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HOW TAXES KEEP HIGH-TECH INVESTORS AWAY FROM ISRAEL

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Introduction

Israeli high-tech companies raised more than \$3.2 billion in 2000. This amount is three times higher than the amount raised in 1999, which was \$1 billion. The local venture capital market also reached record levels in 2000, with investments of \$1.1 billion. This amount, one-third of the total amount of capital raised by Israeli high-tech companies, compares to \$435 million invested in 1999. From 1991 to 2000, venture capital funds raised a total of \$6.5 billion, with \$3 billion available for new and repeat investments.¹

The following data gives a good picture of the importance of the high-tech sector in Israel: In 1999, the high-tech portion of the GDP was approximately \$2 billion. Exports of the Israeli electronics sector were approximately \$7 billion. High-tech accounts for eight percent of total commercial production, with an annual export growth rate for the last decade of more than fifteen percent. As of October 2001, the high-tech electronic and software industries employ approximately 68,000 people.² The annual growth rate of high-tech employment over the last decade is 6.7 percent, as opposed to rising unemployment in the general economy.³

The 20 largest Israeli high-tech transactions were estimated, on the day of the transaction, to equal more than \$12 billion, and high-tech transactions comprised more than 50 percent of Israeli exports.⁴

From the above facts it is clear that the Israeli high-tech industry plays a major role in Israel's economy and is a key element for future economic growth. Nevertheless, it appears that

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in the last two years the Israeli high-tech locomotive has been derailed. Numerous technology companies have moved their operations to the United States, and the majority of newly founded Israeli companies register their corporations as U.S. companies.

Israeli venture capital funds are also moving their operations to the United States, and more and more venture capital raised in Israel is coming from foreign funds. In the last half of 2000 venture capital investments dropped all over the world, along with the fall in NASDAQ and other high-tech indices. In Israel, in the last quarter of the year 2000, there was a 30 percent decline in foreign investments in Israel, which lowered overall investments by 18 percent, to \$845 million.⁵

There are many explanations for what is happening in Israel. Some of them are:

- Israeli tax laws deter investors.
- Registering Israeli companies in the U.S. is logical considering the proximity to the U.S. market and its sources of financing.
- The security situation in Israel deters foreign investors.
- Israeli corporate legislation makes mergers and acquisitions difficult.

Of all these explanations, tax considerations appear the most important factor in the flight of foreign investment and local companies. In some cases, investors may have come to Israel because the government had promised to reduce taxes, or because the high-tech boom and NASDAQ prices were such that the investors thought their high profits from investments in Israel would compensate for the high tax payments. Today all potential investments in Israel are scrutinized, as it were, with magnifying glasses. Israeli tax laws and the regulatory environment are inappropriate to the current global competitive market, in which countries compete for foreign investments by offering investors user-friendly investment terms.

Israeli taxes burden entrepreneurs as well as existing companies and cause investments in Israeli companies to shrink (both in size and number), while encouraging Israeli companies to move their operations to countries which have more favorable tax laws.

In 1999, a committee headed by Finance Ministry director general Avi Ben-Bassat was appointed by then Minister of Finance Avraham Shochat to plan income tax reform. The committee's mandate was to examine the Israeli tax environment and to recommend appropriate legislative tax reforms. The committee declared that tax laws have become a critical tool for determining a country's competitiveness and determining its market share of international investments and trade, and noted that the ease of capital flow and worker migration, "...could cause capital and economic activity to move to countries [outside of Israel], resulting in damage to the Israeli economy and a significant reduction in the amount of taxes collected by the Israeli government." The committee concluded that "...the taxation rate on economic activities in Israel could not significantly differ from those rates customary in the United States and western Europe without damaging the competitiveness of the Israeli economy."⁶

Nevertheless, the committee's recommendations were limited in scope, including a recommendation to change the basic tax system to a personal tax rather than the current combination of both personal and territorial taxes. Ben-Bassat's only constructive recommendation was to reduce tax rates on capital gains to 25 percent instead of the marginal tax rates in place today, which are usually above 50 percent.⁷

The committee did not deal with aspects of Israeli taxation that affect investors. Worse, it recommended a series of new taxes on savings, retirement funds, pension funds, and the Tel Aviv Stock Exchange. It even recommended imposing gift and death taxes. These new taxes belie the committee's stated intent to improve Israel's standing regarding taxation and, if implemented, would further lower Israel's ability to attract domestic or international investment.

The Ben-Bassat Committee recommendations have not been implemented and it is doubtful, if they are implemented, whether they will be implemented as they were prescribed. The Ben-Bassat Committee has been added to a long list of other tax "reform" committees whose influence has been nil.

Changes in Tax Systems Around the World

Many countries around the world, mainly developed countries such as the U.S. and Germany, which dictate the rules in the international arena, have undertaken tax reform which can be characterized in the following two ways:⁸

1. Reduction of marginal taxes: The U.S. lowered its maximum capital gains tax to 18 percent on investments held for five years or more, in order to encourage long-term investment.⁹ A maximum 20 percent rate applies to investments held for at least one year, while shorter-term investments are taxed at higher rates.¹⁰

Professor Alvin Rabushka has criticized the distinction between short- and long-term investment, which is based on an anachronistic need for longer-term investments. In a modern economy, an investor should be able to realize his holdings based on when he can maximize profit, without taxation affecting his decisions.¹¹

Germany plans to gradually lower its income tax rate from 53 percent to 45 percent and so, too, do Holland and other countries.

2. An income tax model was adopted in which income tax rates are progressive while income from capital gains (dividends, interest, and sale of shares) have a flat tax rate, as opposed to taxation based on marginal tax rates.

International Competition for Foreign Investors

Countries whose sole resource is their high-quality manpower have implemented other competitive advantages to attract foreign investments. A number of countries, such as India,

Singapore and Ireland, have begun building new technology infrastructures and restructuring fiscal legislation to offer tax relief.

They have done this with an eye towards the high-tech industry in general, and the electronics industry in particular.

India

India has adopted a policy of offering investment incentives and significant benefits to foreign investors in order to turn itself into the leading software-producing country in Asia. Included in these benefits are tax exemptions – over a ten-year period – on revenues generated from companies that operate from within industrial parks designated as Software Technology Parks and Electronic Hardware Technology Parks.¹²

Additional benefits include reductions in duties and value added taxes. Companies that do not operate out of industrial parks also receive benefits such as tax exemptions for revenues generated by software development. India has also allowed partial tax exemptions on the realized investments and dividends paid to foreign shareholders (who enjoy an almost 50 percent exemption from the tax rate that would ordinarily apply).

Singapore

Singapore also legislated significant benefits to companies that deal with electronics and high-tech.¹³ Companies that receive these benefits enjoy a reduced tax rate of 10 percent for five years.

Singapore offers foreigners tax exemptions on dividend distributions, and local companies paying royalties to owners abroad are exempted from withholding taxes for e-trade.

In addition, Singapore grants special benefits to Singapore-registered companies that serve as a base of international operations or hold foreign subsidiaries, and also high-tech companies under certain criteria. Tax exemptions can vary from periods of 5 to 10 years, and sometimes longer.

