

**ISRAEL AND A EURO-MEDITERRANEAN INTERNAL
MARKET - A SURVEY OF EXISTING BARRIERS
TO TRADE AND POSSIBLE REMEDIES**

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Abstract

This paper tries to briefly estimate how integrated the Israeli economy and state currently are with the EC in the sectors and fields of cooperation that the Commission and the Euro-Mediterranean ministerial conferences have identified as important to the formation of a Euro-Mediterranean internal market. In each issue area the paper describes the Israeli commitments under the EMAA and relevant multilateral agreements, and the practice of EC-Israeli exchange. The EC-Israel bilateral agenda is not distinguished from the regional agenda, as both are interrelated, and both determine the practice of EC-Israel integration.

The paper first explores possible distortions to EC-Israeli trade in industrial goods arising from the asymmetric effects of rules of origin, drawbacks, standards, the embargo on dual use goods, boycotts of Israeli goods, exports from the settlements, obstructions to EC-Palestinian trade, and customs procedures. It then deals with trade in agricultural goods and trade in services. It describes Israel's commitments under GATS and elaborates the potential gains and difficulties in EC-Israel trade in services in five major sectors: Financial services, air and maritime transportation, tourism, telecommunication and trade in labor. Other issues explored include public procurement, foreign direct investments in Israel and the regulatory investment environment, intellectual property rights, competition, the EC's financial assistance to Israeli infrastructure development, and EC-Israeli cooperation in research and development.

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The general conclusion is that while Israel aspires to OECD institutional and legislative standards, die-hard monopolies still persist in various sectors, and well-intentioned government officials still believe in the need for government planning and regulation in many sectors. That being said, the transformation in Israel's economy in the past decade is remarkable and its trade with the EC is probably less distorted than that of its fellow Mediterranean countries. With the final completion of the financial liberalization process in 2003 more progress can be expected.

List of Abbreviations

- BP - Barcelona Process
- CEECs - Central and Eastern European Countries
- DIIME - Declaration on International Investments and Multilateral Enterprises
- EC - European Community
- EIB - European Investment Bank
- EMAA - Euro-Mediterranean Association Agreement
- EP - European Parliament
- EU - European union
- FATF - Financial Action Task Force
- FDI - Foreign Direct Investment
- FICC - Federation of Israeli Chambers of Commerce
- FTA - Free Trade Area
- GATS - General Agreement on Trade in Services
- GCC - Gulf Cooperation Council
- GDP - Gross Domestic Product
- GLP - Good Laboratory Practice
- GNP - Gross National Product
- GPA - Government Procurement Agreement
- ILS - Israeli Shequel
- IMF - International Monetary Fund
- IPR - Intellectual Property Rights
- MOF - Ministry Of Finance
- MOTI - Ministry Of Trade and Industry
- MRA - Mutual Recognition Agreement
- NCCT - Non-Cooperating Countries and Territories
- NTB - Non-Tariff Barrier

NTC - Non-Trade Concerns
OECD - Organization for Economic Cooperation and Development
OSCE - Organization for Security and Cooperation in Europe
PA - Palestinian Authority
ROO - Rules Of Origin
RTD - Research and Technical Development
SII - Standards Institute of Israel
SM - Single Market
SPS - Sanitarian and Phyto-Sanitarian
TASE - Tel Aviv Stock Exchange
TBT - Technical Barriers to Trade
TRIMs - Trade Related Investment Measures
TRIP - Trade Related Intellectual Property
UN - United Nations
UNSCR - United Nations Security Council Resolution
USTR - United States Trade Representative
WETA - Wider European Trade Area
WIPO - World Intellectual Property Organization
WMDBM - Weapons of Mass Destruction and Ballistic Missiles
WTO - World Trade Organization

1. INTRODUCTION

The last decade has been one of dramatic developments, both in the politics and economics of Israel. Gross Domestic Product (GDP) per capita increased from USD 12,000 in 1990 to USD 18,000 in 2001. Israel's purchasing power parity GDP per capita now equals 88 percent of the average among members of the Organization for Economic Cooperation and Development (OECD). The Israeli economy became more open and dynamic, with trade accounting for almost 80 percent of GDP. High-tech industries became the engine of economic growth, which averaged an annual 5 percent in the 1990s. According to the World Development Report Israel ranks 36th and 32nd in terms of Gross National Product (GNP) and GNP per capita respectively, and 22nd in the UNDP Human Development Report. The International Monetary Fund (IMF) regards it as an advanced economy, and the World Bank Atlas defines it as a high-income economy (OECD, 2002, 15).

The underlying sources for this remarkable development of the Israeli economy were the growing international interest in emerging markets, and the favorable geopolitical conditions from the Madrid conference in 1991, through the Oslo process, and until the outbreak of hostilities in October 2000. In addition, since the mid-1980s the involvement of the Israeli government in the economy was reduced, regulated sectors were liberalized, and public companies were privatized. Israeli authorities became increasingly successful in controlling inflation, government deficits and national debt. During the 1990s Israel also liberalized its exchange system. In May 1998 the Israeli Shequel (ILS) became almost fully convertible (OECD, 2002, 25-7).

Israel and the European Community (EC) signed a Free Trade Area (FTA) agreement in 1975, which has been implemented in full since 1989. Since the late 1980s Israel has been seeking to deepen its economic cooperation with the EC. The relationship had to be adjusted to the economic and technological developments in the world, and to the changes in the EC itself, such as the Single Market (SM) program and the admission to the EC of new members, including three Mediterranean countries - Greece, Spain and Portugal. The demise of the Soviet Bloc increased the interest of the EC in its southern flanks. The Gulf Crisis, in particular, demonstrated the dangers of Middle Eastern instability to Europe. In this context, the peace process that started at the Madrid Summit of 1991 was a major factor in the EC's willingness to respond positively to Israel's needs.¹

Thus, the European Council decided in Essen in December 1994, "that Israel, on account of its high level of economic development, should enjoy special status with the European Union (EU) on the basis of reciprocity and common interests" (Commission of the European Communities, 1995, 147). In fact, the German version of the declaration translates literally as "privileged status." The negotiations toward a new agreement, which lasted from

¹ The author is well aware that the European Union (EU) was established at the beginning of 1992. However, since the paper deals with Israel's economic relations, the EC is generally the proper reference.

September 1992 to November 1995, led in the end to the conclusion of a Euro-Mediterranean Association Agreement (EMAA) between the EC and Israel.² Israel's privileged status was reflected in its association, since August 1996, with the EC's Framework Programs for Research and Technical Development (RTD). Israel was the first non-European country to be associated with these framework programs.

This new approach towards Israel is part of the new policy of the EC toward the Mediterranean region as a whole, known as the Barcelona Process (BP). The BP, launched in 1995, aims at enhancing economic development, democracy and liberal values in the Mediterranean basin; the lack of these so far is deemed by the EC to pose an increasing threat to its own political stability. Euro-Mediterranean cooperation in the BP encompasses three "baskets": Economic, political and cultural. These baskets are reflected in the EMAAs, which the EC has so far concluded in the framework of the BP with all of the Mediterranean countries (including Jordan) except for Libya and Syria.³ Each EMAA consists of provisions allowing for a FTA in industrial goods, and liberalization of trade in agricultural goods and services, capital movements, government procurement, competition policy, and protection of Intellectual Property Rights (IPR). Each EMAA also consists of a bilateral political dialog, and cooperation on cultural and social matters. The implementation of each EMAA and dispute settlement are governed by an Association Council, and an Association Committee.

Within the economic basket the aim of the BP is to establish by 2010 a FTA among the EC and all Mediterranean countries, based on the EMAAs and on FTA agreements between Mediterranean countries. To this effect the EC has been pressing for liberalization of Mediterranean economies and structural adjustments. The MEDA financial assistance program has been set up, through which the EC helps in the development of infrastructure and the business communities in its partner. The BP is taking place within

² See Dafni, 2000; and 2001; Kosnikowski, 1999; and Paasivirta, 1999.

³ Negotiations with Syria are ongoing. Libya is not part of the Barcelona Process.

the context of agreements of the World Trade Organization (WTO), and aims to be compatible with them. Thus, the EC has been urging its Mediterranean partners to join all of the WTO's multilateral agreements and commitments, including the General Agreement on Trade in Services (GATS).⁴ Annual Foreign, Industrial and Trade Ministers Conferences have been established to develop the BP as a common interest, in addition to the Euro-Mediterranean committee, which acts as a steering committee. Working groups have been established on industrial cooperation, Rules of Origin (ROO), services, and regional-integration-related trade measures. Businesses, environmental, research, and cultural networks have been established as well.

Thus, while initial activity in the context of the BP focused on allowing duty-free trade among the Mediterranean partners, increasingly the focus is shifting to wider and more fundamental issues. The Euro-Mediterranean Ministerial conference on Trade decided to implement an Action Plan on Trade and Investment Facilitation covering customs procedures, standardization, regulatory framework for investment, protection of IPR (Commission of the European Communities, 2002a). The Fifth Euro-Mediterranean Conference of Ministers of Foreign Affairs in Valencia in April 2002 endorsed this Action Plan, and asked that the harmonization of ROO and liberalization of services would be considered as well (Commission of the European Communities, 2002b). These plans for further liberalization of trade and harmonization of technical issues, which would otherwise form barriers to trade, follow on the proposals of the Commission of the European Communities (the Commission).⁵ The Commission also recommended improving market access in agriculture and increasing financial assistance to the Mediterranean partners.

The tendency to view the BP not merely as a scheme for regional trade integration but as a process of profound economic and political change among the participants follows on the same Neo-Functionalist logic on which the EU is founded. Cooperation in

⁴ See COM (2000) 497 final, 6, 8.

⁵ See SEC (2002) 159 final.

supposedly simple and technical issues spills over to much more fundamental issues, increasingly impinging on state sovereignty. Thus, in its recent recommendations to foreign ministers of participant states to the BP, the Commission states that proposals should be put forward "...with a view of introducing the appropriate reforms for the gradual development of a Euro-Mediterranean internal market."⁶

This paper tries to briefly estimate how integrated the Israeli economy and state currently are with the EC in the sectors and fields of cooperation that the Commission and the Euro-Mediterranean ministerial conferences have identified. The paper assesses the existing barriers to trade and the required remedies. Section 2 explores possible distortions to EC-Israeli trade in industrial goods arising from the asymmetric effects of ROO, drawbacks, standards, the embargo on dual use goods, boycotts of Israeli goods, exports from the settlements, obstructions to EC-Palestinian trade, and customs procedures. Section 3 deals with trade in agricultural goods.

Section 4 is devoted to trade in services. It describes Israel's commitments under GATS and elaborates the potential gains and difficulties in EC-Israel trade in services in five major sectors: Financial services, air and maritime transportation, tourism, telecommunication and trade in labor. Section 5 analyzes the issue of public procurement. Section 6 discusses Foreign Direct Investments (FDI) in Israel and the regulatory investment environment. Section 7 elaborates on the issue of IPR. Section 8 focuses on the legal and institutional innovations in Israel in the recent decade that improved competition in the markets, and contrasts them with data on the concentration of the Israeli economy. Section 9 is devoted to the EC's financial assistance to Israeli infrastructure development over the years. Section 10 deals with EC-Israeli cooperation in research and development. Section 11 concludes.

⁶ See SEC (2002) 159 final, 14.

This is not a legal review of the differences in the laws and codes that regulate these issues in the EC and Israel. Rather, in each issue area this paper describes the Israeli commitments under the EMAA and relevant multilateral agreements, and the practice of EC-Israeli exchange. Multilateral agreements are increasingly emphasized by the Commission as a common ground, the adherence to which by all parties would help achieve a Euro-Mediterranean internal market. In addition, this paper does not distinguish EC-Israel bilateral agenda from regional agenda, as both are interrelated, and both determine the practice of EC-Israel integration. Obviously, the issues this paper encompasses are vast, and therefore the present analysis should be viewed as of a preliminary nature.

2. TRADE IN INDUSTRIAL GOODS

The EU and Israel allow each other's goods duty free access according to the EMAA. Except for agriculture, Israel employs very little import licensing requirements. Israel has not been an active user of anti-dumping legislation or countervailing or safeguard measures in the 1990s (WTO, 1999, xxi).

