OECD Economic Surveys: Israel 2025

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The Israeli economy has been remarkably resilient to the shock of the 7 October terror attacks and subsequent war. This strength under exceptionally difficult circumstances stems from its sound fiscal position before the war, deft monetary management, a stable financial system and strong growth potential owing to high employment rates and a vibrant high-tech sector. Keeping the economy steady and securing solid growth requires curbing inflation and containing fiscal deficits while funding future spending needs. Economic performance would strongly benefit from reforms that address infrastructure gaps and improve educational outcomes and labour-market participation among ultra-orthodox and Arab Israelis. Removing barriers to foreign and domestic and foreign trade, by cutting red tape, easing border processes and lowering tariffs would strengthen productivity, increase incomes and durably lower consumer prices. Capitalising on an already strong artificial intelligence (AI) industry is essential, by maintaining a flexible regulatory approach and further nurturing links between higher-education institutions and AI firms. Reducing greenhouse gas (GHG) emissions further requires carbon-free power generation through higher carbon tax rates on natural gas and more energy-efficient buildings.

SPECIAL FEATURE: ADDRESSING THE HIGH COST OF LIVING

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Foreword

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Israel were reviewed by the Committee on 11 February 2025. The draft report was then revised in light of the discussions and given final approval as the agreed report of the whole Committee on 11 February 2025. The cut-off date for information included in this report is 24 March 2025.

The Secretariat's draft report was prepared for the Committee by Boris Cournède and Erik Frohm, with contributions from Federico Giovannelli and Avia Libermann, under the supervision of Mame Fatou Diagne.

Research assistance was provided by Federico Giovannelli and editorial support by Robin Houng Lee and communication assistance by François Iglesias.

The previous Survey of Israel was issued in April 2023.

Information about the latest as well as previous Surveys and more details about how Surveys are prepared is available at www.oecd.org/eco/surveys.

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BASIC STATISTICS OF ISRAEL, 2023

(Numbers in parentheses refer to the OECD average)

LAND, PEOPLE AND ELECTORAL CYCLE					
Population (million)	9.8		Population density per km²	450.9	(39.2)
Under 15 (%)	27.6	(16.9)	Life expectancy at birth (years, 2022)	82.8	(80.6)
Over 65 (%)	12.4	(18.2)	Men (2022)	80.7	(78.0)
International migrant stock (% of population, 2020)	22.3	(15.7)	Women (2022)	84.8	(83.2)
Latest 5-year average growth (%)	1.9	(0.4)	Latest general election	November 2022	
ECONOMY					
Gross domestic product (GDP)			Value added shares (%, 2022, OECD: 2023)		
In current prices (billion USD, 2024)	540.3		Agriculture, forestry and fishing	1.3	(2.7)
In current prices (billion NIS, 2024)	1 999.3		Industry including construction	20.8	(27.1)
Latest 5-year average real growth (%, 2024)	3.1	(1.7)	Services	77.9	(70.2)
Per capita (thousand USD PPP)	53.9	(59.0)			
GENERAL GOVERNMENT					
Expenditure (% of GDP)	40.0	(42.4)	Gross financial debt (% of GDP)	61.6	(113.0)
Revenue (% of GDP)	35.0	(37.8)	Net financial debt (% of GDP)	59.5	(66.7)
EXTERNAL ACCOUNTS					
Exchange rate (NIS per USD)	3.68		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	3.57		Machinery and electronics	27.5	
In per cent of GDP			Chemicals	17.4	
Exports of goods and services	30.4	(31.2)	Miscellaneous	15.8	
Imports of goods and services	27.6	(31.1)	Main imports (% of total merchandise imports)		
Current account balance	3.8	(-0.3)	Machinery and electronics	23.6	
Net international investment position	41.5		Fuels	11.6	
			Transportation	11.2	
LABOUR MARKET, SKILLS AND INNOVATION					
Employment rate (aged 15 and over, %)	61.4	(58.0)	Unemployment rate, Labour Force Survey (aged 15 and over, %)	3.4	(4.8)
Men	64.5	(65.5)	Youth (aged 15-24, %)	6.0	(10.6)
Women	58.3	(50.8)	Long-term unemployed (1 year and over, %)	0.2	(1.0)
Participation rate (aged 15 and over, %)	63.5	(60.9)	Tertiary educational attainment (aged 25-64, %)	50.3	(41.0)
Average hours worked per year	1 880	(1 742)	Gross domestic expenditure on R&D (% of GDP, 2021)	5.6	(2.9)
ENVIRONMENT					
Total primary energy supply per capita (toe)	2.5	(3.7)	CO2 emissions from fuel combustion per capita (tonnes)	6.0	(7.6)
Renewables (%)	5.7	(12.5)	Water abstractions per capita (1 000 m³, 2022)	0.1	
Exposure to air pollution (more than 10 µg/m³ of PM 2.5, % of population, 2020)	99.9	(56.5)	Municipal waste per capita (tonnes, 2022)	0.6	(0.5)
SOCIETY					
Income inequality (Gini coefficient, 2022, OECD: latest available)	0.345	(0.316)	Education outcomes (PISA score, 2022)		
Relative poverty rate (%, 2022)	16.8	(11.7)	Reading	474	(476)
Median disposable household income (thousand USD PPP, 2022. OECD: 2021)	26.2	(30.0)	Mathematics	458	(472)
Public and private spending (% of GDP)			Science	465	(485)
Health care	7.6	(9.2)	Share of women in parliament (%)	24.2	(32.8)
Pensions (2021, OECD: 2019)	5.5	(9.5)	Net official development assistance (% of GNI, 2022)	0.1	(0.4)
Education (% of GNI, 2020)	6.4	(5.1)			

Notes: Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 80% of member countries. OECD aggregate refers to weighted average for GDP per capita (thousand USD PPP).
Sources: Calculations based on data extracted from databases of the following organisations: OECD, International Energy Agency, International Labour Organisation, International Monetary Fund, United Nations, World Bank.


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Executive summary

Key messages:

- Monetary prudence and fiscal discipline, relying on least distortionary taxes to reduce the deficit, are essential to chart a safe way out of the economic turbulences created by the conflicts. Given demographic trends, long-term economic performance would strongly benefit from reforms to address infrastructure gaps and improve educational outcomes and labour-market participation among ultra-orthodox and Arab Israelis.

- The economy can capitalise on an already strong artificial intelligence (AI) industry by maintaining a flexible regulatory approach and further nurturing links between higher-education institutions and AI firms.

- Putting the economy on track towards net zero greenhouse gas (GHG) emissions requires carbon-free power generation through higher carbon tax rates on natural gas and more energy-efficient buildings.

- Removing barriers to domestic and foreign trade, by cutting red tape, easing border processes harmonising technical standards with the rest of the world and further reducing tariffs, would strengthen productivity, increase incomes and durably lower consumer prices.

Steering economic resilience

Tight monetary policy and well prioritised fiscal consolidation will safeguard economic stability. Structural reforms will help to address the high cost of living, maximise gains from AI and curb GHG emissions.

The Israeli economy has been resilient to the shock of the 7 October terror attacks and subsequent war, thanks to its sound fiscal position before the war, deft monetary management, a resilient financial system and strong growth potential owing to high employment rates and a vibrant high-tech sector. The war however has prompted a jump in military expenditure that has widened the fiscal deficit, while also hurting investment and exports.

Policies need to keep the economy steady and ensure its return to solid growth. This includes curbing inflation, containing fiscal deficits while funding future spending needs. Long-term sustainable growth can be spurred by unlocking public investment, maximising the gains from a leading high-tech and AI sector, reducing GHG emissions in line with net zero targets and addressing the high cost of living.

Maintaining macroeconomic stability

The economy remains heavily influenced by the conflicts, which hit investment and exports while war-related expenditure soared. Growth is set to pick up when the economic environment becomes closer to normal. Monetary policy should remain tight to curb inflation. Fiscal policy needs to reduce deficits.

After dropping immediately after 7 October 2023, aggregate activity partly recovered but remained very weak in 2024. The composition of economic activity steeply changed in late 2023 and 2024. Investment by end-2024 stood 15% below its pre-war level, held back by labour shortages especially in construction following the suspension of work permits for Palestinians. Exports are still weak. Activity is set to pick up when the geopolitical environment improves (Table 1). The labour market will remain tight with labour shortages continuing to weigh on construction.

Risks are very large on both sides. On the upside, renewed de-escalation would ease some of the supply constraints and unleash foreign and domestic private demand while facilitating international business. New agreements with Middle East countries would boost trade and investment. On the downside, continued intensification of the conflicts could further degrade public accounts while directly reducing activity.

The financial system has withstood the shock of the attacks and subsequent war well. The currency and stock exchange recovered and then expanded, reflecting investor confidence.

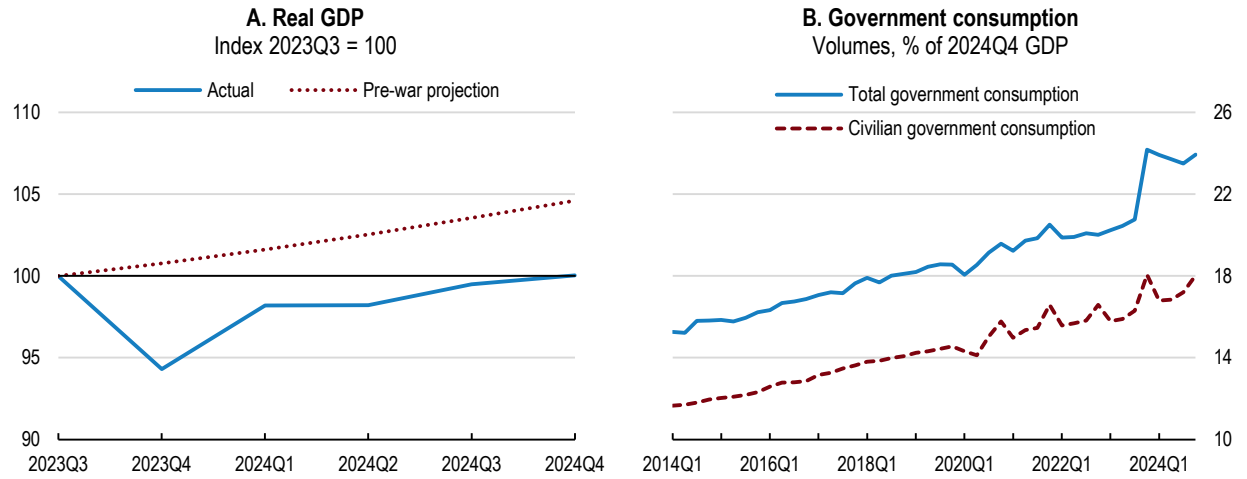
The fiscal balance has moved from surplus to a large deficit. The sovereign risk premium is 50 basis points higher than before 7 October 2023, reflecting a reassessment of country risk and a higher public-debt-to-GDP ratio.

The fiscal policy stance must be carefully balanced. Avoiding an adverse feedback loop between debt accumulation and interest rates requires reducing the deficit. At the same time, very rapid and deep consolidation should be avoided, especially as long as elevated geopolitical tensions weigh on private demand.

Looking ahead, fiscal consolidation will have to take into account spending pressures. One is the objective of keeping military spending higher than before October 2023. Another is the need to close infrastructure gaps and prepare for strong demographic growth.

Fiscal adjustment should mobilise the levers that have the comparatively least detrimental effects on sustainable growth. This includes ending VAT exemptions and increasing carbon tax rates while taxing sugary drinks and single-use plastic items. The mileage tax ought to be implemented to anticipate the end of falling fuel tax revenues as electric vehicles take over. Congestion fees could be implemented using digital technology.

Figure 1. The war hit the economy hard and prompted a sharp increase in government spending



Source: OECD Economic Outlook: Statistics and Projections No. 116 database; OECD Economic Outlook 113 database; and Israel Central Bureau of Statistics (CBS).

StatLink https://stat.link/us4t6d

Expenditure restraint also has a role to play in consolidation. Comprehensive spending reviews should be conducted with effects on long-term growth among the core criteria of evaluation. They should be tightly integrated in the budget process.

Structural reforms can support fiscal sustainability in addition to boosting long-term growth. Product-market liberalisation (see below), education and labour-market reforms hold considerable potential to boost employment, thereby supporting fiscal sustainability, alongside long-term growth. Many young Israelis in the ultra-orthodox and Arab sectors especially receive incomplete or lower-quality education in core subjects, limiting their later possibilities to join the labour market and their productivity – and wages – if they do. Enforcing the conditioning of school funding on teaching the core curriculum and ensuring equal per pupil funding for schools with similar socio-economic characteristics would improve subsequent labour-market performance. Removing benefits that discourage work among ultra-orthodox men would also boost employment.

Table 1. GDP growth will pick up

Annual growth rates, %, unless specified

	2023	2024[1]	2025[1]	2026[1]
Real GDP	1.7	1.0	3.4	5.5
Private consumption	-1.2	3.7	5.6	6.0
Government consumption	8.0	13.0	0.9	0.8
Gross fixed capital formation	-1.6	-6.7	8.7	4.6
Exports of goods and services	-1.1	-5.6	4.1	8.9
Imports of goods and services	-7.5	-0.4	4.9	5.2
Unemployment rate (% labour force)	3.4	3.0	2.2	1.6
Index of consumer prices	4.2	3.1	3.7	2.9
General government fiscal balance (% of GDP)	-5.1	-8.2	-4.7	-3.8
General government debt (% of GDP)	61.6	66.2	66.6	65.4

Notes:
1. OECD Economic Outlook No.116 estimates and projections, with updates, and OECD Annual National Accounts database for 2024 GDP growth.
Source: OECD Economic Outlook: Statistics and Projections database.

Reaping the benefits of AI

The vibrant AI-creation ecosystem has thrived on the basis of the dynamic high-tech sector. Further success on the global AI market requires removing bottlenecks in terms of advanced education and academic research in the fields that are critical to AI while maintaining a supportive regulatory framework. In the rest of the economy, the deployment of AI can bring large productivity benefits under proper skill policies.

AI has become a core part of new high-tech activity in Israel, accounting for almost half of all new high-tech startups and funding rounds. This makes AI critical to the continued performance of the high-tech sector, a key engine of export and GDP growth.

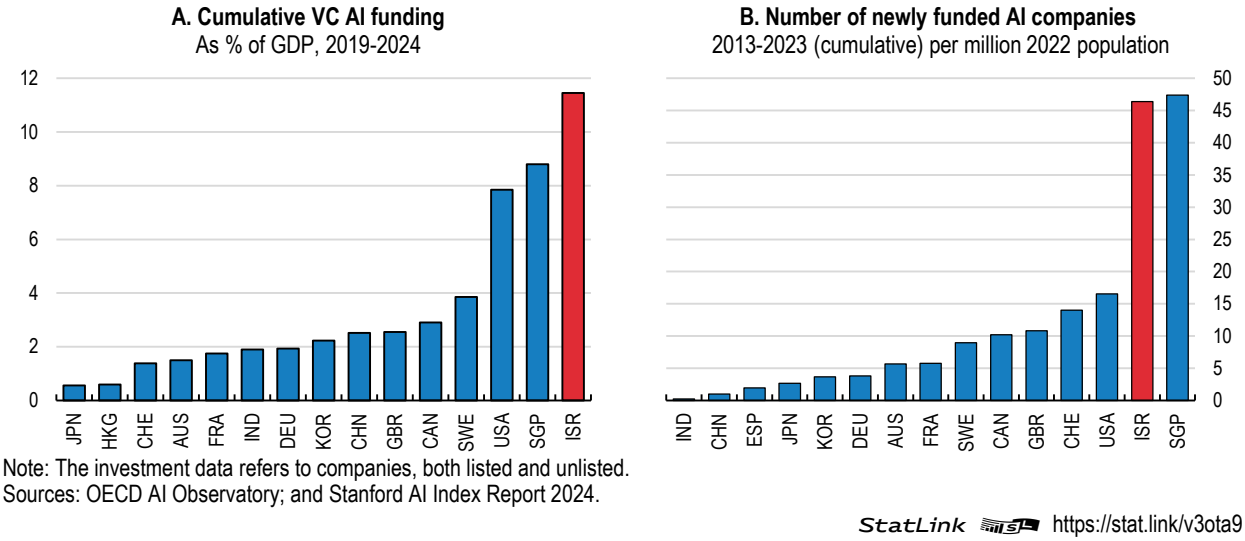
The conflicts put the sector under stress by constraining international business linkages and increasing risk premia but it is also prompting renewed investment in cyber and security-focussed AI. In late 2023, public authorities stepped in with emergency help for startups, which then evolved into more permanent support programmes. These should be regularly monitored and correspondingly adjusted.

Looking ahead, a flourishing AI sector will require a stronger basis of high-level competencies and academic research. Advanced competencies especially in mathematics, statistics, computer science and physics are a critical ingredient of AI development, of which the sector has been facing long-standing shortages. Public authorities should broaden the supply of higher education in these fields including at the master level, where the number of graduates is currently low by international comparison (Figure 2). This can be achieved by expanding capacity in public-sector institutions and allowing the establishment of private-sector universities. The authorities are investing to expand computing capacity available to research universities and early-stage startups.

Bridging the very large gender gap in AI would broaden the talent pool. Only 23% of AI professionals are women. Recent programmes to encourage more female pupils to take up relevant fields in university should be scaled up if successful.

Maintaining a flexible approach to regulation fosters AI development. AI regulation has been allocated at the sector level, an approach that has proved conducive to experimentation and innovation. It is important to ensure that new data privacy legislation, while adequately safeguarding privacy, provides AI producers and users with legal stability.

Figure 2. AI creation activity is buoyant



Note: The investment data refers to companies, both listed and unlisted.
Sources: OECD AI Observatory; and Stanford AI Index Report 2024.

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Addressing gaps in the education and lifelong learning systems would also help AI production and deployment across the economy. Providing a higher quantity and quality of teaching in core curriculum subjects, including mathematics and English, to ultra-orthodox and Arab pupils would

widen the future pool for higher-education studies in relevant fields. Advances in these areas would support AI production while also having benefits for the deployment of AI and digitalisation across the economy, which has been sluggish. Given the currently fragmented accreditation system, establishing a National Qualification Framework, with proper coverage of AI-relevant skills, would ease the recognition of skills, fostering their acquisition and best use.

Strengthening decarbonisation and climate change adaptation efforts

Efforts to decarbonise the economy need to involve all sectors, including power generation and buildings. Power generation, despite accounting for half of total greenhouse gas (GHG) emissions, remains subject to very low rates of carbon pricing. Buildings, which represent the main source of electricity demand, need to become more energy efficient. Simultaneously, buildings and urban patterns need to adapt to climate change.

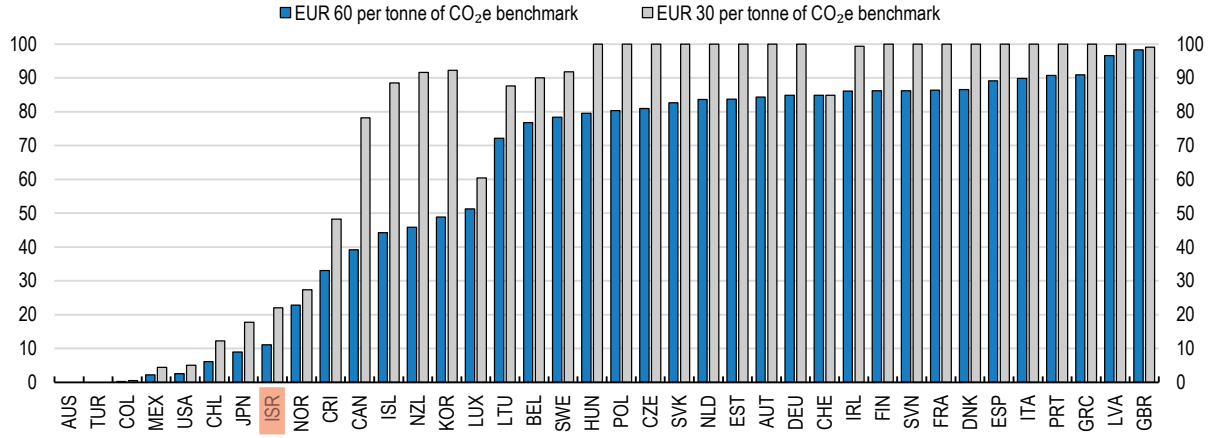
Moving towards carbon-free electricity is a key ingredient for economy-wide decarbonisation. An effective way of creating proper conditions for long-term investment in carbon-free power generation is to price input fuels based on their carbon content. The new carbon tax provides a strong basis for action in this direction: the trajectory for the rate applicable to natural gas over time should be increased from its current low level.

A successful energy transition also requires avoiding unnecessary electricity consumption by making buildings more energy efficient. The newly adopted green building standards can be updated to require strong energy performance from new buildings including individual homes and small buildings. Greater transparency about the energy quality of existing buildings can encourage their retrofitting: the authorities should require the production of an energy performance certificate for sales of existing property and new rentals.

Buildings also need to adapt to intensifying climate change. The programme to map risks should be accelerated and its results widely disseminated to encourage pre-emptive action. Consequently, urban plans should be systematically adjusted in light of climate risks. Preventive investment, such as increases in run-off water management capacity, should be undertaken well before costly floods occur.

Figure 3. Electricity, 71% of it used to power buildings, is subject to comparatively low carbon pricing

Share of sources used to generate electricity priced above the benchmark rate, %, 2021



Notes: A 100% score means that all sources are priced at or above the benchmark rate. The carbon tax effective from 1 January 2025 does not fundamentally change the position of Israel given that the rate applicable to natural gas is well below the EUR 30 per tonne of CO_2 benchmark.
Source: OECD Effective Carbon Rates database.

StatLink https://stat.link/ml0xcy

Addressing the high cost of living

Living standards have improved substantially over the past two decades. GDP per capita has more than doubled, employment rates have increased and unemployment remains low. Yet, barriers to trade, pervasive red tape and lack of competitive pressures contribute to a high cost of living. Reducing trade barriers by

implementing recent imports reforms would spur competitive pressures and help lowering import prices. Policies that ease market entry and facilitate competition could strengthen productivity, increase incomes and durably lower consumer prices.

