economic ties, particularly with the United States and Europe, go beyond trade and investment. There is a large positive net balance of transfers comprising government-to-government transactions, not only from US military aid, but also transfers between private households (including remittances) and transfers to non-governmental organisations that support a wide range of groups and causes. Net private transfers come to about 2% of GDP, which is high

by OECD standards. Land property rights are also somewhat unique: only 7% of land is privately owned, 12% is owned by the Jewish National Fund, and the remaining 81% either directly by the State of Israel or by the Development Authority.

These positive and negative influences have contributed to an average growth rate of nearly 4% per year since 1996, the sixth highest figure among OECD countries. However, growth has also been helped by relatively rapid population increase. Over the same period, per capita growth was only 1.7%. On a purchasing-power-parity basis, the level of GDP per capita, at \$27,661 in 2009, is just over 80% of the OECD average (that average was about \$33,023), and is far below that of top-ranking OECD countries. Furthermore, for a developed country, Israel suffers from high rates of poverty, particularly among Arab-Israelis and Ultra-Orthodox Jews. Building a good environment for stronger, more inclusive long-term economic performance must remain a core goal for both macroeconomic and microeconomic policies.

In several respects the economy is already on that path. The absence of critical failure in the domestic financial sector ensured that the recent downturn was mild and the recovery relatively speedy. Meanwhile, new finds of offshore natural gas will further reduce the need for imported energy and permit a cleaner fuel mix. The associated tax and royalty revenues will help fiscal balances, which are in better shape than many OECD countries but nevertheless need improving. The ratio of public debt to GDP was 75% in 2010, which is lower than many OECD countries but higher than is optimal.

However, there remain significant macroeconomic challenges. The monetary authorities are facing a difficult scenario in which rapidly rising house prices and overall economic performance have

Israel: Economic outlook

	2007	2008	2009	2010	2011	2012
	Current prices		% changes			
	NIS billion		volume 2005 prices			
GDP at market prices	690.1	4.2	0.8	4.7	5.4	4.7
Private consumption	389.6	3.0	1.7	5.1	4.9	4.5
Government consumption	171.3	2.4	1.9	2.1	3.3	1.5
Gross fixed capital formation	130.5	4.1	-6.5	12.6	13.3	7.2
Final domestic demand	691.4	3.0	0.3	5.7	6.0	4.3
Stockbuilding ¹	7.7	-0.4	-0.6	-1.1	-0.7	0.0
Total domestic demand	699.0	2.6	-0.4	4.5	5.4	4.5
Exports of goods and services	292.9	5.9	-11.7	13.6	7.1	8.7
Imports of goods and services	301.8	2.3	-14.1	12.6	8.1	8.1
Net exports ¹	- 8.9	1.5	1.1	0.6	-0.2	0.2
Memorandum items						
GDP deflator	-	0.9	5.0	1.1	1.4	2.5
Consumer price index	-	4.6	3.3	2.7	3.7	3.4
Private consumption deflator	-	4.8	2.4	2.9	3.6	3.4
Unemployment rate	-	6.1	7.6	6.6	6.2	5.7
General government financial balance ^{2,3}	-	-3.7	-6.4	-5.0	-3.7	-2.9
Current account balance ²	-	0.9	3.6	3.1	1.2	1.0

Note: Last updated: 20 May 2011. National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook Sources and Methods* (<http://www.oecd.org/eco/sources-and-methods>).

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

² As a % of GDP.

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

Source: *OECD Economic Outlook 89* database.

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favoured an early start to normalising the policy interest rate. However, this has prompted exchange-rate appreciation, with potentially damaging effects on the profitability of the export sector. Fiscal policy also faces tough trade-offs. While there is a need for debt reduction, achieving policy goals in some areas, particularly on the social front, will require additional spending, and revenue growth is being restrained by ongoing cuts in income-tax rates, as part of a wider programme for encouraging business activity.

In structural policies, significant in-roads have yet to be made in reducing outcomes in poverty. However, measures are in train that ought to have impact in the future. In particular, education reforms are moving ahead quite rapidly on some fronts. For instance, in secondary education, teachers' pay is being increased in exchange for increased hours devoted to teaching small groups of students.

For the business sector, ongoing cuts in income tax rates are being accompanied by efforts to lighten urban planning procedures and to cut other aspects of red tape for businesses. However, much work remains to be done, notably regarding competition. One study has estimated that the 20 largest family business holdings totalled 30% of the market value of Israeli company shares, a relatively high value compared with equivalent calculations for other countries. Public concern about the role of these groups in the economy has prompted the government to appoint a special committee, which is due to report in the coming months.

For more information on the economy contact Philip Hemmings at the OECD Economics Department

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OECD Review of Agricultural Policies: Israel



ISBN 978-92-64-07934-2

Israel's agriculture is unique among developed countries in that land and water resources are nearly all state-owned and that agricultural production is dominated by co-operative communities. Israel is a world leader in agricultural technology, particularly in farming in arid conditions. Israeli agriculture thus relies on an "induced", rather than "natural" comparative advantage, one built on knowledge and technological progress. Israel has made progress in removing policies that distort trade and resource allocation, and support to agriculture is lower than the OECD average. The 2010 Review of Agricultural Policies in Israel measures support provided to Israeli agriculture and evaluates the effectiveness of current agricultural policy measures.

A special focus of the 2010 report examines agriculture's performance with respect to water resources and pollution, soils, biodiversity, air emissions and climate change. The future success of Israeli agriculture and further productivity gains will rely heavily on ensuring an effective system of research, development and technology transfer, the report says.

Corporate Governance in Israel



ISBN 978-92-64-09750-6

Israel has made considerable progress over the last decade in improving its corporate governance framework, notably through adoption of its 2000 Companies Law and the implementation of a succession of subsequent upgrades of various parts of its legal architecture. Economic efficiency and a level playing field between public and private enterprises have been further promoted.

The review of Corporate Governance in Israel describes the corporate governance setting including the structure and ownership concentration of listed companies and the structure and operation of the state-owned sector.