Total trade between the EC and Israel has doubled in the last five years, from Euro 14 Billion in 1995 to Euro 26 billion in 2000. Excluding diamonds EC-Israel trade represented 32 percent of Israeli exports and 41 percent of Israeli imports. Israel's main exports to the EC are electrical machinery and equipment (39 percent), chemical products (17 percent), plastics and rubber (9 percent), agricultural products (9 percent), and optical and medical equipment (8 percent). Israel's main imports from the EC were electrical machinery and equipment (35 percent), chemicals (13 percent) and base metals (6 percent). In the last 20 years the share of EC-Israel exchanges in their total trade with the rest of the world has almost doubled, and currently Israel is the EC's 15th largest export market.⁷

⁷ See Second Meeting of the Association Council – Declaration of the European Union, 14271/01 (Presse 433 - G), 6.

The development of EC-Israel trade was accompanied by a growing Israeli trade deficit. In 1990 Israel's trade deficit with the EC amounted to USD 3.5 billion, which was equivalent to 102 percent of Israel's total trade deficit. In other words, Israel was at an aggregate surplus with its non-EC trade partners. By 2000 Israel's trade deficit with the EC inflated to USD 6.9 billion, which was equivalent to 159 percent of Israel's total trade deficit. At the same time Israel's trade surplus with the US rose from USD 643 million to USD 5.1 billion.⁸ The simultaneous incidence of Israel's deficit with the EC and its growing surplus with the US raised the possibility of distortions in Israel's trade and provoked studies over the right framework for Euro-Israeli relations.⁹ The following sub-section surveys a few explanations that were offered for this puzzle, including the asymmetric effects of ROO, drawbacks and standards.

A few technical and political bilateral issues plague Euro-Israeli trade in recent years and disturb the free flow of goods. The last five sub-sections explore them: The embargo on dual use goods, the boycott of Israeli goods in Europe, customs debts arising from exports to the EC of goods origination in the Israeli settlements, Israeli obstructions to EC-Palestinian trade, and customs procedures.

2.a. Hypotheses about the causes of Israel's chronic trade deficit with the EC

Conspiracy theory: The first and rather instinctive explanation was offered by some Israeli officials who complained that the deficit is the result of unfair trade practices on the part of the EC. Needless to say, EC officials flatly denied these suggestions.

The incomplete Single Market: Other officials argue that while European goods better suit Israeli consumption preferences than

⁸Israel's Central Bureau of Statistics (2001) *Statistical Abstract of Israel*, 52, Table 16.5.

⁹See Hirsch, Inbar and Sadeh, 1996. For earlier appraisals of EU-Israeli trade relations see Pomfert and Toren, 1980; and Silber and Berrebi, 1988.

American ones, the European market is less attractive to Israeli exporters than the American market because the internal market is still uncompleted. While this could have been a reasonable explanation in 1990, it seems less credible in 2000.

High-tech trade: Perhaps the growing US-Israeli trade in high-tech goods is responsible for the Israeli surplus in the late 1990s. According to this explanation, since Israel's overall deficit is macroeconomically determined by factors such as national saving and investment, its great surplus with the US forces a large deficit with the EC. While this hypothesis could go a certain distance in explaining Israel's trade deficit with the EC, it suffers two shortcomings. The first is that the high-tech sector was not developed in the early 1990s, when Israel's deficit with the EC was already growing. The second shortcoming is that the trade-balance forms only one part of Israel's current account, which is the true macroeconomic variable. The absence of comprehensive data on the direction of trade in services makes it hard to verify the high-tech explanation.

Distance: The effects of distance partly explain the fact that Israel does not have a trade deficit with the US (Sadeh, 1999).

The asymmetry of the ROO and the pan-European system of origin: An alternative explanation was offered by Sadeh (1999), who argued that the FTA agreements that Israel signed with its major trade partners are at fault. The FTA agreements between Israel and the US and between Israel and the EC redistributed welfare in favor of Israel's partners, and increased its trade deficit with them. Estimating a gravity equation, Israel's imports were found to be much more correlated with the existence of an FTA than its exports. This was especially pronounced in the 1990s, as the implementation of the FTA agreements progressed.

This asymmetry in the trade effects of Israel's major FTAs, which are inherently deficit-enhancing, was also supported by Foux (1997, 20), although in his estimates Israeli imports were unaffected by the FTA, while exports actually declined. The

tendency of these FTAs to widen Israel's trade deficit can be accounted for by the nature of the ROO.

Both the EC and the US are big and sophisticated economies. Their producers can in most cases exploit economies of scale without recourse to foreign subcontractors. Also, being geographically large they are economically diversified with a different specialization in different regions within. This again reduces the need for an international process of production. Israel on the other hand is a small economy that relies much more on foreign subcontractors (supplying different components and services) than the EC and the US. This in turn means that there are more Israeli exports to these FTA partners that do not comply with the ROO and are not tariffs-exempt, than Israeli imports from those partners that do not comply with the ROO.

Of course, cumulation of origin is recognized between the partners of FTAs, but not between them and third parties. For example, Israeli exports to the EC would not be tariffs-exempt if a significant portion of the Israeli good was produced in the US, in Eastern Europe or in the Far East. It can be assumed that Israeli exporters to the EC are much more involved with non-EC foreign subcontractors than EC exporters to Israel. This is because Israel is not part of the SM and has no borders with the EC members (Hirsch and Almor, 1996).

Thus, on the imports side, Israel experienced trade creations as well as trade diversions upon the establishment of the FTA with the EC, while on the exports side it experienced a muted positive welfare effect. Israel's FTA partners, in contrast, experienced muted trade creations and trade diversions on their imports side (not discriminating in favor of those Israeli producers who do not pass the origin test); they also experienced a strong positive welfare effect in their exports. In other words, *prima facie*, the asymmetry in the ability to comply with the ROO leads to an asymmetry in the balance of the FTA's welfare effects, in favor of Israel's partners (Sadeh, 1999).

To refine the argument further, an FTA agreement carries an additional distinct distortion beyond the usual distortions of trade agreements. Either the origin criterion is fulfilled (and a full exemption from the tariff is given to the member), or the criterion is not fulfilled (and no exemption at all is given). This discontinuity in the tariff level is a source of distortion. For example, a 50 percent non-European component in an Israeli good would not award it a tariff exemption, if more than 50 percent Israeli content is required (in reality the origin criteria in the Euro-Israeli FTA are not defined in terms of added value, but the logic still holds). Under a CU, however, the Israeli producer pays the full Common Customs Tariff only on 50 percent of the good's value when the non-European components are purchased. So effectively, the tariff is higher under an FTA for a small country producer, than under a CU. Similarly, it is higher under a CU than under an FTA, for a large country producer.

Recognizing this, Israel is keen on joining the pan-European system of origin, known also as the Wider European Trade Area (WETA), which was established between the EC and its European trade partners in recent years and is gradually being implemented since 1997. The system ensures harmonization of the ROO among the members and diagonal cumulation of origin among them (Hirsch, 2001b).¹⁰ In March 2002 the Euro-Mediterranean Ministerial Conference on Trade agreed to the principle of the participation of Mediterranean partners to the system of pan-European cumulation of origin. A special working group, which was set up by the trade ministers in May 2001, is currently working out the details of this participation (Commission of the European Communities, 2002a).

Joining WETA would enable Israel to export tariff-free products made in eastern European countries to the EC.¹¹ In order to join

¹⁰Diagonal cumulation of origin allows peripheral country A to use inputs from peripheral country B in the production of a good exported to the EC while still identifying the final good as a country A good.

¹¹Currently Israel enjoys only bilateral cumulation of origin with the EC. Therefore, Israeli goods with East European inputs may not comply with the ROO in the EMEA.

WETA Israel must modify its trade agreements with those countries and adopt the WETA ROO model. Since the differences between the ROO in these agreements and the WETA model are relatively minor, this can be done in a relatively short time. The modification of the ROO in the EMAA merely requires approval by the Euro-Israeli Association Council, without member states' involvement and a long ratification process. While allowing diagonal cumulation of origin can greatly develop Israel's exports to the EC, the harmonization of ROO in itself should not entail significant effects on Israel's trade (Hirsch, 2001a; and Hirsch, 2001b).¹²

Drawbacks: Another FTA-related factor possibly accounting for the simultaneous incidence of Israel's trade deficit with the EU and its balance with the US are drawbacks. Drawbacks are refunds that an exporter gets from his home country's customs authorities due to tariffs paid on imported inputs used for the production of the exported goods. Such refunds are considered to be a kind of export subsidy, and are therefore banned under the EMAA (as well as in all of the trade arrangement in Europe). However, under the American-Israeli FTA drawbacks are permitted.

Standards: Another asymmetry in the application of the FTA agreement stems from the difficulty of Israeli producers in certifying their quality. Wherever the EC standards are applied in EC-Israel trade, the Israeli producers are often at a relative disadvantage, having to adjust themselves to these standards and go through expensive tests in Europe. To this effect the Israeli Ministry of finance (MOF) has sought to reach a Mutual Recognition Agreement (MRA) with the EC, which would allow both mutual recognition between the laboratory accreditation authorities of the EC and Israel, and mutual recognition in EC and Israeli standards (Dafni, 2001). The European authorities refused this so far, arguing that MRAs such as those reached between the

¹² According to Israeli trade officials the EC is currently in the process of modifying its agreements with the CEECs. Once that process is complete Israel is expecting to receive from the Commission a revised draft of the EMAA ROO protocol.

EC and Japan and the US are technically very complicated and are not justified in the case of the small Israeli economy. Officials in the Standards Institute of Israel (SII) are skeptical too of a Euro-Israeli MRA, arguing that the SII is often able to help Israeli exporters to Europe in getting the certification they need.

Nevertheless, some progress was achieved in May 2000, when the Agreement on Good Laboratory Practices (GLP) entered into force, allowing Israeli laboratories to certify the fulfillment of EC industrial standards by Israeli producers of industrial chemicals, cosmetics, medicine, pesticides, and food additives.¹³ Israel submitted to the Commission a list of fields in which it would like to negotiate mutual recognition of laboratory tests. These include pressure vessels, telecommunications terminal equipment, medical services, electromagnetic compatibility, low voltage, and machinery (Hirsch, 2001a). Anyway, increasing global harmonization of standards gradually erodes the potential benefits of a bilateral MRA. A related issue, which mostly falls under consumer protection, is the Israeli desire to participate in the European Rapid Alert System, alerting consumers to damaged or malfunctioning goods and removing them from the market (Hirsch, 2001a). The Commission's initial response was positive and Israel is currently preparing a draft proposal.

A more profound way to solve the standards problem is for Israel to adopt the EC standards. For example, in 1993 the SII introduced the Green Label, for environmentally friendly products, based on EU Directive 880/92 (WTO, 1999, 68). However, Israeli adoption of EC standards, a possibility that so far was not raised officially, could put Israel at odds with the United States Trade Representative (USTR), since American industrial standards differ from those of the EC. In fact, according to Israeli officials the USTR has sought in a number of cases to alter Israeli standards to better suit American manufacturers. Examples include standards of ladders, food products and cars, and allowing products to be marketed in round non-metric weight units (such as pounds and ounces). Generally, some Israeli officials see potential for

¹³ See *Official Journal*, L263, 9 October 1999, and <http://www.eu-del.org.il>.

participation of the SII in the European system of standards institutes, because of the greater participation of European institutes in the making of standards, compared with American institutes, which are mostly private. Under the European system, each national institute carries one vote, and thus, as a small country Israel could exert greater influence on new standards than in the context of its bilateral relations with the main trading blocks.

Anyway, the tendency in the 1990s has been to reduce the scope for mandatory standards. Israel has amended its standards law, aimed at meeting its commitments under the WTO's agreement on Technical Barriers to Trade (TBT). In January 1998 the Standards Law was narrowed so that fewer standards could be made mandatory. The status of about 250 standards changed from mandatory to voluntary or partially mandatory. Some 500 mandatory standards still exist, mostly in the food and electrical engineering sectors, although a quarter of these are equivalent to international standards (WTO, 1999, 67-9).

In spite of this progress, Israeli importers often view the SII as heavily influenced by the interests of the Israeli industry. They complain that Israeli standards are sometimes tailored to the needs of the local industry, and designed to thwart foreign competition. Examples include certain requirements for Kosher labels, and restrictions on the size of letters on the package, and on marketing foreign private labels in Israel. Israeli importers argue that tailored standards are applied to glass bottles, electrical sockets, ladders, instant coffee, tea, aerosols, electrical transformers, car engines, special shoes, industrial vacuum cleaners, and cement. The Federation of Israeli Chambers of Commerce (FICC) complains that in addition to this violation of the principle of national treatment, the SII is acting to preserve its monopoly over certification in Israel. This monopoly, which according to the FICC allows the SII to charge unreasonable prices, is to be replaced by a competitive certification market, according to the decision of the Israeli government of August 2000.

