MITVIM
The Israeli Institute for Regional Foreign Policies

Improving access to the EU's market for services

Marc Luban*

June 2021

Regulatory heterogeneity between Israel and its key trading partners restricts the potential for bilateral trade. Approximation of the European Union's regulatory standards would contribute to increased trade and investment. Upgrading Israel's 1995 trade agreement with the EU could provide the optimal response to the regulatory heterogeneity and improve mutual access to markets for services.

A. The economic importance of trade in services

- The services sector accounts for a significant share of the Israeli economy - some 70% of its GDP and nearly 80 percent of its employment (similar to the OECD average). In 2020, Israel's services exports equaled its goods exports for the first time, reflecting on global trade trends. Service sectors account for some one-third of Israeli exports, and 54 percent in terms of value added (transportation, logistics, financial and communications services are deeply imbedded in manufactured goods being traded all over the world).

- Unlike trade in goods, services are often intangible and invisible. Over time, advances in communication technology has brought new services into the global economy. Some examples include legal, engineering, and other professional services, computer services and telecommunications, just to name a few.

- Trade and investment in services has been expanding rapidly, at a faster pace than trade in goods and turning into a leading global growth engine. The accelerated development of information and communications technologies has significantly expanded the volume of cross-border trade in services. Foreign investments (trade in services through a commercial presence in another territory) serve as a central conduit for the transfer of technological knowledge via multinational corporations, exerting positive economic influence on their local goods and services suppliers. New indicators developed by international economic organizations illustrate the positive effects of accelerated trade in services on the economic resilience.

- Israel stands to gain from being more open to trade and investment in services sectors that account for a rising share of global trade. For example, the agreement on aviation arrangements between the EU and Israel (the 'Open Skies' reform) led to a marked increase in the activity of foreign airlines in Israel and doubled the number of Israelis travelling abroad by air (from 3.9 million departures in 2012 to 7.8 million in 2018). The reform led to an increase in incoming tourism to Israel of almost 50

* Marc Luban works for the Finance Ministry's Chief Economist. He is responsible for ties with the OECD, the IMF and the EU Commission, and focuses on lifting barriers to trade in services. The paper reflects his personal views.

percent (the number of incoming tourists by air increased from 2.5 million in 2012 to 3.6 million in 2018), contributed to increased efficiency of Israeli airlines and increased the wellbeing of Israeli vacationers.[1]

- The Covid-19 pandemic and its impact on the global economy brought into play the key role of financial services industry[2] in supporting all local and global economic activity by stabilizing markets and ensuring credit and payment flows. The crisis also underscored the need to manage cash flows and liquidity on low price for business and households.

B. Current status of Israel-EU trade

- The legal basis for the EU's trade relations with Israel is the EU-Israel Association Agreement, which entered into force in June 2000. Such agreement is also called "first generation" agreement that focus on tariff elimination in industrial and agricultural goods with very limited provisions on investment and services (have never been implemented) as the agreement focus mostly on goods. ..[3] The "new generation" Free Trade Agreements (FTAs) are comprehensive FTAs negotiated after 2006 with selected third countries (i.e. South Korea, Colombia, Peru, Ecuador, Central America and Canada). These agreements typically go beyond tariff cuts and trade in goods and help to establish a regulatory framework to facilitate the provision of services. .

- The absence of an investment and services chapters could result in 'trade diversion' benefitting third parties that enjoy advanced free trade agreements with the EU.[4]

- The EU is Israel's biggest trade partner, accounting for 29.3% of its trade in goods in 2020. 34.4% of Israel's imports came from the EU, and 21.9% of the country's exports went to the EU. Two-way trade in services between the EU and Israel amounted to €15.9 billion in 2019. Israel exports of services represented €6.6 billion, while imports accounted for €9.3 billion (chart 1).

[1] Bank of Israel Annual Report 2018.

[2] The past decade has seen increased trade in financial services among the 37 OECD states, which reached some $200 billion in 2018, double its 2010 volume. This development is integrated with the growing trade component in all global service industries as a result of the digitization revolution that has changed consumer habits. A comparison of Israel's imports with those of other OECD member states shows a low level of insurance and financial services imports, comprising only 2.7% of the total services imports compared with a 9.7% OECD average.

[3] For example, Article 29 on the Right of Establishment and Supply of Services: "The Parties agree to widen the scope of the Agreement to cover the right of establishment of firms of one Party in the territory of another Party and the liberalisation of the provision of services by one Party's firms to consumers of services in the other." Article 48 on Financial Services: "The Parties shall cooperate, where appropriate through the conclusion of agreements, on the adoption of common rules and standards, inter alia, for accounting and for supervisory and regulatory systems of banking, insurance and other financial sectors.." Article 55 on Approximation of Laws: "The Parties shall use their best endeavours to approximate their respective laws in order to facilitate the implementation of this Agreement.."

