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Executive Summary

Examining the Law for the Encouragement of Capital Investment in Israel - and Alternatives

Shelly Hasan

Koret-Milken Institute Fellow

Koret Foundation | Milken Institute

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Recommendations:

- The LECI has failed to achieve any of its intended objectives while wasting billions of shekels of taxpayer funds. It should be rescinded immediately
- Budgeted LECI funds should be redirected to:
  - Infrastructure projects improving transportation between the periphery and the major population centers of the country
  - Reduce corporate tax rates rapidly to attract private equity fund and global investments to spur economic development throughout Israel; and
  - Increase leveraged credit to small business in the periphery, the engine of economic growth and jobs, instead of continuing to support LECI-type industry failures.

Introduction

The level of capital investments is one of the key indices in measuring the development and international position of a nation's economy. The legislation of an incentives policy to encourage capital investments in industry is common practice in many countries. This policy has various objectives: attracting foreign investment, advancing regional development, increasing exports, encouraging employment, and more.[1]

In Israel, the Law for the Encouragement of Capital Investment (LECI) was passed in 1959. The law provides tax benefits, grants, and other incentives to investors, either in general or based on an investment program. The main criteria used to determine the type and amount of benefit offered are the type of company, amount of investment, and the region in which the investment is carried out.[2] The background for the enactment of the law in the 1950s was a shortage of human and physical capital, and an intense need for foreign capital investment.[3] In addition, the law was supposed to help reduce severe unemployment in the country's peripheral regions, which resulted from the government's policy, at the time, of sending many new immigrants with no professional training to these regions.[4] Government assistance was therefore provided, via LECI, for unskilled labor-intensive industrial plants in peripheral regions.[5]

The question of the effectiveness of government incentives in developing and encouraging regional industry has been addressed in many studies, in Israel and abroad. One of the important conclusions reached is that such government policy treats the symptoms, but does not provide a solution to the essential problems of these regions. For example, through location-related incentives, the government often encourages investments in economically inferior areas, without taking into account the specific characteristics of each area.[6] The construction of anachronistic or economically unsustainable plants in such areas has perpetuated their economic backwardness and the poverty of their inhabitants. Today, too, transferring a high technology plant to a development town without infrastructure, a suitable level of human capital, and a supportive business environment, is tantamount to giving aspirin to a cancer patient. Rather than having taxpayers fund foolish investments, the characteristics of each region should determine the appropriate investments and industries, and any strategy of economic development needs to be based on the involvement of local organizations and particularly of local residents.

In addition, regional criteria for government aid programs influences considerations related to the feasibility of investments and biases decisions regarding the location of plants. This may result in regional discrimination, leading to a collapse of industry in areas surrounding a region granted a benefit. Furthermore, selective encouragement attracts undesirable investments, such as unstable plants that require ongoing assistance. The conclusion is that biasing the feasibility considerations of investors often causes the inefficient allocation of investments and losses to the investors themselves, to the taxpayer, and especially to residents of the region.[7]

Another finding of recent international research is that despite the fact that the incentives target disadvantaged areas, they do not target weak population groups.[8] Studies found that companies in development areas tend to hire employees from the metropolitan, rather than the local, labor market.[9] It was also found that programs intended for economically inferior regions are not effective unless extensive resources are invested over a long period of time.[10]