2.b. Israel and the European embargo on dual use goods

The EC's regime for the control of exports of dual use items and technology, based on Council of Ministers' (the Council) regulation 1334/2000, entered into force in September 2000 and is an integral part of the Common Commercial Policy. According to this regulation, exports of items and technology that can be used to develop, produce, handle, operate, maintain or store Weapons of Mass Destruction or Ballistic Missiles (WMDBM) require special authorization (Annex I), except for intra-EC trade and exports to ten specifically listed non-member states (Annex II).¹⁴ Special authorization is also required for exports of non-WMDBM items and technology that can be intended for military end-uses to countries that are under an arms embargo by the EU, the Organization for Security and Cooperation in Europe (OSCE) or the United Nations (UN). Each member state can put together its own list of such items (Article 3, Paragraph 2). Finally, Article 5 allows each member state to prohibit or restrict the export of items that it considers to be of dual use for reasons of public safety or human rights.

Thus, the EC's regime for the control of exports of dual use items and technology can be described as a three-layer regime. At the top layer, relating to WMDBM, both the items and the banned destinations are collectively and specifically defined. At the middle layer, relating to exports of non-WMDBM items with possible military end-uses to countries under an arms embargo, the banned destinations are defined collectively, but the banned items are defined nationally. At the bottom layer, relating to exports of non-WMDBM items with possible military end-uses to countries that are not under an arms embargo, both the items and banned destinations are defined nationally. In other words, the rules of the regime are tight at the top layer, but loose at the bottom layer. However, the implementation of this regime is left to the member states, since the power to authorize exports rests with them, rather

¹⁴ Annex IV lists additional items that are so sensitive that they need an authorization to circulate even within the EC.

than with some supra-governmental, inter-governmental or non-governmental organization.

As Israeli-Palestinian violence intensified, some have sought to apply the EC's dual use regime at the middle and bottom layers to the Middle East. In April 2002 the European Parliament (EP) called on the Council to institute an arms embargo on Israel and the Palestinians. In fact, the EP also called on the Commission and the council to suspend the EMAA.¹⁵ The fact that this call so far went unheeded is only of partial comfort for Israel since it reflects the public opinion in Europe and sometimes the official opinion too.

It is at this point that the looseness of the rules at that bottom layer of the EC's dual use regime comes into play. While no EC policy with regard to exports of dual use items to Israel was made public, increasingly EC member states restrict exports to Israel under the dual use argument. These restrictions result to some extent from legitimate decisions regarding specific items, but mostly from an enhanced enforcement effort in the Israeli case. This discriminatory enforcement of the dual use regime is in violation of the national treatment principle.

These developments are a cause for growing concern among Israeli businessmen and officials. The restrictions are applied mostly on Israeli imports of electronics, chemicals and metals, and mostly by the authorities of Britain and Germany. For example, Germany refused to export tank spare parts, and Britain suspended the sale of parts of fighter jets. While these two states are generally among the more pro-Israel of the member states, their decisions are potentially more damaging to Israeli imports as they constitute major sources. Other known cases were the refusals of Belgium and Austria to export handguns to Israel. Somewhat surprisingly, France, which is often regarded as the more pro-Arab among the member states, has generally not been enthusiastic to apply the dual use regime to Israel, although it did refuse to export riot gear.

¹⁵ See the EP's resolution on the Middle East P5_TA (2002) 0173 of 10 April 2002.

Israeli officials are so far mostly successful in convincing European trade officials that the items are not destined to military end-uses. When needed problems are solved at the ministerial level. In the end the damage to EC-Israel trade is mostly in the delays caused to shipments, and the bureaucratic hassle involved. Sometimes Israeli businessmen and the government simply prefer to find alternative sources for such restricted imports, although such alternatives come at a delay as well. For example, certain Israeli imports are recently diverted from Belgium to the US. Arms sales are another example. From Israel's point of view the application of the European dual use regime amounts to a Non-Tariff Barrier (NTB). From the European point of view this raises the question of the effectiveness of the application of the dual use regime to Israel, which comes at a price for Europeans too.

2.c. European boycott of Israeli goods

Another issue that has a potential to disturb EC-Israel trade recently is a boycott of Israeli goods in Europe. Potentially, a boycott has three levels. At the state level, a boycott can be a government policy applied by the public sector, or a law, binding on individuals and firms as well. At the corporate level a boycott is the result of policies of firms. At the individual level a boycott is the result of many decisions by individual consumers, whether coordinated by NGOs or not.

While European governments and the Council have so far refrained from suspending the EMAA, calls for a boycott of Israeli goods were sounded in Europe at the corporate and individual level. At the corporate level a few cases of stores refusing to purchase Israeli goods are known in Scandinavia (mostly in Norway, which is not an EC member state, but also in Sweden and Denmark), Belgium and Britain (Selfridge). This boycott was mostly directed at Israeli food products and cosmetics. So far almost all of these decisions were reversed following pressure on the stores from pro-Israeli consumer lobbies.

At the individual level data is harder to come by, but Israeli trade officials detect a decline of sales of Israeli consumer goods in

Scandinavia. This is true especially for Israeli fresh produce, where the origin of the goods is clearly marked. The boycott against Israeli goods at the corporate and popular level has caused unease to the Norwegian government, to the extent that in the spring of 2002 the Prime Minister came out with a declaration supporting trade with Israel. Somewhat surprisingly in France the possibility of a popular boycott against Israeli goods was only recently raised by anti-Israeli lobbies and may be currently gathering support. However, Israeli officials reckon that the French legal system provides Israel with ample remedies.

2.d. The Israeli settlements in the occupied territories

The EC decided not to recognize products originating outside the green line (Israel's 1948 border) as having an Israeli origin. While this view is popular in Europe, the EMAA does not define the territory of the State of Israel. Israel unilaterally annexed the Golan Heights and Eastern Jerusalem, and in practice applies the Israeli law to the settlements in the West Bank and the Gaza strip as well. The Commission argued that public international law takes a different view, and supported its argument in relevant United Nations Security Council Resolutions (UNSCRs) and UN General Assembly resolutions. The Commission argued that although not adopted under Chapter VII of the UN charter, those UNSCRs are an authoritative interpretation of international law. Others have argued that the settlements are illegal according to the 1949 Geneva Convention IV, which prohibits the transfer of the civilian population of an occupying power into the territory it occupies.¹⁶

Although the main motive of the above decision in 1998 was political, so far both parties seemed keen to maintain a technical profile to the issue. In its memorandum on the matter, the Commission put it in the context of the desire to allow cumulation of origin among Euro-Mediterranean partners.¹⁷ Exports from the settlements to the EC with an Israeli certificate of origin were

¹⁶ See Paasivirta, 1999, 315-6; and SEC(1998)695 final, 7-8.

¹⁷ See Council conclusions of 29 June 1998 (Bull. EU 6-1998, point 1.4.98); and SEC (1998) 695 final, 3.

violating the EMAA's protocol on ROO in the Commission's opinion, and therefore, were obstructing the progress towards cumulation of origin in the Mediterranean, and the developments of EU-Israel relations. In the next paragraph the Commission put the settlements issue on a par with the infamous orange juice case, explaining that such matters of ROO have been encountered and solved in the past.¹⁸

Various working groups have tried to tackle the issue on a technical level, involving customs officials from both parties. 2500 certificates of origin were sent for examination by the Israeli customs authorities, which starting in March 2001 have been sending back verifications for certificates in question. In May 2001 Israel formally announced that all certificates in question were verified, and all comply with the requirements of the EMAA (Arbeli, 2001). Of course, the Commission took a different view. Thus, in November 2001, following a meeting of the Euro-Israeli Association Council, the Commission published a notice (Avis) warning EC importers of products coming from the settlements that they might be charged tariffs over these imports.¹⁹ In addition, based on Protocol 4 to the EMAA, the Commission has initiated in November a ten-month period of verification, at the end of which the Commission could start to collect the customs debt.

The next step could be legally binding arbitration, according to Article 75 in the EMAA. However, Israel probably prefers to avoid legal procedures, lest an international tribunal find in favor of the EC, and reinforce the opinion that the settlements are illegal. This could determine the borders of the State of Israel before the issue has been resolved in a political process between Israel and the Palestinians.

Israeli officials estimate industrial exports from the settlements to Europe at USD 100 million. The damage to these exports from the loss of duty-free access to the EC is estimated at a mere USD 5 million, since the MFN tariff on many of these products is very

¹⁸ See below.

¹⁹ See OJ C-328, 23 November 2001.

low. In anticipation of customs debt collection by the Commission, legislation is underway in the Israeli parliament (the Knesset) to compensate the settlers to this amount.

2.e. Obstructions to EC-Palestinian trade

Obstructions to EC-Palestinian trade distort EC-Israeli trade. Due to a lack of outlets the Palestinians depend on transit through Israel for their trade with the EC. The EC complains that Israel has not allowed the implementation of the 1997 EC-PLO Interim Association Agreement on Trade and Cooperation, long before the outbreak of the current hostilities. The 1997 agreement provides that the Palestinian customs authorities issue certificates of origin. In addition, the Israeli-Palestinian 1994 Paris Protocol on Economic Relations accords the Palestinians the right to export their agricultural and industrial produce to external markets without restrictions on the basis of certificates issued by the Palestinian Authority (PA) (Paasivirta, 1999). Therefore, the Commission concludes, Israel has acknowledged the PA's right to sign international agreements. However, the Paris Protocol also establishes the principle of the territorial indivisibility (for the interim period) of the Israeli-Palestinian customs union, which Israel argues is violated by the EC-PLO agreement. In practice, according to the Commission, Israel puts important barriers to the free movement of goods and does not grant Palestinian exporters trade and economic treatment on an equal footing.²⁰

Since many Palestinians cannot in practice export their goods to the EC, or might suffer damage and delay while attempting to do so, they are tempted to export it under an Israeli certificate of origin, according to the Commission. Often Israeli and Palestinian produce are mixed in the process, but sometimes the Israeli agent simply sticks a "Made in Israel" label on the Palestinian produce. Examples, according to the Commission, include cut flowers from the Gaza strip, strawberries, aubergines, oranges, lemons, pickles, fruit juice, shoes, leather products and garments.²¹

²⁰ See SEC (1998) 695 final, 9-10.

²¹ See Paasivirta, 1999, 323; and SEC (1998) 695 final, 11.

In the same manner, the Commission argues, Palestinian imports are suffering from Israeli practices. Israeli port and airport authorities have required all Palestinian importers to sign a legally binding pledge to sell imports from the EC only in the West Bank and Gaza strip, while Israeli importers were not required to sign such a pledge. This, of course, enables Israeli agents to enjoy a mediation rent, or avoid competition with a Palestinian importer of the same product.²²

For the same purpose, the Commission argues, the Israeli authorities delay or do not grant import licenses to Palestinians, making them dependant on Israeli agents (for example paint and pharmaceuticals from Germany, Britain and the Netherlands). While legitimate reasons may be given for such delays and refusals, at the same time an Israeli agent is often granted a license to import the same product.

2.f. Customs Procedures

Customs procedures have long been recognized as another form of technical trade barriers. Within the framework of its WTO commitments, Israel has modernized its customs valuation legislation in the 1990s. The customs valuation method has been changed from the Brussels Definition of Value to the transaction value method. Under the Brussels Definition of Value the value of imported goods was the value of the goods on the open market on the day when they are released from the custom authorities.

Israel also abolished in 1998 the "harama" system, which in the past increased the value of most imports by as much as 10 percent before tariffs were imposed. According to the "haramah" system, the Israeli customs authorities uplifted the value of most products imported by exclusive agents to bring it to an "acceptable" level for customs valuation (WTO, 1999, 30).

Two Euro-Israeli committees are in charge of resolving customs issues and developing cooperation in this field. The first is the

²² See SEC (1998) 695 final, 12.

Customs Cooperation Committee, established in accordance with Article 39 of Protocol 4 to the EMAA. The second committee is an informal framework of customs experts, established to maintain a professional dialog, as called for in Article 49. In September 2000 the first meeting of the informal group took place. The Israeli officials expressed their interest in joining the Commission's OLAF database, which is very useful for customs inquiries (Arbeli, 2001).