Ireland

The government of Ireland designated the area of Shannon a preferred area for investments. Companies that operate in Shannon receive tax benefits which include, among other things, a reduced tax rate of 10 percent until 2010. Ireland also reduced corporate tax rates for active (as opposed to shell) companies, and beginning January 1, 2003, the corporate tax rate in Ireland will be 12.5 percent.¹⁴

As a result of these tax benefits, Ireland has undergone dramatic changes. This past year, the television show “60 Minutes” described the “new Ireland” as a land which has undergone impressive growth, in which many of the world’s established multinational corporations operate.

The unemployment rate in Ireland has impressively shrunk from 15 percent to 4 percent, at the same time that three hundred thousand new workers have immigrated to Ireland.¹⁵

Foreign investors attributed their decision to invest in Ireland to the low tax rates offered and the educated and English-speaking population. They invested even though Ireland was recently considered unstable in terms of security and the danger of instability is still present.¹⁶

In addition, Ireland has also become a preferred place of residence for wealthy individuals. Economists from KPMG (one of the five leading accounting firms in the world) say this phenomenon is a result of Ireland's low taxation; its capital, Dublin, is a hub of international trade; and obtaining Irish citizenship is extremely easy. In order to obtain citizenship a person simply needs to purchase a residence in Ireland and live there for part of the year. Possession of an Irish passport then allows its owner to pass uninhibited throughout Europe because Ireland is a member of the European Union.¹⁷

An interesting article in *Forbes* magazine describes the same phenomenon of wealthy individuals who move to foreign countries for tax purposes. *Forbes* describes how this injects large amounts of capital into the new country of residence while removing that same amount of capital from the person's country of origin.¹⁸ The authors of the article point out that in 1981, the year that then president of the United States Ronald Reagan lowered taxes, not one U.S. citizen canceled his citizenship. In 1993, on the other hand, 306 American renounced their citizenship as a direct result of tax considerations.

In Israel, an example of emigration resulting from tax considerations is Zev Lederman. American born, Lederman grew up in Israel but now resides in the U.S. He sold his company Tradeum to Verticalnet for \$500 million. In an interview with *Globes* magazine he said: "In my opinion, Zionism in the twenty-first century, the age of globalization, means making as many Israeli millionaires as possible, not necessarily living here. But I don't think the Israeli government and the tax authorities encourage entrepreneurship in Israel, because they just want to take. They don't help create wealth that we all can have a part in, and this is unfortunate. By the way, I hope you misspell my name so the tax authorities don't come after me (laughter)."¹⁹

In contrast to Ireland, Japan, Hong Kong, and the U.S., Israel has put itself at a disadvantage regarding the encouragement of foreign investment. The Israeli income tax rate can reach 50 percent and causes young talented Israelis to look for work abroad. It raises the expenses of local companies, which are increasingly taking into account the take-home pay of their employees when offering salaries.

The Israeli capital gains tax on the sale of stock in Israel is based on one's marginal rate and may reach 50 percent and sometimes more. This contrasts with lower capital gains taxes in many other countries. The profit on a sale by the owner of a company is based on the purchase price; when he himself issues stock, for which there was no set value at the time, the profit is the sale price minus the amount of the owner's original investment in his company.²⁰

It should be noted that the Israeli tax laws discriminate in favor of existing, established companies. When a company needs money it can issue stock and it can be taxed when the stock is sold.²¹ This is fine for established companies which can issue stock and wait until they need the cash before selling. But start-ups need cash quickly and will prefer to sell their company outright or make a stock swap with a company whose stock is already valuable and can therefore be sold immediately for cash. In these two cases, the start-up will be taxed either immediately for selling the company or within two years for a stock swap. Thus, under Israeli tax law, it is easier for established companies to raise cash than for new companies.

The tax deferment on stock swaps that was legislated in Israel in 2000 is limited to a period of two years²² in contrast to the U.S. where there is no taxation at all on stock swapping.

Many Israeli legal restrictions hinder mergers and acquisitions. They limit the size of companies during restructuring resulting from mergers and acquisitions, how long stocks may be held, transaction requirements, and so forth. In fact, even the tax benefits that do exist for foreign corporations and for venture capital funds have no clear guidelines. This makes it difficult for foreign investors to decide whether or not to invest in Israel, for fear that they will not be eligible for tax benefits. (These problems, and others, will be explained below.)

In spite of the international competition for foreign investments, the Ben-Bassat Committee wrote: “The committee does not see any justification to continue to discriminate in favor of foreign investors, to the detriment of local ones, specifically in light of the tremendous foreign investment we have seen in the past few years.”²³

This economic policy of the political establishment has had its effect on the Israeli Income Tax Authority. Doron Kochavi, a partner and tax expert in the law firm of Kost, Forer and Gabbay, and Magen Altuvia, tax consultant to the law firm Tulchinsky-Stern, were both involved with the sale of Chromatis to Lucent and represent many venture capital funds. They say tax officials do try to accommodate foreign investors. Nonetheless, “The Tax Authority thinks only in terms of preventing tax evasion,” said Kochavi, “...and they ignore the fact that the tax environment in Israel is inappropriate for the high-tech age.”²⁴

“Discrimination” favoring foreign investors is a tool used by countries around the world to attract foreign capital, and in fact benefits local companies and of course the general economy by accelerating growth and creating jobs. It is important for the Israeli Income Tax Authority and government economists to pay attention to these global trends and to note Israel’s inferior competitive position in the global market.

Furthermore, if a state committee which ostensibly wants to reform the Israeli tax system arrives at the conclusion that discrimination is inappropriate, then it would certainly be preferable to lower taxes for everyone than to leave taxes high for everyone. This would be a true reform, resulting in economic growth in Israel.

Now we will examine different aspects of international taxation and Israel’s inferior competitive position.

Corporate and Marginal Taxes

The majority of countries around the world have begun to understand the tremendous implications of foreign investments on their budgets, and as a result they have taken numerous steps to reduce taxes and give significant financial benefits and incentives to attract foreign investors.

KPMG's economic survey for the year 2001 shows that corporate taxation in Europe continues to steadily decline and, on the average, stands at 32.96 percent, down from 34.02 percent in 2000.²⁵

Tax reform in Germany and tax cuts in France, Italy, and Ireland have contributed to this decline, and further significant corporate tax reductions seem to be on the way: The government of Ireland has recently decided to reduce its tax rate to 12.5 percent by 2003. Ireland's decision is expected to cause many other countries to follow suit and lower their tax rates, in order to avoid losing capital investments. In comparison, Israel's current corporate tax rate is 36 percent.

These rates are counterbalanced in some cases by state subsidies and benefits which reduce the effective tax rate. Table 1 shows the difference between nominal and effective tax rates in various countries. The situation in Israel is similar.