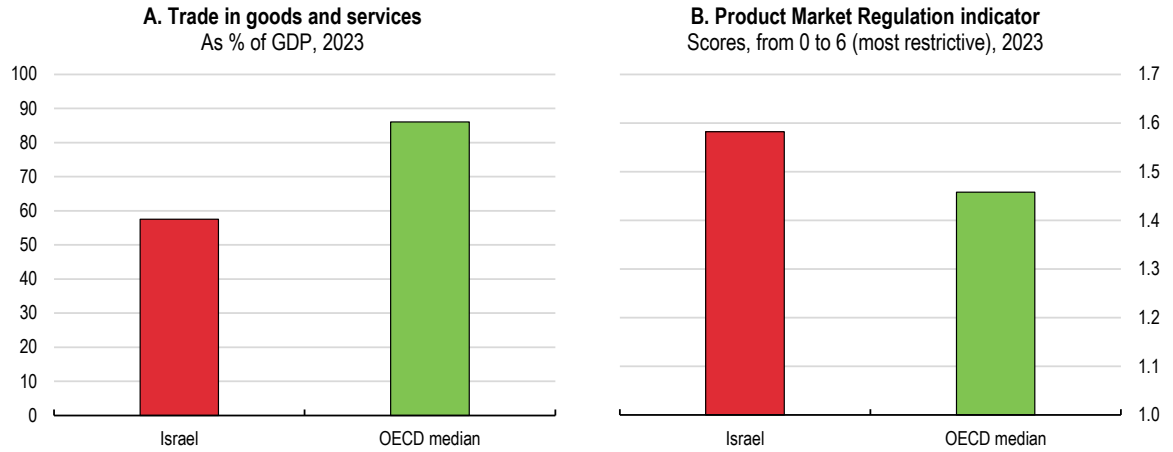
Israel's comparative price level is among the highest in the OECD, despite GDP per capita being lower than the OECD average. While all households are affected by high prices, lower-income households are particularly affected by the high cost of living, as they spend almost all their income on essential goods and services such as food, housing and transport.

Reasons for the high price levels are multifaceted. Administrative red tape and planning obstacles, as well as tax differentials between residential and non-residential buildings reduce the supply of housing. While significant progress has been achieved, trade barriers remain that result in higher import costs for companies and consumers. Stringent product market regulations and entry barriers hamper valuable competitive pressures in the domestic market.

Lower trade barriers are essential to reducing import costs. Continuing to negotiate free trade agreements and enhancing existing treaties will reduce trade costs further by lowering uncertainty about future trading relations. A good example is the signing of the Abraham Accords, which have led to a surge in trade between Israel and signatory countries. Limiting tariffs, removing technical barriers to trade and revamping trade facilitation efforts can enhance competition and reduce import costs. Implementation of recent import reforms and the adoption of EU regulatory standards through "What is good for Europe is good for Israel" will help facilitate imports by harmonising technical standards in Israel. The reforms have the potential of reducing transactions costs by limiting the time goods are being processed at the border and reducing bureaucratic requirements. To maximise effectiveness, as many products as possible should be included and exemptions limited.

Pro-competition reforms should be pursued and state involvement in the economy diminished. Price and quantity controls are still applied to numerous products and services, many of which have been abolished in other OECD countries. Government-mandated price and quantity controls are poor instruments to ensure affordability and equity and should be removed to allow market price signals to influence consumer choice and behaviour. Less stringent product market regulations are essential to facilitate market entry for new companies and will help foster competition. Streamlined planning and permitting regulations and harmonised property taxes would boost housing supply. Taken together, these measures will foster a more competitive and dynamic economy in Israel, which can durably increase living standards and reduce the cost of living.

Figure 4. Lower trade barriers and domestic competition can spur incomes and lower prices



Note: In Panel A, the Product Market Regulation (PMR) indicator is a composite index that encompasses a set of indicators that measure the degree to which policies promote or inhibit competition in areas of the product market where competition is viable.
Sources: OECD Economic Outlook: Statistics and Projections database; OECD Product Market Regulation database; and OECD calculations.
StatLink https://stat.link/asqvre

Main findings	Key recommendations
Maintaining macroeconomic stability	
The inflation rate has risen above the upper bound of the 1-3% target range since July 2024. Inflation expectations are stable but in the upper half of this range.	Maintain a tight monetary policy stance to bring inflation durably back in the target range.
The fiscal balance has moved from surplus to a large deficit. Credibly lasting measures are needed to contain the deficit before reducing it. Given defence spending and public investment needs, revenue must be raised as part of the fiscal adjustment.	Implement a medium-term fiscal adjustment plan based on a comprehensive review of the tax system, reduce VAT exemptions, and prioritise growth-enhancing expenditures.
Spending reviews can improve allocation and help create fiscal space. Most spending reviews have typically been narrow in scope. The existing strong budget process provides a basis for ambitious spending reviews.	Consider conducting systematic spending reviews that are integrated with the budget process.
Coverage of the core curriculum is incomplete in ultra-orthodox streams and under-resourced in many Arab schools, impairing pupils' employment, productivity and wage prospects. Improving their future employment and wages would strengthen fiscal sustainability.	Condition school funding on full teaching of the core curriculum and equalise funding for Arab schools with other schools presenting similar socio-economic characteristics.
Reaping the benefits of AI	
The regulatory environment is generally supportive with a flexible approach that assigns responsibility for complying with overall policy objectives, including OECD AI Principles, to sector-level regulators.	Maintain a flexible, innovation-friendly stance in AI regulations.
Employment rules applicable to public-sector universities complicate the retention of AI scholars given strong business demand.	Enable faculty members in AI-relevant fields to work in industry alongside part-time academic duties.
Strengthening decarbonisation and climate change adaptation efforts	
GHG emissions from power generation remain severely underpriced, as the carbon tax applies a low rate to natural gas.	Increase the carbon tax rate on natural gas and gradually equalise effective tax rates per tonne of CO2 while providing targeted support to vulnerable adversely affected households.
Building energy performance rating is mandatory only for new construction.	Mandate the production of an energy performance certificate for sales of existing property. Consider gradually extending the requirement to existing buildings.
Built-environment geography largely determines commuting patterns as well as the deployment and use of low-carbon public transport. Land-use and public-transport planning remain incompletely linked.	Tightly integrate land-use and transport planning including by encouraging high-density development around nodes of the public-transport network.
A large-scale climate-risk mapping exercise is underway. Local adaptation plans are being developed.	Actively disseminate and integrate into adaptation plans the results of the ongoing climate-risk mapping.
Addressing the high cost of living	
Trade barriers remain. Free trade agreements (FTAs) reduce trade costs and lower uncertainty regarding trading relations. Israel's FTAs cover 48 countries, yet trade within those FTAs is low compared to the OECD average.	Maintain efforts to negotiating new trade agreements and deepen existing ones to diversify import sources and expand export markets.
Successive tariff cuts and reforms have lowered import costs. Yet, tariffs are still comparatively high for many agricultural products.	Lower trade restrictions on agricultural imports, including by cutting tariffs on vegetables, fruit and dairy.
Border procedures are cumbersome, technical regulations burdensome, and product-standards are often different from the main trading partners, restraining trade.	Continue to simplify border processes and remove technical barriers to trade. Implement planned import reforms, notably "What is good for Europe is good for Israel" and limit the number of products exempted from the reform.
Administrative and regulatory requirements are among the most stringent in the OECD, hindering entry and growth.	Reduce the time, cost and number of procedures required to start a new company and introduce an online one-stop shop.
Price or quantity controls are applied widely for staple foods, distorting consumer choice and leading to shortages.	Abolish price and quantity controls on food.
Entry barriers are higher than the OECD average in several professional services sectors. Importers of food face several cumbersome procedures and entry barriers such as document and licensing requirements.	Reduce entry barriers for professional services and importers, notably by simplifying and extending import licensing.
Building permit procedures are lengthy. Slow permitting is perceived as a key obstacle to construction.	Streamline building permitting procedures. Ensure implementation of the Expedited Licensing Plan to reduce permitting times. Adopt the "silence is consent" principle for approving building permits
The property tax system favours commercial over residential real estate, contributing to housing supply pressures.	Reduce the difference between non-residential and residential property tax rates.

1 Maintaining macroeconomic stability

Boris Cournède, OECD

Geopolitical tensions in the Middle East continue to shape economic developments. Labour shortages in construction are constraining investment. Faced with resurgent price pressures, monetary policy has remained appropriately tight. The high level of risk calls for maintaining sufficient capital buffers among banks. Fiscal policy should contain deficits in 2025-2026 and then secure debt sustainability. Revenue increases and careful spending prioritisation will be needed to ensure debt sustainability. Structural policy adjustments to favour greater employment and productivity across population groups would support fiscal sustainability and long-term growth.

1.1. Real activity is set to pick up once geopolitical tensions ease

The economy remains heavily affected by the evolving conflicts

After a sharp post-COVID-19 rebound, the Israeli economy was experiencing robust but moderating growth with inflation remaining above target. The 7 October 2023 terrorist attacks changed the growth outlook substantially. Schools and many services closed for three weeks. The suspension of work permits for Palestinians, who provided a third of the construction workforce, as well as the departure of many foreign workers, halved the number of non-Israeli workers from 6.7% of employment before October 2023 to 3.5% two months later. Investment shrank by 26% in the last quarter of 2023 mainly due to a sharp decrease in construction. Government consumption soared on account of military expenses, rising to a fifth above its pre-war levels in 2024.

Considering the circumstances, the economy has been resilient. Consumption quickly recovered from its post-7-October-2023 slump at the end of 2023 and beginning of 2024. Households have however been more cautious in the rest of 2024 as the conflicts widened, with private consumption growing sluggishly and household confidence staying relatively weak. Business confidence by contrast has been stronger, with stock markets more than recovering from post-October 2023 losses. The positive effect of business confidence on investment has however remained constrained by persistent labour shortages. Few new foreign workers (0.4% of employment) have entered Israel since work permits were suspended for Palestinians (who made up 4% of employment in Israel before the war). Continued rocket attacks reduced industrial and farm production in Northern areas in 2024. With supply constraints, the recovery was quickly followed by a pick-up in inflation from 2.5% in February 2024 to 3.5% in September 2024.

The evolving conflicts have been impacting foreign trade. Ship attacks in the Red Sea have made merchandise shipping more expensive, while a sharply reduced number of airline connections has complicated international business. Intensifying tensions in the second half of 2024 had repercussions on the high-tech sector, halting the rally in high-tech shares, even if foreign direct investment in high-tech was robust in 2024. Inward foreign tourism remains nearly absent.

Growth is expected to pick up

On the assumption that conflicts ease in 2025-2026, activity is projected to rebound from 3.4% in 2025 to 5.5% in 2026 (Table 1.1). Exports are anticipated to accelerate as the business environment improves in 2025, facilitating trade including in high-tech services. Private consumption should broadly follow the same path apart after the slowdown at the beginning of 2025 owing to the VAT rise. Investment remains constrained by labour shortages, reducing supply capacity, which may over time contribute to inflation. Inflation is projected to rise in 2025 to 3.7% before moderating to 2.9% in 2026 under the effect of fiscal contraction and reduced supply constraints.

Risks are very large on both the upside and downside.

- On the upside, a renewed reduction of of geopolitical tensions would further ease supply constraints, especially relating to labour shortages and lower risk premia. These developments would allow a rapid recovery in construction as well as stronger foreign trade and investment and faster return of foreign tourists, all prompting a faster-than-projected upturn. Fundamental improvements in the geopolitical situation could unleash considerably stronger long-term growth.
- On the downside, continued intensification of the conflicts could substantially degrade public accounts while directly reducing output if conditions require stopping certain activities. Loss of foreign-investor confidence could result in renewed increases in government bond yields and put pressure on financial and foreign-exchange markets. Ample foreign-exchange reserves, covering 20 months of imports, however, provide cushion against external shocks.

Table 1.1. Macroeconomic indicators and projections

	2022	2023	2024[1]	2025[1]	2026[1]
	Current prices (NIS billion)	Annual percentage change, volume (2015 prices)			
Gross domestic product (GDP)	1764.4	1.7	1.0	3.4	5.5
Private consumption	876.2	-1.2	3.7	5.6	6.0
Government consumption	369.3	8.0	13.0	0.9	0.8
Gross fixed capital formation	439.5	-1.6	-6.7	8.7	4.6
Housing	130.0	-8.0	-17.5	9.0	4.4
Final domestic demand	1685.0	0.8	3.5	5.1	4.4
Stockbuilding[2]	41.9	-0.7	-0.9	-1.4	0.0
Total domestic demand	1726.9	0.0	2.6	3.7	4.4
Exports of goods and services	553.8	-1.1	-5.6	4.1	8.9
Imports of goods and services	516.3	-7.5	-0.4	4.9	5.2
Net exports[2]	37.5	1.9	-1.6	-0.1	1.2
Memorandum items					
Employment	. .	3.3	1.1	1.9	2.2
Unemployment rate (% of labour force)	. .	3.4	3.0	2.2	1.6
GDP deflator	. .	4.7	5.8	3.7	2.8
Index of consumer prices	. .	4.2	3.1	3.7	2.9
Index of core inflation[3]	. .	4.2	2.6	3.7	2.9
Current account balance (% of GDP)	. .	4.5	3.8	3.9	4.7
General government fiscal balance (% of GDP)	. .	-5.1	-8.2	-4.7	-3.8
General government primary fiscal balance (% of GDP)	. .	-2.5	-5.8	-2.1	-1.3
General government debt (% of GDP)	. .	61.6	66.2	66.6	65.4
General government net debt (% of GDP)	. .	59.5	64.1	64.5	63.4
Three-month money market rate, average	. .	4.4	4.3	4.3	4.3
Ten-year government bond yield, average	. .	3.9	4.7	4.8	4.9

Notes:
1. OECD Economic Outlook No. 116 database, with updates, and OECD Annual National Accounts database for 2024 GDP growth.
2. Contribution to changes in real GDP.
3. Index of consumer prices excluding food and energy.
Source: OECD Economic Outlook: Statistics and Projections database.

Current shortages and longstanding gaps in the labour market hold back activity

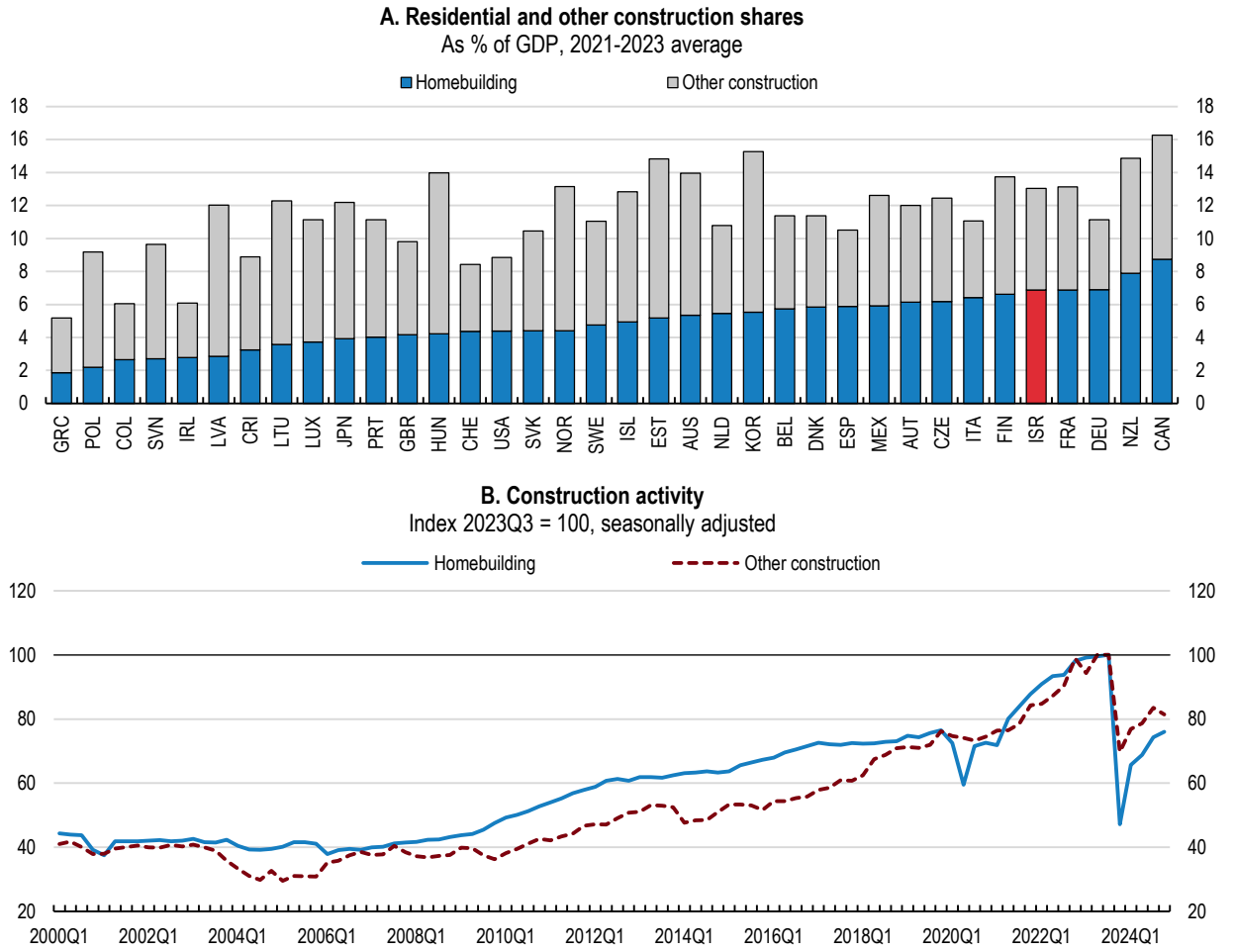
Labour shortages in construction constrain investment

Residential construction contributes more to GDP in Israel than in most other OECD countries (Figure 1.1 Panel A). The civil protection measures taken in the immediate aftermath of the 7 October attacks resulted in a temporary closure of construction sites. Consequently, homebuilding activity more than halved in the fourth quarter of 2023, while other construction contracted by 27% (Figure 1.1 Panel B). The reopening of construction sites triggered a fast rebound. However, the suspension of Palestinians' work permits immediately after 7 October 2023 has caused severe labour shortages that have limited the size of the construction recovery: before October 2023, Palestinians represented a quarter of the construction workforce.

Medium-term prospects for construction and other labour-intensive sectors such as agriculture largely hinge on employment, following the suspension of Palestinians' work permits. The policy goal of the Israeli authorities is to attract foreign workers from other countries including India, Moldova and Sri Lanka. Between September 2023 and September 2024, the number of foreign workers has risen by

22,000,considerably short of the 170,000 Palestinians who worked in Israel in the third quarter of 2023 (Central Bureau of Statistics, 2024[1]; Population and Immigration Authority, 2024[2]).

Figure 1.1. Residential construction has collapsed after 7 October 2023



Notes: Data refer to gross fixed capital formation. In, Panel A, the construction shares are computed in value. In Panel B, construction is measured in volume.
Sources: OECD National Accounts database; and OECD calculations.

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Persistent labour shortages in construction would have a continued direct constraining impact on GDP through lower building activity but also knock-on effects on the availability of built structures including homes. This is an important difference with sectors such as farming, where imports can substitute for local production, even if effective barriers to trade can complicate this adjustment (Chapter 4).

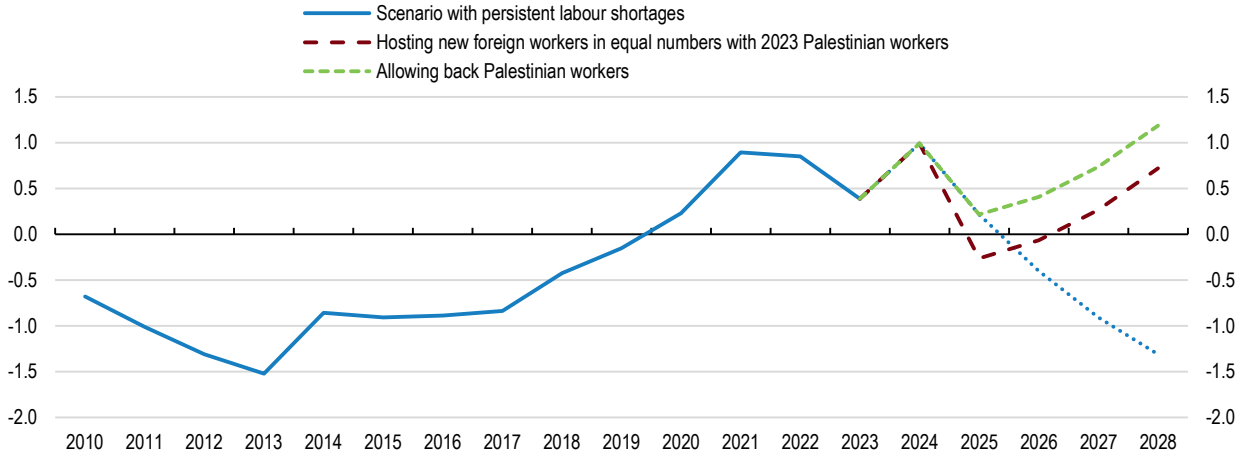
Stylised scenarios based on estimated past relationships illustrate the difference that labour-policy choices make for the housing sector. Israel's fast population growth requires a quickly expanding housing supply (Figure 1.2). Supply was rising strongly in the period immediately before the war, reflecting measures to facilitate construction, including through urban renewal programmes and post-COVID-19 catch-up (Chapter 4 and Figure 1.2). If labour shortages persist, the net supply of new dwellings risks lagging the needs of a growing population, resulting in a housing deficit opening up over time (Figure 1.2).

Continued action to remedy labour shortages is important to allow adequate levels of construction including in the residential sector. If foreign workers come in numbers comparable to Palestinian workers ahead of October 2023, then homebuilding can pick up back to its pre-October-2023 GDP share. A difference is that

these workers need accommodation in Israel, whereas Palestinian workers go home at night. Foreign workers however require fewer additional dwellings compared with a same-sized increase in the rest of the population given their usual lodging arrangements. Stylised simulations suggest that a housing deficit could temporarily open in the scenario with foreign workers (Figure 1.2). By contrast, ending the suspension of work permits for Palestinians would allow homebuilding to expand without creating new housing needs (Figure 1.2).