The cooperation between EC and Israeli customs authorities was put to the test in 1994, when the Commission reported that the Israeli authorities were asked to verify the authenticity of certificates of origin of certain goods. Specifically, the goods in question were orange juice concentrates, which were alleged to have contained an excess of non-originating components, entering the EC as tariff-free Israeli goods. In the absence of a satisfying verification on the part of the Israeli authorities the Commission called into question the ability of the Israeli authorities to implement the ROO. Accordingly, it published in November 1997 a notice (Avis) warning EC importers of non-originating products coming from Israel that they might be charged with tariffs over these imports (Paasivirta, 1999, 322). In its notice the Commission stated that "...various elements have come to light which confirm a lack of effective administrative cooperation... between the Community and Israel... to the extent that the validity of all preferential certificates issued by Israel, for all products, are put in doubt."²³

Obviously, these developments complicated EC-Israeli trade relations. Officially, any eventual customs debt would be recovered from EC importers. Thus, European businessmen were wary of dealing in Israeli goods. In effect Israeli exporters were often asked by their European counterparts to provide financial guarantees in case their certificates turn out unacceptable.²⁴ The Israeli authorities have undertaken to verify origin certificates from 1995

²³ See OJ C-338, 8 November 1997, 13.

²⁴ As were, according to the Commission, Palestinians exporting to the EC through Israeli agents. See SEC (1998) 695 final, 11.

onwards (Paasivirta, 1999, 322).²⁵ More than 2000 certificates were examined and some were indeed revoked. Finally, as stated above, in November 2001 the Commission published a new notice, replacing the one of November 1997.²⁶ The new notice, in addition to warning EC importers about goods originating in the settlements, stated that "...movement certificates for orange juice, found to be invalid, have been withdrawn by Israel and that the necessary measures have been taken to allow administrative cooperation..."²⁷

The orange juice case underscores the need for a better definition of responsibilities with regard to certification of the origin of goods. Under the EMAA the exporter has to apply to his home customs authorities for a certificate of origin. Each shipment needs a separate certificate, and the verification of the goods' origin is the responsibility of the national customs authorities. Only specially authorized exporters are allowed to issue certificates of origin on their own. This process is expensive and cumbersome, and involves many documents. However, in the end the certificate of origin carries very little information. In effect the customs authorities cannot open a real investigation each time they issue a certificate of origin.

On the other hand, the US-Israel FTA leaves the responsibility over certificates of origin for each shipment with the exporters. Specially-authorized exporters are even allowed to issue annual certificates of origin, rather than shipment-specific ones. The exporters are required to provide details on the certificates of origin, which would enable verification (Shimoni, 1997). The US-Israeli procedure for origin verification is much more efficient than the Euro-Israeli one. It is less of a trade barrier, more effective in ensuring honesty, and makes verification by the authorities easier. It is also important to make sure that disingenuous declarations of origin are a felony according to the exporting country's law.

²⁵ In fact, by 1998 the Commission has expressed its satisfaction at the progress achieved on this issue. See SEC (1998) 695 final, 3.

²⁶ See above.

²⁷ See OJ C-328, 23 November 2001.

3. TRADE IN AGRICULTURAL GOODS

Agricultural exports formed 3 percent of Israel's total export in 1999, and the EC's markets absorbed 76.2 percent of this trade. Almost one half of Israel's domestic agricultural product is intended for the EC markets. In 1998-2000 Israel's agriculture trade with the EC was in a small balance (roughly USD 100 million), with annual turnover averaging USD 1.5 billion. Israeli exports to the EC consisted mainly of cut flowers, vegetables (potatoes, tomatoes, sweet pepper, spices and herbs); fruit (oranges, grapefruits and avocado), seeds, raw cotton, and processed products. Israeli imports from the EC consisted mainly of bovine frozen meat, fish, milk powder, wheat, barley and corn.²⁸

Like the EC, Israel supports its agricultural sector through different means, including import quotas, licensing requirements, variable levies, and subsidization of inputs such as water and capital. A number of agricultural products receive unlimited protection against imports, as licenses to import them are not usually granted (Halevi, 1994; and WTO, 1999, 41, 82-91). Under the WTO's agriculture agreement, which entered into force in January 1996, Israel is considered a developing country, and as such is not required to tarifficate its trade barriers. Israel was allowed to impose any tariff it chose below a certain binding ceiling. The ceiling is decreasing over a ten-year period, starting with tariffs of hundreds of percents in some sectors, and averaging 24 percent in the process (Munin, 1996).

However, in practice Israeli applied rates are often lower than the binding rate, due to a liberalization program, which was devised by the MOF, the Ministry Of Trade and Industry (MOTI), and the Ministry of Agriculture. According to this program, imports of fresh produce with a CIF price lower than the local production costs will be subject to a 100 percent tariff. Imports with a CIF price higher than the local production costs, as well as off-season imports, will be subject to a 30 percent tariff. A rise in local

²⁸ Ministry of Agriculture's data and Israel's Central Bureau of Statistics (2000) *Statistical Abstract of Israel*, 51, Tables 6.7, 8.6 and 9.13.

wholesale prices beyond 200 percent of the local production costs will automatically trigger free imports. As for processed food, the Israeli liberalization program set the tariff ceiling at 100 percent at the beginning of a seven-year tariff-reduction process, and 50 percent at the end.²⁹ The program also established a 12 percent floor for the effective tariff at the end of the process (Munin, 1996). Agriculture has always constituted one of the most difficult issues in the negotiations between Israel and the EC, and the disagreement in this sphere was one of the last obstacles to the conclusion of the 1995 EMAA. In spite of the small share of agriculture in the GDP and the small share of the labor force of Israel and the EC employed in agriculture, both parties consider it an important sector from a political point of view. Over the past 30 years Israel's agricultural exports to the EC underwent a cyclical process of preferential treatment and preference erosion.

Thus, while mutual customs concessions were granted in the 1975 agreement, the fundamentals of EC-Israel agricultural trade changed significantly thereafter, damaging the Israeli agricultural exporters. Israel developed new agricultural products (mostly flowers), the European consumer's demand for traditional Israeli exports (such as oranges) declined, and the EC gave new concessions to other non-member states and was enlarged to the south. In order to adapt the EC-Israel agricultural regime to these changes, in 1987 the parties signed a fourth protocol to the 1975 agreement, according to which most of the Israeli agricultural exports to the EC were given zero-tariff quotas, and others were subject to reduced-tariffs quotas (Hirsch, 1996).³⁰

Alas, these preferences eroded further due to parallel concessions given to eastern European states, the establishment of the EEA, the

²⁹ A few sensitive products were allowed a 60 percent tariff ceiling at the end of the process, such as wine, apple and grape juice and concentrates, chicken, frozen vegetables and conserved corn, peas and carrots.

³⁰ The 1987 agreement also enabled reference quantities, which are arbitrary quantitative import restrictions, designed to protect the local producers in response to seasonal or unexpected changes in local and foreign production levels. However, reference quantities were never used in effect in EC-Israel agricultural trade, according to the Israeli agricultural representative in Brussels.

EC's 1995 enlargement to the north, and the 1994 Israeli-Palestinian Cairo agreement. Israel's agricultural trade deficit with the EC widened. The principal Israeli demands were to increase the existing quotas of flowers, to lower minimum prices of oranges, and to expand the seasonal periods allowed for the export of grapefruits. The EC representatives raised their own demands, such as in concentrated apple juice and butter. Finally, in the 1995 agreement the EC yielded in oranges, flowers and grapefruits, while Israel increased the quotas for several European products, such as apples and frozen beef (Hirsch, 1996).

A repetition of the process of preference erosion is inevitable. Specifically, the EC's anticipated enlargement to the east, and the gradual process of liberalization in agricultural trade at the WTO level would further weaken the relative position of Israeli agricultural exporters. In addition, the growing shortage of water in Israel is gradually changing the composition of Israeli agricultural production and exports. For example, cotton and citrus fruits are gradually being phased out.

In fact, Article 11 to the EMAA mandates further liberalization of EC-Israeli agricultural trade and an examination of the situation from 1 January 2000. Article 14 states that the Association Council shall examine the possibility of the parties granting each other further concessions. Article 15 states that the EC and Israel will examine, three years after the entry into force of the EMAA, the possibility of granting concessions in fisheries products. Indeed, following the entry into force of the EMAA a meeting of the Association Council decided to start negotiations on further liberalization of agricultural trade. Meetings took place in May and September 2000, and in May 2001. Israeli officials reckon that by now the negotiations are more or less complete at the experts level. The signing of the protocol is apparently awaiting political approval.

In the recent negotiations Israel was especially interested in expanding its export quotas in products that return a high yield relative to the water input, or in high value-added niche markets. These products include cut flowers, easy peelers (citrus fruits),

exotic fruit, fresh herbs, off-season greenhouse vegetables, and organic agriculture. The main obstacle in the negotiations was the price preference mechanism used by the EC in flowers. This mechanism is especially harmful to Israeli rose growers, who cannot know in advance whether they would receive a tariff concession. On the other hand, competing flowers from ACP countries (mostly Kenya) and from Morocco enter the EC free of tariffs (Shavit, 2001). According to Israeli officials EC officials were willing to address these grievances. Another problem is the EC's refusal to allow Israeli exports of olive oil.

On the other hand, EC officials were unhappy with the discriminating way in which Israeli Kosher requirements are applied to imports from the EC.³¹ In addition, special Israeli levies are applied as of January 1996 solely on EC products in yogurt, sweet corn, pasta, baked goods and ice cream (Munin, 1996).³² However, the demands of EC negotiators focused on larger quotas for its exports in milk powder, potato seeds, cheese, apples and pears, dried fruit and nuts.

Beyond export quotas, Israeli trade officials are concerned that veterinarian Sanitary and Phyto-Sanitary requirements (SPS) are increasingly replacing tariffs as trade barriers, and are seeking equivalence agreements with the EU, such as those recently signed with the US and Canada. Israeli importers of plants and vegetables from the EC share this concern and complain that the Israeli authorities make it very difficult to obtain a license. On the other hand, the EC and Israel cooperate at the WTO level in introducing Non-Trade Concerns (NTC) to the next WTO agricultural agreement. These center mostly around the preservation of the rural sector and the environment (Shavit, 2001).

³¹ For example, shrimps are imported to Israel from the US but not from the EC. In addition, non-Kosher meat can be produced locally but not imported.

³² The EC agreed to these levies at the time due to their sensitivity.

4. TRADE IN SERVICES

4.a. The GATS framework

Trade in services has grown in importance in recent decades. For example the external trade of the EC in services reaches about one-third of the value of its trade in goods. However, the provision of and trade in services are burdened by heavy national regulation. Even when the regulation is not intended to protect the domestic industry, it often has a non-tariff barrier effect. The thick regulation makes bilateral negotiations on trade in services very complicated and prolonged. Thus, the WTO's GATS provides a convenient global common ground for liberalizing trade in services. Like many other countries the EC and Israel prefer to regulate their trade in services in the framework of GATS.³³ So far no special agreement on trade in services was concluded between the EC and Israel. The EMAA (Articles 29-30) includes only a general statement on the need to widen the scope of the Agreement to cover trade in services, and a reference to the commitments of the parties under GATS.

GATS defined four modes of supply of services. The first is "cross-border" supply such as in computing services and software transmitted electronically. The second mode is "consumption abroad" such as in tourism and education. The third mode of supply is "commercial presence" such as in food and serving services. The fourth mode of supply of services is "presence of natural persons" such as foreign workers and foreign legal representation. The GATS definition of services excludes services supplied in the exercise of governmental authority such as law enforcement and security.

Under GATS the contracting states commit to particular obligations concerning market access and national treatment. Registering as "None" in a certain sector means no limitations are applied there

³³ The EC is regarded here as a block since discrimination in the provision of services based on nationality or place of residence is forbidden among the member states, and national legislation affecting trade in services is harmonized.

and trade is free. On the other hand, registering as “Unbound” means the contracting party is not committed to free trade. The GATS Agreement adopts the MFN principle, although some aspects of this principle are given a derogation, such as regional agreements in services. Each contracting state chooses the sectors and the modes of supply it is willing to bring under the terms of GATS (Hirsch, 1996; and Munin, 2000; and 2001).