The review then examines the legal and regulatory framework and company practices to assess the degree to which the recommendations of the OECD Principles of Corporate Governance and the OECD Guidelines on Corporate Governance of State-Owned Enterprises have been implemented.



The banking sector

Banks in Israel have played an extremely important role in the process of positioning Israel as a developed, advanced economy that is attractive to international investors.

As reported in the January 2011 report on Israel by the International Monetary Fund: “Banks proved resilient to global downturn and have strengthened further”. The report continues: “Financial stability indicators suggest that the resilience of the banking system has increased over the past year. Capital adequacy ratios, notably including Tier 1 capital relative to risk-weighted assets, have risen for most banks, while impaired and non-performing loan ratios have declined. Indicators of credit risk also appear strong; although household leveraging has increased somewhat in recent years, the overall level is low, and mortgage loan-to-value ratios are also low by international standards. Banks maintain high liquidity, and interbank and direct exchange rate risk exposures are small”.

The impact of the global financial crisis on the economy was moderate in Israel, relative to the developed countries. This effect was primarily felt in the last quarter of 2008 and in the first quarter of 2009; in the subsequent quarters, conditions changed in Israel as a positive trend emerged. This trend continued into 2010, although growth slowed somewhat in the last few months of the year due to a decrease in exports. Looking ahead, the Israeli economy is on a course of balanced growth. The main source of potential risks is a scenario of negative developments in the global economy, which would obviously affect Israel; however, in scenarios without a crisis of this type, the consensus among economists puts growth in the Israeli economy at 4.2% in 2011.

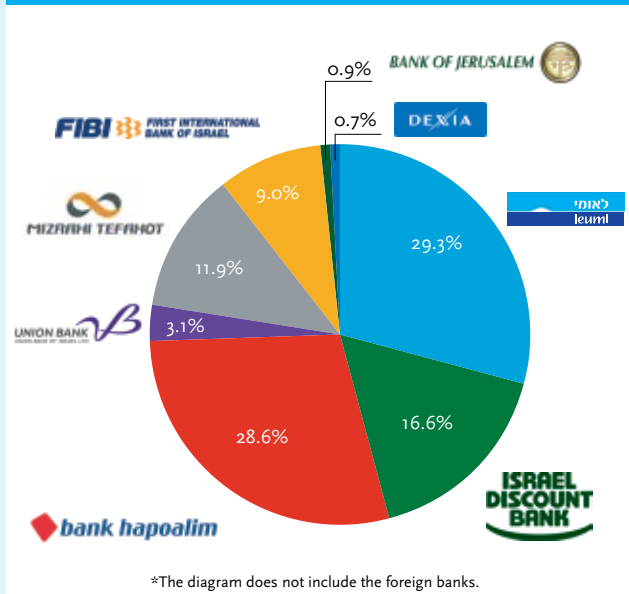
On May 2010 Israel was invited to join the OECD. The Association of Banks in Israel sees the invitation as recognition of Israel's achievements, economic strength and its ability to contribute to the organisation and to the global economy. Local economists estimate that Israel's accession to the OECD will give Israeli society and the economy a boost and contribute to upgrading areas such as the environment, education, employment and many others.

The banking industry in Israel displayed strong resilience during the recent financial crisis. The financing strategy deployed by Israeli banks

Israel's banking industry encompasses 19 commercial banks. Most of the banks are concentrated into five banking groups

relies primarily on deposits from the public, rather than on funding through the capital market. In other words, unlike banks elsewhere in the world, which were dependent on the capital market and on securitisation instruments in order to finance their operations, the Israeli banks had more stable financing sources heading into the crisis. As a result of this strategy, the Israeli banking industry's investments in risky assets overseas were of negligible volume relative to the total volume of the banks' assets, and the banks were not harmed by various toxic assets. Overall, the actions taken by the banks strengthened the financial robustness of the system and increased confidence in the banks, both of the Israeli public and of global financial entities.

The division of the Israeli banking system According to the volume of assets*, 31 December 2010



The relatively favourable macro-economic background along with the cautious, responsible conduct of the banks in Israel over the years supported the banks' rapid recovery from the direct effects of the downturn. As a consequence, in contrast to banking industries worldwide, which have experienced mergers and acquisitions and other structural changes, the global crisis did not damage the resilience of the Israeli banks and did not affect their structure.

Israel's banking industry encompasses 19 commercial banks. Most of the banks are concentrated into five banking groups: Leumi, Hapoalim, Discount, Mizrahi-Tefahot and FIBI. Alongside these groups are three independent banks (Union Bank, Bank of Jerusalem and DEXIA) and four branches of foreign banks (HSBC, Citibank, BNP Paribas and State Bank of India). The operations of the foreign banks with branches in Israel are relatively limited in scope, representing less than 2% of the assets of the banking system. These banks do not operate in the retail sector and are mainly focused on corporate activity, private banking and investment banking.

Israel has more than 1,100 bank branches. In recent years, the main trend in the area of branching has been the opening of smaller, specialist branches, such as branches specialising in retail banking, private banking, corporate banking, etc. The new branches opened based on this format rely on advanced self-service technologies, which allow for more efficient service and enable the banks to recoup their investment in the new branch within a shorter period.

Technological sophistication

Over the years, Israel's banking industry has been at the forefront of global technology, offering its clients services based on a wide range of advanced technologies and direct-service channels, including online and mobile services. Internet-based banking services in Israel are considered highly successful both as a means of receiving information and of executing banking transactions.

Leaders in business sector financing

Banks play a key role in supporting the growth of the business sector in Israel. Over the years, the commercial banks have developed extensive activity in the business and commercial sectors and have become leaders in corporate financing. The corporate divisions of the banks provide services to the major corporations in the Israeli economy as well as to middle-market businesses. The banks also offer services to small businesses through business banking departments within bank branches. Experts in the areas of investments, foreign trade, project financing, securitisation and syndication are available to clients at the banks. In addition, the banks provide support to clients through professional consultants, such as attorneys, accountants, and appraisers.