Figure 1.2. The housing supply-demand difference can evolve differently depending on labour-market developments: stylised scenarios

Deviation of actual from equilibrium number of dwellings, %



Notes: Dotted lines refer to projections. The equilibrium number of dwellings is estimated through a co-integration relationship with population over 1995-2023. Population numbers follow the assumptions underpinning the OECD Economic Outlook No. 116 long-term baseline except in the "Hosting new foreign workers in equal numbers with 2023 Palestinian workers" scenario, where case it is assumed that foreign workers enter Israel in 2025 in numbers equivalent to the number of Palestinian workers in the country in 2023Q1-Q3. The stylised scenario assumes that their impact on housing needs is a third of that of the local population since many live in barracks or share flats. Dwelling numbers are forecast by adding to the previous year stock a new number of net deliveries that is estimated based on the volume of construction activity. The regression linking new homes to homebuilding (and a time trend) is estimated on 1995-2023 data with very tight fit (R2=97%). The forecast over 2024-2028 is then produced by holding constant the last residual constant (in logarithm form). A negative residual is observed in 2022-2023 reflecting a sharp rise in the share of demolition-rebuilding, upward extensions and heavy renovations among new dwellings delivered (see Chapter 4). In the baseline scenario, the homebuilding share in GDP stays at its last observed historical value (2024Q3). This can be considered an optimistic hence conservative assumption if all the labour potential has been exploited already at the time of the last observation. In the other two scenarios (dotted brown and green lines), the homebuilding share in GDP goes back to its (much higher) 2023Q1-Q3 ratio.
Sources: Israel Central Bureau of Statistics; OECD Economic Outlook 116 database; and OECD econometric estimates.

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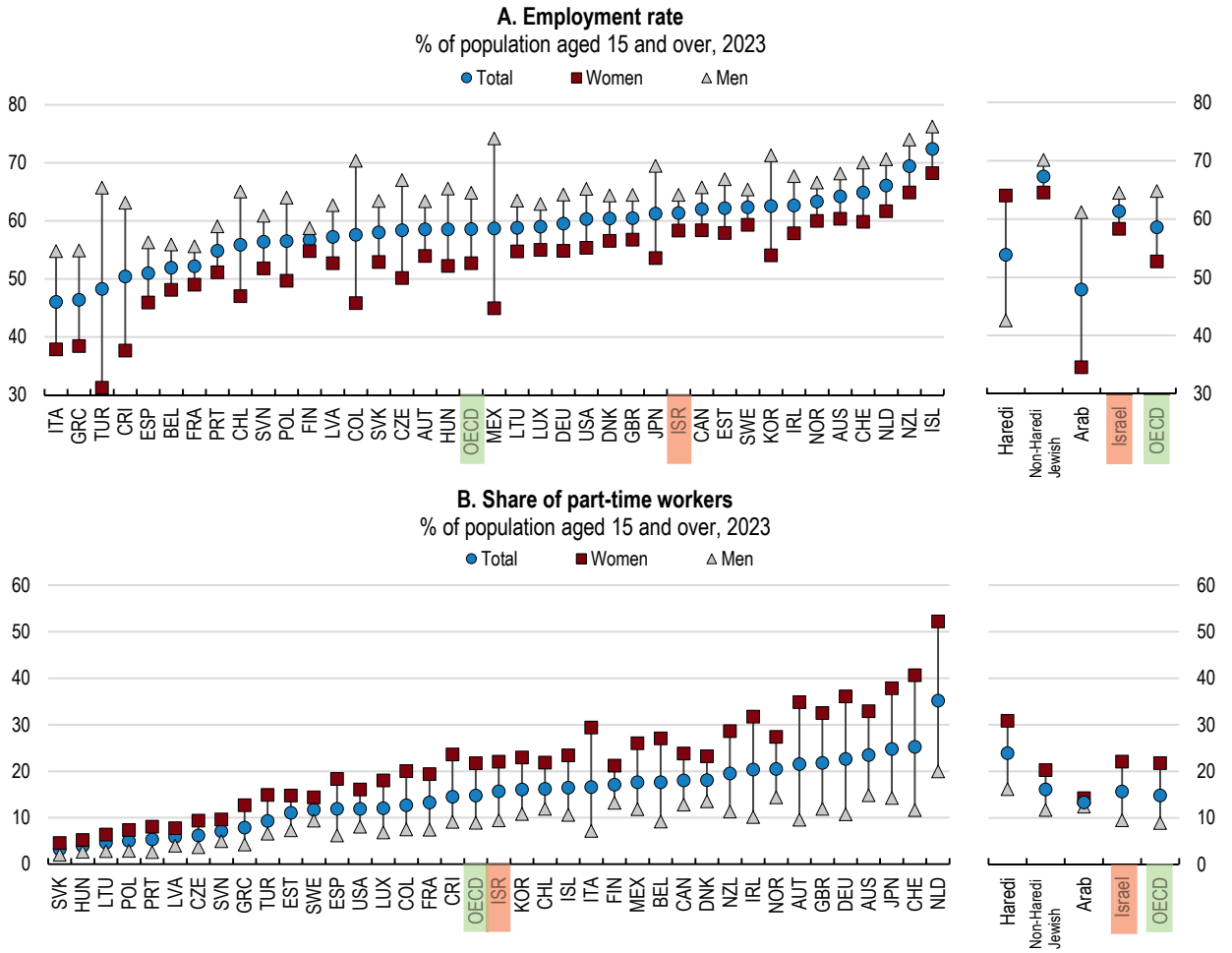
Tackling participation and skill gaps between population groups is a central policy requirement for sustained long-term growth

A source of long-standing unrealised potential for the Israeli economy is the weak labour-market attachment that characterises large population groups. Many Haredi (ultra-orthodox) men and Arab-Israeli women stay out of employment (Figure 1.3). Part-time work is prevalent among Haredi women (Figure 1.3). This situation to some extent reflects cultural choices, such as many Haredi men opting for long religious studies in yeshivas.

Alongside cultural factors, public policy settings are influencing women's and men's decisions to seek work or not. They include subsidies for yeshiva students, whose recipients are considered as employed for the purposes of eligibility to childcare support that is conditional on both parents working (Betz and Krill, 2019[3]). Lack of childcare, particularly in Arab-Israeli municipalities, complicates labour-market participation for Arab-Israeli women. Previous reductions in childcare costs in Israel have raised

employment rates among mothers of young children (OECD, 2023[4]). The six-day length of the school week implies long school holidays, which in turn mean that schools are closed on many business days. This increases the burden of childcare for parents of school-age children, a burden that typically falls on mothers, who may consequently move into part-time, flexible or less-demanding jobs (OECD, 2023[3]). Besides suggesting benefits from reforming the school week, this situation underscores the benefits of expanding, and facilitating access to, childcare. As recommended in the previous *Survey,* a range of reforms are available to increase participation among women and across population groups (Table 1.2).

Figure 1.3. Gender gaps are large among the Arab-Israelis and Haredim



Notes: In Panel A and Panel B, data for the Haredi and non-Haredi Jewish groups do not include persons living outside localities (Bedouins in the South) or in institutions (permanent samples). In Panel B, data for Arab, Haredi and non-Haredi Jewish do not fully comply with the OECD harmonized definition of part-time workers.
Sources: OECD Labour Statistics database; Israel Central Bureau of Statistics (CBS); and OECD calculations.

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There is considerable economic potential from closing gender gaps. Women in Israel earn wages that are on average more than a fifth lower than men's, one of the highest differences among OECD countries (Gonne and Trincão, 2024[5]). Women are under-represented in the high-tech sector (see Chapter 2), partly reflecting a 30 percentage-point gender gap in entry into tertiary STEM studies, one of the largest gap across OECD countries (Gonne and Trincão, 2024[5]). By contrast, the share of women on listed companies' boards , at 26.7% in 2021, was near the OECD average of 27.7% (Denis, 2022[6]).

Demographic trends mean key determinants of Israel's growth trajectory in future decades will be the share of Haredim in employment (Box 1.1) and the productivity levels of the jobs they take. Economic benefits of greater Haredi labour-market inclusion would include both individual and social benefits, helping to overcome a currently high poverty rate of 39.5% (Ben-David, 2024[7]). To achieve progress towards higher participation as well as higher productivity levels and wages, with potentially large long-term growth benefits (Box 1.3), policy reforms are required in the areas of work incentives and education.

Table 1.2. Recommendations in previous economic surveys to enhance labour-market participation

RECOMMENDATION	ACTION TAKEN SINCE APRIL 2023
Remove government subsidies for yeshiva students and condition childcare support on fathers' employment in addition to mothers' employment.	Budgetary support for yeshivas was increased to 50% above 2022 levels in 2023 and 58% in 2024.
Permanently re-introduce the bonus for second earners in the Earned Income Tax Credit and align fathers' benefits with that of mothers.	The EITC bonus for second earners has not been re-introduced. The work grant given to working fathers has been increased to the same level as for mothers. Additionally, both men and women since 2024 receive an extra tax credit point for each child aged 6-18.
Increase the provision of accredited childcare in Arab municipalities.	The budget of the "550" five-year plan aimed at employment in the Arab sector was reduced by 15% by contrast with the 5% across-the-board cut in discretionary spending in 2024.
Introduce paid paternity leave.	No change.
Switch to a five-day school week.	The government has announced that it would review the implications of such a change

Policy changes over 2023-2024 have mostly reinforced Haredi men's disincentives to work. There has been a substantial rise in budgetary support for yeshivas (seminar), whose students stay outside the labour force and are exempt from military service. On the other hand, in 2024, the High Court has ruled that the Haredim ought to be enlisted in the armed forces. Reportedly, however, few have effectively joined defence forces. Military duty can be a powerful channel for greater labour-market inclusion through the formation during this period of a network of contacts that can facilitate taking up employment or starting a business. Another one is the acquisition of dual skills that can also prove valuable in the civilian labour market. Additionally, enlisting Haredim allows freeing reservists for many days every year, allowing them to contribute more to civilian production (Tur-Paz and Gordon, 2024[8]).

Education and skill policies offer important additional avenues for narrowing labour-market gaps with a strong potential impact on Israel's overall economic performance, as outlined in previous *Surveys* and Chapter 2. The reason is that large differences currently separate average educational outcomes across population groups (Figure 1.5 Panel A). These in turn reflect discrepancies in funding between Arab and Hebrew education streams (Figure 1.5 Panel B) as well as incomplete coverage of the core curriculum for Haredi pupils, especially boys (Ben-David, 2024[7]).

A key policy lever is to reallocate budgetary resources away from educational institutions that refrain from fully teaching the core curriculum towards those that do, with priority to currently underfunded ones (Koelle, 2023[9]). This reallocation would encourage core curriculum studies among young Haredi while freeing resources for currently comparatively lower-funded schools, including many in the Arabic-language sector. For Haredi boys, acquiring core-curriculum competencies, including in mathematics and English, would facilitate their later employment while enhancing their wage prospects. The same outcomes would arise for Arab-Israeli pupils from receiving higher-quality primary and secondary education (Ministry of Finance, 2021[10]). Furthermore, work placement and life-long programmes should be reviewed to ensure adequate coverage of Haredim and Arab-Israelis (Koelle, 2023[9]).

Box 1.1. Long-term labour market impacts of demographic change: stylised scenarios

With the highest total fertility rate (TFR) among OECD countries, Israel experiences strong population growth. Another key demographic feature is the fertility difference between population groups. While all groups have TFRs significantly above the minimum replacement rate of 2.1, the Haredim (ultra-orthodox Jews) have a much higher TFR than other groups, implying that their share in the overall population is set to increase considerably over coming decades. Haredim's share among people aged between 25-29 is consequently set to rise from 13% in 2025 to 28% in 2060 in CBS projections. By comparison, the share of Arab-Israelis in the overall population aged 25-29 is projected to remain roughly stable around 21% over the same period.

Table 1.3. Total fertility rates by population group

2020-2022 average

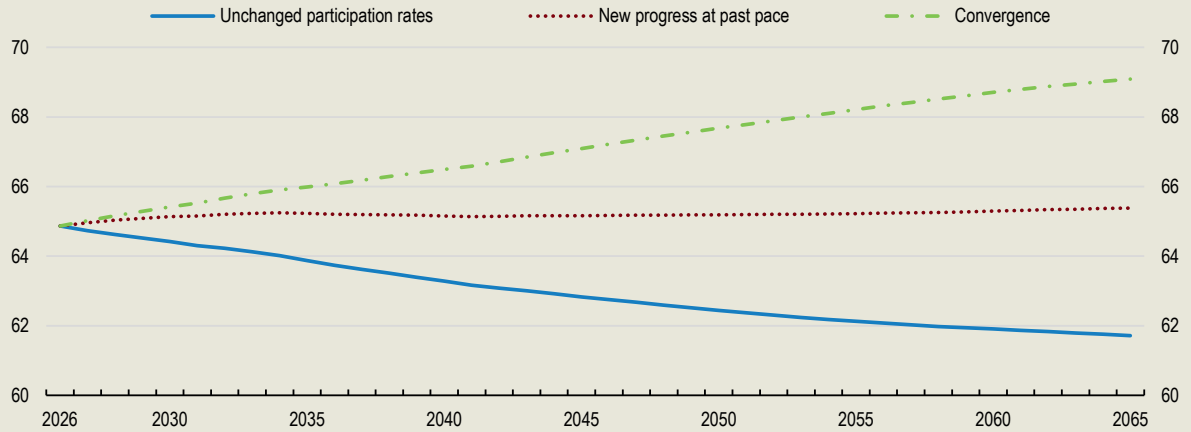
Total	Non-ultra-orthodox Jews	Ultra-orthodox Jews	Arab-Israelis	OECD average
3.0	2.5	6.4	2.9	1.5

Note: The total fertility rate is the average number of children born per woman over a lifetime.
Sources: Central Bureau of Statistics and OECD (2024[11]).

The labour-market participation choices of members of currently under-represented groups will have deep implications for the employment potential, and therefore the prosperity, of the Israeli economy (Figure 1.4). The reason is that Haredim and Arab-Israelis currently are significantly more likely to be out of employment than non-ultra-orthodox Jews (Figure 1.3). The high share of the Arab-Israelis in the population (21%) and the quickly rising share of Haredim imply that trends in their labour-market participation will drive the number of people in employment relative to the overall population.

Figure 1.4. Demographic change can lead to contrasting labour-market outcomes

Labour force as a share of the population aged 15 and more, %



Notes: The "unchanged participation rates" scenario assumes that participation rates by age, gender and population group will remain as in 2023, so changes are driven by the demographic composition. The "convergence" scenario predicts declining entry and exit rates, allowing Haredi men to close 75% of the participation gap in prime ages with Jewish non-ultra-orthodox men, Arab men to close 69%, and Arab and Haredi women to close 90% of the gap with Jewish non-ultra-orthodox women. The scenario of "new progress at past pace" assumes that the recently observed differences in employment propensities across various cohorts will persist, along with improvements in the participation of new generations of Arab women in line with historical trends.
Sources: Central Bureau of Statistics of Israel; OECD Economic Outlook No. 116 database and OECD (2025, forthcoming[12])simulations.
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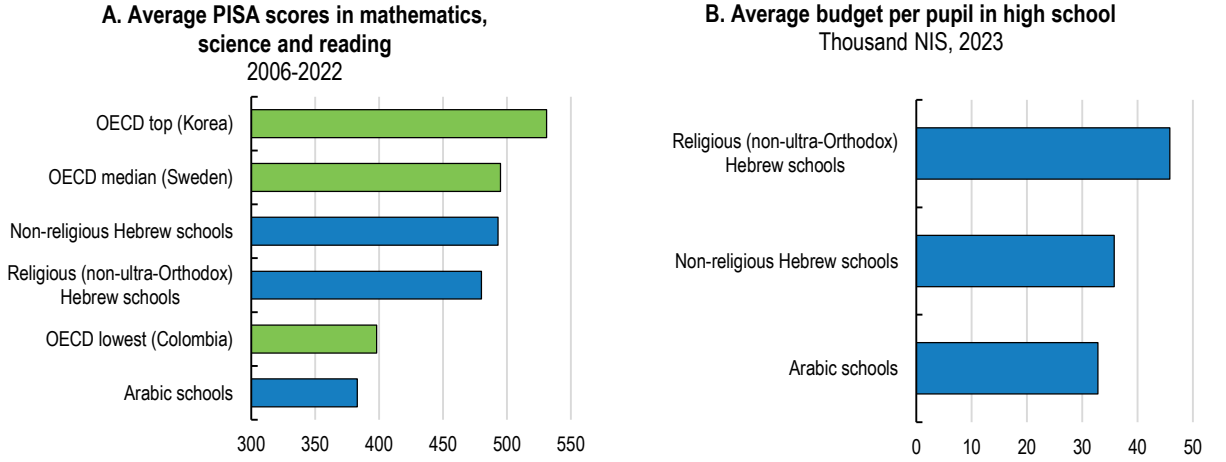
Quantitatively, work currently underway by the OECD (2025, forthcoming[12]) points to different plausible long-term scenarios for Israel's labour market. If forthcoming generations participate in the labour force with the same participation rates per group as current ones, the ratio of the labour force over the population aged 15 and more will decline by two and a half percentage points over 2030-2060 (Figure 1.4). By contrast, if the participation by Haredi and Arab Israelis converges towards that of non-ultra-orthodox Jews, this ratio will rise by 3.3 percentage points over the same period (the "convergence" scenario on Figure 1.4). In a middle-of-the-road scenario where past improvements in participation rates are repeated in the future, the same ratio rises by 0.2 percentage points over 2030-2060. In turn, the size of the labour force relative to the whole population has far-reaching consequences for economic performance (Box 1.3) and fiscal sustainability (Box 1.6).

Figure 1.5. Large disparities separate population groups in terms of education



Notes: Panel A, most Haredi boys do not take the PISA test. Panel B, data are unavailable for Haredi schools, which operate under a separate budgetary system.
Sources: Ben-David (2024[13]) and Blass and Bleikh (2024[14])

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Further productivity-enhancing reforms would buttress long-term growth prospects

Besides labour-market outcomes among the fast-growing Haredi population, another factor that will influence growth over the long run is the impact of larger defence commitments. The authorities are considering permanent increases in military expenditure (see fiscal section below) and reserve duties. The evidence on the economic effects of military spending is mixed, with significant potential for negative effects on long-term growth (Box 1.2). The planned increase in reserve days from 18 to 42 days for soldiers and 28 to 55 days for officers is bound to complicate the organisation of production (Tur-Paz and Gordon, 2024[8]).

The challenges of this new environment magnify the benefits of structural reforms to boost growth (Box 1.3), as these can offset negative effects from larger defence commitments. Implementing the economic policy options to reduce the cost of living (see Chapter 4) would have positive effects going well beyond a lower price level. Reforms that open economies to competitive pressure from trade and domestic competition have a proven track record of unleashing productivity growth, in turn boosting investment and employment (Égert and Gal, 2017[15]). The above-mentioned policies to enhance labour-force participation and skill acquisition among the Haredim and Arab-Israelis would boost aggregate employment and productivity.

The economy would benefit from strengthening public investment management, allowing a broadening of the public-capital base, which is currently low by international comparison (Figure 1.6). As highlighted in previous *Surveys*, better public infrastructure would support growth including by easing road congestion from its currently elevated levels and by facilitating the uptake of public transport, and there is scope for streamlining regulatory and administrative procedures. As developed in Chapter 2, higher public investment could contribute to buttressing the computing and network infrastructure for AI research and for its deployment across the economy.

Box 1.2. Defence expenditure and economic growth:

Ongoing conflicts following Russia's war of aggression against Ukraine and the 7 October 2023 terror attack on Israel as well as heightening geopolitical risk in the Asia-Pacific have led many OECD countries to spend more on their defence. In the economic literature, the link between military expenditure and economic activity has long been a subject mostly focusing on developing nations. While defence spending in OECD countries shrunk to low levels in the aftermath of the Cold War, generating a peace dividend (Berthélemy, McNamara and Sen, 1994[16]; OECD, 2023[17]) , renewed conflicts and tensions have put the question to the fore. This box summarises available evidence from the literature on potential positive and negative economic effects.

Potential growth-enhancing economic effects of military expenditure

Besides its accounting contribution to GDP in the forms of public consumption and investment, defence expenditure can have broader economic effects by spurring technological advancements, particularly through research and development (R&D). Defence-related R&D can produce innovations, some of which may have substantial technological spillover effects in the civilian sector (Adams and Gold, 1987[18]). For example, the internet, GPS, and many advanced computer systems originated from military research but later became vital components of the civilian economy. The investment component of defence expenditure has been empirically found to associated with subsequent higher long-term growth in OECD countries (Fournier, 2016[19])..

Negative economic effects of military expenditure

There are also significant downsides to military spending, particularly in the long run. One of the primary concerns is the crowding-out effect. Defence expenditure competes with other forms of public spending, crowding out in spending on key areas for long-term growth such as education, healthcare, and infrastructure development (Azam, 2020[20]). The large part of military expenditure that is spent on imported equipment and to maintain standing armies brings no spillover benefits to the rest of the economy.

Another concern is that military expenditure can distort resource allocation, reducing aggregate productivity (Hong, 1979[21]). When a significant portion of skilled labour is employed in the military or defence industries, these workers are unavailable for civilian projects. In Israel, this can be a cause for concern especially in the high-tech sector given the shortages of highly skilled labour (see Chapter 2).

Box 1.3. Illustrative quantitative estimates of reform effects on GDP

Table 1.4 provides illustrative quantitative estimates of the benefit in terms of GDP per capita of selected main recommendations in this Survey using the OECD long-term modelling framework (Guillemette and Château, 2023[22]). As developed in Chapter 4, product market reforms are assumed to cut red tape, reduce state involvement in the economy and lower barriers to entry, so that Israel reaches the OECD average on the PMR indicator. Trade barriers are lowered through the introduction and deepening of free trade agreements, lower tariffs, less technical barriers to trade and trade facilitation measures. The education reform scenario assumes that educational outcomes of currently underperforming groups (Haredim and Arab-Israelis) converge over ten years to the ones observed among secular and religious (non-ultra-Orthodox) Jews. Consequently, total factor productivity increases gradually in the illustrative reform scenario as cohorts having benefited from education reforms enter the working-age population. Withdrawing subsidies and other policies discouraging labour-market participation of Haredim and Arab-Israelis is assumed to gradually improve labour supply over time.