Under GATS Israel agreed to varying degrees of liberalization in communication, financial, and tourism services. A number of additional services were allowed all modes of supply except the presence of natural persons. These include sewage and refuse disposal services, legal services (but commercial presence was limited to Israeli residents or citizens), accounting, architectural services, engineering services, urban planning, advertising, market research and public opinion, management consulting, scientific and technical consulting, photographic services, and computer services. Services incidental to mining and oil fields were allowed only the commercial presence mode of supply.³⁴

The remainder of this section will elaborate the potential gains and difficulties in EC-Israel trade in services in five major sectors: Financial services, air and maritime transportation, tourism, telecommunication and trade in labor.

4.b. Financial services

Under GATS Israel committed itself to allow foreign commercial presence in banking, insurance and securities, but as financial liberalization was not mature enough in the early 1990s Israel did not commit to the cross-border mode of supply. In April 1997 the EC (and US) invited Israel to bilateral negotiations on further liberalization of trade in financial services, in the framework of the general negotiations to conclude a GATS agreement in this field. The EC’s main requests from Israel were three. First, Israel was asked to ease the restrictions on capital flows. The second request was to commit consumption abroad of maritime transportation

³⁴ See GATS/SC/44.

insurance. Finally, the EC asked Israel to allow MFN treatment of foreign banks in Israel. Israel agreed to the second request and included it in the second supplement to the GATS schedule of commitments.³⁵ Regarding the other two requests Israel explained that restrictions on capital flows and on foreign bank activity were part of its exchange controls, and would duly be relaxed when the process of financial liberalization is complete (Susnitsky, 1997). Unfortunately, no progress has yet been achieved in liberalizing Israel's banking sector.³⁶

However, the process of liberalization of capital flows in Israel, which began in 1989, is almost complete. In 1993 Israel formally accepted the obligations of Article VIII of the IMF's Articles of Agreement, which prohibits exchange controls on payments and transfers for international current account transactions. In 1998 Israeli individuals were allowed complete freedom with regard to holding foreign assets, but the holdings of foreign assets by financial institutions such as pension funds and insurance companies were still restricted to no more than 5 percent of their portfolio. This limitation was since relaxed to 20 percent, and is planned to be completely waived in January 2003. In addition, the recently adopted tax reform plan is supposed, among other things, to reduce fiscal distortions to the capital account.

One of the unfortunate results of the liberalization process has been the attraction to Israel of money laundering activity. This caused the OECD-based Financial Action Task Force on Money Laundering (FATF) to include Israel in the list of Non-Cooperative Countries and Territories (NCCT). This meant that financial institutions were advised to take particular care when doing business and transactions with individuals, companies and institutions in Israel. Obviously, this had a significant potential to disturb capital flows to and from Israel. However, following measures taken by the Israeli government to close the legal loopholes, Israel was removed from the NCCT in June 2002, with the support of the EC. Especially, in August 2000 the Knesset

³⁵ See page 216.

³⁶ See page 218.

enacted the Prohibition on Money Laundering Law, and in February 2002 the Israel Money Laundering Prohibition Authority began to operate.

As the liberalization in capital flows progressed, the scope for the development of Israel's foreign trade in financial services expanded. The involvement in the Israeli economy of foreign financial institutions and companies brought to the fore the difficulties that financial regulation caused to trade in financial services.

In financial services, state regulation is intended to protect the customers and the stability of the financial system. Thus, national authorities closely monitor the activities of financial institutions in their territory. Providers of financial services must fulfill a minimum solvency margin, and foreign providers usually are required to hold some of their financial assets in the state's territory. Thus, in the absence of an agreement among states, international trade in financial services among them might suffer from a duplication of supervision.

There are generally two alternative principles according to which international trade in financial services can be regulated without duplication of supervision. The first principle, which the EC applies, is home control. According to this principle the state in which a financial institution is established is responsible for supervising its operations, whatever the territory in which they take place. Thus, financial institutions need only a single license in order to market their services all over the EC (Hirsch, 1996).

The second principle for regulating international trade in financial services is local control, under which each state supervises the activities of all undertakings in its territory, whatever their nationality. For example, in the EC insurance sector non-member undertakings need a license for each member state in which they operate. This is because the establishment in EC territory of branches of foreign undertakings is left to the discretion of the member states, which are required to consider a foreign undertaking separately from its head office. The solvency margin

of the foreign branch is calculated according to the volume of its own activity, and those assets that it keeps in the EC (Hirsch, 1996). The remainder of this sub-section is divided into the two main financial sectors: Insurance, and banking and capital market activity.

Insurance: In the insurance sector the Israeli authorities have consistently applied the principle of local control (except for reinsurance and direct insurance from abroad). Until the mid-1990s Israel was quite restrictive in allowing competition in insurance, particularly in life insurance. Considerable bureaucratic obstacles prevented not only the entry of foreign insurers but also the establishment of new Israeli competitors. These obstacles were excused by the need for exchange controls and financial stability. The expected contribution of the foreign insurers to the Israeli insurance industry and to the economic policy of the government was another alleged consideration (Sassoon, 1990, 236).

However, the strong pressure that the local insurance sector exerted on the Israeli decision-makers was also an important factor in policy-making. The rent of local insurers, especially in life insurance, was ensured by the government, which in addition to preventing competition guaranteed a high interest on the insurance companies' assets. Thus, a high level of concentration and relatively high prices characterized the Israeli insurance sector. During the negotiations leading to the conclusion of the EMEA the EC's proposal for broad provisions concerning trade in insurance services was rejected (Hirsch, 1999).

In spite of these obstacles to free trade, foreigners were not altogether banned from the Israeli insurance market. Lloyds and dozens of other foreign insurers had a representative in Israel for many years. About 75 percent of the total Israeli reinsurance was transacted with European firms, most of them from EC member states (Levi, 1994). In effect, the Israeli insurers were often mere intermediaries between the Israeli consumer and the European insurers.

Similarly, under GATS Israel agreed not to prohibit the entry of new foreign insurance firms into the non-life local insurance market and accepted the possibility of cross-border supply. It registered as 'None' in the cross-border and commercial presence modes of supply both in market access and in national treatment, and as 'Unbound' in the consumption abroad and presence of natural persons modes of supply. However, in life insurance and pension funds it committed only to commercial presence.³⁷

An important turning point came in 1995, when Doron Shorer was appointed as capital market commissioner in the MOF. During his office term the staff of his department was doubled and replaced with young liberal-minded professionals. The licensing procedure was changed, and applicants were granted a license solely on the basis of their ability to maintain an insurance business. As a result, new insurance companies entered the market, such as the Israeli insurer Direct Insurance in 1996, and the American insurer AIG in 1997. The entrance of the credit insurer EMI in 1998 enabled a significant expansion of the Israeli mortgages market. Currently, foreigners control some 12 percent of the Israeli non-life insurance market. In addition, the Italian Generali insurance company bought the Israeli Migdal insurance company in 1996 and gained control over some 30 percent of the Israeli life insurance market. The old insurance companies had to restructure, as their profits were no longer guaranteed.

However, limitations on the operations of foreign insurers in Israel persist. The first and minor barrier to foreign insurance companies is the minimum solvency margin set by the Ministry of Finance at USD 5-12 million. Another barrier is the current policy of the MOF that prefers foreign insurers to operate in Israel through the commercial presence mode, and is generally reluctant to allow new ones to operate through the presence of natural persons. In other words, setting up an Israeli subsidiary is encouraged, rather than opening a local branch or sending a representative. Existing foreign companies with a representative in Israel such as the German diamond insurer Delvag, the Swiss Alpina, and Guardian are

³⁷ See GATS/SC/44.

allowed to continue operating in this mode, but are required to keep a certain minimum of their assets in Israel.³⁸ Israeli subsidiaries of foreign insurers (such as AIG) are planned to be relieved of that requirement in January 2003, when the liberalization of capital flows would be completed. MOF officials argue that allowing local branches to operate exposes the Israeli insurance market to short-term considerations, while foreign direct investment has positive spillover effects.

Finally, the duplication of prudential requirements is also a barrier to foreign activity in Israel, as well as Israeli activity in the EC. Foreigners are subject not only to Israel's system of supervision, but also to supervision by their home states' authorities. While the same goes for Israeli companies in the EC, the potential profits from operating in a small market like Israel's are often too little to make this double regulation worthwhile (Hirsch, 1999). This difficulty could be overcome by the adoption of the EC's supervisory rules by Israel, and the full adoption of the principle of home control between the EC and Israel. In fact the MOF has already commissioned and received a report by external consultants on such possible harmonization.

In the 1997 round of GATS negotiations on financial services Israel switched to 'Unbound' in cross-border supply of non-life insurance, except for reinsurance, insurance intermediation, and marine and transportation insurance, in which Israel committed itself to restrict only the presence of natural persons mode of supply. In services auxiliary to insurance (consultancy, actuarial services, risk assessment, and claim settlement services) which were not specifically related to in 1994, Israel allowed only commercial presence. Compulsory car insurance required a special license. Foreign reinsurers were subjected to special registration.³⁹ The lack of progress in Israeli commitments under GATS in

³⁸ The French insurer COFACE is another exception, given a license in 2000 to operate without setting up a subsidiary, because of the MOF's special desire to develop the Israeli credit insurance market.

³⁹ See GATS/SC/44/Suppl.2; and WTO, 1999, 106-7. The liberalization of marine and transportation insurance was in response to a specific request by EC negotiators (Susnitsky, 1997). See page 211.

insurance services can be attributed to an incomplete financial liberalization process. Perhaps in the next round of negotiations on financial services Israel would allow more cross-border and consumption abroad of insurance.

As for Israeli insurance of European clients, the potential is not great. Although Israeli insurers are not suffering any discrimination in Europe, most of them preferred not to establish commercial presence abroad, and incurred losses when attempting the cross-border or natural presence modes. Nevertheless, as the Israeli insurance market grows and local companies develop it is possible that their presence in the EC would be felt.

Banking and capital market activity: The 1990s saw a dramatic rise in investment flows to Israel, motivated mostly by the development of the high-tech industries and the central role of capital markets in financing the growth of these industries. The progress of the financial liberalization process has enabled foreigners to invest in Israeli undertakings through the Tel-Aviv Stock Exchange (TASE), and enabled Israelis to raise capital through foreign stock exchanges. Flows not related to FDI accounted for 56 percent of the total USD 33.2 billion invested in Israel between 1995 and 2000.⁴⁰ At the same time USD 10 billion were invested by Israeli residents abroad, of which 43 percent was in the form of non-FDI. At USD 5 billion, inward non-FDI investment flows in 2000 equaled 4.6 percent of GDP, and outward flows reached USD 2.8 billion. At the end of 2000 non-FDI foreign investment stocks in Israel reached USD 96 billion, equal to 88.5 percent of GDP, and outward foreign investment stocks reached USD 60.7 billion, equal to 56 percent of GDP (OECD, 2002, 16-7).

Under GATS Israel agreed not to prohibit the commercial presence of foreign banks but registered as 'Unbound' in all other modes of supply both in market access and in national treatment. This was excused by the macroeconomic need to maintain exchange controls. No limitations were placed on the repatriation of

⁴⁰ FDI flows are analyzed separately in Section 6.

distributed profits. In capital market services such as trade in securities Israel also allowed cross-border activity.⁴¹

In the 1997 round of GATS negotiations on financial services Israeli commitments in banking hardly changed, although in the fields of financial data processing and the provision of guarantees Israel allowed all modes of supply except the presence of natural persons. The Israeli commitment to foreign commercial presence was limited to banking institutions as regards depositing, lending, and leasing. As regards settlement and clearing services for financial assets Israel made clear that such services in the TASE are exclusively provided for the Stock Exchange members.⁴²

The lack of progress in Israeli commitments under GATS in banking and capital market services can once again be attributed to the incomplete financial liberalization process. Indeed, the presence of foreign investors in the Israeli banking sector has remained minimal. Nine foreign banks (including BNP PARIBAS and Crédit Industriel et Commercial) have opened representative offices in Israel in recent years, three more foreign banks have opened branches, and three small Israeli banks were purchased by foreigners. In addition, a non-banking American investor purchased 34.5 percent of Israel's biggest bank, and the Italian-based Generali purchased 9.6 percent of the second biggest bank. The main reason for the relatively limited activity of foreign investors in Israeli banking is the centralized structure of the sector (OECD, 2002, 42-3). The five largest banks control 93.7 percent of all bank assets, and the three largest control 75 percent. Reciprocity conditions may apply in the granting of banking licenses to foreign banks not established under Israeli jurisdiction, and there are incorporation requirements for some activities in securities. For example portfolio manager and investment advisor licenses are only granted to Israeli citizens or residents and Israeli-registered companies (OECD, 2002, 69-70, 73-4).