[4] The EU-Canada Comprehensive Economic and Trade Agreement (CETA) includes a chapter that mproves and secures EU companies' access to the Canadian services market. According to the European Commission, EU services exports to Canada grew by 12.3% in 2017-2018 following the agreement. In 2014, Ukraine, Georgia and Moldova signed a Deep and Comprehensive Free Trade Area (DCFTA) with the EU. Tunisia and Morocco are conducting negotiations with the EU on such an agreement.

C. Impact of regulatory and non-regulatory barriers on trade in services

- Israel's regulatory barriers, which outnumber the EU average (Chart 2), undermine the profitability of investments, deter new investors, and hamper the economy's growth potential through trade and investments. Whereas the discussion of trade regulations focuses on tariffs and quantitative quotas, regulation of trade in services consists of non-tariff barriers (NTBs) (directives, certification and inspection rules that restrict exports/imports), which touch on a wide variety of regulation aspects, directives and rules that limit trade in services.

Chart 1: Balance of EU-Israel trade in services (in billions of euro)

Source: Eurostat

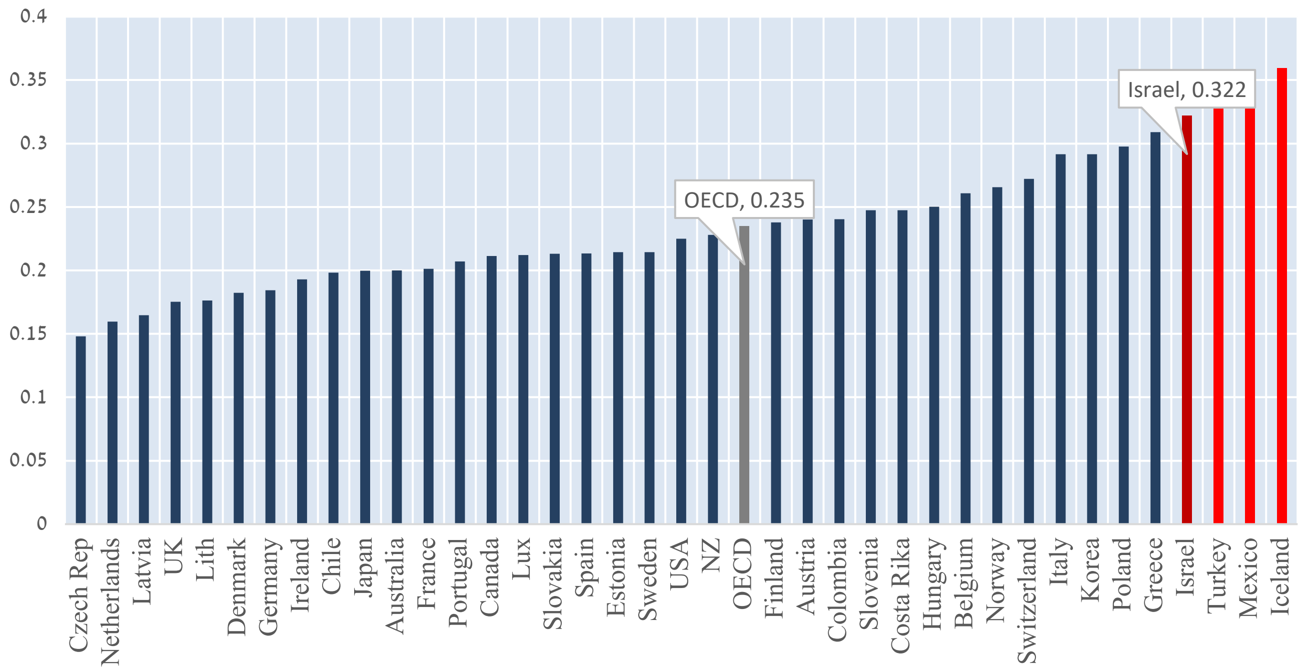
- The OECD's Services Trade Restrictiveness Index (STRI) ranked Israel in 35th place (out of 38) in terms of regulations affecting trade in services in 22 sectors across all OECD member countries.

- Examples of Israel's regulatory barriers to trade and investment in services:
  - Multi-stage and multi-interface processes for company foundation and registration (absence of one-stop shop that would ease significant market access and regulatory barriers for small firms, encourage the entry of additional players, increase competitiveness, push for greater productivity, lead to lower cost of living and improvement of product quality and diversity);
  - Land acquisition by non-Israelis conditioned on approval of the Israel Land Authority;
  - Citizenship and residency requirement for services suppliers;
  - Restrictions to movement of people – Israel's commitments scheduled under Mode 4 were largely limited to one category of of natural persons: intra-company transferees;

- Labor market test for issuing work visas for employees of foreign firms seeking to work in Israel for a limited time period;

- Restrictions on foreign entry[5] (legal, accounting, architectural, engineering).

Chart 2: 2021 STRI
(The STRIs are composite indices taking values between zero and one, zero representing an open market and one a market completely closed to foreign services providers.)