Table 1.4. Illustrative impact of selected reforms on GDP per capita

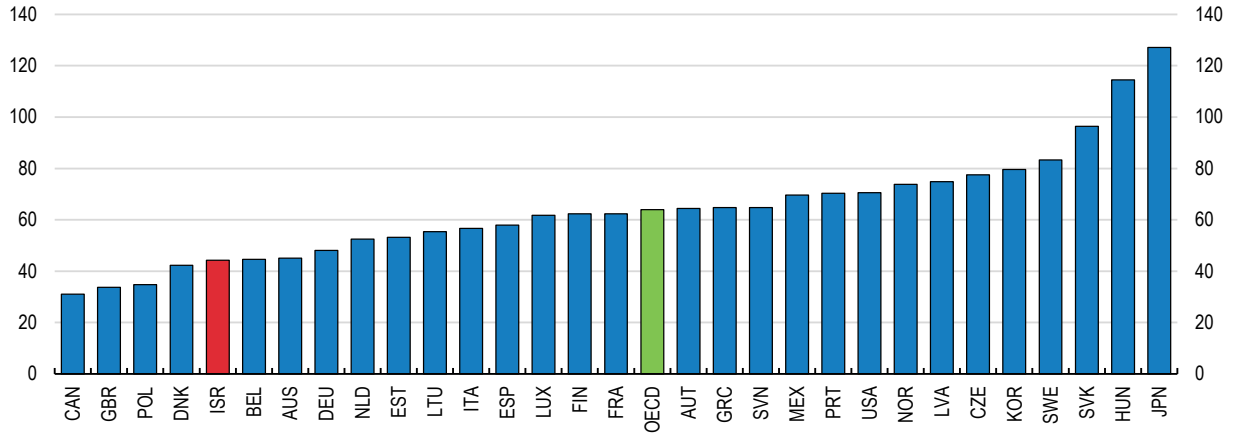
Relative to the "unchanged policies" scenario

Reform	Ten-year effect	Effect by 2060
Product-market reform to enhance competition and trade liberalisation.	2.2%	6.9%
Strengthen public investment management to ensure adequate and effective infrastructure spending.	2.1%	2.6%
Better educational and labour-market outcomes across socio-economic groups by:		
(i) conditioning the funding of schools to the teaching of core subjects and equalising per-pupil funding across schools with equal socio-economic characteristics.	0.1%	3.1%
(ii) withdrawing subsidies and other policies discouraging labour-market participation of Haredim and Arab-Israelis.	1.1%	3.5%
Total impact.	**5.5%**	**16.1%**

Notes: The estimates rely on Égert and Gal (2017[15]) for trade and product-market reforms, Guillemette and Turner (2018[23])for public investment using the elasticity for Israel reported in Section 4.4, Égert, de la Maisonneuve and Turner (2023[24]) for education reforms and a demographic model for the greater labour-market participation of Haredim and Arab-Israelis (which assumes the achievement of half of the improvements in the "convergence" scenario described in Box 1.1).

Figure 1.6. Enhancing the public capital stock from its low level would support future growth

General government non-financial assets, as % of GDP, 2022 or latest available year



Source: OECD National Accounts database.

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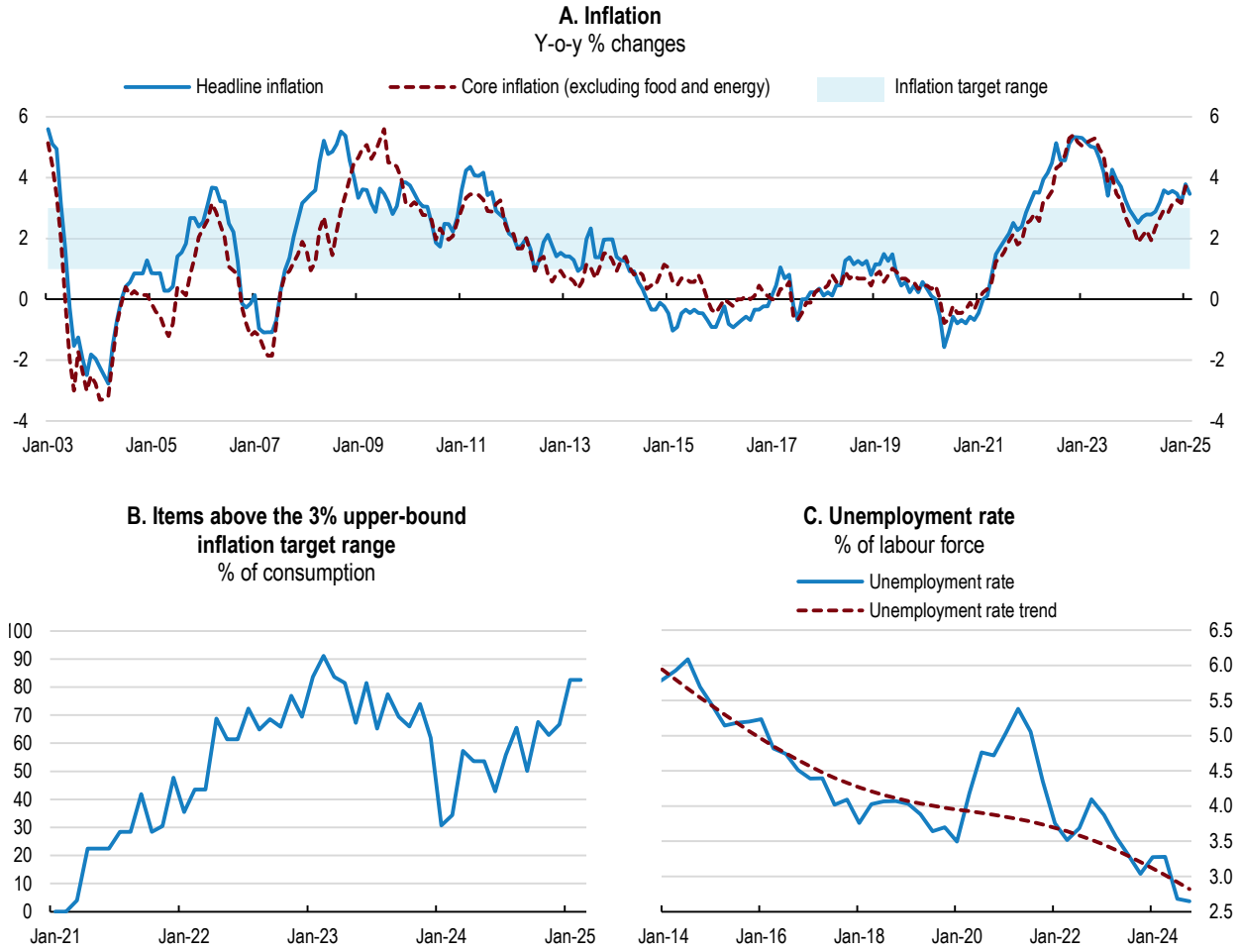
1.2. Monetary policy should return inflation below 3%

Inflation has been rising since the beginning of 2024, going above 3% in July -- the upper bound of the central bank target range -- and reaching 3.6% in August 2024. Inflationary pressures are widespread: core inflation, a measure that excludes food and energy, two areas with large price swings, also increased substantially, by one percentage point over the same period. Another indicator of the widening breadth of price pressures is that, since the beginning of 2024, more of the goods and services consumed by Israeli households have recorded price increases in excess of 3%.

Figure 1.7. Inflation rates have been rising on a broad basis



Notes: Trend unemployment is calculated as a Hodrick-Prescott HP filter of observed quarterly unemployment (lambda=1600) and OECD Economic Outlook No. 116 projections up to 2026Q4 to avoid end-point bias. The calculation corrects for the impact of COVID-19 by replacing the observed unemployment rate during COVID-19 (2020Q2-2021Q4 in Israel given early vaccination) with its trend (calculated in a preliminary stage also with a HP filter).
Sources: OECD Price Statistics database; and OECD Economic Outlook: Statistics and Projections database.

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Supply disruptions and constraints are contributing to inflation

The conflicts are weighing on production and the labour market

The return of inflation stems in part from adverse supply shocks while the surge in war-related government spending has supported demand. The terrorist attacks of 7 October 2023 and the continued rocket attacks

on the north of Israel since then have severely disrupted agricultural production. Food prices have consequently risen sharply, contributing one percentage point to overall inflation in August 2024. Rocket attacks on the north of the country severely impaired industrial production as well as the activity of high-tech companies operating in the area (such as food-tech firms).

The war has involved a large mobilisation: in the year from October 2023, nearly three hundred thousand reservists (6.5% of the workforce) served in the armed forces for an average of 61 days each (Israel Defence Forces, 2024[25]). In addition to a direct effect equivalent to a 1.1% reduction in the civilian labour force, this enlistment has also had consequences for partners of the mobilised soldiers. Many reduced their working time as they had to take care of family duties singlehandedly during their partners' duty periods. Reserve calls have also complicated the organisation of production for employers.

Housing could contribute to overall price pressures if labour shortages keep constraining homebuilding

Housing-supply imbalances influence rent developments and CPI inflation in addition to bearing on living standards (Chapter 4). Lack of sufficient housing translates into higher rents: with housing making up 26% of consumption as recorded in the CPI, including imputed rents for homeowners, changes in rent have strong effects on overall inflation. Over the past three decades, movements in housing supply above or below demographically-driven equilibrium levels of housing have had quantitatively large effects on the dynamics of rents.

Looking ahead, the sharp homebuilding contraction of end-2023 may have significant effects over time if labour shortages in construction remain widespread (Table 1.5). Given construction lags, the end-2023 contraction will result in reduced deliveries by comparison with pre-October-2023 trends in the course of 2025. Even though homebuilding rebounded in 2024, residential construction remained in the third quarter of 2024 more than 25% below its level in the third quarter of 2023. The contraction appears more limited when considering housing starts, which in the third quarter of 2024 were only 8% below their level a year before, suggesting that a number of developers may still start projects despite uncertainty about the possible pace of construction.

If labour shortages persist, the supply of housing could go below trend, with the effect that housing would put increasing pressure on inflation over time through market and imputed rents. As of November 2024, rent inflation is running a yearly rate of 3.6% for market rentals (and 4.0% for homeowners' imputed rents). Despite high mortgage rates, dwelling prices increased by 6.7% in the twelve months to September-October 2024. These indicators suggest that tensions may be building already in the housing sector despite the relatively high number of new dwellings available for sale at 71,000 in November 2024, which is equivalent to about 21 months for sale, a ratio of inventory to sales that is comparable to January-September 2023. An explanation could be a mismatch between some of the new supply and the characteristics that buyers are seeking in terms of location or features (Mirovsky, 2024[26]).

Policy levers are available to mitigate the risks of such pressures building up. Addressing labour shortages through facilitating entry of more foreign workers and/or ending the suspension of work permits for Palestinians would avoid the gradual widening over time of a housing gap. Another avenue for more homebuilding would be to encourage productivity enhancements, even if international experience suggests that this is challenging as productivity growth in residential construction has been very weak or even negative over recent decades across countries (Kane and Lopez, 2023[27]). Measures discussed in Chapter 4 can help to remove obstacles to housing-supply adjustment by easing regulatory constraints on homebuilding, further facilitating densification in areas of demand and considering social-housing construction. By contrast, subsidies to help low-income tenants pay their rent need to be carefully targeted and limited in size and time as otherwise they risk further feeding rent inflation (Chapter 4).

Table 1.5. Simulated medium-term effects of persistent labour shortages in homebuilding on rents and inflation in stylised scenarios

Estimated medium-term (2029) effects, Percentage points

	Unchanged labour shortages	Foreign immigrants fully replacing Palestinian workers	End of the suspension of Palestinians' work permits
Contribution to:			
Change in rents	3.1	-1.7	-2.8
CPI inflation	1.0	-0.6	-0.9

Notes: The stylised scenarios are those underpinning Figure 1.2. The simulations combine the housing-supply trajectories in these scenarios with econometric estimates of the link between the housing gap (effective minus population-based equilibrium supply) and rent changes. The housing gap that separates actual from equilibrium dwellings (Figure 1.2) is tightly linked to rent movements. Econometric regressions using the previous year's housing gap and inflation excluding housing explain more than six tenths of the variation in both actual and imputed rents (as measured in the CPI). Changes in actual and imputed rents are both statistically significant above the 95% confidence level while inflation is statistically significant at the 99% level.
Source: OECD simulations based on OECD Economic Outlook No. 116 and Central Bureau of Statistics databases.

Price pressures are set to remain significant

Demand factors have also been contributing to price pressures. The rapid rebound in consumer expenditure combined with the surge in government consumption more than offset the effect of lower investment. Due to the prolongation of the conflicts, the impetus from military-expenditure has been larger through 2024 than expected on 1 January 2024, when the Central Bank lowered the policy rate from 4.75% to 4.5%. In mid-2024, domestic demand snapped back to 2.7% above its pre-COVID-19 trend in mid-2024. Despite an increase after October 2023, unemployment remains below its long-term trend.

Inflation is set to remain strong in the first half of 2025 before moderating. The one-percentage point increase in VAT in January 2025 and supply constraints related to geopolitical tensions, which are assumed to remain elevated until the second quarter of 2025, will contribute to price pressures in the first half of 2025. Some wage pressure will come in the business sector from the tight labour market. The construction shortfall since October 2023 amid persistent labour shortages implies that, even after the shortages are addressed and investment can fully recover, the capital stock will for a time remain below equilibrium levels, constraining supply with implications for price pressures.

Keeping a careful monetary policy stance is appropriate

The increase in inflation through 2024 marked a turning point after a period of disinflation. A series of central bank rate increases implemented over April 2022-May 2023 brought down price pressures. Core inflation declined from over 5% at the end of 2022 to below 2% in early 2024. Over the same period, disinflation was broad based: items with price increases above 3% per annum went from making up more than half of consumption to less than a fifth of it. The share of consumption categories with above 3% inflation however rose through 2024.

Continued prudent demand management is appropriate to keep inflation under control. The stability-oriented macroeconomic policy strategy followed since October 2023 stands in contrast with the monetary financing of government spending that characterised the period after the Six-Day and Yom-Kippur wars (Box 1.4). Since this period, reforms including the independence of the central bank and the establishment of the fiscal framework have considerably strengthened monetary and fiscal institutions (Box 1.5).

The key monetary policy objective of keeping the CPI inflation rate between 1 and 3% attracts market credibility. After drifting to the upper part of the range during COVID-19 years, medium and long-term measures of inflation expectations have remained anchored within the target-range in recent years. The stability of these indicators below 3% reflects confidence in the inflation objective. This supports the

monetary policy framework, which, looking backward, has been successful with inflation averaging 1.7% since the entry into force of the 1-3% target range in 2003. One-year-ahead inflation expectations, which are more sensitive to short-term developments, have moved up in line with inflation outturns in the course of 2024 without going above them: markets see the risk of a wage-price spiral as contained.

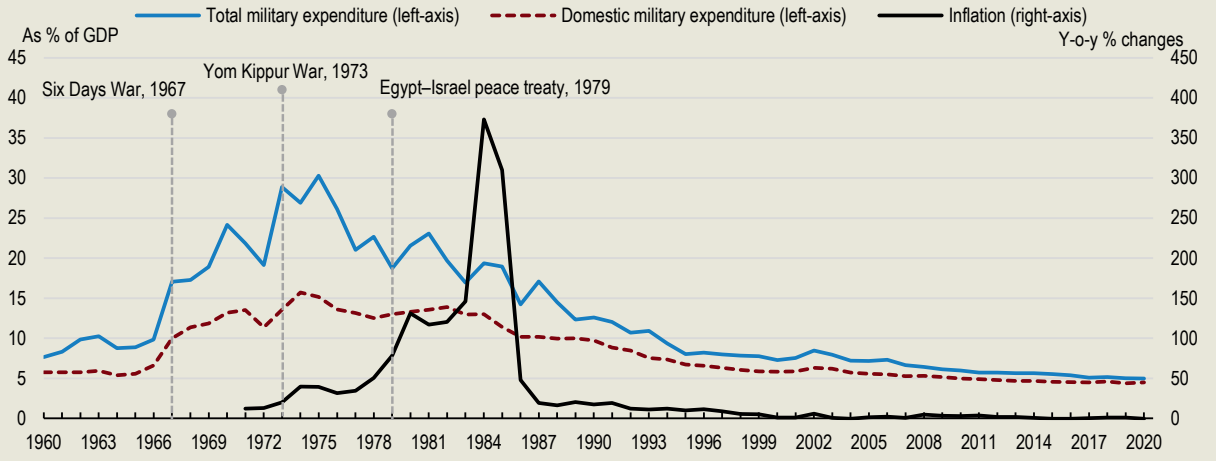
Box 1.4. Economic consequences of the Six-Day and Yom-Kippur wars

Large fluctuations in military expenditure that accompanied and followed the Six-Day (1967) and Yom Kippur (1973) wars deeply influenced the Israeli economy for decades. Defence spending surged after both conflicts: from less than 10% of GDP before 1967, defence expenditure soared to 30% of GDP from 1973 to 1976 (Figure 1.8). This increase reflected wartime expenditures in a first stage followed in a second stage by the decision to maintain larger defence forces than before owing to an upward re-assessment of military threats.

A central economic consequence of Israel's high military spending was inflation. Government expenditures after 1973 rose to an average level of 75% of GDP until 1985 (Sargent and Zeira, 2011[28]). Despite an increase in public revenue, much of the rise in government spending was funded through deficits, which averaged 15% of GDP over 1973-1985. Monetary financing has been estimated to have covered a third of these deficits (Sargent and Zeira, 2011[28]). The resulting overly rapid expansion in money supply-fuelled inflation, which took off after the Yom-Kippur war to ultimately reach a rate of nearly 400% in 1985 (Figure 1.8) (Weissbrod and Weissbrod, 1986[29]).

In the wake of the Yom Kippur War, much of Israel's defence spending was allocated to imports (Figure 1.8), primarily of weapon systems from international markets, with only a third of the total increase in defence spending contributing directly to local economic activity (Lifshitz, 2023[30]). Large imports of military equipment, despite being partly funded by foreign aid especially from the United States, implied substantial current account deficits (Zeira, 2021[31]).

Figure 1.8. Military expenditure and inflation



Source: Israel Central Bureau of Statistics (CBS, 2022[32]); and OECD Price Statistics database.

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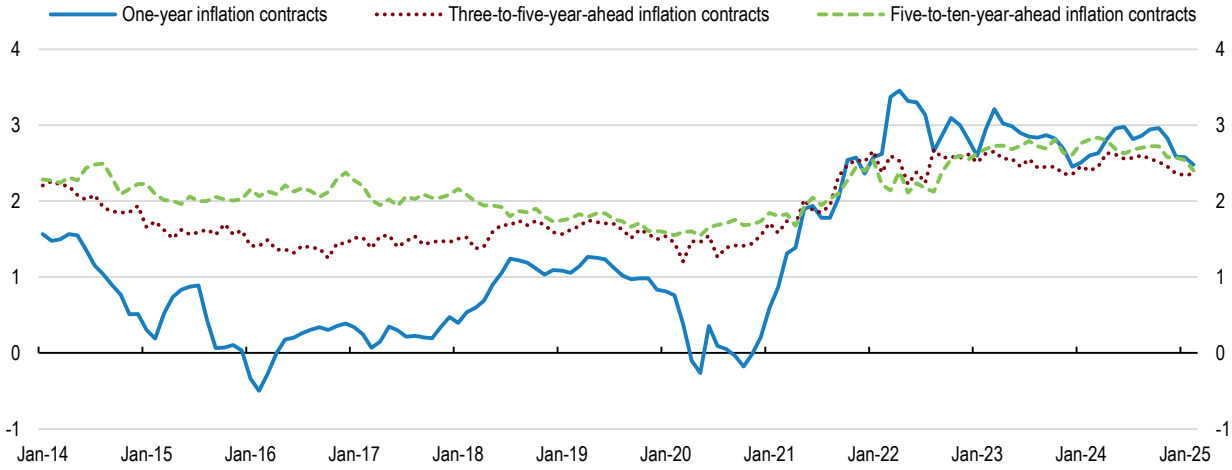
The surge in defence expenditure had evolving effects on Israel's domestic economy. The initial effects were mostly of a cyclical nature: in particular, the rise in military expenditure at the time of the Yom Kippur War sustained economic activity in the face of global economic turbulence. Over time, the defence industry, especially weapons production, experienced rapid growth. Between 1965 and 1977, the defence sector grew at a rate of 15% annually, far outpacing the 7.9% growth rate of total industrial

production. This expansion transformed Israel from a net importer of military goods into a global exporter, with weapons exports rising sharply in the 1970s and 1980s, accounting for nearly a quarter of industrial exports by 1985 (Labarge, 1988[33]; Mintz and Ward, 1989[34]). By the mid-1980s, the defence sector accounted for 50% of all industrial investments, and one in four industrial workers was employed in military-related production. The defence industry was dominated by a small number of oligopolistic firms, heavily reliant on government contracts. This concentrated market structure hindered competition and limited innovation.

Peace agreements, particularly with Egypt in 1979, enabled a decrease in defence expenditure. The shift from conventional country-to-country warfare to asymmetric conflicts, such as the First Intifada (1987-1991), accelerated this fall by reducing demand for large-scale military forces and heavy equipment. Public investment shifted toward non-defence sectors, particularly in industries like technology and services, which exhibited higher marginal productivity and became key drivers of economic growth (Cohen et al., 1996[35]).

Figure 1.9. Inflation expectations have remained anchored though at high levels

Expected CPI inflation rates from swap contracts, %



Source: Bank of Israel.

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Monetary authorities should keep interest rates on hold until inflationary pressures are well contained while remaining data dependent. There is little space for reducing rates given the inflation outlook, with the prospect of strong demand from private consumption and exports amid continuing labour shortages in 2025. Another reason to err on the side of caution is the need to keep long-term inflation expectations anchored – they are currently above 2.5%, though within the 1-3% target range. However, the improvement in the geopolitical situation at the turn of 2025 has resulted in an easing of supply constraints including by reducing reserve duty requirements and by allowing an increase in international air connectivity. Furthermore, the return of currency appreciation, if maintained, will lower medium-term price pressures (Figure 1.10). In this uncertain environment, the monetary policy stance should remain data-dependent to regularly assess supply-demand imbalances that shape the trade-off between inflation and output.