Competition is hardening among the banks over leadership in financing deals in the Israeli economy, with foreign banks operating in Israel also involved. In many cases, major transactions are financed through risk sharing (syndication) among a number of banks, as well as non-bank entities.

The crisis, especially the last quarter of 2008 and the first quarter of 2009, was an important test for the banks. On one hand, this ordeal revealed that in contrast to parts of the non-bank market, which operated without adequate controls, the banks maintained highly responsible credit-risk management policies over the years. On the other hand, the credit crunch at the outbreak of the crisis required the banks to be acutely alert to developments in the corporate sector and to support its emergence from the downturn to the extent possible.

The banks' willingness to continue to support the business sector during this difficult time eventually proved justified and helped bring about the turnaround in the Israeli economy, which quickly returned to a trajectory of growth.

The banks' responsible policies and the relative cautiousness of private customers in Israel are reflected in clients' debt burden. The debt burden (the ratio of credit granted to private customers to their disposable income) serves as a measure of borrowers' ability to repay their debts; this ratio has remained low relative to other OECD countries. The low debt burden also stems from the high rate of savings in Israel, in a global comparison.

In the area of credit for private customers, an increase in housing credit has been evident in the last five years. This trend stems from the upswing in the economy, which has also been reflected in a steep increase in prices of homes; this increase in turn has heightened demand for larger mortgages. However, despite the expansion of housing credit, the ratio of this credit to income remains low relative to other developed countries.

High capital adequacy

The Israeli banking system has already entered the era of Basel II. During 2009, the banks began to implement the Basel Committee's recommendations, which represent an innovative and advanced approach to risk management and capital allocation. Since the end of December 2009, the Israeli banking system has operated in accordance with the Basel II guidelines, adopting the standard approach to the measurement of capital adequacy.

The transition from the Basel I guidelines to Basel II did not have a significant impact on capital adequacy ratio values (the ratio decreased from 13.69% under Basel I to 13.61% under Basel II). However, estimates indicate that Israel's banking industry will align with the global trend, in which supervisory agencies are demanding higher capital ratios and better capital quality, over the coming few years.

As in other countries, risk management has become one of the key issues of concern for the financial industry in Israel. Banks have been required to create a central risk-management function headed by a chief risk manager with the status of a member of management.

Foreign investors

Capital movements into Israel in foreign currency in 2010 were marked by a significant increase in the volume of short-term financial investments by foreign investors, and by Israelis investing overseas. A substantial part of foreign investments in Israel were in government bonds, and the foreign investors' share of this segment rose significantly.

2010 was also a significant year in foreign investors' relationship with the Tel Aviv Stock Exchange (TASE). In May, MSCI transferred Israel from its emerging-markets list to its developed-markets category. This change, which was based on an appreciation of the development and resilience of the Israeli economy, led to the departure of foreign investors specialising in the emerging markets during the months preceding the switch; they are now being replaced by foreign investors who are adding the Israeli capital market to their developed-markets investment portfolio. This changeover, reflected in an increase in the volume of foreign investments in local equities, has been gradual.

2010 was also a significant year in foreign investors' relationship with the Tel Aviv Stock Exchange (TASE). In May, MSCI transferred Israel from its emerging-markets list to its developed-markets category

The process of arrival of these foreign investors is expected to continue in the second half of 2011, in view of the strong performance of the Israeli economy in terms of growth and relative financial stability. As a result, the volume of foreign investments on the TASE is likely to grow. Israeli banks operate sophisticated dealing rooms and offer all

of the services required by foreign investors for their activity in the Israeli capital market.

Alongside the foreign operators active in Israel, the banks also serve Israeli and foreign clients operating overseas. A change in the banks' strategy with regard to international operations has been evident in the last two years. Whereas in the past, the banks' policy in this area was to expand their activity by means including the acquisition of local banks in foreign countries, today this strategy is being reconsidered, and the emphasis is on the development of activity within the existing branches. Assets of the branches of Israeli banks overseas totalled ILS 145 billion at the end of 2009 (~\$40 billion), accounting for approximately 14% of total assets.

Against this background, it is likely that over the coming year the banks will continue to focus on reinforcing their stability and developing new services, products and areas of activity. More intense competition in future within the entire financial sector and the need to cope with stricter regulation globally will pose considerable challenges for Israeli banks.

Assessing environmental risks

Under the general heading of risk management, a specific area being led by the Association of Banks, in collaboration with the Supervisor of Banks, is a drive to increase the banks' awareness of environmental risks. These are risks to which the banks may be exposed as a result of financing (through credit or investment) of entities whose activity could cause environmental damage. This initiative is aimed at positioning Israeli banks in line with leading banks globally, which in recent years have devoted a great deal of attention to such risks. The Association of Banks also recently promoted a requirement, within a new standard in the area of appraisals, for appraisers assessing land for credit applications to specify all information they receive regarding any pollution or suspected pollution of the ground.

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Start-up nation: An innovation story



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Innovation is a major driver of productivity, economic growth and development. Many OECD countries today are looking to boost productivity through investments in science, technology and R&D. What experience can Israel, new OECD member and the “start-up nation” feted in a recent book by Dan Senor and Saul Singer, bring to the table?

Israel’s innovation laurels are several—highest gross expenditure on R&D, largest amount of companies listed on NASDAQ outside of North America, highest level of venture capital as share of GDP, etc. How did this success come about?

According to Israeli venture capitalist Dr Orna Berry, there is no doubt smart policies played a key role in spurring innovation. “The Israeli government made a crucial strategic decision to jump start a science-based sector by providing financial support for commercial R&D,” says Ms Berry. “This policy made up for market failures and the heightened risk in operating in a geographically isolated market like Israel.”

She knows the system well, having seen it through both the private and public sectors. In addition to a 25-year career in science and technology industries, she was the chief scientist from 1996 to 2000, a post

Since the first companies emerged from the incubator programme in 1993, 61% have secured follow-on funding

that embodies the Israeli government’s hands-on approach to innovation. The Office of the Chief Scientist was created in 1969 within the Ministry of Industry, Trade and Labour, and would eventually become an important player during the high-tech boom.