⁴¹ See GATS/SC/44.

⁴² See GATS/SC/44/Suppl.2; and WTO, 1999, 101-5.

4.c. Air and maritime transportation

During the 1990s the Israeli government adopted a policy of liberalization and facilitation of greater competition in the international and domestic civil aviation sector. Some restrictions on the capacity of supply of companies were lifted and transport charter flights policy was liberalized. This has led to lower prices, a greater variety of destinations and an increase in the flow of passengers and cargo (OECD, 2002, 76; and WTO, 1999, 108-10).

However, since aviation was excluded from the terms of the GATS agreement by a special annex (Munin, 2000), Israel is unbound by commitments in this sector. Acquiring an Israeli airline license is conditional upon at least two thirds of the capital of the company being held by Israeli nationals (inconsistent with the principle of national treatment) and at least two thirds of the directors being Israeli nationals. Cabotage operations may only be conducted by Israeli airlines.

Thus, El-Al is still the only Israeli air carrier operating scheduled international flights; It competes with 45 other scheduled airlines operating in Israel pursuant to bilateral aviation agreements and several charter companies. El-Al is usually not a profitable business, and the government's attempts to privatize it have so far failed.

The outbreak of hostilities in the Middle East has dealt a major blow to the Israeli aviation market even before 11 September 2001. With the decline in tourism and business travel foreign airlines reduced the frequency of their flights to Tel-Aviv or terminated their service altogether. Many Israeli officials concurred that these developments justified the strategic argument for the maintenance of the loss-making national airline. In this atmosphere of uncertainty it seems that further liberalization of this sector will await better times (OECD, 2002, 76).

The Israeli market for maritime transport is small but steadily increasing. Over 43 million tones of cargo arrived in 2000 in Israel via the sea. The main shipping company in Israel is Zim, of which

the state owns 48.6 percent. Zim is planned to be fully privatized during 2002. Israel undertook no commitments under GATS in the maritime transport sector. Foreign-controlled enterprises established in Israel are entitled to register a vessel in Israel, conditional upon the holding of over 50 percent ownership in the licensee company by the state, an Israeli national or a corporation established under Israeli law. Cabotage operations are limited to Israeli vessels and to foreign vessels subject to a reciprocity condition (OECD, 2002, 76-7; and WTO, 1999, 110-1).

4.d. Tourism

Tourism accounts for 3 percent of Israel's GDP. Foreign investors control some 20 hotels in Israel, equal to 5 percent of the number of hotels, usually luxury hotels. This amounts to 20-25 percent of assets in the entire hotel industry. This sector was affected more than any other sector by the outbreak of hostilities in the region and the terrorist attack of 11 September 2001, which are estimated to have halved activity. The cost to the economy is estimated at USD 2 billion (OECD, 2002, 87).

Under GATS Israel agreed to allow the consumption abroad and commercial presence modes of supply in market access to hotel services, stating that ownership must be in the hands of an Israeli-registered company. As for national treatment, tourists are exempt from VAT on services given by hotels and paid in foreign currency. Food serving services were allowed all modes of supply both in market access and in national treatment, except for presence of natural persons. Travel agencies were allowed the consumption abroad and commercial presence modes of supply, but Israel stated that ownership must be in the hands of an Israel-registered company, and that travel agencies should employ at least one Israel-licensed travel expert. Finally, with regard to tourist guides services, while consumption abroad was allowed, commercial presence was permitted only by an Israeli resident or citizen.⁴³

⁴³ See GATS/SC/44; and WTO, 1999, 114-5.

4.e. Telecommunication

The Israelis are great consumers of telecom services. For example, 96 percent of households had at least one direct telephone line in 1996, and more than 5.5 cellular lines were in use (an 85 percent penetration) in 2001 (OECD, 2002, 42). The Israeli telecommunications sector, traditionally monopolistic and government-owned, went through major deregulation and privatization in recent years, which turned it into a great attraction for foreign investors.

Thus, the long-distance telephone service market was opened for competition among three operators in 1997. One of the competitors, which in 2000 controlled 30 percent of outgoing calls, is 46 percent foreign owned, of which 10.5 percent are by Deutsche Telecom and a similar portion by France Telecom. 26.4 percent of another competitor, which in 2000 controlled another 30 percent of calls, is owned by Italy Telecom. Thus, European telecom companies control some 14 percent of the Israeli market. As a result of these developments, prices dropped considerably, and the market expanded (OECD, 2002, 42).

There are currently four cellular service providers in Israel. According to current market shares of these operators and the portion of foreign ownership in them, foreigners, all of whom are based in North America and Hong Kong, control 42.5 percent of the Israeli market. In cable TV there are three operators, each with a monopoly over a given geographic area, one of whom is 45 percent owned by the Dutch based UPC (OECD, 2002, 42).

However, elsewhere more work has to be done in opening the Israeli telecommunications sector to competition. Under GATS Israel agreed to allow the cross-border and commercial presence modes of supply in postal and courier services of items above 500g, in mobile phone services, and in data and message transmission. Indeed a recent government decision opens postal services to competition by January 2005. However, with regard to mobile phone services Israel stated that the number of licenses is subject to tests of economic needs, and that commercial presence may

require a local partner. Data and messages must be transmitted via the infrastructure of a local licensee. Audiovisual services were allowed the consumption abroad and commercial presence modes of supply, but movies with at least a 25 percent Israeli investment component are entitled to a grant.⁴⁴

In the 1996 round of GATS negotiations on communication services Israel expanded its commitments in the telecommunication sector. The government stated that Bezeq - the Israeli telecommunication company - has exclusive rights in domestic telecommunication services and infrastructure, which will terminate not later than 2001.⁴⁵ Foreign equity participation in Bezeq was permitted. The government also stated that there are three operators of international services, which have exclusivity until January 2002, and promised to reexamine its policy regarding further competition in this field towards 2001. Foreign ownership in providers of international and cellular services was limited to 74 and 80 percent respectively. Public voice telephone and facsimile services were allowed the cross-border (through the network of Bezeq or any other licensee) and consumption abroad modes of supply. Non-public voice telephone (closed user groups and private networks) was also allowed the commercial presence mode, but resale of excess capacity and any transmission to a third party were not permitted. Paging and satellite services were allowed all modes of supply except presence of natural persons.⁴⁶

In 2002 Israel stated that the control of a domestic fixed-line operator must be held by an Israeli individual or a corporation incorporated in Israel, in which an Israeli individual holds at least a 20 percent interest. The ceiling on foreign ownership of providers of cellular, satellite, and cable TV services was reduced to 74 percent, and foreign operators were banned from holding more than

⁴⁴ See GATS/SC/44; and WTO, 1999, 111-4.

⁴⁵ Bezeq's monopoly in fixed-line telephone services indeed terminated legally in 2000, but no competitors have entered the market yet. The Histadrut national trade union organization blocked the tenders in this sector, fearing mass layoffs. Much of the rent of this monopoly goes to Bezeq's employees, who are wary of losing it.

⁴⁶ See GATS/SC/44/Suppl.1; and WTO, 1999, xx.

49 percent of the control of a licensee. The 49 percent ceiling was also applied to foreign ownership of commercial television and regional radio (OECD, 2002, 80).

4.f. Labor services

EC-Israeli labor flows are very limited, compared with flows between the EC and other Mediterranean countries (Paasivirta, 1999, 307). Israel's immigration policy resulted in the significant limitation of the fourth GATS mode of supply of services - the presence of natural persons. As a general rule Israel banned this mode of supply, except for the temporary entry of specialists in compliance with labor market tests, and the temporary entry of executives and managers, without requiring compliance with labor market tests. In addition, the Israeli Companies Law requires that a public corporation must have on its board of directors at least two directors representing the public at large, who must be residents of Israel.⁴⁷ However, companies that list their shares abroad can appoint a non-resident director (OECD, 2002, 49).

Foreign workers are not allowed to work in Israel except for special cases or in specific sectors. Nevertheless foreign workers (including unreported ones) account for some 10 percent of the Israeli workforce. In agriculture and construction, which are labor-intensive sectors, the Israeli economy is heavily dependent on foreign workers. Since 1967 Palestinian workers were employed in these sectors. In the 1990s, mainly due to security problems, Israel has been in the process of replacing the Palestinian workers in these sectors with workers from other countries, notably Romania, Thailand, the Philippines, and increasingly China. Thus, while in 1993 only 6,000 work permits were issued, in 1997 the number of work permits reached 106,000 (Dar, 2001). However illegal foreign workers in Israel (both legal workers whose permits have expired and tourists whose visas have expired) are estimated at almost the same number.

⁴⁷ See GATS/SC/44.

In order to stem the tide of foreign workers, the Israeli government decided in 2000 to expel illegal workers and penalize their employers. However, the number of foreign workers has not declined. In 1999 the Knesset approved a law that ensures appropriate living conditions and health insurance for foreign workers. This law serves both humanitarian concerns and the interest of local workers who can otherwise be replaced by what in many accounts amounts to slavery. In addition, different fees apply to employers of foreign workers. Currently the Israeli government is reducing the number of permits of foreign workers, in an effort to force more employers to hire Israeli workers and reduce unemployment (OECD, 2002, 52). As a result of the new policy some European undertakings have encountered difficulties in getting their personnel into Israel. Recent examples include a manager in Alitalia and employees of a Spanish construction company.

As for Israeli labor outflows, certainly a potential exists here as well. Israel's workforce is highly skilled, with one of the world's highest proportions of engineers and scientists for its population. Almost a third of the population over the age of 15 has post-secondary or degree-level qualifications, and illiteracy is practically non-existent. So far, however, the economy was able to absorb these skills due to the high growth rate (OECD, 2002, 52). The Israeli government does not object to migration, but is not enthusiastic about it either, because Israelis usually do not send their earnings back home, as do, for example, Turkish workers in Germany.

5. PUBLIC PROCUREMENT

Governments are inclined to prefer domestic products even when foreign products are cheaper or better. In spite of the privatization process in Israel and the EC, governments and their agencies are still large purchasers of goods and services, and in some sectors, such as telecommunications, governments even have a dominant purchasing power. According to the WTO (1999, 72) purchases by the central government represent some 12 percent of Israel's GDP. Of this, about 15 percent was awarded to foreign-based suppliers.

The 1994 WTO Government Procurement Agreement (GPA) covers only specified goods and services and certain public utilities, applies only to the public entities specified in its annexes, only to the extent of each state's commitments, and only to contracts over a certain value threshold (Hirsch, 1996).

According to the principle of national treatment, governments are to treat producers of the contracting parties no less favorably than domestic ones, including tendering procedures. The contract must be awarded to the applicant whose offer is either the cheapest or the most advantageous in terms of the specific evaluation criteria. The GPA prohibits offset requirements (which frequently take the form of minimum local content), but developing countries (including Israel) may use offsets under certain conditions, and only as a qualification for participation in the tender (not as a criterion for awarding contracts).

The EC's obligations under the GPA are generally incorporated into EC law under the Treaty of Rome (Article 300). Regarding non-members, the 1993 EC Utilities Directive dealing with the water, energy, transport and telecommunications sectors, which were not included by the EC in the GPA, authorizes EC members to give preference to EC suppliers. The foreign applicant to the tender is identified, not on the basis of the place of incorporation, but rather in accordance with the origin of the goods included in the tender (Hirsch, 1996).

EC suppliers of water, energy, transport and telecommunications are protected by the principles of rejection and preference. Under the rule of rejection, any offer may be rejected when the proportion of the products originating from third countries exceeds 50 percent of the total value of the products. Under the preference rule, when two or more offers are equivalent in light of the award criteria, the prices would be considered equivalent if the price difference does not exceed 3 percent (Hirsch, 1996).