Table 1
Nominal and Effective Tax Rates

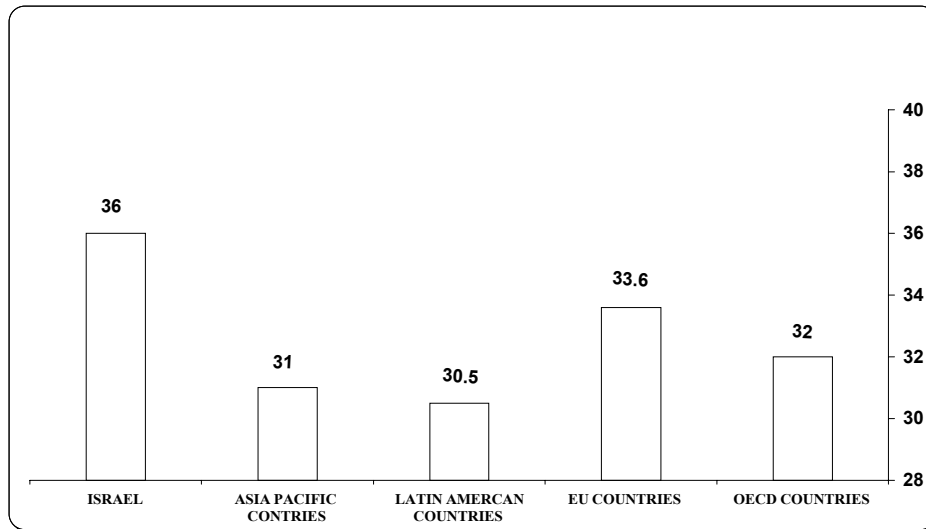
Country	Nominal Tax (%)	Effective Tax (%)
Ireland	20	9.43
Austria	34	18.25
Belgium	40.17	18.89
England	30	20.83
Germany	39.36	25.20
France	35.33	30.11

Sources: www.bakerinfo.com/publications/documents/1547_tx.html;
KPMG, *Corporate Tax Survey*, January 2001: <http://www.kpmg.com/search/index.asp?cid=299>

In an IASPS *Policy Studies* by Adam Ruskin on the subsidization of Israeli R&D, it was found that the Ministry of Industry's Chief Scientist's Office funds many high-tech investments and these subsidies and other benefits mean the effective high-tech corporate tax rate is lower than the nominal 36 percent. Yet Ruskin points out that these subsidies are granted in ways which discriminate in favor of established companies and against start-ups. Established large and medium-sized corporations received 85 percent of the state grants, while start-ups received 15 percent.²⁶ This discrimination takes place even though the larger established companies already have more and wider alternate sources of funding, and most of them are listed on the capital markets.

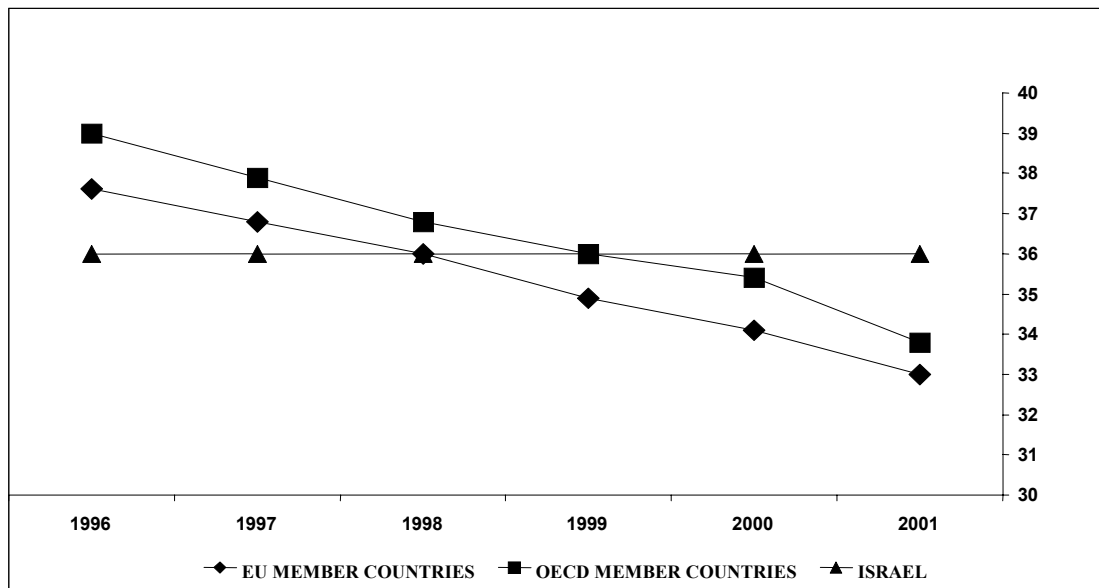
Figures 1 and 2 compare Israel's corporate tax rates with rates in other countries.

Figure 1
Corporate Tax Rates (January 2001)



Source: <http://www.kpmg.com/search/index.asp?cid=299>

Figure 2
OECD and EU Average Corporate Tax Rates



Source: <http://www.kpmg.com/search/index.asp?cid=299>

To further complicate matters, new Israeli corporate legislation was enacted in January 2000 that on the one hand does not allow corporations to grant options to corporate directors, yet on the other hand imposes more regulations regarding transparency on the corporate directors. This further discourages foreigners from investing in Israeli companies.²⁷ The Ministry of Justice came under criticism from the business community for this legislation and is in the process of proposing changes, but until now they have not been made.²⁸

In addition to the problem of high corporate tax rates, another problem in Israel is high marginal tax rates which, as noted, are as high as 50 percent. This doesn't include additional health and national insurance taxes, which, when combined can reach an additional 9.7 percent for certain income brackets. It is self-evident that an effective tax rate of more than 50 percent is too high, to say the least.

Understandably, these tax rates have a negative impact on foreign investment in Israel. Economist Yossi Laster estimates that the direct tax burden in Israel is more than 30 percent of the GDP, in comparison to European countries where the average is 20 percent. Laster points to Professor Alvin Rabushka, who has written that one of the criteria for a sound tax system is relatively low tax rates which apply to as broad an income base as possible.²⁹

The last proposed tax reform in Israel was that of the Ben-Bassat Committee. Although the committee's recommendations were not adopted, they still serve as the basis for the current discussion of reform for Israel's international or high-tech taxation.³⁰ It is important to note the committee's main concern was to lower tax rates in order to energize the economy, create new jobs, and minimize the emigration of high-tech manpower. In addition, tax reduction would reduce the incentive for tax evasion and therefore contribute to a more equal and efficient system.

However, it is difficult to argue the proposed reforms would have attained these stated goals; for, aside from lowering tax rates on labor (mainly for middle-income earners), the recommendations also included eliminating tax credits and certain tax exemptions and adding new taxes for retirement funds, supplementary education funds, the bourse, and savings plans. Taking all of these factors and the planned gift and estate taxes into consideration, we are led to conclude that as a result of these "reforms" the tax burden on labor would have been minimally reduced, if at all.³¹

Another problem regarding Israel's taxes on labor is the taxation of incentives and stock options. One possibility is to consider options as income from labor and tax the income according to the earner's marginal tax rate, which is often 50 percent, especially in the high-tech sector. Another possibility is to apply the capital gains tax rate, but in Israel this involves rigid restrictions such as turning half the options over to a trustee for two years.³² We will not go further into this issue because it is complex and also not a major factor in decision making by investors. In any case, lowering marginal tax rates and capital gains rates, both of which should be done, would resolve this issue as well.