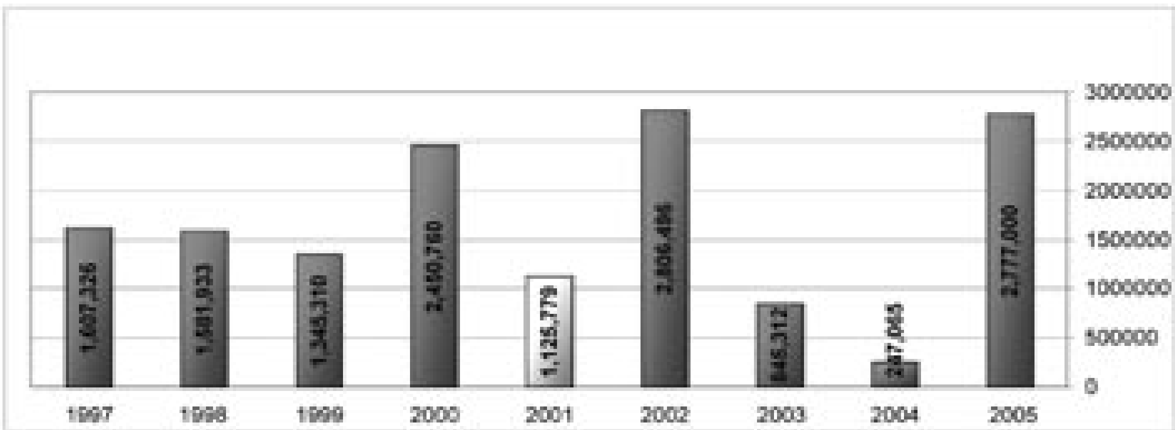
Government tax policy is another factor influencing regional development. It was found that a 10% tax reduction would increase employment and business activity in a metropolitan area, in the long term, by 1% to 6%, or, from another perspective, increase the number of new companies in the area by 2%-3%.[11] Furthermore, the prevalent view does not support sectoral tax breaks, which may result in market failures[12]; rather, a comprehensive tax reduction will expand the economic activity of the entire private sector.[13]

The Law for the Encouragement of Capital Investment - 5719-1959

As noted above, the LECI provides investors tax benefits, grants, and additional incentives, with priority to investments in development areas.[14] For the purpose of the law, the boundaries of areas to benefit from the law are marked as Priority Areas and determined by government decree. Municipalities in the Jerusalem, South, North, and Haifa regions are classified as Priority A Areas if they are rated in clusters 1 to 3 (the lowest rating) of the Socio-Economic Index and have an annual average unemployment rate of 10% or higher, or as Priority B Areas, if they are rated as cluster 4 and have an annual average unemployment rate of 8% or higher.[15] The Finance Minister and the Minister of Industry, Trade, and Labor are responsible for executing the LECI, while the Investment Center within the Ministry of Industry, Trade, and Labor administers it.[16]

Since the LECI's enactment, the Israeli government has given LECI grants amounting to tens of billions of shekels. The cost of the tax benefits granted under the LECI is estimated at additional billions. In the last decade, with the exception of years in which tax benefits and grants were given to specific large investments, there was a downward trend in spending authorization budgets. Graph 1 describes the utilization of spending authorization budgets by the Investment Center, as of one year ago.

Graph 1
Utilization of Spending Authorization Budgets (in NIS thousands)



Sources: Ministry of Industry, Trade, and Labor, *Investment Center Report for 2002-3* (Jerusalem: Ministry of Industry, Trade, and Labor, 2004), p. 51; Ministry of Industry, Trade, and Labor, *Investment Center Report for 2001* (Jerusalem: Ministry of Industry, Trade, and Labor, 2002), p. 49; Itay Yehezkeli, Investment Center economist, telephone interview with author, May 7, 2006.

Despite the structural changes that have taken place in Israeli industry, the format of government assistance for investments was not altered over the years.[17] This situation changed with the passage of the Economic Policy Law for the Fiscal Year 2005, which approved the most comprehensive amendment of the LECI since its enactment.[18] One of the most significant changes made was the stipulation of the conditions for entitlement to government benefits, with an emphasis on the export criterion, while the employment criterion was cancelled.[19]

This legislative change conflicts with the objectives of the national Employment Goals and Regional Development Law; while the main problem facing Priority Areas is severe unemployment, which is of a higher rate than in other regions of Israel. Further, it is unclear why the LECI is limited to certain industrial sectors, based on the export criterion, rather than being applied to any economic activity that would contribute to regional growth. This question is all the more relevant considering the fact that most industries in Priority Areas are traditional industries that do not export.[20]

Even before the LECI was amended, the Bank of Israel addressed the anticipated effects of the legislative changes on employment, based on the proposed legislation, and concluded:

…Subsidies of capital for exporting plants only, giving them priority over plants that produce for the domestic market, distort the allocation of resources in the economy. The encouragement of employment in the periphery through capital investments alone, as is practiced today, is inefficient, as such subsidies encourage surplus, wasteful usage of capital and under-use of labor.[21]

The government policy of granting benefits for investments in physical capital encouraged capital-intensive investments, non-utilization of existing capital, and a distortion of resource allocation, while neglecting human capital.[22] As a result, not only did Priority Area residents not advance or modernize their capabilities as new technological developments swept the world; they even lost their relative advantage. Many industrial plants in peripheral areas have transferred their activity to countries with a cheaper workforce, leading to higher unemployment and a concentration of an unskilled workforce in the Priority Areas.