Similar to the EC's policy, Israel also does not apply the GPA to contracts for the purchase of water and energy. Otherwise, the GPA applies to most Israeli government entities and state-owned

corporations except the Ministry of Defense, the Office of Internal Security, and the aircraft industry. Israel employs the rule of preference (but not that of rejection), and considers the prices of domestic and foreign suppliers to be equivalent if the price difference does not exceed 15 percent. Israeli law, however, prohibits this preference whenever it is inconsistent with the state's international obligations. Contracts exceeding ILS 2.15 million (roughly USD 450 thousand) oblige the foreign supplier to offsets of at least 30 percent of the value of the contract. Israeli offsets requirements are legal under the GPA because Israel invokes developing country status. However, as a developing country, the GPA mandates that Israeli offsets be lowered to 20 percent by 2005. Established foreign-controlled enterprises can benefit from this system of preferences on the same basis as domestic producers provided they fulfill the same local content conditions. The local content requirement may take the form of a requirement for a local partner (OECD, 2002, 57-8; and WTO, 1999, 73-5).

Public procurement was one of the important subjects discussed in the negotiations that led to the EMAA. Israel postponed the ratification of the GPA until it could secure access to European public tenders for telecommunication equipment.⁴⁸ In the first stages of the negotiations, Israel suggested that the telecommunications sector (where it believed its industry has an advantage) be open for public procurement between the parties on a reciprocal basis. The EC responded with a proposal to open up completely governmental procurement between the two parties (Hirsch, 1996).

Israel was not interested in opening up the entire sphere of government procurement, so the negotiations subsequently focused on the opening up of specific sectors. The EC wanted the new agreement to include the sectors of public transportation, energy and medical instruments, where it felt its industries had an advantage. Israel was prepared to include the sectors of energy and medical instruments, but refused the inclusion of public transportation. The reason for this position was the practice of

⁴⁸ See <http://www.eu-del.org.il>.

offsets conducted by Israel in the purchase of buses from the EC states. Israel has made its purchase of buses from abroad conditional on the assembly of their parts in Israel (by the Merkavim and Ha'argaz corporations).⁴⁹

Two agreements were reached in the end in December 1995 and entered into force in August 1997. In the first, Israel agreed to apply the GPA to a variety of services including maintenance and repair services, building-cleaning services, property management, publishing and printing. Medical equipment and urban transport products were added too (with the exception of buses) but only towards EC suppliers. The EC too extended its commitments to include the urban transport sector. However, Israel excluded El-Al from the GPA. This paved the way for Israel's political discrimination of Airbus in favor of Boeing in public tenders in 1997 and in 1999, much to the anger of the EC, which issued an official diplomatic protest. While El-Al preferred the Airbus airliners on a professional basis, the Israeli government, which still controls El-Al, was under heavy pressure from the American government to prefer Boeing passenger carriers.

In the second agreement, specifically-listed operators of telecommunications were forbidden from discriminating against suppliers of the other party in any way (including offsets, price preferences, local content requirements). Israel was still left a few loopholes until January 2001. In addition, the 1995 EMTA forebode additional discriminatory measures, beyond those agreed in the GPA, in the fields of heavy electrical and medical equipment.

6. FOREIGN DIRECT INVESTMENT

As a party to the WTO's Trade Related Investment Measures (TRIMs), Israel is committed to apply the national treatment principle with regard to foreign and local investments. Quantitative

⁴⁹ The EC request to open the public transportation market was apparently initiated by Spain, who wanted its industry to have a greater share of the Israeli bus market, the majority of which is in the hands of the German bus industry.

restrictions are prohibited as well, such as conditioning the imports of a foreign undertaking in Israel on its exports, or requiring certain levels of local procurement. However, TRIMs relates to goods, not to the provision of services. An important recent development is the eligibility of Israel, as of July 2002, for adherence to the OECD Declaration on International Investments and Multinational Enterprises (DIIME). This declaration promotes national treatment of foreign direct investment, proposes voluntary standards of behavior to multinational enterprises and encourages moderation and restraint in the use of investment incentives and conflicting regulatory requirements. Above all, Israel's eligibility for adherence to the DIIME signals its emerging status as a developed country, and the compliance of its regulatory investment environment with western standards, barring a few exceptions.

This followed a decade of law-making in Israel that transformed it from a socialist and patronage-oriented economy into a capitalist one. Most of these changes are documented in other sections of this paper. One of the most important changes that is not mentioned elsewhere, is the new Israeli Companies Law (1999), which came into effect in February 2000, and revised the legal framework to make it more favorable to the international business environment. Foreign investors wishing to operate in Israel via an incorporated enterprise are subject to ordinary corporate registration requirements, unless they apply for special government incentives. There are generally no special rules or procedures for the acquisition of Israeli companies by foreign investors.

However, certain non-negligible discriminatory entry restrictions apply, such as in the form of equity restrictions in the communications, electricity and transport sectors. Foreign investors may also operate as foreign companies, but have to register as such, nominate an Israeli-resident attorney, and translate their documents into Hebrew (OECD, 2002, 47-50, 64). Land in Israel is almost entirely owned by the state and is leased, but rarely sold. Nevertheless, the Israeli law guarantees a high degree of protection for property rights. Contrary to the national treatment principle, foreign-owned companies are required to have the approval of state authorities in order to acquire rights to use a land, but such

approval is normally granted for business purposes. There is no other discrimination *re* foreigners relating to land use (OECD, 2002, 50-1). Partly as a result of these changes FDI flowed into Israel in large amounts in the mid-1990s, attracted also by the high-tech industry, the competitiveness of the food and textiles industries, and by the liberalization of the financial and telecommunications sectors. FDI in Israel amounted to USD 14.6 billion between 1995 and 2000, and peaked at USD 4.4 billion in 2000, accounting for 4 percent of GDP (OECD, 2002, 16). Outward Israeli FDI flows amounted to USD 5.7 billion between 1995 and 2000, and USD 2.9 billion in 2000. Inflows from the EC amounted to Euro 155 million in 1999 (bringing the stock to more than Euro 1 billion), and outflows to the EC amounted to Euro 116 million (bringing the stock to Euro 613 million).⁵⁰ FDI flows proved resilient to the global downturn in the high-tech sector, the worldwide economic slowdown, and the deteriorating geopolitical situation in the Middle East. At USD 3 billion, inward FDI in 2001 was higher than in 1999 (OECD, 2002, 16-7). At the end of 2000 FDI stocks in Israel reached USD 21 billion, equal to 19.4 percent of GDP. Israeli FDI stocks abroad reached USD 9.6 billion (OECD, 2002, 17).

While NASDAQ attracted the majority of Israeli capital-raising abroad, the role of European exchanges has been growing recently too, as a result of their own development and the waiving in 1994 of the secondary and tertiary Arab boycott by the Gulf Cooperation Council (GCC) states. European exchanges such as the Swiss SWX New Market, the German Neuer Markt of Deutsche Borse, the British AIM and techMark, and the French-Belgian-Dutch Euronext, offered flexible registration conditions, the possibility of raising small amounts of capital, and high obtainable prices in biotechnology and medical equipment. The number of Israeli companies registered for trading in European stock exchanges rose from two in 1996 to 29 in 2000.⁵¹ Of a total of USD 4.4 billion

⁵⁰ See Second Meeting of the Association Council – Declaration of the European Union, 14271/01 (Presse 433 – G), 6. In 1996 FDI inflows from the EC amounted to USD 226.1 million (Dafni, 2000).

⁵¹ However, at 125, Israel was the third largest country after the US and Canada in terms of the number of listed companies in NASDAQ.

raised in 2000 by Israeli companies abroad, USD 1.3 billion were raised in Europe. European investors, especially Swiss and Italians, accounted for 41.6 percent of FDI through the TASE (OECD, 2002, 17-21).

As for Israeli FDI outflows, flows to Western Europe amounted to USD 320 million in 2001 compared with USD 262 million to North America, and stocks in Western Europe amounted to USD 3.7 billion compared with USD 3.2 billion. However, many of the Israeli investments in Western European based companies use them as a channel for investments in Central and Eastern European Countries (CEECs) (OECD, 2002, 21-22).

7. INTELLECTUAL PROPERTY RIGHTS

Israel is a member of the World Intellectual Property Organization (WIPO). Since 2000 Israel is also a party to the WTO's Trade Related Intellectual Property (TRIPS) agreement.⁵² Under TRIPS Israel is committed to the national treatment and MFN principles. In according with Annex 7 of the EMAA Israel will soon join the Rome Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organizations. In addition, Annex 7 commits Israel to accede a few other multilateral conventions on IPR, no later than three years past the entry into force of the EMAA. Thus, by June 2003 Israel has to comply with international rules regarding literary and artistic works, registration of marks, and patent procedures. According to Israeli trade officials, acceding to some of these conventions poses difficulties for Israel, and the matter would be discussed in the next Euro-Israeli Association Council, scheduled to meet in December 2002.

However, Israel was placed on the USTR's Special 301 Watch List in 2000 and 2001 because of high levels of piracy, inadequacy of the copyright law and enforcement problems. The FICC estimates that copyright violations in Israel caused losses of USD 250 million in 2000 (OECD, 2002, 54). The USTR's complaints centered on the

⁵² Prior to 2000 Israel invoked the developing country status. See OECD, 2002, 48, 112; and WTO, 1999, 75-8.

Israeli pharmaceuticals industry, computer software, music and clothing. Part of the counterfeited goods is of local production, and part is contraband. However, over the last two years Israel has devoted substantial resources to the revision and enforcement of its IPR regime corresponding to international norms.

For example, products are now required to bear a marking identifying the manufacturer, and a special court jurisdiction was established to resolve copyright disputes. Special IPR police units and prosecutors were established, and the customs authority has put in place a revised enforcement program. The number of IPR-related convictions has risen, resulting in imprisonment, significant fines and other sanctions on the convicted. The government has implemented programs to prevent the unauthorized use of computer software by its officials and employees, and the Ministry of Education has initiated high-school level courses on IPR protection. Further legislation is underway (OECD, 2002, 54).

It is important to note that when it comes to IPR problems in Israel, Europeans are often at a disadvantage compared with Americans. While American complaints are handled by the USTR, offended European owners of intellectual property must individually contact the MOTI. This could be a hurdle not worth the trouble. Thus, the USTR is the source for 90 percent of IPR-related complaints directed at the MOTI. European complaints are rare, the Dutch-based Philips (household electric appliances) being a recent example.

8. COMPETITION

Israel's industry is small and has traditionally been plagued with centralization and non-competitive market practices. This can be seen in Regev and Bar-Eliezer's (1994) concentration index. This index is the percentage of sales of the three biggest producers out of the total sales in the market. If the index exceeds 80 percent,

then the market structure is considered to be monopolistic.⁵³ Table 1 and Figure 1 are based on the work of Regev and Bar-Eliezer and its updates.⁵⁴ Imports were defined as competing imports if their share of the market did not exceed 80 percent, and/or a high tariff rate was imposed. The figures in the table are the weighted averages of 94 industrial averages.

Table 1: Israeli Market Structure

Year	Concentration Index	Competing Imports	Non-Leading Producers
1965	45.0	10.0	45.0
1977	37.5	23.6	38.9
1980	40.6	22.3	37.2
1982	42.7	21.2	36.1
1985	39.8	21.6	38.6
1988	35.8	24.9	39.3
1990	33.8	25.0	41.2
1992	31.2	26.8	42.0
1995	30.7	31.6	37.7
2000	28.1	37.4	34.5

Sources: Regev and Bar-Eliezer, 1994; and http://www.cbs.gov.il/hodaot2002/23_02_76.htm.

The period 1965-1977 is characterized by an increase in foreign competition at the expense of both leading and non-leading producers, thus increasing the competition within Israeli industry, in general. Then, from 1977 to 1982, there is an increase in the concentration measured, and from 1982 on there is a process of increased competition again. Nevertheless, Table 1 shows that although there are FTAs between Israel and its major trading partners and import penetration has been increasing since 1982, some non-competitive monopolies still exist in Israel.

⁵³ The index's main deficiency is its failure in detecting a cartel comprised of many small and legally independent producers, and yet it is a simple means of giving a rough estimation.

⁵⁴ See http://www.cbs.gov.il/hodaot2002/23_02_76.htm

The researchers found that Israeli monopolies suffer from low productivity and are non-competitive on an international level. Israeli monopolies tend to concentrate around small industrial branches - mostly mining, food industries and base metals. Foreign competition, which tends to lower prices and increase productivity in Israeli industry, is especially low in these branches, but strong in the fields of rubber goods, machinery and precision equipment. In the second half of the 1990s import penetration increased mostly in the leather, clothing, electronics, and pharmaceuticals sectors. Table 1 and Figure 1 also indicate that while increased import penetration came at the expense of leading Israeli producers from 1982 to 1992, imports in the 1990s replaced mostly small Israeli firms.