Box 1.5. Israel's monetary and fiscal policy frameworks: an overview

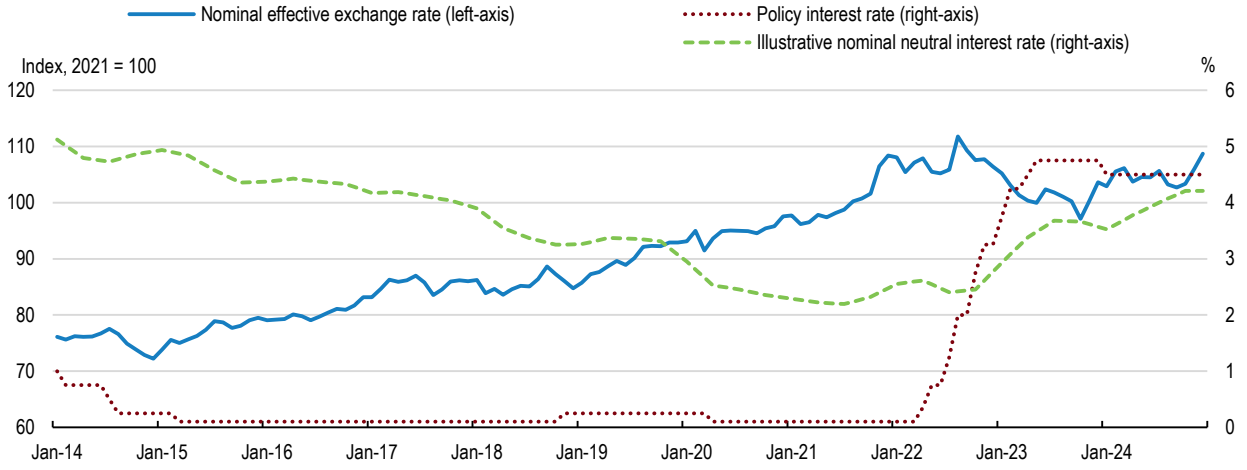
Israel's monetary policy aims at keeping inflation between 1% and 3%. The Bank of Israel is responsible for meeting this 1-3% inflation target range, which the Government decided in 2000 with effect from 2003. The 1-3% target was reaffirmed in November 2024 following a review. Legislation enacted in 2010 gave overarching priority to the inflation target while enshrining the Bank of Israel's *de facto* independence into law. The main monetary policy instrument is the Bank of Israel interest rate, which determines the overnight interbank rate.

The fiscal framework aims at ensuring fiscal discipline through annual deficit caps and long-term expenditure ceilings with a strong centralisation of responsibilities in the Ministry of Finance. Budgets are approved for one or two years, with a deficit ceiling for each year (and a revision in the second year) in the case of biennial budgets. Furthermore, since 2005, governments have been setting long-term expenditure ceilings to strengthen compliance with deficit targets while keeping in check the size of the government relative to the economy. Since the Stabilisation Programme of 1985 that followed hyper-inflation (see Box 1.4), the budget foundations and arrangements laws have given the Ministry of Finance greater control over the budget. Following a report by the State Comptroller, the Ministry of Finance in 2013 tightened the process for preparing the economic forecasts underpinning the budget including through the creation of a dedicated team within the Chief Economist's Department.

Sources: (Brender, 2021[36]; Ribon, 2021[37])

Figure 1.10. Monetary conditions remain restrictive

Central Bank policy interest rate, estimated neutral nominal interest rate and effective exchange rate



Notes: A rising nominal effective exchange rate increase corresponds to the shekel appreciating against the currencies of commercial partners, weighed by their share in Israel's foreign trade. The neutral rate shown on the chart is an exponentially smoothed time-varying illustrative estimate from a semi-structural latent-variable model where the difference between the observed real interest rate and a random-walk neutral real neutral rate influences variations in the unemployment rate. The observed real interest rate entering the model is the policy interest rate minus inflation expectations for the year ahead. The parameters are estimated by maximising the log-likelihood of the model computed with the Kalman filter initialised with parameter values obtained from a time-invariant specification. The illustrative estimate of the real neutral rate is obtained by exponentially smoothing the filtered path of the corresponding variable. The estimation is carried out over the period since the setting of the inflation target band. The illustrative estimated nominal neutral rate reported on the chart is obtained by adding exponentially smoothed (as in the model) inflation expectations to the estimated illustrative real neutral rate. Substantial uncertainty surrounds this estimate, which is therefore reported only for illustrative purposes.
Sources: OECD Economic Outlook: Statistics and Projections database and OECD calculations.

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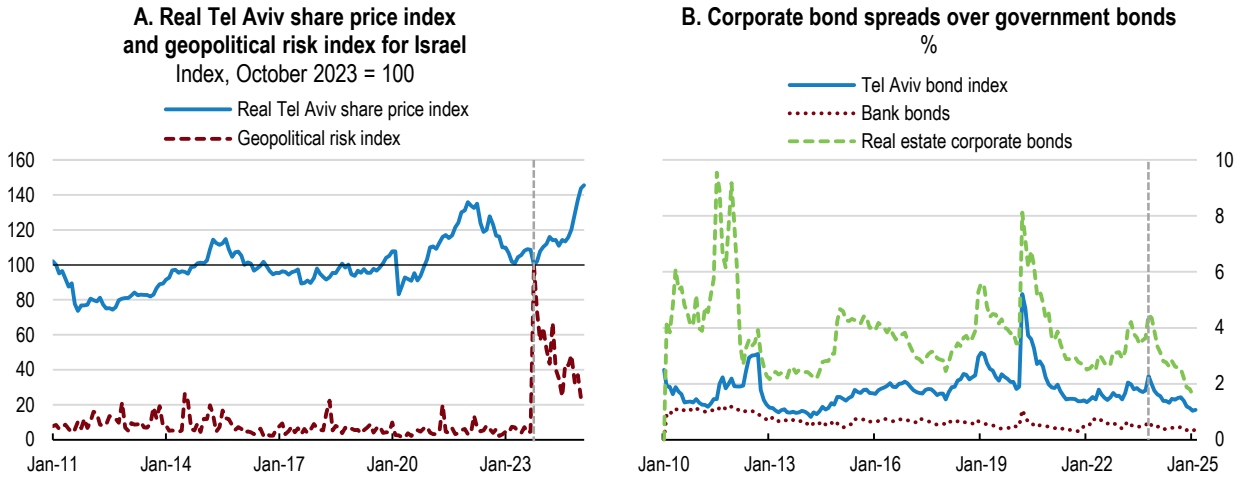
1.3. Vigilance is in order to preserve financial stability

Financial markets have been remarkably resilient

Capital markets suffered limited losses in the immediate aftermath of 7 October 2023 followed by a rapid recovery. Even if geopolitical risk for Israel after 7 October increased in a manner unprecedented since the start in 1985 of Caldara and Iacoviello's (2022[38]) so-called "recent" index, share prices fell by less than a tenth before bouncing back robustly (Figure 1.11 Panel A). Corporate bonds similarly recorded an increase in yields before easing (Figure 1.11 Panel B). The commercial real estate sector, which due to its heavy reliance on debt is vulnerable in times of high interest rates, has also withstood the shock of October 2023, with spreads rapidly returning to previous levels (Figure 1.11 Panel B).

This stability in the face of a very large geopolitical-risk shock reflects credibility in the monetary framework (see previous section), financial-system buffers (see below) and a relatively sound fiscal policy position going into the crisis (see fiscal section below), low private sector indebtedness, as well as deft crisis management. The Bank of Israel ensured currency stability by announcing on 9 October 2023 an open-ended pledge to sell up to USD30bn in foreign reserves, a credible amount since it represented less than one sixth of its holdings. The Bank of Israel supplied further liquidity by opening foreign-currency swap lines up to USD15bn. Further, the Bank of Israel on 16 October 2023 put in place programmes enabled vulnerable borrowers, including displaced people and categories of adversely affected businesses (especially among SMEs), to defer loan repayment.

Figure 1.11. Stock and bond markets recovered quickly from limited losses



Notes: The real share price index refers to the TAV100 deflated by the consumer price index. The geopolitical risk index for Israel measures is built using references to the country in major newspapers (Caldara and Iacoviello, 2022[38]).
Sources: OECD Financial Markets database; OECD Consumer Price database; Bank of Israel; and Caldara and Iacoviello's (2022[38])'s updated database.

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Banks need to maintain strong capital buffers

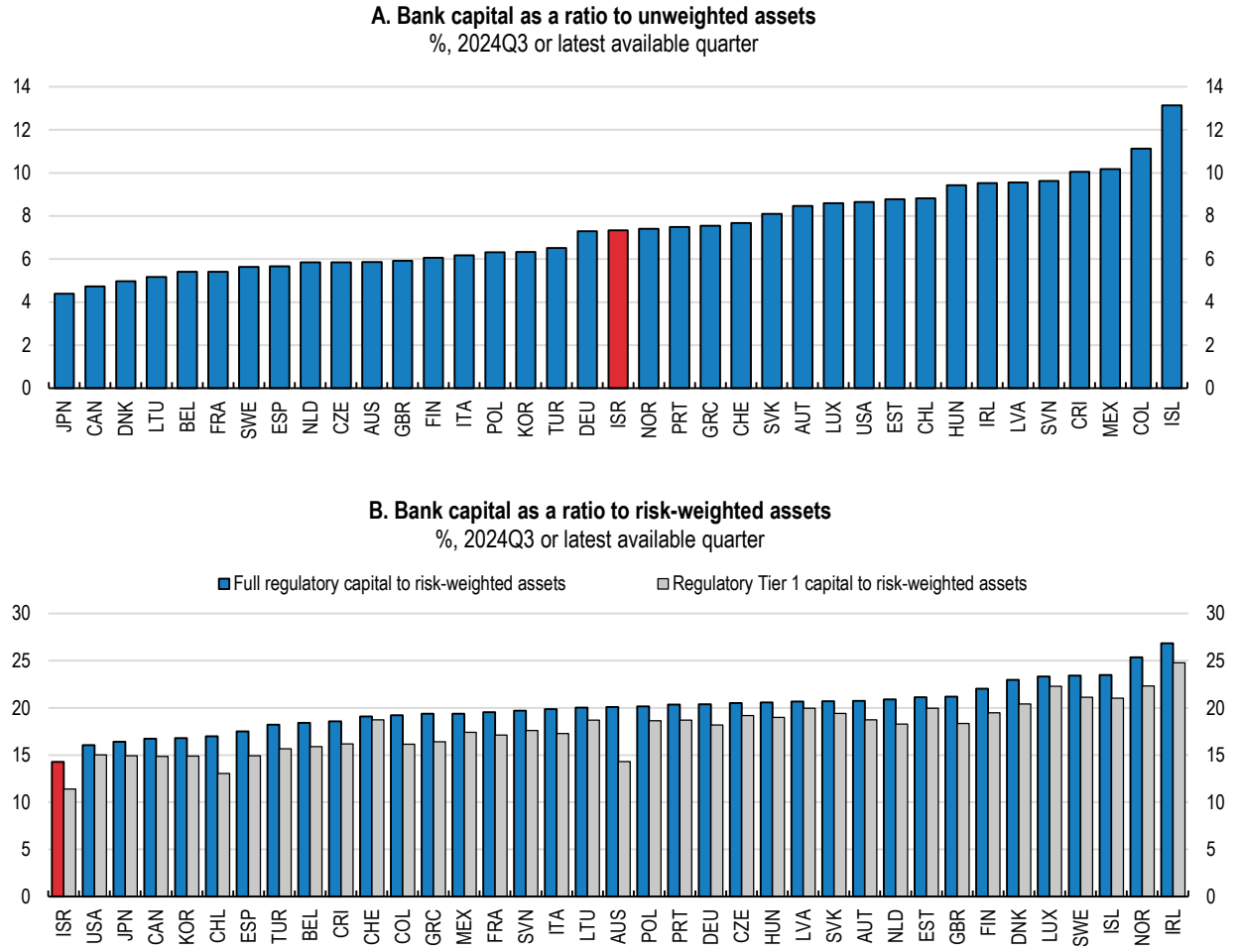
Capital buffers lay at the centre of the financial system and are a key source of overall financial stability and resilience. Among OECD countries, the Israeli banking system has capital buffers, relative to total assets, that are in the average, (Figure 1.12 Panel A). Capitalisation looks thinner when applying risk weights, but this partly reflects regulatory prudent and conservative choices with regards to risk weighting, which follows the standardised rather than internal-model approach (Figure 1.12, Panel B). Taking the example of housing loans, average risk weights are 53% and vary from 35% (when the loan-to-value (LTV) ratio is lower than 45% and the debt-service-to-income (DSTI) ratio below 40%) to 100% when the DSTI

ratio is above 40% (CGFS, 2023[39]). By comparison, most EU-country banking systems operate with risk weights on housing loans that lie well below 15% (HCSF, 2019[40]).

The banking system's resilience is underpinned by good loan performance (Figure 1.13). In mid-2024, non-performing loans (NPLs) stood at 0.8% of total loans, which is half the OECD average. When netted out of loan-loss provisions, thereby providing a more direct measure of capital depletion, NPLs amount to 4.5% of bank capital.

Supervisory policy has tools to keep fostering banking system resilience. Despite some decline in lending over deposit margins, banks produce very strong return on equity (Figure 1.13). This high profitability in part stems from reductions in operating costs, especially salary expenses, following productivity improvements (Bank of Israel, 2025[41]). The high return on equity may also reflect market concentration, as five banking groups hold 98% of total bank assets, highlighting the importance of the Bank of Israel Banking Supervision Department secondary objective of fostering competition (Chapter 4) alongside the primary goals of maintaining the stability of banks and credit card companies and a fair culture towards customers.

Figure 1.12. Bank capitalisation is moderate



Notes: Risk weights in Israel are measured using the standardised approach while most other countries allow large banks to use internal models. No data point refers to before 2023.
Source: IMF Financial Soundness Indicators (FSI) database.

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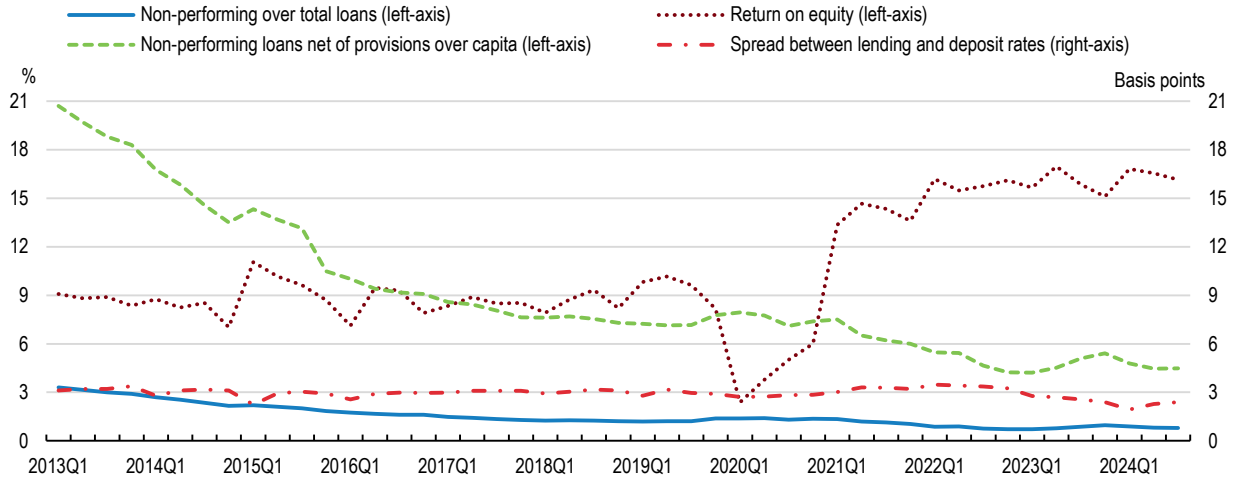
Banks' solid financial performance offers a powerful way of buttressing capital buffers: supervisory authorities can require a minimum of profit reinvesting by capping dividend payments or share buybacks. The Supervisor of Banks in November 2023 required banks to follow a prudent and conservative approach when distributing dividends, after which banks reduced the share of their profits distributed as dividends. The potential risks that the Israeli financial sector is currently facing from geopolitical events, public debt accumulation and the construction downturn put a premium on continuing such supervisory action to ensure that banks retain a sufficiently high share of their profits.

Figure 1.13. Banking performance indicators have broadly remained strong



Source: IMF Financial Soundness Indicators (FSI) database

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Housing-related financial risks seem contained but continued monitoring is warranted

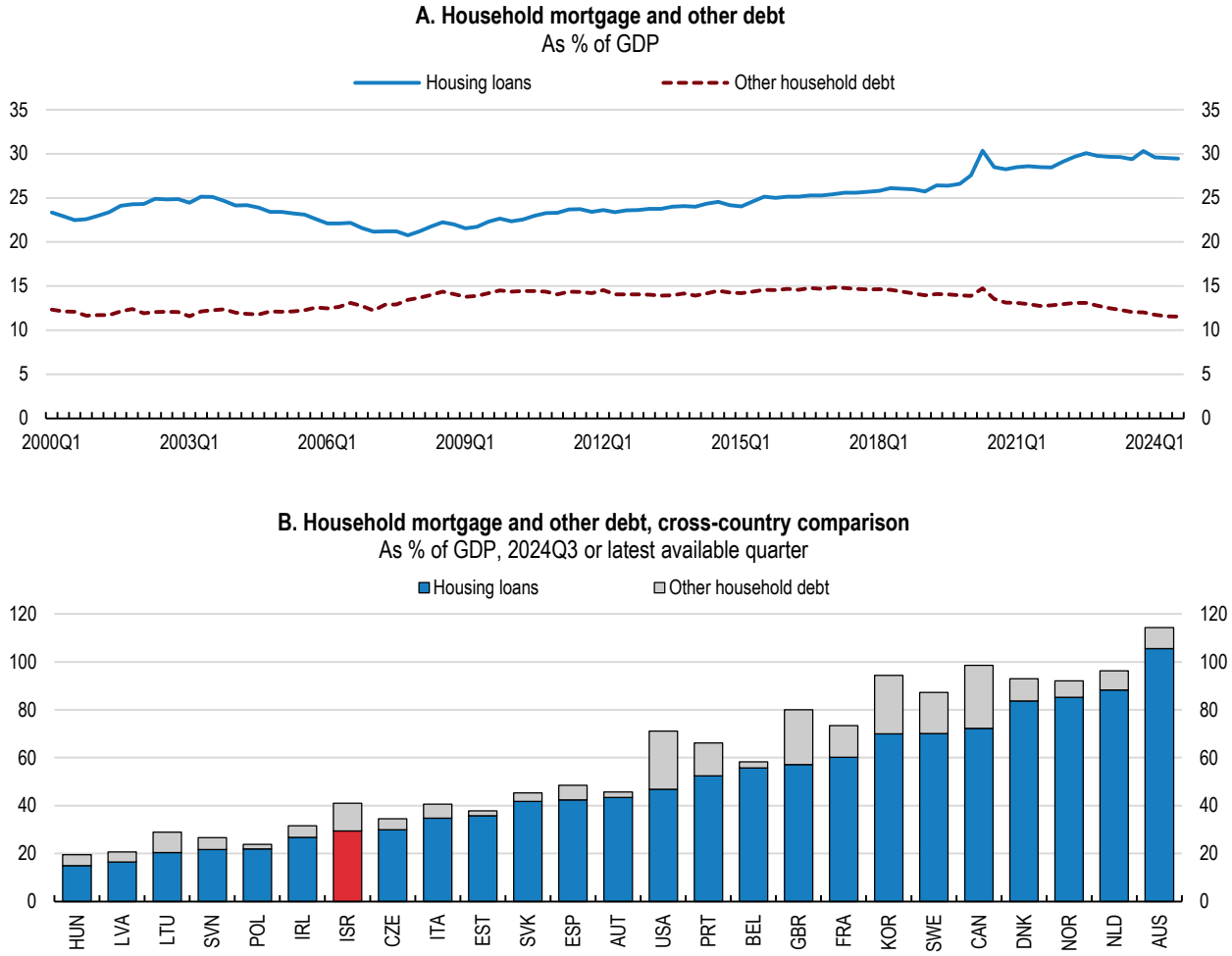
The macroeconomic risks from mortgage over-indebtedness appear limited for Israel at the current juncture. Outstanding housing loans are low by comparison with other OECD countries. This situation is favourable for both financial stability and long-term economic growth. The experience of OECD countries provides ample evidence that large household debt, especially linked to housing, is associated with greater financial instability and weaker economic resilience in the face of shocks (Caldera Sánchez et al., 2017[42]). Furthermore, too much household debt has shown able to slow long-term growth by magnifying the costs and distortions associated with implicit bank government guarantees, increasing vulnerabilities to shock and generating boom-bust cycles (Cournède, Denk and Hoeller, 2015[43]) as well as reducing the lending capacity available to fund non-financial firm growth (Bezemer et al., 2021[44]).

It is important to maintain the prudent macro-prudential policy framework and stance that have been in place since 2012-14, given that both have proven successful at keeping household debt in check. The current framework combines borrower and lender-based measures. On the borrower side, housing loan amounts are capped at 75% for principal residences, 70% for secondary homes and 50% for investment properties. Furthermore, debt service payments cannot exceed 50% of the borrower's income. In addition, at least one third of the loan must be at a fixed interest rate. On the lender side, as previously mentioned, the authorities apply risk weights that are higher than in many other OECD countries.

Still, regular and careful monitoring is needed. Contractors are routinely marketing sales of new apartments through the provision of balloon loans (i.e. loans with low monthly payments and a large final payment) that buyers commit to repay upon delivery of the dwelling. Such arrangements involve a risk that a number of buyers may fail to repay the balloon loan at the time of completion, especially in the event of a downturn. The realisation of this risk could leave contractors with inventories of unsold apartments. Their difficulties

can threaten lenders, who could in turn refrain from taking new real estate exposures or reduce their existing exposures, potentially triggering an adverse feedback loop. Bank capital provides a key source of protection against a potential negative feedback loop between developers and lenders, which reinforces the importance of encouraging banks to maintain strong capital buffers.

Figure 1.14. Housing debt remains low relative to GDP by international standards



Notes: In Panel B, the data are for 2024Q3 in Canada, Israel, the United Kingdom and the United States and 2023Q4 in most other countries. No data point refers to earlier than 2023Q4.
Sources: Bank of Israel; OECD Economic Outlook: Statistics and Projections database; and OECD calculations.