But at the time of the Chief Scientist’s creation, Israel’s economy followed a distinctly corporatist approach, with widespread public ownership and heavily restricted trade. The so-called “lost decade” that followed the 1973 Yom Kippur War saw public debt rise to almost 300% of GDP. Israel wouldn’t find its feet again until 1985, when it tackled hyperinflation and public debt through its Economic Stabilisation Programme.

It was the emergence of Israel’s export-based high-tech sector in the early 1990s that really put the country’s economy on track, with GDP growth of at least 4% a year. Specialising in computer hardware and software, medical technologies and pharmaceuticals, this sector became world-renowned for innovation. Flash drives, cardiac stents, instant messaging and shopping.com are only a few of Israeli-bred innovations that have emerged in the last few decades. High-tech industries represent almost 50% of total industrial exports today, according to OECD data. Between 1995 and 2004, Israel increased its spending on R&D, calculated as a percentage of GDP, from 2.7% to 4.6%, a rate higher than any OECD country.

Israel certainly had the human capital by the early 1990s to fuel the boom. Israel’s compulsory military service provides early training in sophisticated technologies. Furthermore, the country saw the influx of almost one million ex-Soviet Jewish immigrants in the 1990s. These highly educated immigrants, whose ranks included 82,000 Russian-trained engineers, assimilated into the local labour market, providing key scientific and IT skills. The Jewish diaspora also provided a large pool of researchers.

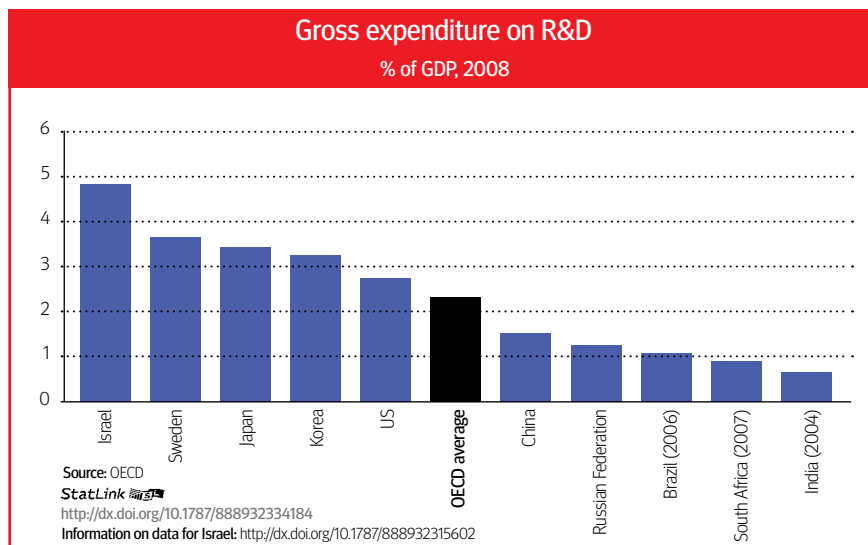
“Government policy was instrumental in unleashing the potential of this abundant human capital,” says Ms Berry. The technological incubator programme was set up in 1991, in part to provide these skilled immigrants with funding and know-how to become successful entrepreneurs. It was run by the Office of the Chief Scientist, which funded potential entrepreneurs. Since the first companies emerged from the incubator programme in 1993, 61% have secured follow-on funding and 40% are active to this day. The private sector has since invested over \$2.5 billion in incubator graduates, according to the OECD.

At the core of Israeli innovation policy is the chief scientist’s matching grants programme. Through this initiative,

firms submit R&D proposals to the chief scientist, and grants are awarded on a competitive basis, with between 66 and 90% of the research costs covered. “We reviewed proposals according to their technical and commercial feasibility, risks and the potential for projects to generate expertise,” says Ms Berry. These grants are actually high-risk loans—successful projects must pay back the Office of the Chief Scientist the funding received via a deduction of a small percentage of annual sales.

Another government programme set up in the early 1990s, Yozma, has been credited with creating Israel’s vibrant venture capital industry. Founded with a budget of \$100 million in 1993, Yozma established 10 venture capital funds, contributing up to 40% towards the total capital investment. The rest was provided by foreign investors, who were attracted by risk guarantees. Nine of the 15 companies that received Yozma investment went public or were acquired. “In 1997 the government received its original investment with 50% interest and the funds were privatised,” recalls Ms Berry. A recent OECD report on innovation calls Yozma “the most successful and original programme in Israel’s relatively long history of innovation policy.”

Although these programmes have benefited Israel’s export-led growth and offered a model for other OECD countries, their legacy is mixed today, says Mario Cervantes, OECD senior economist. “The returns in terms of longer-term job creation and income growth have not kept up, despite continued investment in high-tech,” he says. “Many Israeli start-ups are sold to the US market and get absorbed into global firms, never really expanding in Israel. This is expected given the small size of the internal market, but it does raise questions about how much of the returns from innovation end up back in the economy in terms of jobs created.” According to OECD data, Israel’s information and communication technology sector accounts for about 20% of total industrial output and 9% of business sector employment.



Moreover, Israeli businesses can be just as held back by excessive red tape as they are encouraged by government innovation policy. The OECD’s Product Market Regulation Database, a set of indicators to measure how policy promotes or inhibits competition, gives Israel a worse score than any other OECD country. The OECD’s 2009 *Economic Survey of Israel* called for more work to be done in reducing regulatory barriers and other channels of state influence on business.

While government policy has actively promoted high-tech industries, other sectors seem to have been left out. “With the exception of the information and communications technology services sector—which is very R&D intensive—innovation in other service sectors has received less attention, as illustrated by the weaker labour productivity performance of the business service sector compared to the US, Korea or the UK,” says Mr Cervantes. “Perhaps this is because of—or despite—the competition as well as regulatory barriers that limit incentives for innovation.” Israel’s economy remains heavily reliant on its high-tech sector, which provides a narrow base for growth, the OECD argues. Innovation policy will have to reach out to Israel’s traditional industrial and service sectors as well. Indeed, the OECD’s

landmark Innovation Strategy stresses a broader view of innovation, beyond R&D, that encompasses both technological and non-technological forms of innovation such as design, organisational change and marketing.