Capital Gains Tax

A central problem in Israel is that the capital gains tax is much higher than in the United States and western Europe. The long-term capital gains tax in the U.S. varies from 18 percent to 20 percent while Germany has eliminated capital gains tax altogether to prevent the flight of German capital.

In contrast, Israeli citizens pay a 50 percent capital gains tax on new founding stock (profits on existing shares traded by individuals on the TASE remain tax free). In the past few years, the fuel that has fed the Israeli economy has been start-up companies in information technologies that are not initially traded on the public market. Small new companies that appear to have found a market niche are sought by investors, who invest in them by purchasing stock. In this instance, the owners who founded the successful company are required to pay a marginal income tax of 50 percent on the sale of that stock. A tax rate so high is significant enough to motivate companies to incorporate abroad.³³ Established corporations not in need of an immediate cash flow have the option of issuing stock on the Tel Aviv Stock Exchange (TASE) or abroad, and then choosing to delay taxation until the stock is sold. This option is often unavailable to start-ups who instead need to sell their companies for cash and who end up paying high capital gains taxes.

There are two accepted models in developed countries to tax gains from capital investments. One model is using marginal tax rates, which vary from person to person, and the second model is to impose a flatter rate on financial income. This latter model has been adopted by the U.S., England, Canada, and others. In the 1990s, Scandinavian countries led an international trend adopting a dual model where the capital gains tax remained flat and low, and marginal tax rates on income from labor were progressive.

The Ben-Bassat Committee placed great importance and emphasis on the dual model. The committee recommended lowering the capital gains tax to 25 percent even if that would be lower than the tax on labor. This was an attempt by the committee to harmonize Israeli taxation with that of the Western world and especially the U.S.³⁴

One can criticize this recommendation of the committee. Since the capital gains tax is not designed to serve purposes of socialism but rather to attract foreign investments to Israel and prevent the flight of capital, the truth is that a 25 percent tax rate has no intrinsic significance. One can argue that the capital gains tax should be lower, in order to attract global investments and compete for foreign and domestic investors.³⁵

Tax rates as an incentive for investments and globalization should be on par with other countries: the 18 percent in the U.S., for instance, or even more competitive rates. Tax rates should be based specifically on attracting investments, not only preventing the flight of money and manpower. It is not clear why Israel decided on 25 percent and not 18 percent or any other percent.

One hypothesis is that the committee's attempt to establish a connection between capital gains tax and income tax was based on a verbal association ("tax") which has no economic or global justification.³⁶ When the committee recommended a lower capital gains tax it should have set rates which would yield higher tax income for government coffers; but this will only happen by lowering the tax rate and thereby attracting more foreign investment. Foreign investment would grow if the capital gains tax were 10 percent or lower.

To obtain the desired results, the first step in tax reform should be to lower the capital gains tax to 18 percent. Eventually, it should be made even lower with the ultimate goal of attracting even more investments.

Table 2 compares short-term and long-term tax rates and requirements for holding periods in Israel and other countries.

Table 2

Comparison of Capital Gains Tax Rates for Individuals and Corporations

Country	Individual Capital Gains: Max. Tax Rate on Equities		Individual Holding Period
	Short-term	Long-term	
Belgium	Exempt	Exempt	None
Germany	55.9%	Exempt	6 months
India	30.0%	20.0%	1 year
Ireland	20.0%	20.0%	None
Italy	12.5%	12.5%	None
Singapore	Exempt	Exempt	None
United Kingdom	40%; shares valued at less than \$11,500 are exempt	The rates vary: 1 year: 35% 2 years: 30% 3 years: 20% 4 years: 10%	Sliding scale of rates applies to 1 to 10 years. Assets held 10 or more years face a top marginal rate of 10 percent.
United States	39.6%	20% (1-year holding period)	1 year
Israel	50%	50%	For stock swaps only: 2-4 years earns a delay but not a reduction in tax.

Sources: <http://www.part.gc.ca/36/2/parlbus/commbus/senate/Com-e/bank-E/re...rep05may00-e.ht>; *Israel Income Tax Code* 1961, article 104(8).

Venture Capital Fund Investments

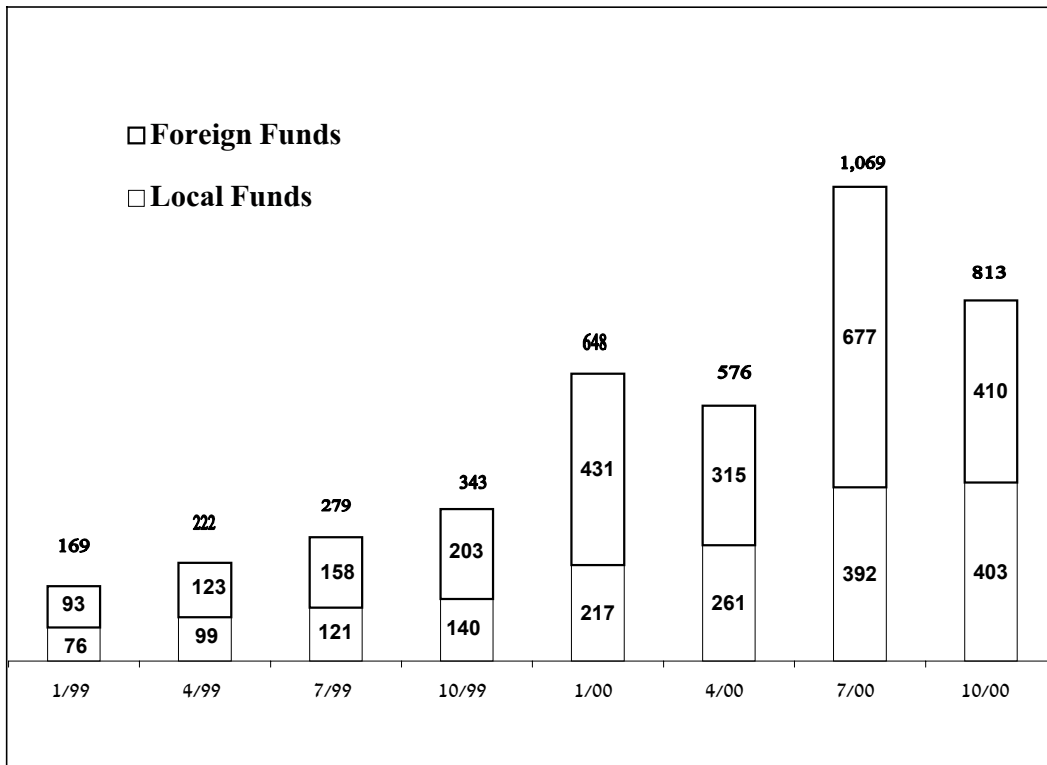
Venture capital funds make their investments via partnerships or companies that focus on high-tech companies in their early stages. Most venture capital funds realize their investments some time after the initial public offering of the company. In the last few years there has been a

dramatic increase in the amount of venture capital money invested in start-ups and the number of such investments.