Moreover, support for physical capital over human capital has not been proved to be a policy that supports a company's stability and growth. Researchers who examined the stability of factories in Migdal Ha'Emeq, Ma'alot, and Ofakim between 1977 and 1983 found that in large plants (with over 100 employees), repeated subsidization occurred. Thus, for example, the five largest plants in Migdal Ha'Emeq that received government assistance obtained a total of 16 grants, with one of the plants receiving government aid six times within that period. It was also found that businesses that closed received government aid before closing.[23]

Consequences of the LECI

State Comptroller Reports indicate that despite the LECI's high cost, the Investment Center has not conducted a comprehensive examination to test whether the investments have achieved the law's objectives. The Comptroller therefore conducted an investigation of his own to determine whether enterprises for which programs were approved between 1985 and 1989 had fulfilled the employment and export forecasts based on which their programs were approved for grants. Only 36% of the plants that had received letters of approval for grants were found to have completed their investments.[24] It was also found that based on employment forecasts, over 7,000 new jobs should have been created as a result of the businesses' investments. In reality, the number of jobs grew by only 524.[25] At the 16 largest plants, which received grants in a total amount of $100 million, the number of employees should have grown by 2,600; in fact, not only did the number of employees not grow – it declined by 4,800.[26]

Subsequent to the State Comptroller Reports, the Investment Center carried out a "Survey of Surveys," with the aim of comparing actual performance to forecasts at enterprises that had received Approved Enterprise status between 1990 and 1992. The survey's findings indicated that the actual output of the plants examined was 55% of forecasts, the rate of exports was 54% of forecasts, and the number of employees was 44% of forecasts.[27] The following table summarizes the findings of the State Comptroller and of the Survey of Surveys:

Table 1
Examination of the LECI's Fulfillment of its Objectives

Criterion	Rate of performance vs. forecast
Completion of investment	36%
Output	55%
Exports	54%
Number of employees	Approximately 7.5% (according to Comptroller) 44% (according to Survey of Surveys)

Sources: State Comptroller, *State Comptroller Report* 46 (Jerusalem: State Comptroller, 1996), pp. 585-591; State Comptroller, *State Comptroller Report* 52B (Jerusalem: State Comptroller, 2002), pp. 876-887.

These results indicate unequivocally that the LECI has been a failure. The law's objectives of regional development and encouragement of employment were not achieved, and despite the great efforts of Israeli governments over the years, the problems of development towns and Priority Areas have not alleviated.

Why Are Development Towns Still Development Towns?

The form of state aid was not adapted over the years to developments in the Israeli economy and throughout the world (such as the transition from capital-intensive industries to knowledge-based industries, innovations, and the development of capital markets). As a result, and as a direct consequence of government aid, Priority Areas became entrenched in traditional industries, failing to adapt their business environments and the capabilities of their residents to the requirements of advanced technological industries. Contrast this with the developments in other areas that received no government aid (such as Tel Aviv and Haifa). In fact, the rate of persons employed in industry in Haifa, Tel Aviv, and the Central region of Israel out of total employees in industry in Israel in 2004 stood at 17.3%, 12.1%, and 16.2%, respectively, whereas in the Northern and Southern regions, this rate stood at 23.5% and 20%, respectively.[28]

The quality and capabilities of employees in Priority Areas were also directly influenced by government policy. For example, the percentage of persons with an occupation requiring higher education out of total employed persons in the Southern and Northern regions stands at 10.3% and 9.8%, respectively, versus 15.9% in Tel Aviv and 16.9% in Jerusalem.[29] The differences in the level of human capital and the low demand for skilled workers affect the income levels of members of similar professions in the different regions, leading to a migration of strong populations to the center of Israel and a widening of social and economic inequalities. The findings of a study by the Bank of Israel, which assessed the contribution of human capital to productivity and growth in the Israeli economy between 1970 and 1999, indicate that investments in human capital have a higher rate of return than investments in physical capital.[30]