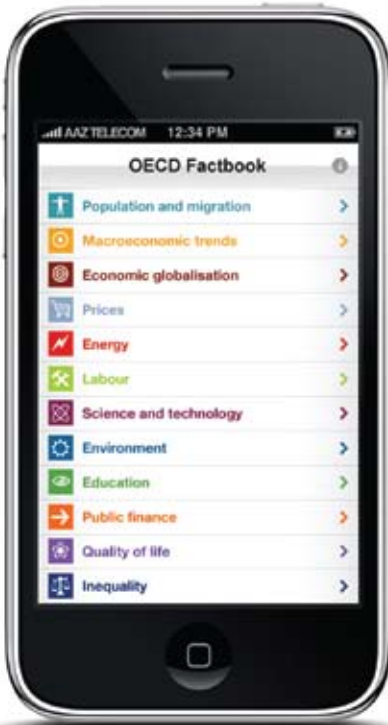
Authors Senor and Singer found another trait in Israeli culture behind the “start-up nation” worth mentioning. They credit Israeli *chutzpah*, an almost untranslatable word meaning gall, audacity and guts (or bold arrogance, depending on the context). In Israel, *chutzpah* in business is most often seen in the country’s risk-taking culture and is something other OECD countries might do well to adapt to their innovation policies. However, Israel should not sit on its laurels either, since innovation is an ongoing enterprise. “Maybe there is still scope for some more *chutzpah* in Israel’s innovation policy as well,” Mr Cervantes adds. *Ilan Moss*

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Tax notes for investment

Co-ordinated by **Harel Locker**, Tax Partner, and Margalit Apelbaum, Tax Associate, at S. Friedman & Co Law Offices

Israel has been witness to a sharp rise in foreign direct investment (FDI), since drastic steps were taken to liberalise the economy and reduce public debt. The stock of inward FDI has grown from about 7% of national GDP in 1996 to over 30% in 2007. In 2010, the net FDI inflow was \$5.2 billion.

As mentioned in a recent OECD Economic Survey of Israel (page 19): “Government support to business is wide-ranging, with three principal themes: promoting large-scale greenfield investment, small and medium-sized enterprises, and research and development.” Israel’s accession to the OECD should have a positive impact in attracting yet further investment.

Encouraging capital investment

Israel’s industry is well positioned among the top high-tech world leaders, among other reasons, due to its investment incentives policies. In January, the Israeli Knesset passed a substantial set of changes to its Law for the Encouragement of Capital Investments (“the Law”).

The changes in the Law have created widening opportunities for initiatives in Israel. New investors will find that access to tax benefits and grants have been simplified and are relatively easy to operate in Israel.

As of 2011 fixed tax rates are charged to all companies, which run an “Industrial Enterprise” provided they meet a minimum export quota as income from production activities.

A qualifying industrial enterprise is a business which is competitive and contributes to the national product or any aspect of renewable energy. The benefits are not limited in time, and no minimum investment is required. The benefits apply only on preferred income, considered to be generated from activities in Israel only.

Currently, the standard corporate tax rate stands at 24%, but will be reduced gradually to 18% by 2016. The income tax rate imposed on preferred income may reach as low as 6%.

Under certain conditions, R&D activities in Israel for the benefit of a foreign resident and royalties, may also qualify as preferred income. Furthermore, a preferred company is entitled to accelerated depreciation rates on productive assets. Industrial enterprises are eligible for grants as well as tax benefits. Both grants and loans are available. The volume of a grant may reach up to 24% of the investment program.

Why invest in Israeli companies and funds?

Setting up an Israeli industrial subsidiary or greenfield investment is not the only driver of investment. Israel is open to foreign investments, and the government actively encourages and supports the inflow of foreign capital through foreigners investing in Israeli shares or securities. In 2010, foreign investment in traded securities accounted for \$9.1 billion (which represent a growth of 280% from 2009).

Generally, a foreign resident will be exempt from tax on the capital gain earned upon the sale of the security of an Israeli resident company, or upon the sale of a right in a foreign corporation, the main assets of which are rights, directly or indirectly, in assets located in Israel, subject to the following conditions:

- The capital gain is not attributable to a permanent establishment in Israel.
- The security is not of a real estate company.

However, non-Israeli corporations will not be entitled to the foregoing exemptions if an Israeli resident (i) has a controlling interest of 25% or more in such a non-Israeli corporation, or (ii) is the beneficiary of or is entitled to 25% or more of the revenues or profits of such a non-Israeli corporation, whether directly or indirectly.

In addition to the above, and for the purpose of encouraging investments in Israel, Formal Notes of the Israeli Tax Authorities grant this exemption to foreign residents who invest in Israeli venture capital funds, hedge funds and private equity funds, under several conditions, even though the management company of such a fund

The changes in the Law have created widening opportunities for initiatives in Israel. New investors will find that access to tax benefits and grants have been simplified and are relatively easy to operate in Israel

is considered to be an Israeli resident and constitutes a permanent establishment in Israel for the fund. This specific exemption for foreign investors in Israeli funds encompasses also interest and dividends paid to the foreign investors, and not only exemptions for capital gains, as granted to investors in regular Israeli companies.

Israel has also a participation-exemption regime for Israeli holding companies. Under specific conditions, Israeli holding companies will be exempt from tax on dividends received from foreign subsidiaries and from capital gains tax upon sale of such subsidiaries. Furthermore, Israeli holding companies will be exempt, inter alia, from tax on interest received on bank deposits in Israel and income (interest, dividend and capital gains) from traded securities. Foreign shareholders will benefit from a reduced withholding tax on dividends of merely 5%.

In contrast, the standard withholding tax rate is 20%. If a foreign company receiving the dividend is a shareholder with a substantial interest (i.e. holds an interest of more than 10% in the payer), the rate is 25%. Israel signed numerous treaties for preventing double taxation. Where, in a particular case, a treaty rate is higher than the domestic rate, the latter is applicable.