In order to address competition problems the Restrictive Business Practices law was revised in 1988, including the introduction of merger control rules. The law now also covers cartels, restrictive agreements, monopolies and abuse of dominant position. The law is based on a mix of European, American and Canadian models. Restrictive agreements are defined as agreements that fix prices, or determine market shares or profit margins, and that harm competition. Monopolies are defined as a market share control of over 50 percent. The restrictions on monopolies are similar to those in European legislative framework (OECD, 2002, 55-6; and WTO, 1999, 58).

Responsibility for antitrust activities was extended beyond corporate entities to include company executives. The enforcement of the law is the responsibility of the Antitrust Commissioner, who heads the Antitrust Authority, an independent government agency created in 1994. The Antitrust Commissioner is also responsible for the granting of exemptions from the law. A special antitrust tribunal vigorously enforces the law, including criminal prosecutions, substantial fines and prison sentences (OECD, 2002, 55-6; and WTO, 1999, 58).

Figure 1: Israeli market structureIsraeli market structure 1965-1990

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2000	28.1	37.4	34.5

Sources: Regev and Bar-Eliezer, 1994; and http://www.cbs.gov.il/hodaot2002/23_02_76.htm.

9. FINANCIAL ASSISTANCE FOR INFRASTRUCTURE DEVELOPMENT

Israel is generally not a recipient of MEDA funds. Due to its developed economy it has no need for a bilateral aid program for structural adjustment. Nevertheless, Israel is eligible for MEDA funds directed at regional cooperation. Thus, Israel participated in recent years in many MEDA funded regional schemes in the fields of youth, audio-visual, cultural heritage, economic and industrial networking, the information society and the environment.⁵⁵

However, Israel did receive bilateral financial assistance from the EC over the years, assistance that was formalized in financial protocols, signed periodically by the EC and Israel for a five-year period. Between 1977 and 1991 four financial protocols were concluded, offering altogether ECU 215 million of non-preferential loans from the European Investment Bank (EIB), the last one

⁵⁵ See <http://www.eu-del.org.il>. However, in effect the Israeli participants in these schemes have received negligible sums of money.

expiring in 1996 (Kosnikowski, 1999, n. 17). In 1995, a new financial protocol was signed, providing for financial assistance by the EIB to infrastructure development projects in Israel. The assistance consisted of loans of up to Euro 22 million for a 20-year period at an annual interest rate of 6.8 percent. However, at the time Israeli undertakings had no difficulty in raising capital and credit in international financial markets, at more convenient terms. The EIB is deemed to be bureaucratic and the Israeli government is wary of providing state guarantees for the loans it provides. Thus, the EIB facility was unutilized for a few years. The money was eventually used in the late 1990s for the “Nahal Soreq” environmental project. As a result of this situation the Israeli MOF tried to negotiate a more favorable financial protocol, which would better suit the credit rating of the Israeli economy.

In June 2000 the EIB and Israel signed a new financial protocol. The terms of the new protocol were not significantly different from those of the previous one, and at the time of its signature MOF officials were skeptical regarding its economic usefulness. Various public companies such as the Airports Authority and Israel Electric turned it down. However, with the deterioration of the geopolitical and economic situation in Israel, and the global slowdown, the new financial protocol might yet come in useful.

10. RESEARCH AND DEVELOPMENT

Israel was the first non-European country to be associated to the EC’s Framework Program for RTD. Israel's special status is the result of its very high level of scientific competence and the dense network of longstanding relations in scientific and technical cooperation between Israel and the EU. In March 1999 Israel and the EC signed the second agreement for Scientific and Technical Cooperation, associating Israel with the fifth framework program for EC RTD (1999-2002). That followed the association of Israel with the fourth framework program, since August 1996, in accordance with Article 40 of the EMAA. As of May 2001, aid for Israeli counterparts in the context of the framework program totaled some Euro 110 million (Hirsch, 2001a). Table 2 details the main recipients and fields of research.

Research and development is considered to be one of the most successful parts of Euro-Israeli cooperation. Israeli universities and companies are taking part in consortia together with thousands of European counterparts. Aside from the scientific gains, the scientific framework programs help introduce Israeli establishments into European business networks.

However, Israel's participation in the fifth framework program followed six-month long difficult negotiations, as a few member states had reservations about Israel's participation. Israel is obviously keen on participating in the Sixth program, which is currently being planned. In particular, Israel is interested in participating in the Galileo satellite project, whether in the context of the Sixth program or in commercial contracts (Hirsch, 2001a).

Table 2: Allocation of Funds to Israeli Participants in the Fifth Framework Program

Recipient	Environment	Aerodynamics	Information society	Life sciences
Universities	53%	32%	26%	64%
Companies	23%	66%	70%	11%
Others	23%		4%	25%
Total	100%	100%	100%	100%

Source: Hirsch, 2001a, 14.

11. MAIN FINDINGS AND CONCLUSIONS

Israel should join the pan-European system of *origin*, known as WETA. By allowing diagonal cumulation of origin the asymmetry between the EC and Israel in the ability to comply with the ROO would be reduced. Joining WETA would enable Israel to export tariff-free products made in eastern European countries to the EC.

In addition, to avoid distortions to trade the *drawbacks* method should be harmonized in all of Israel's FTAs.

As for *standards*, it is recommended that Israel adopt EC industrial standards and the SII join the European system of standards institutes, or an MRA be signed between the EC and Israel. This being said, it is important that global harmonization of industrial standards continue so as to limit distortions to Israel's trade with the US.

The EC should harmonize the lists of *dual use* goods used by its different member states with regard to Israel, and avoid discriminatory enforcement.

The EC should also take measures to stop unofficial *boycotts* of Israeli goods in Europe, as these cause more distortions in EC-Israel trade and fly in the face of its desire to develop a Euro-Mediterranean internal market.

As for goods origination in the Israeli *settlements*, some technical compromise is essential to avoid a worsening in Euro-Israeli relations. For example, perhaps the customs debt can be left uncollected (backed by state guarantees) until the matter is resolved in a final Israeli-Palestinian settlement.

Regarding Israeli *obstructions to EC-Palestinian trade*, it is recommended that the EC allow Israeli-Palestinian diagonal cumulation of origin, even if no Israeli-Palestinian accord exists. This solution is practical (other solutions are simply unenforceable), efficient (some of the leverage Israeli middlemen have on Palestinian producers will be reduced), and politically wise (encouraging Israeli-Palestinian economic cooperation and development even when political cooperation is lacking). Perhaps the EC can adopt the US policy of allowing Israeli-Jordanian diagonal cumulation of origin.

As for *customs procedures*, it is recommended that the (criminally-sanctioned) responsibility for certifying the origin of goods be placed with the exporters, as is provided for in the US-Israeli FTA, rather than with the customs authorities. This would reduce the obstacles to trade, improve the ability of the authorities to verify

the origin of goods under doubt, and deter disingenuous declarations of origin.

In *agricultural* trade, the EC and Israel should sign the almost finished new protocol to the EMAA. It is recommended that equivalence agreements between the two parties be signed, to reduce the risk of abuse of SPS requirements. Negotiations on trade in fisheries products should commence in January 2003.

Great progress has been achieved in liberalizing Israel's *insurance* sector and fostering greater competition. Foreign insurers now control 12 percent of the Israeli non-life insurance market and 30 percent of the Israeli life insurance market. However, the MOF's policy of preferring Israeli subsidiaries of foreign insurers to local branches or representatives is still a trade barrier. Another barrier is the MOF's requirement that foreign companies with a representative in Israel keep a certain minimum of their assets in Israel. While allowing local branches to operate arguably exposes the Israeli insurance market to short term financial fluctuations, the gains from trade liberalization should be taken into account as well. The Israeli schedule of GATS commitments still features too many "Unbounds". Finally, the duplication of prudential requirements is also a barrier to foreign insurance activity in Israel, as well as Israeli activity in the EC. This difficulty could be overcome by the adoption of the EC's supervisory rules by Israel, and the full adoption of the principle of home control between the EC and Israel.

In spite of the impressive growth in financial activities in the 1990s the liberalization of the Israeli *banking* sector is highly disappointing. Five large banks control the market and competition is limited. In GATS Israel is unbound by commitments in all modes of supply except for commercial presence, and even that is limited to banking institutions as regards depositing, lending, and leasing. Reciprocity conditions may apply in the granting of banking licenses to foreign banks not established under Israeli jurisdiction, and there are incorporation requirements for some activities in securities.

As for *air and maritime transportation*, while future privatization of EL-Al seems inevitable, the current geopolitical situation, as well as global conditions in the air travel sector, seem to preclude any quick progress. However, progress can be expected in the privatization of maritime transportation in Israel.

Tourism is another beleaguered sector. However, perhaps these difficult times provide an opportunity for restructuring and liberalization. National treatment should be ensured in hotel services. Limitations on the ownership and operation of travel agencies in Israel should be relaxed.

The *telecommunications* sector is another example of successful progress in liberalization. European telecom companies control some 14 percent of Israel's long-distance telephone service market. Foreigners, all of whom are based in North America and Hong Kong, control 42.5 percent of the Israeli mobile phone market. However, limitations to commercial presence and foreign ownership in the mobile phone, satellite, and cable TV sectors should be relaxed. The principle of national treatment should be applied to audiovisual services. Most importantly, Bezeq's monopoly in domestic telecommunication services and infrastructure has indeed legally terminated, but in practice no progress has been achieved in opening up this sector to competition.

As in the EC, current Israeli immigration policies are not directed at greater liberalization in international *labor flows*, because of the deep recession and the high unemployment rate. This is especially true for skilled labor, where the Israeli government fears that the replacement of Israeli professionals by low-wage foreign professionals might enhance emigration or reduce the incentive for education. Currently, this is not much of an issue on the bilateral EC-Israeli agenda, since EC nationals are high-wage earners. However, European contractors in Israel might find it difficult to import cheap labor to Israel in the near future. In addition the potential for EC-Israel labor flows may grow when the EU is enlarged to the east.

With regard to *public procurement*, Israel should give up its status as a developing country. There is no justification for this status but as an excuse to avoid liberalization. A country that aspires to join the OECD could do without offset requirements. Adherence to the GPA, not to mention privatization, would also free Israel from American political interference in its public tenders, such as in the case of airliners. Alternatively, EC-Israel bilateral public procurement commitments could be developed to cover all sectors. Israel's eligibility for adherence to the DIIME signals its emerging status as a developed country, and the compliance of its *regulatory investment environment* with western standards, barring a few exceptions.

In the field of *IPR*, much has been achieved in Israel. At this point, though, it is imperative to develop better EC-Israeli coordination mechanisms to protect Europeans offended by IPR violations in Israel.

The revision in Israel of the Restrictive Business Practices law, the introduction of merger control rules and the creation in 1994 of the Antitrust Authority improved the legal and institutional framework for *competition*. However, while increased import penetration came at the expense of leading Israeli producers from 1982 to 1992, imports in the 1990s replaced mostly small Israeli firms. This situation, which is mostly the result of decisions of policy makers such as the Antitrust Commissioner, must be changed.

Regarding *infrastructure development*, the EIB should re-examine the terms of credit it offers Israeli undertakings. In order to be useful these terms should match market conditions and Israel's credit rating. In Israel's case ways to relax the requirement for state guarantees to EIB loans should be found.

Israel is a peculiar participant in the BP. Politically Israel is neither a candidate for EU membership nor an Arab state. Economically, Israel is developed and advanced well beyond all other non-EU participants (Dafni, 2002). Thus, for most Israeli officials and businessmen the participation in the BP serves Israel's political ends by enhancing its legitimacy in the region. However, on the

economic level most Israelis reckon that the BP is irrelevant to Israel, an artificial framework that the EU forces on Israel for political reasons, which ignores the obvious differences between Israel and other countries in the region.

This skepticism towards the BP is reflected in a tendency among Israeli officials to think about EU-Israeli relations mostly in bilateral rather than regional terms. From a historical point of view this new skepticism is replacing the old Euro-skepticism that characterized Israeli official thinking in the 1980s. In the 1990s Israeli businessmen and senior officials increasingly developed a European orientation and an appreciation of the strength and importance of the process of European integration to Israel. It is now time to start treating the BP seriously as well. For that to happen, the EU must find ways to reconcile its Mediterranean policy with Israel's uniqueness.

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