Figure 3 shows the amounts of venture capital investment in Israel over the past two years.

Figure 3

Amount of Venture Capital Investment in Israel (millions of dollars)



Source: *Haaretz*, January 5, 2001.

The Israeli tax authorities have made it possible for venture capital investments in Israel to receive a pre-ruling tax exemption and to be taxed at only 20 percent. Although this low tax rate is desirable, obtaining the pre-ruling is not without problems. For example, the reduced tax rate is offered with the understanding it is a final tax rate and supercedes other tax benefits such as relief from double taxation.

In addition, receiving a pre-ruling tax reduction permit involves restrictions that require the investor to prove his business is centered in Israel. He must:

- invest a minimum \$20 million.
- open a file at the Israeli Income Tax Authority.

- establish a permanent presence in Israel, including an office with employees.
- open an active Israeli bank account.
- produce proof of business income.

All these requirements deter foreign investors.³⁷

In addition, the tax benefits afforded venture capital investors are not anchored in clearly defined rules and the investors have no idea if these benefits will actually be granted. The Tax Authority is aware of this problem and a representative recently said, “In the near future transparent criteria will be established so it may be possible to know who is eligible for tax benefits and who is not.”³⁸ At present, no clearly defined principles have been made public because the rules are constantly changing. In general, however, the Tax Authority has given a “green light” and most venture capital funds that request the tax benefits receive them.³⁹

In light of the above, there are numerous financial bodies that refrain from making venture capital investments in Israel, incurring a loss of anywhere from tens to hundreds of millions of dollars of potential foreign investment. The British company Horsely Bridge – which in the past has invested more than \$100 million in Israel – currently refuses to invest in Israeli companies at all, until the tax exemption issue is cleared up.

Advisors of Private Equity, a Swiss company which considered investing in Israel, has also decided not to invest in Israeli companies for the same reason. The government of Singapore also considered investing more than \$120 million in Israeli high-tech companies via venture capital funds but stopped the initiative after the Israeli Income Tax Authority did not guarantee a tax exemption.⁴⁰

Chen Shor, comptroller of the venture capital fund Yozma, cites the example of Goldman Sachs which froze investments of tens of millions of dollars after last year’s sale of Chromatis to Lucent and the tax problems that arose from it. After the finalization of the sale, an Israeli venture capital firm withheld the distribution of Lucent shares as a result of a debate with the Income Tax Authority on the amount of taxes the fund was required to pay. Only in February 2001, after an agreement with the authority was reached, did the fund release the Lucent stock that it received as part of its investment. The agreement was that taxes to be paid will be determined at a later time, when the issue is cleared up with the U.S. tax authorities, in order to prevent double taxation.⁴¹ However, by July 2001 the value of Lucent’s shares had plummeted from the time of the deal’s consummation, and the profit to be realized from sale of the stock had been devalued by some \$570 million. In August Lucent closed Chromatis and fired all of its employees.

Yigal Ehrlich, chairman of the Israeli Venture Capital Organization and CEO of the venture capital firm Yozma, has estimated that Israel lost anywhere from \$600 million to \$1 billion in foreign investments as a direct result of the controversy with the Tax Authority.⁴²

A joint committee, comprised of the Israeli Venture Capital Funds and the Tax Authority, was formed to prevent future problems such as the Chromatis-Lucent fiasco. They have still not

been able to solve the problem of Israeli taxation of foreign investments which is disproportional to the taxation in other countries.

The Israeli Tax Authority is still waiting for the IRS to decide what its position is on the Chromatis deal, since Chromatis was incorporated in the U.S., operated in the U.S., had U.S. investors, and was sold to a large U.S. company, Lucent.⁴³

In light of the above information, it appears that foreign investment in the Israeli venture capital market should be exempt from taxation, if Israel wants to attract such investment.

Finance Minister Silvan Shalom has announced his intentions to grant a general tax exemption to foreign investors in Israeli venture capital funds beginning October 2001, on the condition that these funds invest at least 20 percent of their capital in Israeli-incorporated companies.⁴⁴ Yet even this decision leaves much in doubt. Procedural matters have yet to be resolved, and more conditions may be imposed on eligibility for the exemption. Also, nothing has been resolved regarding already-existing funds established before October.⁴⁵

The Mergers and Acquisitions Law

A survey by KPMG economists shows that in the first half of the year 2000, mergers and acquisitions increased worldwide by 60 percent. According to KPMG, many large established companies feel that in light of the new global economy they have to strengthen their global service alignments and offer a multinational presence. Corporations consider takeovers of foreign companies based on the type of business, profits, market share, and – just as important if not more – the tax environment and regulations in the country in which the company is based.⁴⁶

Mergers and acquisitions are especially important in the high-tech sector, which is characterized by its dynamic environment. Companies are bought by other companies, merged, or spun off more frequently and on a larger scale in high-tech than in other sectors.

The tax aspects of corporate restructuring are addressed in chapter two of the Israeli Income Tax Regulations. This chapter, legislated in 1993, does not adequately deal with merger and acquisitions particularly in light of the speed in which the high-tech industry needs to perform restructuring.

One example is the restriction on the size of the companies that are merging. This was intended to prevent a large company from taking over a smaller company for the purpose of receiving a tax exemption. This restriction is anachronistic in light of the natural business environment of the high-tech industry, where the majority of mergers are accomplished between corporate behemoths and smaller companies.

Previous legislation required the companies to hold the stocks swapped in the restructuring for a period of two years (with some exceptions). This requirement does not make sense from a financial viewpoint and forces the merging companies into an economically baseless holding period. Instead of allowing the merged company to make an economic decision

to sell shares according to their value on the market at a particular time, these companies are forced to hold them in order to receive their tax exemption.

Further, the law does not address the possibility of “chain mergers,” nor does it make tax arrangements for mergers via stock swapping, which today is the means of choice. A stock swap requires immediate payment of taxes by the “seller” even though the “seller” simply received paper (other stock shares that were not actually sold).

This creates an absurd situation in which stockholders have to pay a large amount of taxes but do not have the money to pay. As a result, they are forced to borrow money or sell stock against their will.

Recently, there has been an attempt to resolve the situation through private agreements reached with the Tax Authority. The opportunity is given stockholders to defer payment of taxes until the stocks are sold. This opens the door to preferments, discrimination and even corruption. Further, the opportunity is offered by the Tax Authority only if the company in question deposits its stocks with a trustee, and if the company pays a 50 percent tax at the time of a future sale, instead of the 35 percent tax rate that usually applies to the sale of stocks.⁴⁷

In December 2000, amendment 123 was passed dealing with a long list of issues concerning mergers and acquisitions. The amendment grants a wide berth of authority to the minister of finance to issue new regulations for tax deferrals during restructuring. The new law makes allowances for restructuring, “chain mergers,” and tax deferrals.⁴⁸

Yet this law does not solve the problem of stock swapping, which was the main impetus for the change in the law in the first place. The law as it relates in article 103(20) to mergers involving stock swaps, and which allows deferrals in tax payments until the actual sale of the shares, is largely irrelevant for high-tech industries.