Benefits for immigrants

Israel is also doing its utmost to attract immigrants. New residents enjoy benefits no matter what their immigration status or visa. Even non-citizens immigrating for a short period of time, holding, for example, an expert visa, can partake.

One of the main benefits for new immigrants is a ten-year period (“benefits period”) during which passive, active and capital gain income from abroad is not subject to Israel’s fiscal system.

As for Israeli source income, a new resident will be exempt from capital gain tax on the sale of non-traded (i) securities of an Israeli resident company or (ii) rights in a foreign resident corporation, most assets of which are rights, directly or indirectly, in assets located in Israel, which were purchased by the new resident while being a foreign resident, if the securities or rights were not acquired from a relative of the new resident. The exemption will generally not apply on the sale of securities of a real estate company.

In addition, a new resident may choose not to be considered an Israeli resident for tax purposes for his first year in Israel, provided that he informs the assessing officer about his choice within 90 days from his arrival.

During the benefits period, there are also benefits for foreign corporations held by the new resident.

1. A corporation is domiciled in Israel if:
 - it is incorporated in Israel; or
 - its business is managed and controlled from Israel.

However, a corporation will not be considered domiciled in Israel only because the new resident is managing and controlling the entity’s business from Israel. This will apply also in the case where the new resident established a new foreign corporation after his immigration to Israel.

2. Also, in general, a foreign company whose income is derived from a “special profession” and at least 75% of its control held by Israeli residents is deemed to be an Israeli company.
3. In addition, a foreign company will be considered a Controlled Foreign Company if, among others provisions, more than 50% of its control is held by Israeli residents. Undistributed profits of such a company will be deemed distributed to the controlling (Israeli) shareholders at the end of the tax year, pro rata to their share.

However, for purposes of these provisions, including for examining the control of such companies, the new resident will not be considered as an Israeli resident during the benefits period.

For more information, contact Harel Locker, Tax Partner, of S. Friedman & Co. Law Offices.

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Immigration and employment: A complex challenge



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Israel's labour market is a reflection of the country's complicated demographic patchwork. This brings strengths and weaknesses.

If you are examining the Israel labour market for the first time, probably one of the first features you will notice is how international it is, given its relatively small size. The country, which has a population of just 7.5 million, has managed to integrate massive influxes of immigrants from the worldwide Jewish diaspora into its workforce. In the 1990s no less than a million immigrants from the former Soviet Union alone were absorbed, mostly to the benefit of both newcomers and locals.

But Israel is a divided society. It has the highest poverty rates in the OECD, attributable in part to low labour force participation among certain groups of the population. And while some other Jewish immigrant groups remain excluded, Israel's non-Jewish temporary and foreign labour migration system is in need of major reform. These messages were made clear in the OECD's 2010 *Review of Israel's Labour Market and Social Policy*, which provides some sharp insights into this complex labour market. The report

found considerable challenges ahead for policymakers—tackling poverty and inequality while increasing labour force participation under fair employment conditions. Israel can learn from OECD experience in this respect. Yet, as a country founded on immigration, Israel can also offer some compelling lessons in labour market integration.

Israel's labour market is deeply segmented. Alongside Israel's highly-skilled, high-tech labour force is another far-removed demographic group, marked by high non-employment rates. Labour force participation in Israel is 64% among the working-age population—considerably lower than the OECD average of 71%. This reflects gaps in workforce participation for the two main disadvantaged groups in Israel, Arabs and Ultra-Orthodox Jews, or Haredim. Only 20% of Israeli Arab women work while three out of four male Haredim forgo paid employment for lifetime religious study. Those that do work from both groups are likely to have low-paid employment. For these two groups, poverty and labour force participation are inexorably linked.

According to Bank of Israel statistics, just over half of the Arab population and 60%

of the Haredim live in poverty. Meanwhile, poverty rates for the rest of the population are at 12%. These significant gaps result in a Gini coefficient (whereby the higher the number, the wider the income inequality) of 0.38, higher than the OECD average of 0.31. And such striking inequality exists in spite of Israel's strong economic growth over the last 20 years: except for slumps in 2000 and the current downturn, GDP has grown by at least 4% per year in real terms since the early 1990s. But too many Israelis have been left behind, and the high rate of non-employment is a large factor.

According to OECD experts, good government policy must play a role in bringing people out of poverty and reducing inequality. At 0.4% of GDP in 2007, Israel's public spending on labour market policies is low compared with OECD countries. Nevertheless, one programme has seen some successes. The Wisconsin Programme—modelled after its namesake state's “workfare” initiative—was part of the government's strategy to increase labour market participation among Arab and Haredi groups. In a few pilot regions, working-age individuals who received income support spent 20 to 40 hours a week working. The programme came to an end in 2010. Israel has also used an earned income tax credit to target low-income workers. However, the amounts are small and take-up is low, according to the OECD.

When Israel joined the OECD in September 2010 it seemed that the country had turned the page on immigration. Current rates were well below most OECD countries and since 2002, net immigration has represented only 12% of population growth, compared with the OECD average of 50%. Yet almost 40% of workers in Israel are born abroad—one of the highest ratios in the OECD.

Behind this figure are two separate stories of immigration and labour market integration. The first story—Jewish immigration—has largely been a success, with 60 years of government integration

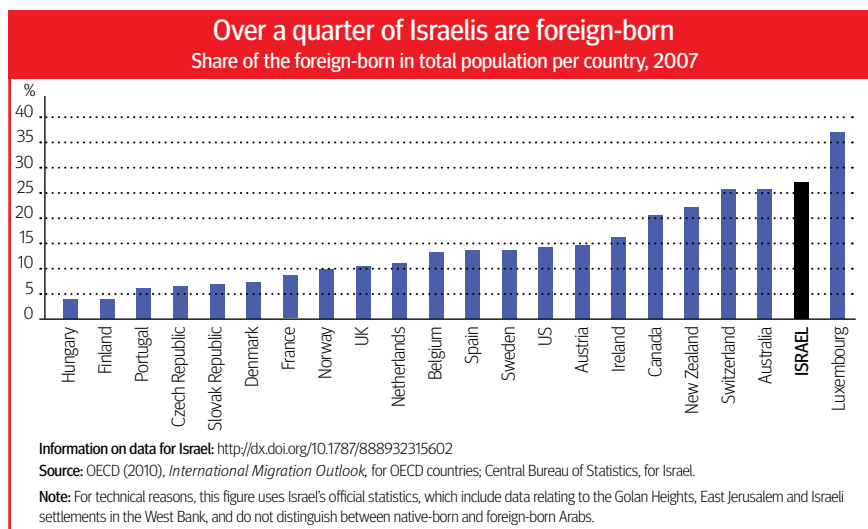
policy. The other face of immigration is that of non-Jewish foreign workers, almost 9% of the workforce, whose employment conditions are poor, with low pay, unpaid overtime, no training and limited job security.