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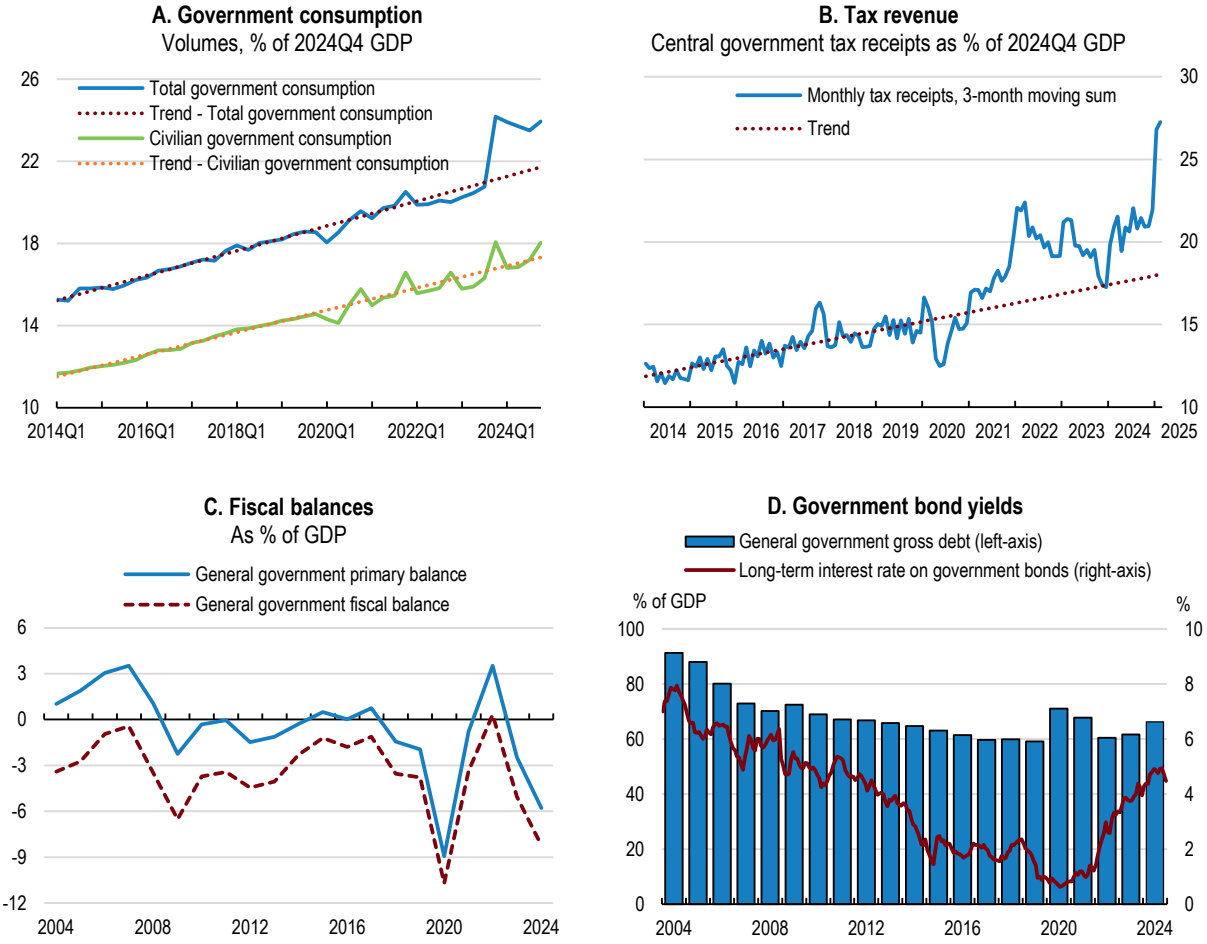
1.4. Fiscal policy needs to navigate the conflicts while paving the way for the future

Public finances have come under stress

The attacks and the conflicts have had far-reaching consequences for public accounts. The war and civil-defence effort required an increase in government consumption of more than 3% of GDP (Figure 1.15 Panel A). In addition, help for the evacuees from the areas around Gaza and northern areas bordering Lebanon required additional government expenditure in the form of transfers to hotels and families to pay for their accommodation, food and day-to-day expenses, for a total of around ⅓ percent of GDP from

October 2023 to October 2024. The coverage of health care for survivors of the 7 October and rocket attacks amounted to 0.1% of GDP as of end 2024. Transfers worth 0.7% of GDP have been made to businesses whose activity was restricted by the war. Overall, the support put in place following the attacks and subsequent war amounted to 1.1% of GDP in the twelve months following October 2023.

Figure 1.15. Fiscal accounts have deteriorated following a jump in public spending



Notes: In Panels A and B, the trend is estimated over 2014-2019. In Panel B, the series excludes social security contributions. In Panel D, general government debt data for 2024 refers to projections.
Sources: Israel Central Bureau of Statistics (CBS); OECD Economic Outlook: Statistics and Projections database; OECD National Accounts database.

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Government revenue, which contracted immediately after 7 October 2023, has recovered. Shop closures and reductions in production dented value-added and income-tax receipts. However, the consumption-led rebound in economic activity that started from the end of 2023 has ensured a tax-rich recovery with receipts going above their long-term trend (Figure 1.15 Panel B). Another important source of revenue has been US military assistance of 1.7% of GDP in 2024, compared with an annual average of 0.8% of GDP over 2017-2021.

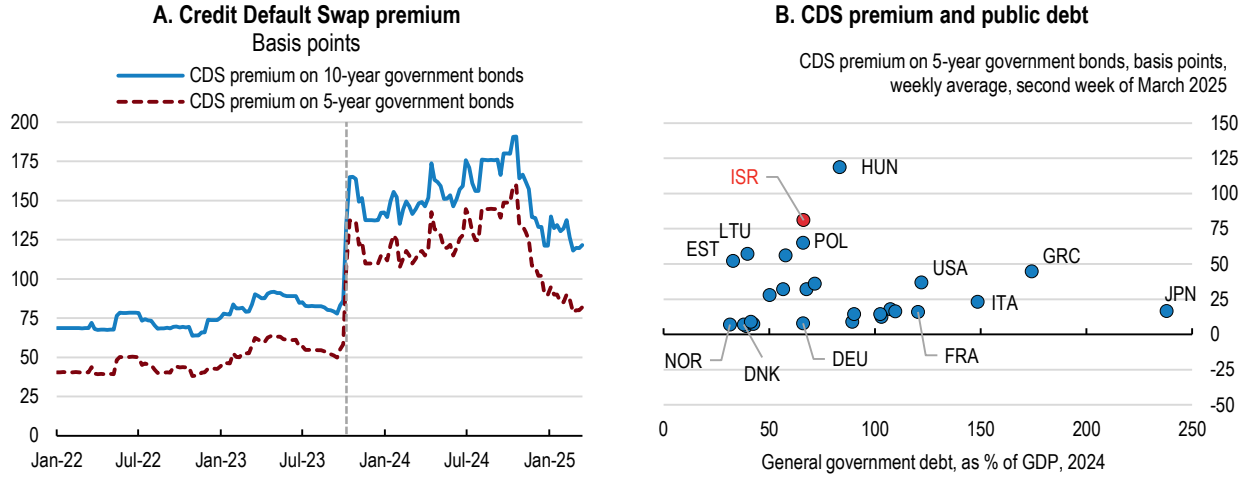
Fiscal authorities have relied on a mix of deficit financing, revenue increases and spending restraint

Fiscal authorities decided to fund the jump in spending in part through public borrowing while also introducing revenue and spending measures (Figure 1.15, Panel C). On the revenue side, a key measure

is the one percentage point VAT increase, which should bring in 0.4% of GDP in additional revenue per year. On the spending side, the main adjustment measures in 2024 comprised across-the-board cuts in the discretionary spending of line ministries, reductions in the public-sector wage bill including through a hiring freeze, and the cancellation or suspension of a number of investment projects.

The widening of the budget deficit and greater perception of country risk since October 2023 contributed to a rise in borrowing costs (Figure 1.15 Panel D). The effects are visible in the sharp rise in October 2023 in the CDS premium for insuring Israeli government bonds against default (Figure 1.16). Other powerful drivers of the run-up in long-term government bond yields after 2022 were the rise in short-term interest rates and inflation (see section on monetary policy). Investor concerns regarding medium-term fiscal prospects have also been reflected in decisions by credit rating agencies Fitch, Moody's, and Standard & Poor's. All three credit rating agencies are keeping Israel on negative outlook. CDS premia and government bond yields declined in December 2024 and January 2025 following geopolitical and fiscal policy advances. The ceasefire with Lebanon and advances in negotiations towards the release of hostages in Gaza resulted in a downward reassessment of geopolitical risk. Furthermore, the Knesset (Parliament) passed first and second readings of several fiscal consolidation measures.

Figure 1.16. Sovereign risk premium has remained higher than before October 2023



Notes: The Credit Default Swap (CDS) premium is the price of insuring a bond against default. In Panel A, the vertical square dotted line indicates the date of 7th October 2023.
Sources: OECD Economic Outlook: Statistics and Projections database; LSEG; and OECD calculations.

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Near-term fiscal policy must keep sovereign risk in check without undercutting near-term growth

The fiscal policy stance must be carefully balanced. Government indebtedness is well below the levels observed in many OECD countries. However, comparatively high geopolitical risk means that stronger buffers against shocks are needed. In addition to risk management, there is also a budgetary case for fiscal prudence allowing to keep debt levels and risk premia in check. Fiscal consolidation should give priority to measures that are most compatible with long-term growth while avoiding very rapid and deep adjustment as long as elevated geopolitical tensions weigh on private demand and international business linkages.

A permanent and credible consolidation favouring growth-friendly measures maximises the risk-premium reduction for a given size of adjustment. Many adjustments planned for 2025 follow this logic with the introduction of new fiscal measures such as the carbon tax and the one-percentage-point increase in the VAT rate, which are welcome. Both environmental and consumption taxes have low effects on long-term growth prospects compared with other taxes, making them particularly efficient tools for fiscal

consolidation (Cournède, Fournier and Hoeller, 2018[45]). The new tax on undistributed accumulated profits of closely held companies is also set to provide a steady stream of revenue. The increase in social security tax will also bring a permanent improvement in revenue although at the cost of raising the tax wedge on labour. The 2025-2026 freeze in tax brackets is also designed to bring a permanent increase in revenue, as indexation is planned to restart only in 2027 without compensating for the lack of adjustment in 2025-2026.

Fiscal policy should adjust to meet long-term challenges

As the conflicts ease, the fiscal position will improve but remain challenging. As the geopolitical situation continues to improve, military spending will fall back to its new level, 0.9% of GDP above pre-October-2023 levels. Before that, one-off expenses will be incurred to replenish stocks and replace equipment. In addition to that, the rehabilitation of damaged infrastructure and post-conflict treatment of veterans and civilian victims, including mental-health care, will require additional expenditure, which may be in the order of 0.5% of GDP over around half a decade. Together with the permanent budgetary adjustments made in 2024-2025, this implies an estimated general government primary surplus below 0.1% of GDP in 2027. The deficits incurred in 2023-2026 are set to bring public debt from 60% of GDP end 2022 to around 69% end 2026: in an environment of higher interest rates than the previous decade, this change implies higher debt service costs.

This anticipated medium-term fiscal position without additional adjustment would put public debt on a trajectory leaving insufficient cushion against risks (Figure 1.17). Such a long-term debt outlook would be sub-optimal in Israel, given a higher sovereign risk premium than most countries with similar or lower public debt-to-GDP ratios, on account of elevated levels of geopolitical risk. In this environment, it would be advisable to aim for keeping public debt below 60% of GDP as was achieved ahead of the COVID-19 crisis. In addition, there is a need to leave room for the increase in expenditure that would follow from removing obstacles to public investment and closing public-infrastructure gaps (see growth section above) while preparing for the needs of a fast-growing population. Besides, the assumptions behind this trajectory do not include negative impacts from climate change (such as post-disaster costs and revenue losses) as well as spending on mitigation and adaptation beyond current levels.

The country has limited space for substantial spending cuts. In typical situations, expenditure-based fiscal consolidation better preserves economic prospects, as a smaller government size is generally associated with higher trend growth across most OECD countries (Fournier and Johansson, 2016[46]). In the case of Israel, however, the low level of non-defence public expenditure limits the leeway for spending reduction. The government spends comparatively little, as a share of GDP, on health and social protection (Figure 1.18). Education expenditure per student is also low while average education outcomes and skills are below the OECD average (Koelle, 2023[9]).

There is some scope to raise revenue while limiting adverse effects on activity. Israel has a relatively low aggregate tax-GDP ratio by comparison with other OECD countries (Figure 1.19). Most tax instruments bringing revenue below or near OECD averages (Figure 1.19). After it increased to 18% in January 2025, the standard rate of value-added tax (VAT) remains below the average among other OECD countries that implement this tax (19.3% in 2024). By contrast with many other OECD countries, there is no reduced VAT rate in Israel. Exemptions (including in the form of zero-rating) however apply to a number of products such as fruit and vegetables, inward foreign tourism, clothing and other shopping items purchased in Eilat. Closing VAT exemptions offers potential for additional revenue generation with more limited effects on long-term growth prospects than most other tax instruments (Akgun, Cournède and Fournier, 2017[47]).

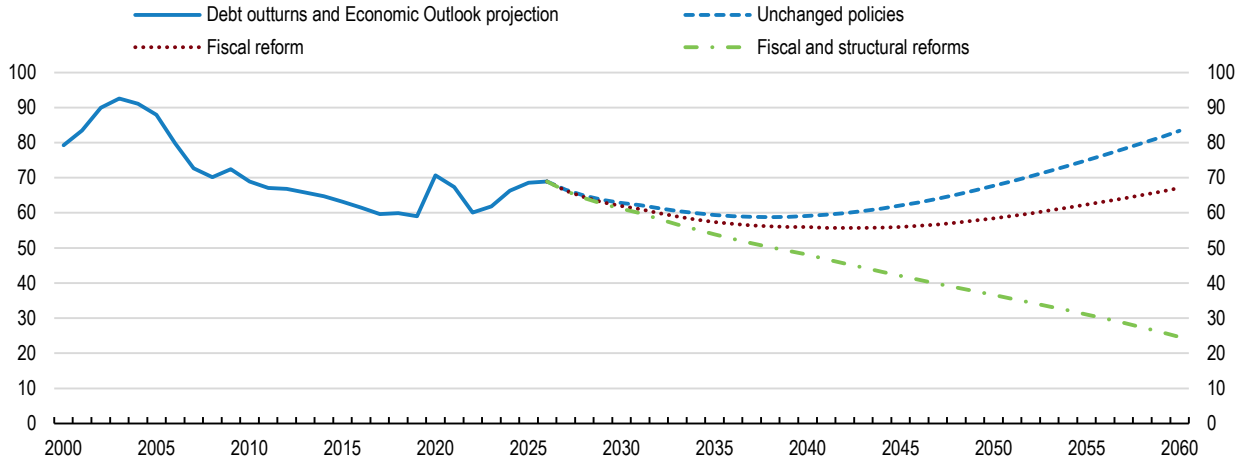
The carbon tax can also be a vehicle for income generation as well as further environmental progress. Currently planned rates are very low per tonne of carbon dioxide (CO2). Aligning planned rates for 2030 with EUR60 per tonne of CO2, the mid-point of the benchmark rate for mitigation efforts in the OECD (2023[48]) would imply a more than threefold increase in the rate on natural gas. Besides bringing in 0.25%

of GDP in extra revenue per year, such a reform would sharpen incentives to deploy carbon-free sources of power generation.

Another important dimension of fiscal reform is to prepare for the gradual fall in fuel tax revenue from the decarbonisation of the economy especially the take-up of electric vehicles. Current fiscal arrangements involve hiking car registration taxes. The authorities are also considering the introduction of a mileage tax, which would offer the benefit of being more directly linked to the budgetary and social costs from road use and congestion. In addition, a mileage tax is fiscally more reliable, as it is untied to cyclical fluctuations in car purchases. Finally, a mileage tax avoids the incentive that high registration taxes create to keep older, more polluting, more dangerous cars on the road. Besides, congestion charging could be deployed, starting in Tel Aviv.

Figure 1.17. Adjustment is needed to safeguard fiscal sustainability

Illustrative general government debt scenarios, % of GDP



Notes: The "Unchanged policies" scenario follows the OECD Economic Outlook 116 database until 2026. Subsequently, following permanent tax and spending changes and the assumption of rehabilitation expenditure of 0.5% of GDP for five years, the primary balance in the "Unchanged policies" scenario starts from a surplus below 0.1% of GDP in 2027 before evolving on account of trend changes in health and pension outlays as well as employment. More specifically, health and pension spending rise according to the profiles in the long-term baseline database of the OECD Economic Outlook No. 116. Potential employment in this scenario evolves according to the assumption that new cohorts have, by population group, the same participation rates as current ones (corresponding to the "unchanged participation rates" scenario in (Box 1.1)
The "Fiscal reform" scenario incorporates higher public investment (+0.7% of GDP to bring the public-sector capital stock to the OECD average by 2040 then +0.3% over 2040-2060) and the tax increases listed in Table 1.6 as well as the GDP impact of higher public investment.
The "fiscal and structural reform" scenario includes increases in trend employment and GDP from the structural reforms described in Box 1.3 and higher public investment. More specifically, employment follows the scenario of "new progress at past pace" described in Box 1.1
Sources: OECD Economic Outlook 116 database; OECD Long-Term Model database; and OECD calculations

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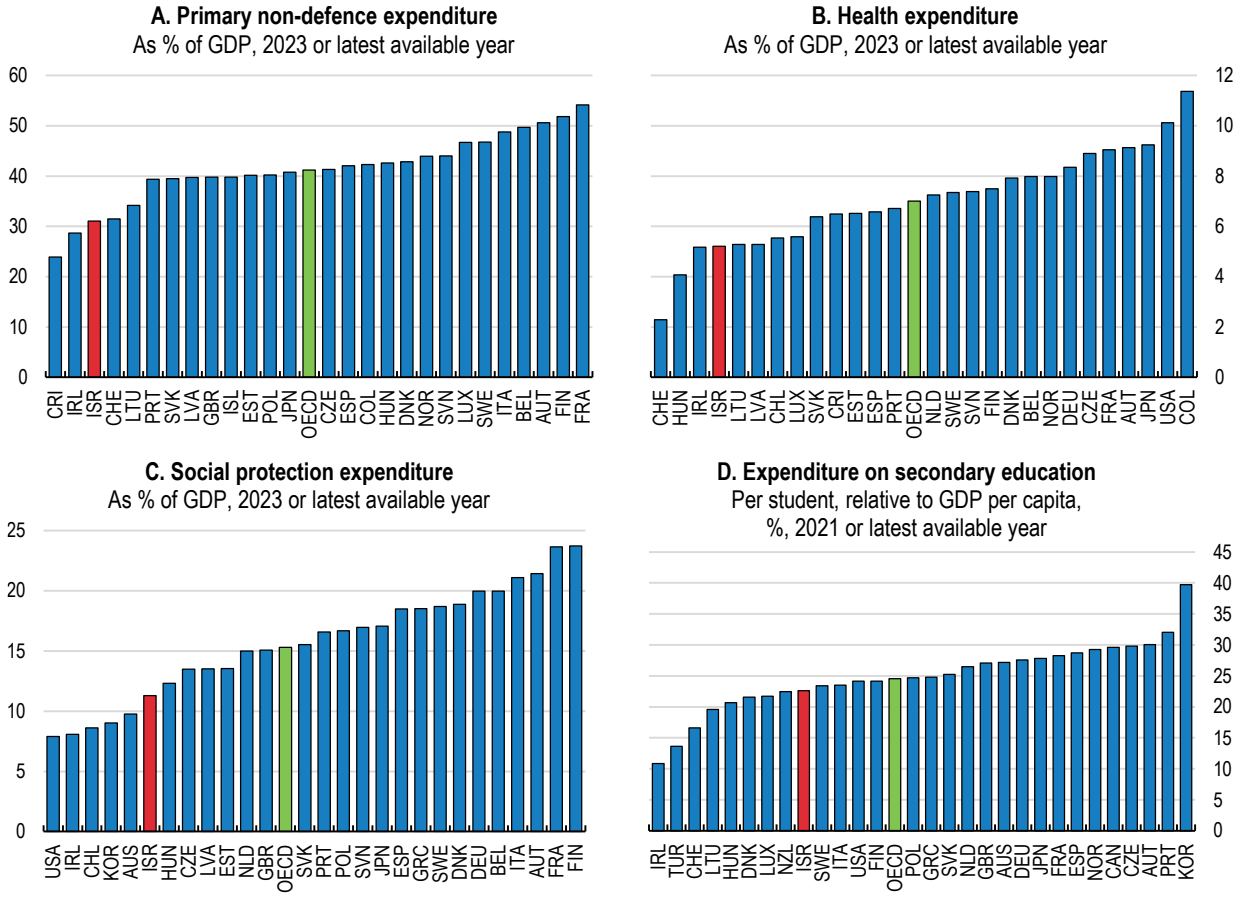
Taxes can also be introduced that improve economic, social and environmental outcomes while bringing revenue. One example is the taxation of unused developable land which encourages construction in areas where it is desirable from an urban-policy perspective. As discussed in Chapter 4, such a tax could be introduced alongside the taxation of rental income and a recalibration of recurring property taxes while shifting away from transaction taxes. A real-estate-taxation reform package of this nature could bring additional revenue while improving tax efficiency. Another example are taxes on sugary drinks and single-use items, which can contribute to improving human health and the environment respectively.

Figure 1.18 Government non-defence spending is comparatively low



Note: Panel A, for IRL as % of GNI.

Sources: OECD National Accounts database; OECD Education at a glance database; OECD Economic Outlook: Statistics and Projections database; and OECD calculations.