For example, the law requires that the acquiring company be Israeli, unless the Tax Authority gives special approval to a foreign company. Another requirement is that the market value of one company involved in the merger not be more than four times the value of the other company. The acquiring company is further required to allocate stocks of equal rights to the stockholders of the other company. There is also a restriction on selling rights and assets of the acquiring company, and much more. These restrictions make more difficult the opportunity for a tax deferral involving a stock swap.

Another option for mergers involving stock swaps is based on article 104(8) of the law, which allows a person, under certain circumstances, to defer payment of taxes until the sale of the stocks: for no longer than two years on half the amount of the stocks, and for four years on the other half of the stock. The use of this option is also largely irrelevant because too many conditions must be met in order to exercise it.⁴⁹

Establishing a specific time when the tax must be paid without regard to the time of sale, exposes an investor to the great risk of incurring tax liability on profits which were never made.

In order to pay the tax, the investor will need to sell the shares without any connection to its potential economic yield, thus, perhaps, flooding the market with an oversupply of the stock and significantly bringing down the stock value on the day the shares are sold. Or, alternatively, in order to pay the tax before realizing a profit, the investor may need to take out a large loan with high interest rates, which will hike the cost of capital to him. Finally, the law requires the investor to pay the full amount of his marginal tax rate, which in some cases may be 50 percent.

Chagai Oppenheim, who served as the director of mergers at the Tax Authority when the laws were enacted, explains that the law concerning tax payment after two years was meant to prevent tax evasion. According to him, the authority is committed to liberalizing the law, for instance in changing the company-size requirements of article 103(20), and in matters relating to R&D.

Oppenheim pointed out that although there are problems with the present law regarding mergers among high-tech companies, it would be wrong to enact reverse discrimination in favor of high-tech companies by allowing them to pay taxes only when the shares are actually sold.⁵⁰

Local experts on the other hand, say the proposed solutions are not acceptable in light of the tax laws in other countries, and in the U.S. in particular, where taxes are paid when the shares are actually sold.⁵¹

Table 2

Tax Payments on Mergers in Different Countries

U.S.	At time of stock sale
Germany	Total exemption from capital gains
Holland	At time of stock sale
Belgium	At time of stock sale
Denmark	At time of stock sale
Israel	2-4 years after transaction

Source: Ilan Ezra, director of the high-tech tax department at Somech Chaikin Accountants, interview with author, June 17, 2001.

The current restrictions on mergers and stock swapping are not appropriate in today's global economy. Taxation should apply to the investor at the time of the actual sale of shares without the investor being forced to hold his investments for a set period, as currently required by Israel. Even then, the tax should be at a competitive rate of 18 percent or less. Above, we have already compared capital gains tax in a number of countries. We have seen that there are differences between long-term and short-term investments in different countries and that different capital gains rates apply. Israel would do well to drop the holding requirement, which is what really differentiates it from other countries.

Influence and Analysis

Even though Israel has highly skilled manpower and great potential to grow and develop advanced technologies,⁵² if tax legislation remains the same it will be faced with one of the following two scenarios:

- Companies will establish limited research and development centers in Israel, while the operations and profits of the company will be concentrated with the mother company abroad. There will be a minimal use of Israeli infrastructure and less money invested in ancillary Israeli companies.
- There will be a massive emigration of skilled workers to countries outside of Israel.

Accountant Doron Kochavi's firm, Kost, Forer & Gabbay, of the Ernst & Young group, is one of the leading accounting firms for young high-tech companies and last year serviced more than 200 start-ups. He estimates the number of Israeli companies among his clients that incorporated abroad at 87 percent for this year, compared to 45 percent in 1999.⁵³

Yitzhak Forer, also of Kost, Forer & Gabbay claims that when the intention to reform Israeli tax regulations was made public, 80 percent of the start-up companies he works with notified him they would freeze their attempts to incorporate in the United States. They stated this was a direct result of the planned tax benefits in Israel. This demonstrates the significance of tax considerations.⁵⁴

According to Kochavi, if not for the current tax laws, Israel could receive \$6 or \$7 billion in foreign investments in the economy instead of the \$3 billion received in the past year. According to him, Israel's tax policies – mainly the taxing of foreign venture capital funds and foreign companies – cause U.S. and other foreign investors to avoid Israel and its tax laws.

Yigal Ehrlich also warned that as long as the Tax Authority continues to tax foreign venture capital funds as it does, it will be very difficult to raise further money, and there will be a decline in investments in local start-ups.⁵⁵

Arala Minkovsky, of the Polaris venture capital fund, agrees that because of local taxation and regulations, and the incentives for venture capital funds abroad, it is worthwhile for Israeli companies to establish themselves abroad, specifically in the U.S. Such an incentive also exists in Singapore, which has complete tax exemption for venture capital funds.

Micki Guter, from the venture capital fund Etgar, estimates the number of Israeli companies that initially registered in Israel and then emigrated to the United States, as between five hundred and six hundred. According to him, Israel is biting the hand that feeds it and it is possible that just as quickly as the high-tech start-up industry took off, it could, in two or three years, disappear.⁵⁶

An economic survey by the Manufacturers Association of Israel states that the influence of high-tech companies on the Israeli economy has been dramatic. In the year 2000 the Israeli growth rate was 6 percent, but subtracting the high-tech start-up companies the number falls to 3.9 percent. In tandem, the business-sector growth rate increased in 2000 to 7.9 percent, but without high-tech companies it was only 4.8 percent. The forecast for 2001 puts the local growth rate at 1 percent, compared to 6 percent in 2000, and the business product at 0.3 percent instead of 7.9 percent last year.⁵⁷

The distortions in the tax methods and regulations in the high-tech industry damage the Israeli economy. Without these legislative tax distortions the growth in the economy might be 2.5 percent higher, by conservative estimate, since every additional billion dollars that is injected into the economy and invested into *active* companies manifests a 0.7 percent increase in the GDP. The fact that venture capital funds and experts testify that they have put on hold investments in Israel because of the problem of double taxation further strengthens this conclusion.

Selling start-up companies to foreign investors does not influence the growth of the economy but rather the export growth. Because of the Chromatis fiasco and tax problems revealed thereafter, Israelis prefer to open companies abroad and, as a result, the local economy suffers.

A Money Tree survey, performed by the accounting office of Kesselman and Kesselman, confirms these findings. According to the survey, the results of which can be seen in table 3 below, 38 percent of high-tech companies that raised money in Israel in the last quarter of 2000 were foreign companies. The most disconcerting fact was that 55 percent of seed investments were directed at companies located abroad. In addition, 20 percent of the money invested by local venture capitalists was not invested in Israel. Along with the worldwide drop in venture-capital and high-tech investment in the second half of 2000, there was a sharp decline of about 30 percent in the amount of investments, including foreign funds, in Israel in the fourth quarter of 2000, which caused a decline of 18 percent in investments in general, which stood at \$845 million.⁵⁸

The first quarter of 2001 saw an increase in companies emigrating; the number of companies raising capital that are incorporated abroad rose to 44 percent, and 66 percent of seed money was invested in companies incorporated as foreign companies. Thus, even with the quarter by quarter drop in the number of companies, the number of companies incorporated abroad went up. In other words, more of the companies being formed were incorporated as foreign entities.