“Israel provides an example of what can be achieved when there is a strong institutional commitment to supporting the integration of newcomers, and also what some of the limits are,” said OECD migration specialist Jonathan Chaloff.

On the eve of statehood in 1948, almost 65% of Israel’s Jewish population consisted of immigrants who had fled persecution and genocide in Europe, according to Israeli government statistics. Initial inflows were enormous relative to the population: 26.2% in 1949, 14.5% in 1950 and 12.8% in 1951. The Law of Return in 1950 stipulated that any Jew is entitled to immigrate to Israel and obtain full citizenship, known in Hebrew as *aliyah*, or “ascent.”

While most Jewish immigrants then were Ashkenazi from Central and Eastern Europe, the 1950s saw the arrival of entire Sephardic Jewish communities from North Africa and Mizrahi Jews from the Middle East. By the end of the decade, a majority of the ancient Jewish communities in the Arab world had resettled in Israel. An array of institutions helped integrate these immigrants, often destitute and low-educated. The Jewish Agency, a governmental body formed in 1929 to “resettle the Jewish people in its homeland,” helped organise airlifts and evacuations from around the world. Numerous “development towns” were created in the country’s peripheries to house Sephardic and Mizrahi Jews. Meanwhile, the *ulpan* Hebrew language teaching system gave Israelis a common language bond. In 1968 the Ministry of Immigrant Absorption was created to share the work with the Jewish Agency.

According to the OECD, central planning objectives dictated how newcomers were dispersed from transit centres to



development towns through the country. Unskilled immigrants were employed through make-work programmes and public employment. Development towns fared rather poorly, contributing to some of the inequalities still existent today between Sephardic and Ashkenazi Jews.

The situation changed in the 1980s, as migration flows into Israel slowed to a trickle. By the late 1980s, the Ministry of Immigrant Absorption had shifted to a market-based approach, consisting of a “basket” of benefits for immigrants. This new system was put to the test in the 1990s. When the Soviet Union crumbled in 1990-91, Israel’s population exploded by almost 20% as Soviet Jews poured into Israel under the Law of Return. Almost 333,000 arrived in the first few years, putting an immediate strain on Israel’s teetering finances. But a number of circumstances allowed for a remarkably smooth integration.

Immediate citizenship allowed Soviet immigrants unrestricted access to the labour market. Their “basket” of benefits on housing, education and consumption provided for seven months of cash grants above the minimum wage and became the *de facto* policy for Russian immigrants in the 1990s. Most Soviet Jews chose this “direct absorption” over state-run reception centres.

The 1990s also saw the emergence of a dynamic high-tech industry, and many experts now view the arrival of 82,000 Soviet-trained engineers as a catalyst. In the 1980s, Israel only had some 30,000 engineers, but immigrants soon filled the ranks as engineers, scientists and IT specialists. However, these newcomers didn’t just join the high-tech boom upon arrival—they first started in low-skill jobs and slowly transitioned to white-collar jobs closer to their educational level.

For employers, Israel’s policy of Jewish immigration had also worked as a labour migration channel, allowing recruitment from a pool of educated and skilled workers. The OECD review found mainly positive outcomes for natives, including increased consumption, little competition with immigrants and most importantly, a general rise in overall incomes in the 1990s.

The other major recent wave of Jewish immigration, the 14,000 Ethiopian Jews who were airlifted during “Operation Solomon” in 1991, has fared significantly worse. With a poverty rate of 51.4%, Ethiopian immigrants are segregated from the rest of society. Almost 25% of these immigrants live in just 15 neighbourhoods, according to the OECD report. Harking back to earlier days, a centralised

absorption programme and publicly-run reception centres remain in place and the state spends three times as much per capita on absorbing Ethiopians. Although employment rates are increasing for Israeli-born Ethiopians, much work remains to be done.

According to the OECD, there is also considerable room for improvement on another avenue of immigration to Israel, that of temporary labour migration. Current Bank of Israel estimates show that 8.7% of the workforce consists of non-citizens. Historically, Palestinian cross-border workers have made up an important part of the temporary labour force, but since the early 1990s, a temporary labour migration policy has brought in non-Jewish migrant workers from Southeast Asia, China, Nepal, India and the Balkans to fill low-skill jobs. In 2008 there were about 200,000 such workers, mostly in domestic services, agriculture and construction. Almost half were irregular.

This system is in need of major reform, argues the OECD. Contrary to Israel's experience of workforce integration for Jewish immigrants, the OECD found that the large-scale admission of foreign workers has not brought a positive contribution to growth. The recruitment system is plagued with illegal fee-taking and other unlawful practices that benefit employers. There is also a lack of enforcement of existing legislation on the hiring of foreign workers, domestic labour law and working conditions.

"Israel's experience in the 1990s was a laboratory for studying the impact of large-scale migration on the labour force, and the long-term results have been positive overall," said Mr Chaloff. "Today's question is how best to manage low-skilled migration to benefit not just employers but the country in general. Israel is still searching for the right answer." *IM*

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Tourism: Rooms for improvement



Israel is a popular holiday destination, thanks to cultural and historical, but also leisure, attractions. But there are challenges to overcome.