The consequences of the government's policy can be discerned not only from a comparison of regions distant from one another, but also from a comparison between adjacent towns. In the 1990s, Nahariya was declared a Priority A Area, and enterprises within its borders were granted large tax benefits. Meanwhile, Acco, 10 kilometers away, did not receive such benefits; as a result, it suffered from negative migration of its working population to nearby Nahariya, and local industry dwindled. Even today, when conditions for the neighboring towns have been equalized, Acco still lags behind Nahariya in many respects, and the government is investing millions of shekels each year in attempts to turn back the wheel.[31]

Alternative Means of Encouraging Capital Investments and Regional Development

The 1990s represent a turning point in the Israeli economy. The opening of the economy to imports, international trade agreements, and the implementation of reforms in the capital market and in banking led to the growth of advanced industries, such as R&D and venture capital funds.[32] As a result, the Israeli capital market is currently considered an advanced, developed market, with financial activity at an international grade.[33] Given this, and in light of the alternative means to be presented below, it seems that government involvement in encouraging regional and nationwide development is less needed.

Private Equity Funds: A Financing Alternative

Private equity funds are a common financial instrument worldwide, and in recent years in Israel as well. In contrast to venture capital funds, these funds invest in traditional sectors (such as banking and communications), though not necessarily industrial ones. More than ten funds currently operate in Israel, and the value of capital raised by the funds is estimated, cumulatively, at more than NIS 2.3 billion.[34] This new sector is marked by a growth trend, accounted for by the shortage of financing sources, a niche filled by banks and the government over the years and diminished during the recession years.[35] In addition, investment opportunities are also facilitated by turn-around funds, which are a subset of private equity funds that focus their investments on companies in distress, with a strategy of controlling the company and increasing its value.[36] Private equity funds are evidence that today, government grants are not necessary; the private market is able, and in any case is willing, to invest in the existing traditional industries, allowing the government to direct its efforts toward the advancement and development of new investment opportunities, instead of working to preserve existing industries.

Local Organizations and Small Businesses

A correct regional development strategy is determined by regional characteristics. Thus, as noted, the involvement of local organizations, particularly of the residents themselves, is important to any economic development strategy. There is evidence that services provided by local organizations are more efficient than services under government auspices.[37] The small business sector constitutes an important component of industrial and employment activity in Israel, and its growth will have positive consequences for the economy as a whole and for Priority Areas in particular. A government policy under which incentives are offered according to the characteristics of each region would bring worthwhile investments to each area, as well as many societal benefits, such as employment appropriate to the skills of the local residents.[38] In fact, in developed economies, there is a clear trend of formulating policy to encourage small businesses, based on a recognition of their importance to the development of a competitive economy, the creation of jobs, and regional economic advancement.

In 2004, 96% of industrial plants in Israel were small and medium-sized plants with up to 99 employees, employing 45% of all employees in industry. At plants with 50 to 99 employees, the annual revenue per employee was NIS 642,000, while the industry average is NIS 636,000.[39] In 2002, the Ministry of Finance examined the effect of the grants system on the budget, and found that the return to the Treasury was greater from relatively small companies. In other words, the financial worthwhileness of benefits for large-scale investments is lower.[40]

However, local organizations and small businesses do not have the resources to invest in creating the conditions to attract potential investors, such as improvements in infrastructure or assistance in obtaining international information in order to encourage exports.[41] The government, on the other hand, has both the means and the incentive to invest in the development of alternate financial programs. As a national legislative entity, the government should use its relative advantages to create a successful development policy.