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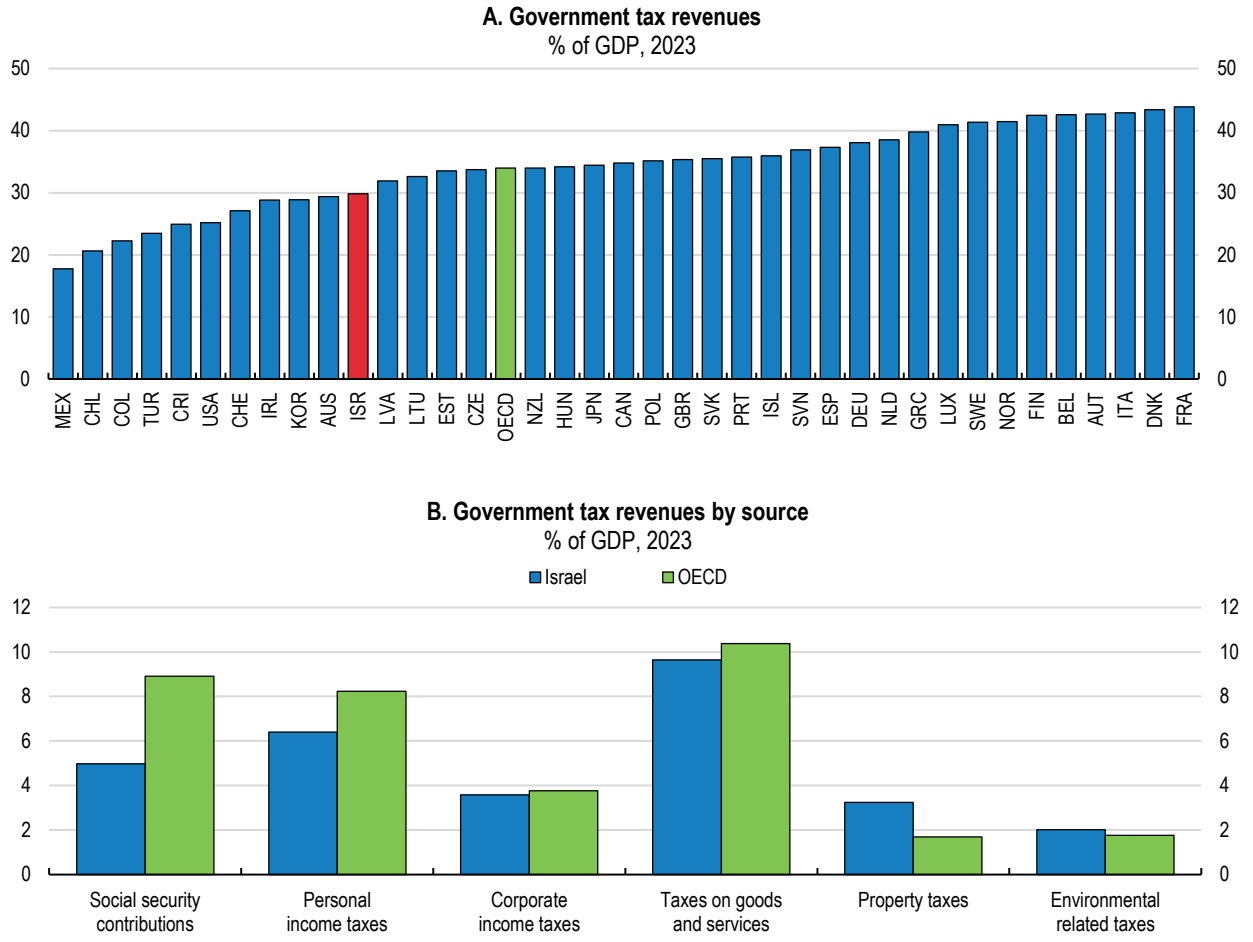
Taken together, the above tax reforms would allow to fund a substantial increase in public investment while putting public debt on a path towards reaching by 2035 similar ratios to GDP as the ones that prevailed before COVID-19 and before 7 October 2023 ("fiscal reform" scenario on Figure 1.17 and Box 1.6). Furthermore, implementing the above-mentioned reforms (see growth section) to foster stronger core-curriculum skill acquisition and greater labour market participation across every Israeli community would lastingly increase employment, considerably improving the long-term fiscal-sustainability outlook (Figure 1.17).

Spending reviews provide a potentially powerful tool to improve efficiency and reduce expenditure on areas or programmes where benefits are not commensurate with costs and current priorities. Spending reviews have in the past been narrow in scope in Israel, covering below 5% of government expenditure (OECD, 2023[4]). Conducting reviews on broader areas of expenditure would magnify the potential for identifying overlaps (Tryggvadottir, 2022[49]). To enhance their benefits, the spending reviews should be tightly integrated in the budget process (Tryggvadottir, 2022[49]).

Figure 1.19. Tax revenue is below the OECD average



Notes: The OECD aggregate is an unweighted average of the countries in the group. Panel A, 2022 for Australia and Japan and as % of GNI for Ireland. Panel B, environmental related taxes data for Israel refers to 2021, while to 2022 for the OECD.
Sources: OECD Global Revenue Statistics database; and OECD Environmentally related tax revenue database.
Trends 2024: VAT/GST and Excise, Core Design Features and Trends, OECD Publishing, Paris, https://doi.org/10.1787/dcd4dd36-en.
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A strong fiscal framework is key to achieving the size of the required fiscal adjustment in a long-lasting way while supporting long-run growth. Fiscal policy has a proven track record of prudence in Israel over the past two decades, but there has also been experience of frequent adjustments in expenditure ceilings. Previous Surveys have recommended strengthening fiscal frameworks (Table 1.7). Adjustments in medium-term plans, which may be needed especially in an environment as volatile as Israel's, can be compatible with credibility if they are undertaken when certain pre-defined conditions are satisfied rather than on a discretionary basis (Moretti, Keller and Majercak, 2023[50]). The on-going programme to improve official long-term fiscal projections offers a welcome way of further anchoring the credibility of the fiscal framework (Box 1.7).

Box 1.6. Quantifying the fiscal impact of policy recommendations

Table 1.6 presents illustrative fiscal impacts of recommendations with substantial spending or revenue implications. The results are indicative. They exclude feedback effects from behavioural responses, except the government revenue gain from the recommended structural reform package through higher employment. Particularly strong uncertainty is attached to the future revenue gains resulting from reforms anticipated to boost employment: consequently, fiscal authorities should wait until these revenue gains have materialised before factoring them into spending decisions.

Table 1.6. Illustrative fiscal impact of the recommended reform package

Fiscal saving (+) and costs (-) after 15 years

	% of GDP
Strengthen public investment management to ensure adequate and effective spending on infrastructure.	-0.7
Total costs	**-0.7**
Increase the taxation of natural gas in line with emission objectives.	+0.3
Remove VAT exemptions.	+0.4
Tax unused developable land	+0.05
Tax single-use plastic items and sugary drinks	+0.05
Increase and widen the congestion fee.	+0.1
Revenue gain in 2040 from the recommended package via higher employment.(1)	*+0.9*
Extra revenues	**1.8**

Note: (1) The employment rate by 2.3 percentage points in 2040 relative to the "unchanged policies" scenario.
Source: OECD calculations based on the OECD Long-Term Model.

Table 1.7. Fiscal policy recommendations in previous Surveys

RECOMMENDATION	ACTION TAKEN SINCE APRIL 2023
Formulate a medium-term fiscal strategy to ensure fiscal sustainability while encouraging adequate spending on infrastructure, education and labour market programmes.	Fiscal policy plans are medium-term oriented with no explicit long-term fiscal strategy.
Regularly review the fiscal rules with a view to strengthening their effectiveness as credible fiscal anchors and reducing pro-cyclicality.	In early 2023, the budgetary procedure was revised to ensure that budgets are based on recent economic projections..
Reduce tax breaks on medium to long-term saving vehicles and streamline VAT exemptions.	None. The standard VAT rate has been raised.
Review the preferential corporate income tax treatment of exporting and high-tech firms with a view to better targeting the scheme.	None.
Consider reducing tax breaks on savings in "advanced training funds", taking into account effects on income distribution and work incentives. In the medium term, streamline VAT exemptions and offset any regressive effects with an increase in existing welfare programmes.	None

Box 1.7. Strengthening long-term spending projections

No official body in Israel regularly conducts and publishes projections on how the main fiscal expenditures and aggregates evolve in the long run if current laws remain unchanged. This contrasts with the situation in most OECD countries. As of 2018, 26 out of 34 OECD countries surveyed in the OECD Budget Practices and Procedures Survey reported that they produce long-term fiscal sustainability reports. The absence of such analysis limits the ability of the Israeli fiscal institutions to incorporate the long-term implications of economic decisions. Making policymakers aware of these implications is crucial for tackling structural challenges and ensuring that the government can avoid sudden and difficult corrections to the balance of income and expenditures. Previous Surveys had stressed the importance of systematically conducting long-term fiscal sustainability analysis.

The OECD is supporting the Ministry of Finance in defining key trends such as population ageing affecting the volume of public expenditures in the long run and developing a model that examines the impact of these trends on budget expenditures, deficit and debt-to-GDP under different policy scenarios up to 2065. The model in development focuses on education expenditures, social transfers to the elderly and the working-age population, pensions, health expenditures, public infrastructure investment and interest payments. The model relies on previous work conducted by the OECD Economics Department on long-run economic and fiscal projections (Guillemette and Château, 2023[22]) with adjustments to include Israeli-specific trends, such as the rapid increase of population groups with comparatively weak labour-market attachment and human-capital accumulation.

Source: (OECD, 2025, forthcoming[12])

Table 1.8. Recommendations for macroeconomic stability in support of growth

MAIN FINDINGS	RECOMMENDATIONS (key in bold)
Ensure price and financial stability	
The inflation rate has risen above the upper bound of the 1-3% target range since July 2024. Inflation expectations are stable but in the upper half of this range.	**Maintain a tight monetary policy stance to bring inflation durably back in the target range.**
Since October 2023, the entry of Palestinians has been halted. As they made up a large share of the workforce in construction, labour shortages are constraining the recovery. Low activity is exacerbating the housing deficit, which can over time significantly contribute to inflation.	Take measures to address labour shortages including by reconsidering conditions of entry.
Banks have capital buffers that are in the average among OECD countries relative to their unweighted assets. Elevated country risk requires maintaining ample buffers.	Continue to require banks to maintain strong capital buffers including by retaining earnings.
Restore fiscal sustainability	
The fiscal balance has moved from surplus to a large deficit. Credibly lasting measures are needed to contain the deficit before reducing it. Given defence spending and public investment needs, revenue must be raised as part of the fiscal adjustment.	**Implement a medium-term fiscal adjustment plan based on a comprehensive review of the tax system, reduce VAT exemptions, and prioritise growth-enhancing expenditures.**
The recently introduced carbon tax and congestion fee raise revenue while creating favourable incentives towards the attainment of other public policy objectives. There is scope for deploying similar instruments in the areas of transport, health and environmental protection. The fast transition towards electric vehicles calls for replacing the diminishing revenue from motor fuel taxes.	Implement the mileage tax and congestion fees, and tax unused land, sugary drinks and single-use plastic items.
Spending reviews can improve allocation and help create fiscal space. Most spending reviews have typically been narrow in scope. The existing strong budget process provides a basis for ambitious spending reviews.	**Consider conducting systematic spending reviews that are integrated with the budget process.**
Low labour-force participation among specific groups (ultra-orthodox men and Arab women) weaken future fiscal prospects and long-term growth. Specific benefits discourage ultra-orthodox men's employment.	Remove disincentives for yeshiva students to acquire labour market skills and transition to the labour force, including by lowering transfers and conditioning childcare support on employment of both parents.
Coverage of the core curriculum is incomplete in ultra-orthodox streams and under-resourced in many Arab schools, impairing pupils' employment, productivity and wage prospects. Improving their future employment and wages would strengthen fiscal sustainability.	**Condition school funding on full teaching of the core curriculum and equalise funding for Arab schools with other schools presenting similar socio-economic characteristics.**

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2 Reaping the benefits of AI

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Israel is well positioned in the global AI market with a strong presence especially in the development and marketing of software. The regulatory approach has been nimble, creating favourable conditions for AI experimentation and growth while protecting privacy and trust in AI systems. Further investment in scientific research and higher education would reinforce the sector. Action to bridge the large gender gap in AI is key to address shortages in the kind of highly skilled labour that is critical to the continued dynamism of the sector. There is also scope for greater participation of currently under-represented population groups, such as ultra-orthodox and Arab Israelis, in the AI economy, through ensuring that young members of these groups have access to high-quality education in AI-relevant subjects. Progress along these dimensions would also facilitate the deployment of AI across the economy, which has been sluggish. For this purpose, continued investment in connectivity infrastructure is a pre-requisite.

2.1. AI holds transformative potential

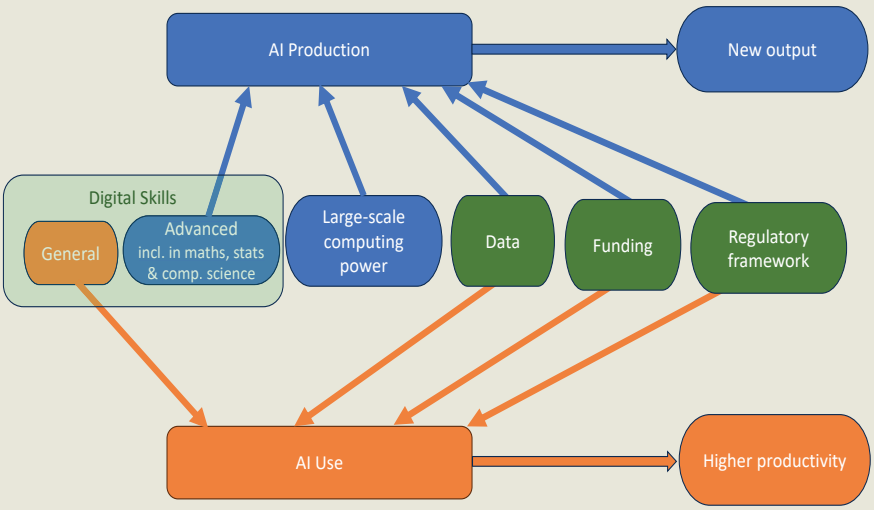
The promise of artificial intelligence (AI) is particularly great for Israel's economy in terms of both production and use (Box 2.1). Israel's thriving high-tech sector is well placed to expand its already strong AI-creation activities. On the use side, the diffusion of AI holds significant potential to help traditional industries and government, which have long lagged behind high-tech firms in terms of productivity, to increase their productivity. As such, if properly mobilised, AI can further buttress the high-tech sector while reducing duality in the economy.

Box 2.1. AI: the OECD definition and a typology of inputs and effects

The OECD AI Principles (OECD, 2019[1]), since their May 2024 revision, define an AI system as such:

An AI system is a machine-based system that, for explicit or implicit objectives, infers, from the input it receives, how to generate outputs such as predictions, content, recommendations, or decisions that can influence physical or virtual environments. Different AI systems vary in their levels of autonomy and adaptiveness after deployment.

Figure 2.1. AI: a stylised typology of inputs and effects



AI systems are constructed using machine learning methods or logic and knowledge-based approaches. They have applications in areas such as computer vision, natural language processing, speech recognition, intelligent decision support systems and intelligent robotic systems. The tasks or functions performed by AI systems include, but are not limited to: recognition (identifying and categorising data, e.g., image, video, audio and text), event detection (connecting data points to detect patterns, as well as outliers or anomalies),forecasting (using past and existing behaviours to predict future outcomes),personalisation (developing a profile of an individual and learning and adapting its output to that individual over time), interaction support, finding the optimal solution to a problem, inferring new outcomes that are possible even if they are not present in existing data, and generating new content (OECD, 2024[2]).

Producing as well as using AI both require specific skills, capital and a regulatory framework. Through AI production, the country's high-tech sector is delivering new output in an area characterised by large global demand. The deployment of AI offers potential for considerable gains in productivity, especially so if labour and capital can reallocate smoothly across occupations and sectors (Filippucci, Gal and Schief, 2024[3]).

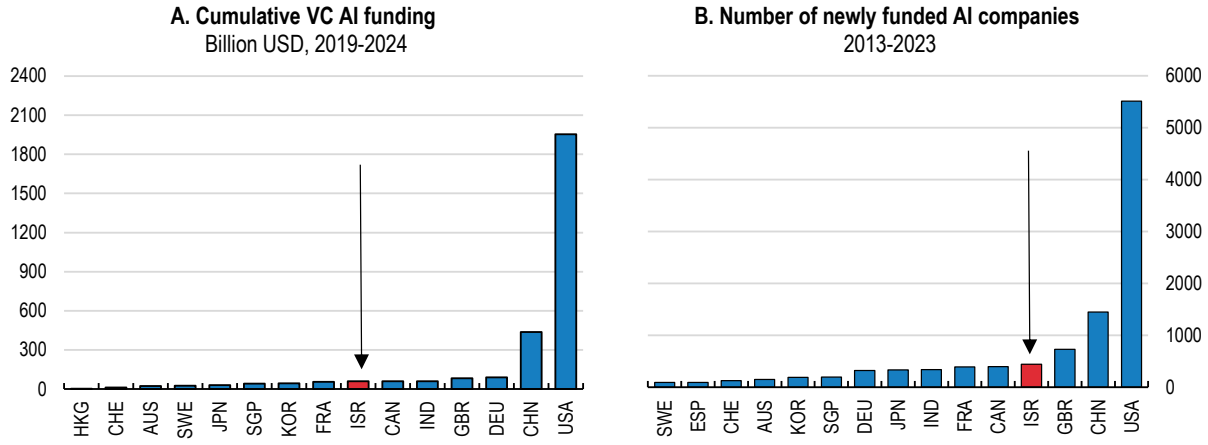
This chapter investigates ways for Israel to gain the most from AI. It first looks at how Israel can expand an already strong AI production sector considering its current labour resources, skills base, physical digital infrastructure and regulatory stance. The chapter then investigates possible interventions to accelerate the take-up of AI throughout the rest of the economy.

2.2. Expanding AI production from a position of strength

A buoyant AI sector is becoming a central part of Israeli high-tech activity

Israel is very well positioned on the global AI market. The country ranked 9th in the world for its level of investment, innovation and implementation of AI in a recent benchmarking exercise (Tortoise, 2024[4]). The AI sector is very dynamic, with strong investment and intense startup creation that make Israel a global player in AI innovation on a par with larger economies (Figure 2.2).

Figure 2.2. AI production attracts ample venture-capital investment amid vibrant startup creation



Note: The investment data refers to companies, both listed and unlisted.
Sources: OECD AI Observatory; and Stanford AI Index Report 2024.

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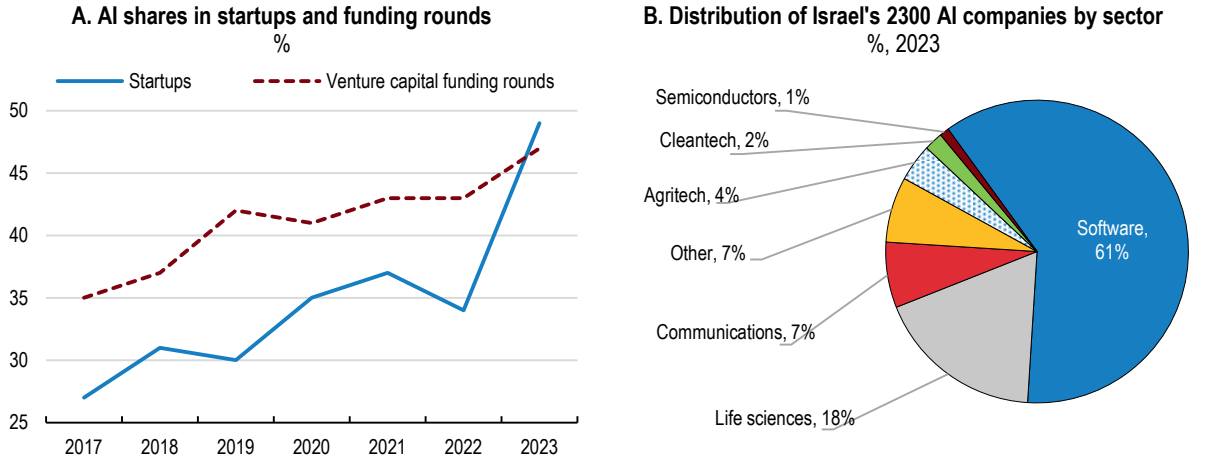
AI has become a core part of new high-tech activity in Israel, accounting for almost half of all new high-tech startups and funding rounds (Figure 2.3 Panel A). This trend makes AI critical to the continued performance of the high-tech sector, which itself is a key engine of the country's export and GDP growth. High tech, which employs 12% of the workforce to produce 20% of GDP, accounted for 40% of 2018-2023 GDP growth (Israel Innovation Authority, 2024[5]). The strong outward orientation of the high-tech sector, which generated 53% of exports in 2023, gives Israel a strong basis to participate in the global AI boom (Israel Innovation Authority, 2024[5]).

The AI sector is concentrated in software (Figure 2.3 Panel B). A significant part of software activity relates to cyber-security, an area where the potential of AI is considerable and Israel highly regarded. Reflecting Israel's well-established strength in high-tech medical and pharmaceutical products, life sciences are another area of significant commercial AI activity. The same holds for agricultural innovations, especially in the use of AI for advanced irrigation systems. Israel also hosts one of the 18 companies worldwide that create foundation models and commercialise associated services (Israel Innovation Authority, 2024[6]).

The ongoing conflict has two-sided effects on AI prospects. On the one hand, many AI professionals have had to join defence forces for reserve duty. Furthermore, agritech and foodtech suffered from the attacks over Israel: a number of experimental fields and installations burned in the south in October 2023 and the north in mid-2024. On the other hand, strong investment in defence-oriented research and development

in response to the needs created by the war are likely to generate innovation and spur prospects for the country's AI sector in the areas of computer vision, automation and cyber defence. The high-tech R&D ecosystem has generally been tightly integrated with defence research (Gandal, Roccas Gandal and Kunievsky, 2021[7]).

Figure 2.3. AI is making up nearly half of overall high-tech firm creation and early-stage activity



Source: IVC data processed by RISE (2024[8]).

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Upscaling computing infrastructure will support AI-production growth

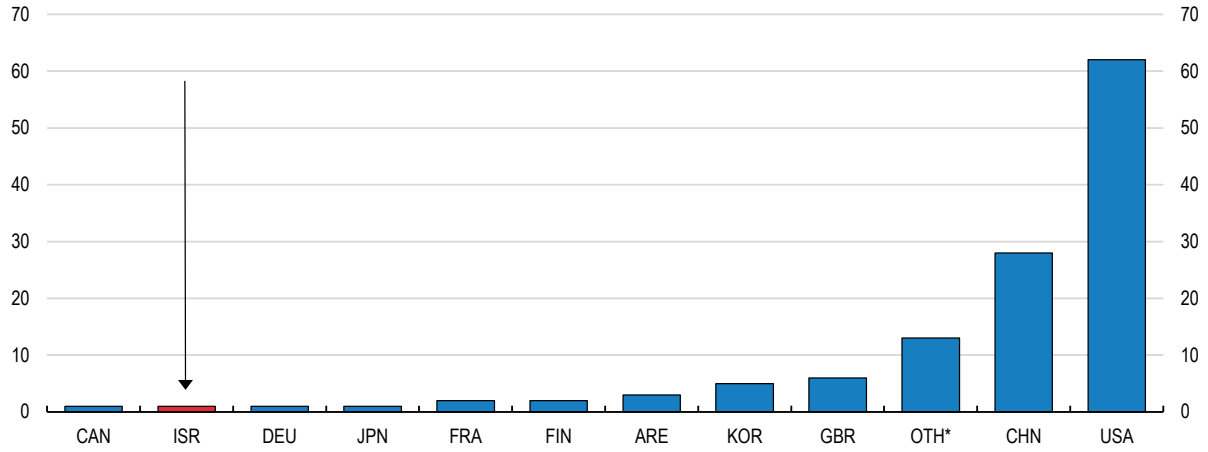
Government bodies as well as private observers have identified computing infrastructure as a weakness for the country's AI sector (Tortoise, 2024[4]; Ministry of Innovation et al., 2024[9]; State Comptroller of Israel, 2024[10]). Latest AI developments, notably generative AI, involve large-scale models that require enormous numbers of computations (OECD, 2024[11]). AI development is anticipated to continue to depend on large-scale computing infrastructure (OECD, 2023[12]). Locally available computing power may be acting as a brake on the development of very large models. As of July 2024, Israel was home to one out of the 125 models trained with more than 10^{23} floating point operations (FLOP). This model, Jurassic-1-Jumbo, ranked 70th at $3.7.10^{23}$ FLOP, two orders of magnitude below the $2.1.10^{25}$, $3.8.10^{25}$ and $5.0\ 10^{25}$ FLOP underpinning the world leaders GPT4, Llama 3.1-405B and Gemini 1.0 Ultra (Epoch AI, 2024[13]).