Source: OECD (February 2021)

D. Significance of lifting barriers and suggested measures

- Removing legislative, regulatory barriers to trade in services is expected to increase competition from imports[6] and deepen the economy's focus on areas where it enjoys a relative advantage, thereby contributing to improved consumer welfare and higher productivity.[7]

- The legal and regulatory climate has significant influence on economic growth and labor productivity. Reducing the regulatory heteregoneity between Israel and the EU by approximating them to the OECD average regulatory differences could result in improved access to financial services and exposure to new financial products as a result of increased foreign investment. Possible measures could include:

[5] The absence of Mutual Recognition Agreements (MRAs) between Israel and its partners constitutes an entry barrier
[6] Israel's economy is centralized, hence the importance of competition from imports to price reductions.
[7] "There is broad consensus on the advantages of openness to international trade: It enables specialization in manufacturing products and services in accordance with their relative advantages in the world, and acquisition of products and services manufactured effectively elsewhere, thereby increasing welfare and productivity" (From a special Bank of Israel Research Division report, "Raising living standards in Israel by increasing labor productivity", (August 2019, p.42).

- Approximation of laws: In order to create stronger incentives for foreign investors and enjoy the advantages of economies of scale, the smaller country will choose to adopt regulations, standards and norms of a significant actor such as the EU (for example, Israel unilaterally adopted the EU's Solvency II Directive (2009/138/EC) designed to codify and harmonise the EU insurance regulation with regard to the amount of capital that EU insurance companies must hold to reduce the risk of insolvency. Binding international commitment on services trade will be an important indicator as to the levels of liberalisation that have been undertaken in a given sector.

- Access to international capital: The presence of a foreign commercial entity, especially in finances, could facilitate access to international capital markets and increase the volume of foreign investments;

- Regulatory transparency: The activities of foreign financial institutions requires increased information transparency on the part of regulators regarding local laws and regulations;

- Modernization of the local financial system: Integrating skills, technologies and new management methods, including improvement of credit risk assessment and data collection systems;

- Liberalization of trade in financial services and adaptation of regulations according to the international standards help deepen and expand financial markets and spread economic risks to new foreign investors as well. All of the above could help build resilience in response to financial shocks.[8]

E. Summary, suggested directions and recommendations

- There are several theoretical models for cooperation between Israel and the EU, starting with full member of the European Union, part in the Economic and Monetary Union (EMU), integrate to the EU Customs Union and member country of the European Economic Area (EEA).[9] However, some of these are irrelevant. EU leaders already declared at the beginning of the 1990s that Israel would not be accepted as a full member even in the distant future.[10] As stated in the Association Agreement, the EU would clearly be willing to advance a relationship with Israel limited to three basic freedoms – goods, services and capital.

- A central pathway to upgrading relations with the EU includes negotiations on establishing a Deep and Comprehensive Free Trade Area (DCFTA) similar to those the EU signed with its eastern partners (Ukraine, Moldova, and Georgia) as part of

[8]"Israel's banking system entered the corona crisis in a robust state: The banks enjoyed large surplus capital, strong liquidity ratios and quality credit portfolios. Since the 2008 global crisis, the Supervision of Banks has worked to strengthen the capital and stability of the banking corporations by adopting advanced international standards, improving the quality of capital and expanding its extent, spreading credit portfolios, reducing exposure to large borrowers, and more" (Financial Stability Report for first half of 2020, Bank of Israel).
[9] Norway, Iceland and Lichtenstein are members of this area. They are members of the EU's common market (except for agriculture and fishing) and accept all its relevant legislation.
[10] EU member states view the State of Israel first and foremost as a non-member Mediterranean state. The Association Council symbolizes a relationship with a neighboring country but without expectations of EU membership.

their association agreements, and even beyond. Specifically, these are a "new generation of trade agreements based on approximation of laws, adoption of European regulations, standards and norms in return for integration into the EU single market. The agreement would adopt the four freedoms that govern the movement of goods, persons, services, and capital within the EU by removing customs and non-tariff barriers, creating a consensual framework that provides for legal certainty and protection of investors, access to government tenders and procurement, liberalization of "visa categories" for temporary entry of natural persons, and more. The legal basis for upgrading the agreement stems from the 1995 Association Agreement (Note 3) as well as the 2004 Israel-EU Action Plan stating that the sides would "Promote the opening of bilateral negotiations on liberalization of services with Israel… Strengthen co-operation between the EU and Israel on regulation, supervision and financial stability and examine the possibility of convergence with a prudential regulatory/supervisory framework equivalent to the underlining principles of those existing in the EU while taking into account Israel's right to maintain and set benchmark standards and regulations, Carry out an assessment of the scope for legislative approximation with a view to inclusion of this sector in a FTA and ultimately Israel's participation in the European Single Market for financial services."

- On February 9, 2021, the European Commission issued a new agenda for the EU's relations with the Mediterranean Basin, stating, "The EU will step up its existing cooperation with Israel in the areas of digital, research and innovation and will identify opportunities to reinforce cooperation in related areas of mutual interest."

- Striving for an agreement of the DCFTA type between the EU and Israel could yield a comprehensive approximation of international standards and EU economic legislation and rules. This regulatory approximation could increase the volume of services exports to the EU and lead to a gradual Israeli integration in the European single market.