The Fund for Promoting Small Business

The Israel Small and Medium Enterprise Authority was established in 1993, with the role of developing financing tools, cultivating enterprise, and more.[42] The state grants financial aid to small businesses through the Fund for Promoting Small Business. Since its inception, the fund has granted 1,524 loans, in a total amount of NIS 450 million.[43] "Based on Tavor's own unaudited survey of 542 out of the 1,347 businesses receiving loans during the first two years of fund activity, the number of jobs grew by 15%, with an average of 2.1 new jobs per business. The actual state investment, including overhead costs for the fund (NIS 6.75 million in the period surveyed) and guarantees from loan losses (NIS 8.5 million), for the creation of each new job averages out to NIS 5,644."[44] While the number of jobs created has not been confirmed and these figures relate only to the first two years of the fund's operation, even if the actual cost of creating a job were double or triple this figure, it would still be clear that investing LECI funds in this method of job creation is far more cost effective than the current LECI. According to the Survey of Surveys, the cost of creating one job under the LECI is estimated at about NIS 2 million.[45]

Recommendations

Government and local policies should provide a supportive business environment. As part of a regional development policy, business activity should be encouraged through the removal of bureaucratic barriers, assistance in obtaining information about business opportunities and about the characteristics of the region, assistance in conducting market surveys, and guidance in obtaining means of financing.

A suitable government policy is likely to attain the objectives of the LECI more efficiently and successfully and at lower cost. The following recommendations focus on the achievement of the LECI's objectives: regional development, encouragement of capital investments, exports, and employment, under the guidance of both national and local policies.

Investment in Infrastructures

The achievement of lasting growth in Priority Areas is supported by the creation of independent economic capabilities, rather than by aid in the form of grants, which creates dependence on the government. Regional development that recognizes the competitive abilities of the region as an economic unit will lead to the growth of industrial clusters and of the region in general.

Connecting the distant periphery to business centers in Israel is essential to any policy of regional development and encouragement of industry and employment, in that it will increase the mobility of both commodities and manpower. As part of a five-year plan for railroad development, the government decided on construction of two railway tracks, the Ha'Emek (Valley) Line, at a cost of NIS 984 million, and the Acco-Carmiel Line, at a cost of NIS 943 million; but this second line has been delayed because of budget problems.[46] For comparison, the tax benefits forecast for 2006 under the LECI are estimated at NIS 2 billion.[47] Instead of spending this money on the LECI, entailing all of the adverse consequences described above, it would be preferable to transfer the entire amount to infrastructure connecting the periphery; half the LECI benefits for 2006 would cover the entire cost of the Acco-Carmiel Line, thereby contributing in a practical manner to employment and growth.

A government policy of investing in the improvement of physical infrastructures and in human capital has been proven to be a more efficient means of attracting capital investments. Investments in infrastructures, in improving organizational capabilities, and in integration between various institutions will increase the competitive ability of these regions relative to the Central region of Israel.[48]

Encouraging Capital Investments

The corporate tax rate in Israel is currently 31%, and is scheduled to decrease gradually to 25% in 2010.[49] This rate is significantly higher than tax rates in other countries, such as Ireland (12.5%) and Cyprus (10%).[50] In 2005, the corporate tax rate was 34%, and state revenues were NIS 24 billion. The significance of a one percent reduction in the tax rate is an NIS 450 million decrease in state revenues.[51] Expenses related to the LECI in 2005 were approximately NIS 2.77 billion.[52] A study performed by the Manufacturers Association of Israel indicates that an acceleration of the tax reduction to 20% by 2010 (in other words, spending the LECI's billions on an extra 5% corporate tax reduction) would lead to added foreign and local investments in the amount of approximately $2 billion by 2009, and an additional billion dollars for every subsequent year.[53]

It should be noted that capital investments can also be encouraged by supporting entrepreneurial and employee training projects and by easing costs for employers.

Encouraging Exports

International contacts are among the government's competitive advantages. Government aid in the form of countrywide public services, such as information about international markets and their development, treaties and export agreements, etc., could serve an incentive not only for specific exporters who apply and receive grants, but also for new exporters to arise throughout the economy. Assistance of this type encourages the discovery of new international markets and international business opportunities for local businesses.

Conclusion

Today, the Israeli economy can replace the government more efficiently and effectively in providing aid to enterprises and in attracting local and foreign capital investments. In order to help the economy as a whole, and distressed areas in particular develop and create sustainable growth and jobs, the government should reduce its involvement and instead create conditions that will promote regional activity, encourage the business sector interaction with local institutions and populations and support small business development..

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תוכנית עמיתי קורת – מכון מילקן
בית מילקן, רחוב תל חי 13
ירושלים, 97102

info@kmifellows.org
www.kmifellows.org