Tourism in Israel has witnessed sharp growth since 2006, thanks to greater stability, economic growth, major marketing drives and an increasing interest worldwide in Israel as a rather unique tourism destination. According to the UN World Tourism Organisation, the industry has experienced an average of 12% growth in the past three years, while the ministry of tourism estimates tourism revenue at close to 2% of GDP.

The general manager of the David InterContinental Hotel sweeps his arm over the blue expanse of the Mediterranean, and then the row of high-rises along the northern shore of Tel Aviv. “You ask why tourism should grow here? Why shouldn’t it? Look at our assets: sunshine, smooth blue swells of sea, sand, and a vibrant economy,” exclaims David Cohen.

His counterpart at the Sheraton, a few miles north, is as adamant. “Our occupancy rate? It averages over 80%, and in peak seasons, July and August, we top 100%! We see growth continuing at 10% to 15% per year in the future,” explains Jean-Louis Ripoché, general manager of the hotel. The Sheraton is now planning new hotels in Tel Aviv and Jerusalem, including an upscale boutique hotel in Jaffa, the first to have a non-kosher kitchen.

The ministry of tourism does not conceal their enthusiasm: “2010 was a record year, with \$4.3 billion in tourist revenues, almost four times the 2002 income of \$1.2 billion,” explains Stas Misezhnikov, minister of tourism.

By the year 2015, the ministry of tourism forecasts that tourism revenues will have jumped another 43% to reach \$6.1 billion, derived from five million annual visitors. What is driving this growth? Experts point to several factors.

First, the indisputable advantage of being the location of a number of holy sites for the world's monotheistic religions. Israel capitalises on religious tourism, and is planning and implementing further projects in this area.

Another strong driver of tourism growth is the booming economy. Business travellers represent a healthy segment in total in-bound tourism, and the increasing demands of various engineering, high-tech and green industry sectors point to larger numbers of visiting managers.

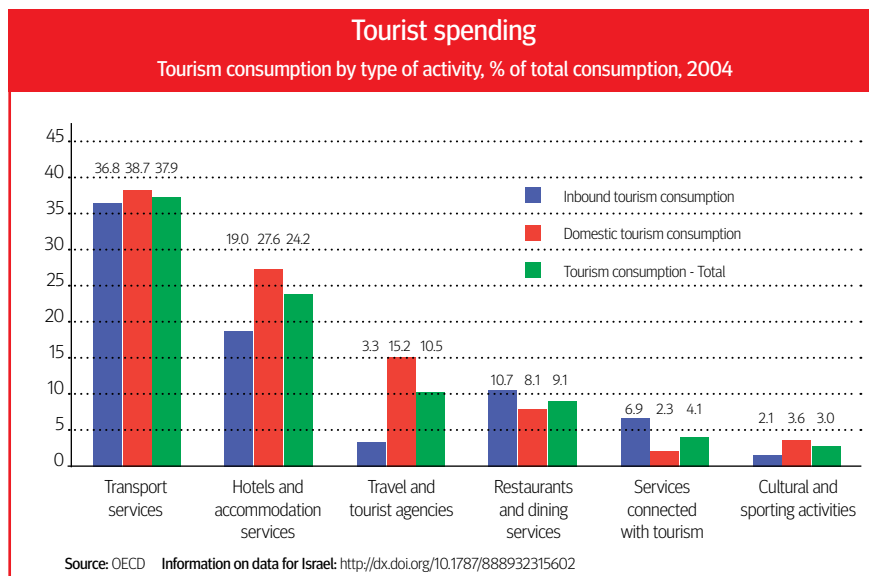
A third major growth factor for the industry is the opportunity presented by emerging markets. In order to increase visitor arrivals, Israel has signed co-operation agreements with over 30 emerging and

New hotels are currently under construction in Jerusalem, Herzliya, Ashdod, Netanya, Rehovot, Nazareth and Mitzpe Ramon

other countries, with positive results. Minister Stas Misezhnikov notes that "there has been a significant increase in the numbers of Russian visitors to Israel since 2005, and now we are seeing increasing numbers of South Americans, tourists from Central Europe, and visitors from the Far East."

Israel has a unique concentration of historic, cultural, religious and natural attractions, and is also one of the region's most developed destinations, with modern infrastructure and a wide variety of services and facilities.

Israel has enjoyed prosperity and stability for the past few years, but must still face the ongoing challenge of changing perceptions, notably about security. For Minister Misezhnikov, "there are still common misconceptions among potential visitors related to security. We spend an excess of \$55 million every year to position ourselves as a unique and attractive tourist



destination. This is a slow cumulative process that will lead us to achieve our goals with time."

Israel's reputation as a relatively expensive tourist destination compared with other Mediterranean competitors, such as Turkey, Morocco or Tunisia, represents a challenge. On the other hand, proponents point to Israel's excellent services and infrastructure, as well as its gourmet food and beautiful sites, which together mean good value for money.

Still, there are several bottlenecks to overcome, such as flight volume and hotel capacity. Building restrictions in Tel Aviv have slowed hotel growth, explain both the Sheraton and David InterContinental managers. "You must also consider that real estate prices are exploding," says Jean-Louis Ripoche. "That does not help hotel investment or room rates." That might well explain why no big new hotels have been built in Tel Aviv for the past 15 years.

But potentially the biggest challenge facing Israel is in relation to recent, and as yet unpredictable, political developments in the wider Middle East and North African regions, which could constrain tourism

development in the short to medium term. Nevertheless, the ministry of tourism continues to encourage investors. Today, Israel offers 400 hotels with more than 42,000 rooms available. Moreover, eight new hotels are currently under construction, in Jerusalem, Herzliya, Ashdod, Netanya, Rehovot, Nazareth and Mitzpe Ramon.

Overall, the increasing number of inbound tourists in the past few years and the continuous growth of tourism revenues shed a bright light over the future of the Israel tourism industry. According to Alain Dupeyras, the head of tourism in the OECD Centre for Entrepreneurship, SMEs and Local Development, "the continued opening up of the country's skies to low-cost airlines will certainly provide a powerful boost to Israeli tourism."

Mediaside

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