According to Yossi Philos, senior partner at the accounting firm of Kesselman and Kesselman and director of its high-tech department, these statistics are very disturbing. Their cause lies, among others things, in Israel's prolonged discussions concerning taxes and tax benefits for technology companies.⁵⁹

Table 3
Capital Flight from Israel

Number of Companies	Companies Incorporated as Foreign (%)	Companies Incorporated as Israeli (%)	Date/Type
193	38	62	Last quarter 2000; All transactions
132	44	56	First quarter 2001; All transactions
44	55	45	Last quarter 2000; Seed transactions
32	66	44	First quarter 2001; Seed transactions

Source: *Ma'ariv*, January 11, 2001, reporting the Money Tree survey.

The restrictions we have described above have also contributed to unemployment. In the high-tech industry there are 65,000 employees, a not-inconsequential percentage of the employees in Israel's commercial sector. In 2001, a year which saw and will yet see massive layoffs, the amount of jobs needing to be filled in the software engineering high-tech sector alone is estimated at two thousand.⁶⁰

Ancillary services to the high-tech field provide about four jobs for every one high-tech job. If filled, these jobs would further reduce unemployment by 2 to 2.5 percent. Since an estimated five hundred to six hundred Israeli companies are incorporated abroad and/or operate abroad, bringing them "home" by allowing the appropriate tax benefits would reduce Israeli unemployment even further. In addition to the high tax rates, intensive government intervention in Israel and the huge state bureaucracy facing investors damage Israel's international economic standing.

A report on global competition by the World Economic Forum (WEF) ranks world economies based on a country's ability to sustain medium- to long-term growth rates. The report, which surveyed 59 countries, examined quantitative data based on national economic indicators, technology and infrastructure and also surveyed CEOs about the countries in which their companies are active.

As can be seen in table 4 below, the survey found that in 1999 Israel was rated 28 out of the 59 countries, ranking near Portugal (27), and Mauritius (30). At the top of list were Singapore, the United States and Hong Kong. Ireland, which was mentioned as a model worthy of emulation, was tenth while two years prior it was 16.

The findings of the survey, as they appear in table 5, show that Israel's growth potential is huge, especially when taking into consideration the technology index which measures

computer use, adoption and level of penetration of new technologies, and size and quality of R&D. In this index, Israel rated ninth.

However, in the “openness” index, which rates a country's ability to liberalize the economy and openness to foreign trade and parameters involving foreign investment, foreign currency and export benefits, Israel rated a low 40th. In the index that measures a government’s efficiency, the influence of fiscal policy, level of economic intervention, quality of government services, marginal tax rates and government expenditures, Israel is found near the bottom of the list, rated 46th.

These facts reflect Israel’s tremendous economic potential, which is stymied because of statism and governmental restrictions.

Table 4

WEF Report on Global Competition for 1999

Country	Ranking 1999	Ranking 1998	Difference in Ranking 1998-1999
Singapore	1	1	0
USA	2	3	1
Hong Kong	3	2	-1
Taiwan	4	6	2
Canada	5	5	0
Switzerland	6	8	2
Ireland	10	11	1
Germany	25	24	-1
Spain	26	25	-1
Portugal	27	26	-1
Israel	28	29	-1
Mauritius	29	-	-

Source: As quoted in Manufacturers Association of Israel website:
http://www.industry.org.il/industry/doa_iis.dll/serve/item/hebrew/1.1.1.4.2.14.html

Table 5
Israel's WEF Ratings

Category	Rating 1998	Rating 1999
Combined Index	29	28
Openness	42	40
Government	41	46
Finance	32	30
Infrastructure	35	26
Technology	7	9
Management	30	31
Labor	23	23
Institutions	22	19

Source: As quoted in Manufacturers Association of Israel website:
http://www.industry.org.il/industry/doa_iis.dll/serve/item/hebrew/1.1.1.4.2.14.html

Minister of Trade and Industry Dalia Itzik has said, “The bureaucracy in Israel is unbearable...it stops initiatives and deters investors. I’ve only been in office for two months and already serious investors have said to me, ‘Why should I come to Israel when in other countries the taxes are lower and the tax benefits are greater?’ Who has corporate taxes of 36 percent like we do?”⁶¹ It is interesting to note that although the government admits there is a high-tech taxation problem, it does not find and implement appropriate solutions.

Summary

This *Policy Studies* examined a number of comprehensive problems in the Israeli tax system and their influence on foreign investments.

Concerning employees we pointed out the high tax rates (50 percent) and the improper timing of taxes on stock options (high tax rates to be paid upon the granting of options without any connection to the actual sale of the options). We recommend, therefore, to reduce the tax rates and to require the payment of taxes on stock options only at the time of sale.

Concerning entrepreneurs we pointed out the high corporate tax rates (36 percent) in comparison to other countries (12.5 percent in Ireland by 2003). We noted the high capital gains tax of 50 percent as a significant obstacle to entrepreneurs, whereas in other countries such as in the U.S., rates are 18 percent or lower on long-term investments. We recommend, therefore, to decisively reduce the tax rate to its level in other countries or even lower, in order to attract investors.

We have seen that flight of investment capital from Israel will reduce Israel’s tax income, reduce the country’s GDP, raise unemployment and reduce Israel’s financial standing. By continuing to impose confiscatory tax rates in the hopes of increasing state revenue, Israel both impairs the freedom of its citizens and investors and reduces its tax revenues.

Concerning corporations we pointed out the significant restrictions on mergers and acquisitions that require tax payments on stock swapping when no shares were actually sold. We

recommend removing restrictions on selling companies via mergers and acquisitions, so taxes will be imposed only when shares are actually sold. This would allow companies to buy or sell shares based purely on financial considerations.

In passing, we also mentioned the problems of the new corporate tax law, which prohibits the granting of options to directors and imposes other far-reaching liabilities on corporate officials. This needs to be changed in line with the appropriate corporate laws that apply in the U.S.

Concerning foreign investors and venture capital funds the lack of clear guidelines in regard to obtaining tax exemptions, the risk of double taxation, and the high capital gains tax cause foreign funds – and even local funds – to look for investments outside of Israel. We recommend that foreign venture capital funds investing in Israel receive tax exemptions, much the way that is done in the U.S. and other countries.

Minister of Finance Silvan Shalom recognizes these problems and has said that he will meet with Prime Minister Ariel Sharon to present a sweeping plan for tax reform. Shalom has cited a tax ceiling of 25 percent for high-tech companies similar to that in the U.S.⁶² His suggestions match those of this *Policy Studies*, and Israel would benefit by adopting them in addition to our other recommendations.

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NOTES

¹ *Globes*, December 20, 2000, based on an IVC-ONLINE survey by the Zinook group. The survey was based on high-tech companies that had at least one Israeli venture capital fund involved in their funding.

² www.industry.org.il/industry/doa_iis.dll/serve/item/hebrew/1.1.1.4.4.4.html (October 24, 2001).

³ Nir Horenstein and Shlomi Regev, “High-Tech Taxation – Present Taxes and Future Trends,” *Israeli Tax Quarterly* 112 (January 2001), p. 7. [Hebrew]

⁴ *Ha’aretz*, January 7, 2000.

⁵ *Ma’ariv*, January 11, 2001. The Money Tree survey was conducted by the accounting firm of Kesselman and Kesselman.

⁶ Public Committee for Income Tax Reform, *Report of the Public Committee for Income Tax Reform* (Jerusalem: Finance Ministry, 2000), p. 6. [Hebrew]

⁷ *Ibid.*, pp. 82, 129.

⁸ *Ibid.*, p. 64.

⁹ The real rate is higher because state tax is paid in addition to federal tax, and the 18 percent rate is nominal.

¹⁰ Marvin A. Chirelstein, *Federal Income Taxation 1999: A Law Student's Guide to the Leading Cases and Concepts* (New York: Foundation Press), pp. 323-325.

¹¹ Professor Alvin Rabushka, letter to the author, July 29, 2001.

¹² See Indian *Income Tax* 1961, article 10, quoted in S. Menuchin and M. Chico-Redumsky "The Future of Electronic Commerce in Israel in Light of Tax Reform — Too Little Too Late?" *Taxes* 14 (June 2000), p. A-71. [Hebrew]

¹³ See *Income Tax (Concessionary Rate of Tax for Cyber Trading) Regulations* 1999, quoted in Menuchin and Chico-Redumsky, "The Future of Electronic Commerce," p. A-72.

¹⁴ Menuchin and Chico-Redumsky, "The Future of Electronic Commerce," p. A-69.

¹⁵ The show was aired as a segment of the Israeli Broadcasting Authority's "Roim Olam" on January 6, 2001 and the data appeared in *Ha'aretz*, September 5, 2001. The information may also be found at www.oecd.org

¹⁶ This teaches us when good investment opportunities are to be found, foreign investors don't pass up the opportunity – something that policy makers in Israel should remember.

¹⁷ KPMG, *Corporate Tax Survey*, January 2001: <http://www.kpmg.com/search/index.asp?cid=299>

¹⁸ R. Lenzner & P. Mao, "The New Refugees," *Forbes*, November 21, 1994.

¹⁹ *Globes*, March 13, 2000.

²⁰ *Israel Income Tax Code* 1961, article 88.

²¹ *Ibid.*, article 101.

²² *Ibid.*, article 104(8).

²³ Public Committee for Income Tax Reform, *Report*, p. 143.

²⁴ Doron Kochavi, interview with the author, December 13, 2000.

²⁵ KPMG, *Corporate Tax Survey*.

²⁶ Adam Ruskin, *Israeli Government Research and Development Subsidies to High Technology Companies*, IASPS Policy Studies, no. 42 (Jerusalem: IASPS, 1999), p. 13. [Hebrew]

²⁷ *Israel Corporate Law* 1999, articles 6, 54, in *Book of Laws 1711*, p. 189. [Hebrew]

²⁸ Ministry of Justice, “Draft Corporate Law 2001” (Ministry of Justice, Jerusalem, 2001, working draft). [Hebrew]

²⁹ Yossi Laster, “Do Israelis Really Pay High Taxes,” March 19, 2001: www.israeleconomy.org/opeds/oped5.htm

³⁰ *Ma’ariv*, August 21, 2001.

³¹ A. Alter, Z. Sharon, N. Horenstein, H. Vinter, “The Intended Tax Reform, Its Essence, Principals and Ramifications,” *Taxes* 14, June 2000. [Hebrew]

³² *Israel Income Tax Code* 1961, articles 3(9), 102 in *Laws of the State of Israel* 6 (1961), p. 120. [Hebrew]

³³ Public Committee for Income Tax Reform, *Report*, p. 135.

³⁴ *Ibid.*

³⁵ Yaacov Sheinin and Yossi Hollander, “Future Industries of Israel: The Social and Economic Environment” (Israel Democracy Institute, Jerusalem, April 2001, draft), p. 12 [Hebrew]. Sheinin and Hollander note that this is also the view of Gary Agron, until 2000 the deputy income tax commissioner.

³⁶ *Ibid.*, pp. 23-24. Sheinin and Hollander are quoting Dr. Avi Alter.

³⁷ Horenstein and Regev, “High-Tech Taxation,” p. 22.

³⁸ *Ma’ariv*, December 19, 2000.

³⁹ Yaron Shidlo, director of international taxation at the Income Tax Authority, telephone interview with the author, June 10, 2001.

⁴⁰ Chen Shor, interview with the author, June 5, 2001.

⁴¹ Magen Altuvia, adv., interview with the author, December 13, 2000.

⁴² *Ha’aretz*, February 25, 2001.

⁴³ Shidlo, interview.

⁴⁴ *Globes*, September 24, 2001.

⁴⁵ *Ha’aretz*, October 18, 2001.

⁴⁶ KPMG, *Corporate Tax Survey*.

⁴⁷ Ilan Ezra, director of high-tech tax department, Somech Chaikin Accountants, interview with author, June 17, 2001.

⁴⁸ *Israel Income Tax Code* 1961, article 103(20), p. 120.

⁴⁹ *Ibid.*, article 104(8).

⁵⁰ Chagai Oppenheim, interview with author, June 17, 2001.

⁵¹ Ilan Ezra and Doron Kochavi, interview with the author, June 14, 2001.

⁵² According to *Red Herring Magazine*, Israel is second in the world in the quality of its high-tech employees, www.redherring.com

⁵³ Doron Kochavi, interview with the author, June 12, 2001.

⁵⁴ *Ha'aretz*, May 4, 2001.

⁵⁵ Yigal Ehrlich, chairman of the Israeli Venture Capital Organization and CEO of the venture capital firm Yozma, interview with the author, May 10, 2001.

⁵⁶ *Globes*, December 4, 2000.

⁵⁷ Manufacturers Association of Israel, Economic Branch, Division for Statistics and Economic Analysis, *Economic Forecast for 2001: Update*, http://www.industry.org.il/industry/doa_iis.dll/serve/item/hebrew/1.1.1.4.1.1.5.html

⁵⁸ *Ma'ariv*, January 11, 2001.

⁵⁹ Yossi Philos, Kesselman and Kesselman, interview with the author, June 3, 2001.

⁶⁰ Amnon Leibowitz, secretary general of the Software Manufacturers Branch of the Manufacturers Association of Israel, interview with the author, September 6, 2001.

⁶¹ *Yediot Aharonot*, May 8, 2001; May 24, 2001, which quotes Yinon Achiman, economic advisor to the Ministry of Trade and Industry, who says these issues come up in practically every meeting with foreign investors.

⁶² *Ha'aretz*, May 11, 2001.

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