More local capacity would be useful despite the international integration of IT systems. For AI model developers, buying computing power from abroad, including from cloud service providers, is an option that offers only an imperfect substitute for local capacity because of the associated need to transfer the corresponding data for processing. This transfer can be costly technically, because of the large sizes involved, as well as legally, because of the interaction between domestic and foreign regulations. Plans by a multinational tech corporation to invest $7.2bn in cloud infrastructure in Israel however open the way for access to large computing capacity with much lower access times than foreign server farms (OECD, 2024[14]).

The authorities are preparing to build an AI High-Performance Computing laboratory as part of the NIS 1 billion (USD 270 million) National AI Programme 2024-2027. The objective is to expand local capacity for academic institutions, startups and emerging AI companies. Speedy completion of this project in a difficult budgetary environment is key to ensure that academic research remains at the frontier and that early-stage startups have access to computing capacity to test-run ideas. The extent to which the project fulfils its objectives and is of sufficient scale should also be regularly reviewed to expand it if necessary.

Figure 2.4. One very large scale model has been developed in Israel

Country breakdown of all known models trained with more than 10^{23} floating point operations, 2024



Notes: The data were retrieved 25 July 2024. *OTH stands for "other".
Sources: Epoch AI (2024[13]) data and OECD calculations.

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AI computing entails large and rapidly growing power requirements. For instance, the development (in the United States) of OpenAI's GPT4 required an estimated 60GWh of power (Groes and Ludvigsen, 2023[15]), which is equivalent to the yearly electricity consumption of 6000 Israeli households. Electricity demand from AI is projected to increase tenfold from 2023 to 2026 (IEA, 2024[16]). Power supply is available in Israel at prices that are lower than in EU countries though higher than in the United States. Electricity wholesale costs are around USD50 per MWh in 2024, levels above the United States (USD30) but well below Germany (USD100) or the United Kingdom (USD90). As discussed in Chapter 3, electricity is mostly produced from natural gas, which is abundant since the discovery of large offshore gas fields. Power supply is therefore available to develop and use AI in Israel, but expanding AI while meeting Israel's greenhouse-gas emission targets will require carbon-free power (see Chapter 3). Locating AI computing and data centres in the north and south of the country will help to reconcile AI-expansion and decarbonisation objectives, as these areas have more abundant renewable energy with surpluses during daytime.

Private funding, strong at early stages, will also need to accompany AI firms' continued growth

Privately funded investment is central to the growth of the AI sector. The country attracts high volumes of venture capital investment into AI (Figure 2.2 Panel A). Faced with the risk of a dearth of funding for high-tech startups following the 7 October 2023 attack, the Israel Innovation Authority and the Ministry of Finance launched "fast-track" grants at the end of October 2023 (Israel Innovation Authority, 2024[5]). This programme was aimed at early-stage high-tech startups (including but not limited to AI) with a survival horizon below six months. Looking beyond the emergency, a Startup Fund (of 0.5bn NIS in 2024 or $133mn) was launched to fund firm creation in fields involving high-risk R&D. The authorities should monitor the results to evaluate the case for expanding the programme.

The wide-scale computing requirements of many areas of AI development, including generative AI, mean that, for successful AI firms to grow, mature-stage and long-term funding is needed in addition to seed financing. This can be a challenge in Israel, where the high-tech sector is characterised by vibrant start-up activity but a comparatively low base of long-term capital. In April 2024, the Israel Innovation Authority launched an initiative (*Yozma 2.0*) to attract institutional investors by providing an additional yield to entities

that participate in the programme. While this programme is primarily aimed at expanding the investor base for venture capital, it also offers opportunities to create links between long-term investors and high-tech companies which can then facilitate their medium and long-run funding. It will be valuable to assess the results of the programme and evaluate if it is worth adjusting so that it also encourages medium and long-term investment alongside venture capital.

Key to the funding of AI as well as other innovative firms over time is a favourable investment climate. The high country-risk premium creates a hurdle for long-term investment. As developed in Chapter 1, fiscal adjustment alongside monetary prudence can contribute to lowering the risk premium. Supporting framework conditions are essential for AI or high-tech-specific policies to bear fruit.

A broader talent base is key to further AI growth

The strength of Israel's AI sector largely rests on specialised advanced skills. The AI sector is however facing intensifying labour shortages (Ehrlich and Mekonen, 2024[17]). One indirect indicator is that, over the first seven months of 2024, wages for scientific researchers-and-developers, on whom AI firms rely particularly strongly even if the statistic refers to those active across the whole high-tech sector, were up 11% against 7.3% for other high-tech workers and 4.6% for the rest of the workforce. This section discusses ways to expand the talent pool by expanding AI-relevant higher education, attracting more women and welcoming foreign workers.

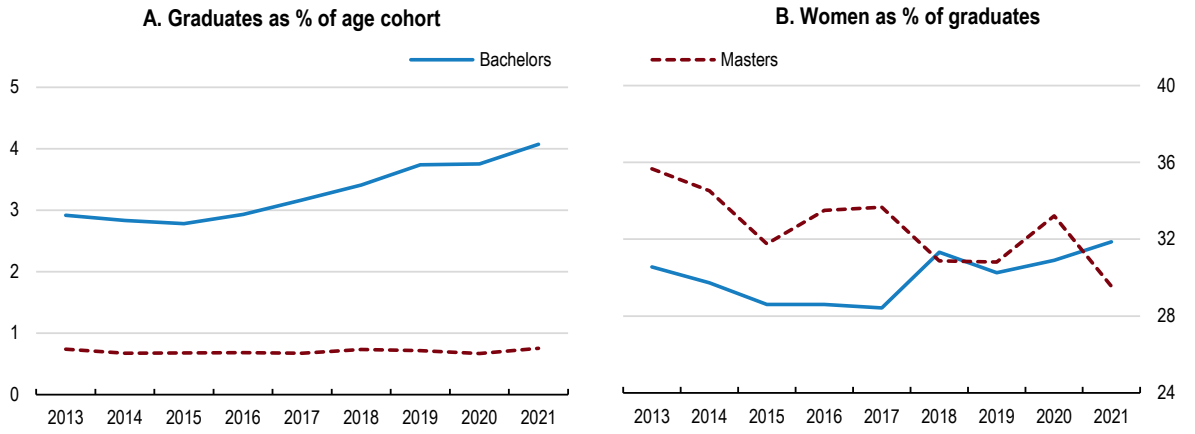
Expanding AI-relevant higher education

The authorities as well as researchers have identified a persistent shortage of higher-education graduates in the subject areas that are critical to creating and developing AI (Israel Innovation Authority, 2019[18]; Artificial Intelligence and Data Science Committee, 2020[19]; Ehrlich and Mekonen, 2024[17]; State Comptroller of Israel, 2024[10]). This scarcity, while it also affects the rest of high-tech, is particularly challenging for AI, which involves particularly strong demand for advanced academic skills (Ehrlich and Mekonen, 2024[17]). Compared with the past decades, training a larger number of graduates in AI-relevant fields has become more important, as the previously large potential of highly STEM-skilled immigrants from former Soviet Union countries has been largely exhausted (Gandal, Roccas Gandal and Kunievsky, 2021[7]).

Efforts undertaken over the past ten years to expand scientific higher education have been fruitful at the bachelor level but less so at the master level. Universities have strongly expanded undergraduate capacity in mathematics, statistics, physics and information and communication technology (ICT), the main fields for AI (Figure 2.5). As a result, many young Israelis earn bachelor degrees in these fields by international comparison (Panel A). Creating AI systems very often requires more advanced degrees: two-thirds of graduates working in AI production hold a master or PhD, compared to 12% for software developers overall in Israel. However, the share of young Israelis earning masters in the most AI-relevant fields has however stagnated over time at a low level by international standards (Figure 2.6 Panel A and Figure 2.6 Panel B). The result is a shortage of workers with advanced degrees in the AI profession (Ehrlich and Mekonen, 2024[17]). This shortage manifests itself through Israel exhibiting the highest share among OECD countries of data scientists and machine-learning experts with annual salaries above $100k per year, at 62%, against 58% in the United States, where GDP per capita is more than 50% higher.

Figure 2.5. More young Israelis, a third of whom women, are earning bachelors in AI-relevant fields

Graduates in mathematics, statistics, physics and ICT



Sources: OECD Education database; and OECD Population database.

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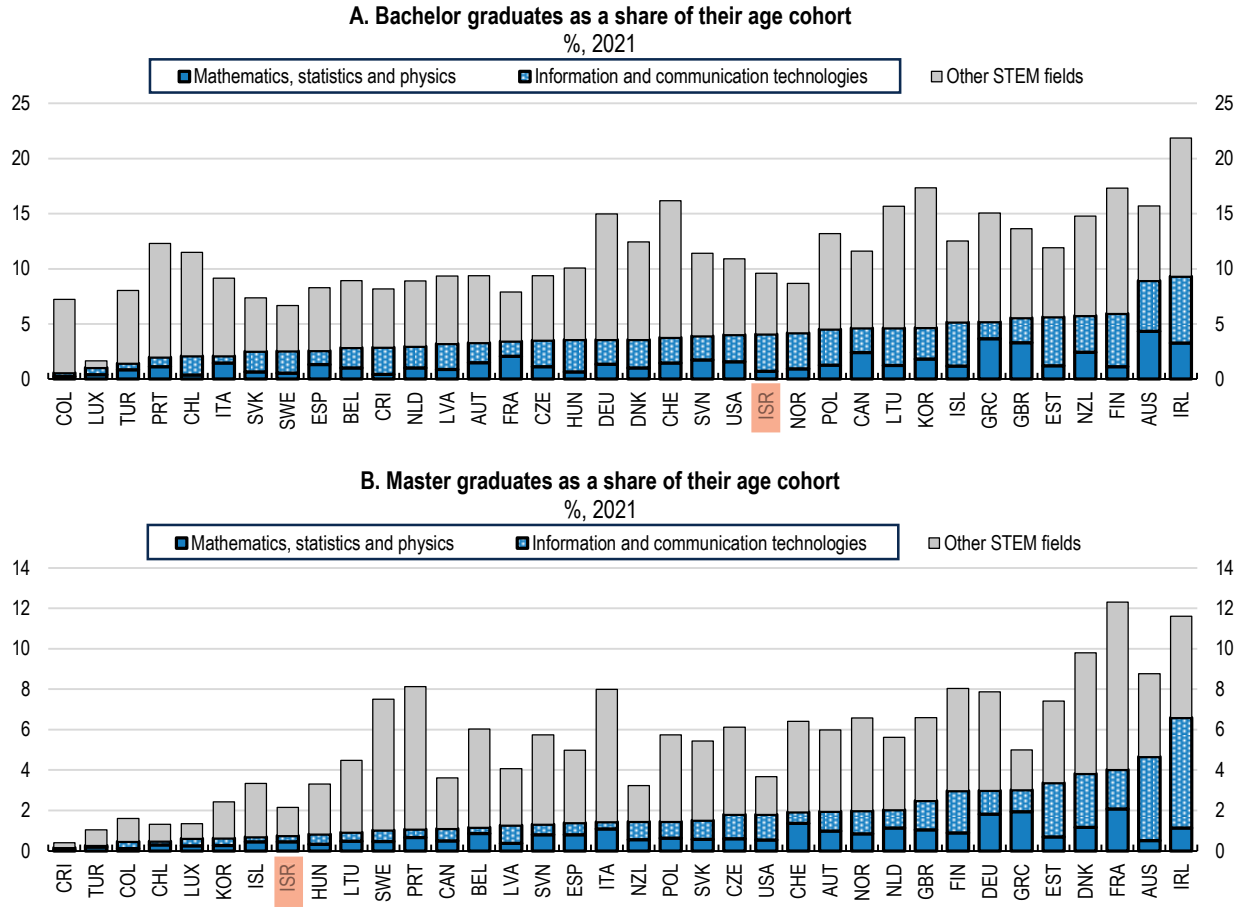
Training more post-graduate students in AI-relevant fields is feasible. Different options exist to expand the number of master-level graduates in AI-relevant subjects starting with an expansion of the current system. The previous *Survey* called for increasing university places in mathematics, statistics and computer science faster than the general trend increase (OECD, 2023[20]). The public education authorities could allocate a larger budget to the sector to increase capacity in higher-education institutions, especially research universities. A prerequisite for doing so is expanding the pool of scholars who can teach AI-relevant master and PhD courses (State Comptroller of Israel, 2024[10]). Action initiated in this direction under the 2019 National Program for the Advancement of Data Science in Higher Education is continued under the second step, adopted in September 2024, of the National Artificial Intelligence Program. The funding of this initiative should be regularly reviewed

An additional challenge for public-sector universities is to retain AI scholars given strong business demand (Ben-Israel, Matania and Friedman, 2020[21]). One way of reconciling these forces would be to allow AI faculty members to work in industry alongside part-time academic duties, as done for instance in France with associate faculty members or the United States with professors of practice (State Comptroller of Israel, 2024[10]; OECD, 2024[22]). Attracting and keeping scholars in AI-relevant fields also requires sufficient flexibility in university salary schemes to provide competitive levels of pay.

Another avenue is to allow market forces to operate more freely at the post-graduate level. The high wages paid to workers producing AI provide a return on the acquisition of post-graduate diplomas in AI-relevant fields. As a result, there can be economically viable scope for private universities or graduate schools to offer training in these fields. For the labour market to work efficiently, employers need to be in a position to trust the degrees that such new private higher-education providers would award. The Council for Higher Education would have a role to play by standing ready to certify programmes teaching these master and PhDs: the criteria should be academic quality only, since the private origin of the funding takes away budgetary costs from the points to consider.

Figure 2.6. The higher education system trains many Israelis in AI-relevant fields at the bachelor level but relatively few at the master level



Notes: Countries are ranked according to the combined share among their age cohort of 2021 graduates in (i) mathematics, statistics, physics and (ii) information and communication technologies. STEM stands for science, technology, engineering and mathematics.
Sources: OECD Education database; and OECD Population database.

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A specific challenge in Israel for earning a post-graduate degree is the long compulsory military service (32 months for men, 24 for women). This raises the opportunity cost of master and PhD degrees for those who would prefer to start working by a given age. Blended-learning programmes combining in-person intensive sessions with online coursework while adhering to high academic standards offer a way to reconcile the pursuit of advanced AI-relevant degrees with the start of work and/or family lives. Existing programmes in AI-relevant fields could be expanded at the Open University while facilitating their creation by other universities.

AI qualifications can also be acquired during military duties. Military authorities are enabling a limited number of conscripts to earn degrees, mostly in technological fields, under the Atuda Programme. As part of the National Artificial Intelligence Programme (Box 2.1), the Israeli Defence Forces (IDF) will develop a specialised AI training programme. It will be worth connecting this programme with academic curricula so that its participants can follow it up with further AI studies in higher education institutions after their military duty if they wish to. Nurturing links between the IDF AI programme and academia as well as the private sector will maximise economic spillovers.

Bridging the large gender gap

There is scope to expand the pool of highly skilled labour for AI by attracting and retaining more women. Women are underrepresented in the AI workforce across OECD economies (OECD, 2024[23]). Currently, in Israel, women perform 23% of professional-level AI-production jobs whilst only 13% of AI startup founders are women (Ehrlich and Mekonen, 2024[17]). These shares are close to the ones observed across the broader high-tech sector, where women make up 29% of technological positions and 12% of startup founders. One study found that high-tech firms treat male and female applicants equally (Neyer and Soroker, 2022[24]) and instead attributed the difference to a "funnel" effect with women being less likely than men to move into high-tech-relevant streams at each stage of their education and professional curriculum. Women earning master's degrees in mathematics, statistics, physics and ICT account for a declining share of their age cohort, declining to below 30% by 2021 from 36% in 2013 (Figure 2.5 Panel B).

A first avenue for action is to create more links between female scientific graduates and AI firms. One step in this direction would be to provide better information within higher-education programmes about AI labour-market prospects. Military duties are a direct way for public authorities to provide more women with training and experience in AI-relevant fields. Defence forces could make greater efforts to recruit more women in software-development and cybersecurity (two areas where they occupied only 23% of positions in 2019) and ensure high female presence in new AI programmes.

Second, the authorities can promote greater take-up of AI-relevant subjects by female students to develop information about career and wage prospects by topic in middle and high-schools before pupils choose their major (Encinas-Martín and Cherian, 2023[25]). It is also helpful for education authorities to ensure that middle and high-school curriculums fully overcome gender biases and stereotypes regarding math and science (Pawelec and Lesher, 2022[26]). A partnership between the Ministry of Labour and the non-profit organisation She Codes in mid-2023 launched a new initiative to encourage more female pupils who completed mathematics credits in high school to opt for academic studies relevant for high tech. The authorities should closely monitor this initiative to expand it if it proves successful. Furthermore, military authorities could increase the share of women (19% in 2019) following science and engineering courses under the *Atuda* programme.

Raising the employment of under-represented groups in AI production

Large segments of the population currently have comparatively few members working in high-tech, offering considerable potential to provide additional human resources in the future for high tech in general, also benefiting AI. Within the working-age population, while on average 11.6% of Israelis work in high-tech, this share is only 4.3% and 3.5% for Haredi (ultra-Orthodox) women and men, respectively, and even lower at 1.7% and 1.1% for Arab men and women, respectively (Israel Innovation Authority, 2024[5]).

Improving the quality and quantity of primary and secondary education for the under-represented groups is essential. Doing so could equip large numbers of young Israelis with the skills necessary to undertake higher education in scientific fields and later have opportunities to work in high-tech including AI. The economic benefits for the economy would materialise in terms of both greater participation and higher productivity. As documented in the previous *Survey* (OECD, 2023[20]), mean proficiency levels among 15-year-olds lag behind those of most other OECD countries, with low outcomes among particular population groups being important factors behind this average result. Four in every five Haredi boys (making up about 8% of their age cohort) receive secondary education from yeshivas, which have reduced or no requirements to teach mathematics or English (Finkelstein, 2023[27]). The Arab education system, which receives lower funding than state Hebrew streams especially at the secondary level, produces substantially lower learning outcomes. There is considerable scope to reform primary and secondary education including by increasing funding for the Arab system and requiring the teaching of core subjects in full across all education streams (Table 2.1). Additional barriers include limited public transportation from Arab towns to high-tech employment hubs, and a shortage of childcare facilities for children under three in Arab municipalities.

Table 2.1. Past OECD recommendations on education and skills and actions taken

Recommendations in past surveys	Actions taken since 2023
Increase funding for Arab schools to equalize their budget to schools with similar socio-economic profiles in the Hebrew sector	The Government Resolution 550 program dedicated funds with the aim of resolving disparities between Arab and Jewish communities especially in education. This budget was in 2024 reduced by 15% by contrast with the general 5% across-the-board cut in discretionary spending.
Increase Hebrew teaching and modernize general pedagogy in Arab schools	None
Make funding to Haredi schools conditional on core subject instruction and on supervision by the Ministry of Education	The government in 2024 allocated NIS600 million to Haredi education streams, equivalent to 17% of their budget, to increase teachers' salaries without conditioning this funding on covering the core curriculum
Create a National Qualifications Framework and improve pathways for mobility between upper-secondary schooling, post-secondary VET and tertiary degrees	None

Bringing in more foreign experts

An additional way of overcoming highly-skilled-labour shortages is to hire non-Israeli workers. One option has been to employ West Bank workers and link with the nascent AI sector around Birzeit University in Ramallah; the Israeli authorities in 2021 issued 500 permits for Palestinians to work in the high-tech sector, but take-up was very limited (below ten persons). In mid-2023, the Israeli authorities opened a tech hub in East Jerusalem. However, the suspension of work permits for West Bank workers following 7 October 2023 closed this avenue for potential labour.

Since 2018, the Israeli authorities have put in place special work visas for high-tech experts. These visas are granted for one year, can be extended to five years, allow spouses to work and benefit from an expedited procedure (6-10 business days). However, the reach of these visas may be limited by the yearly renewals and involvement of the employer, which can create considerable uncertainty for would-be immigrants into a sector that is characterised by strong labour-market churn. This is a small programme in quantitative terms: for the entire Israeli economy, foreign workers holding expert visas represented 0.12% of employment as of mid-2024 (while numbers specific to high-tech are unavailable).

The high-tech expert visa programme could be reformed to become more attractive. A way forward is to tie eligibility criteria to offer permits for a longer period than one year while weakening the link between the visa and a specific employer. Immigration systems putting the employer at the centre have typically been unable to attract very highly qualified migrants in sufficient numbers (Chaloff and Lemaître, 2009[28]).The link to the employer could be weakened by considerably lengthening the permit duration and allowing an extended period of job search if the employment contract is terminated before requiring to depart. However, the absence of a citizenship perspective would limit the attractiveness of the scheme compared with other destination countries.

The regulatory environment is supportive

The authorities are operating a regulatory environment implementing the OECD AI Principles by incorporating them in sector-level regulatory efforts rather than through over-arching cross-sector regulation. In line with the OECD framework for the classification of AI Systems, Israel's AI Policy follows a risk-based approach. Similarly to a number of other jurisdictions, Israel requires sector-specific regulators to assess AI-related risks and take appropriate measures (OECD, 2023[29]; OECD, 2022[30]; Ministry of Innovation et al., 2023[31]). This decentralised framework allows regulators to implement the principles in ways that can be adapted to sector specificities. A government decision of February 2023 established a centre for AI regulation assisting and coordinating the work of sectoral regulators to ensure that regulatory efforts are consistent (OECD, 2023[29]; Office of Legal Counsel et al., 2023[32]).This approach also favours

soft tools such as ethical principles, standards and recommendations for voluntary adoption as well as areas for controlled regulatory experimentations (so-called “sandboxes”).

The sector-by-sector approach has so far served AI development well. It has avoided potential unnecessary costs that might arise from a centralised, cross-sectoral regulation in the hypothesis that it was applied too rigidly (Martens, 2024[33]). Given the rapid advances in AI, the authorities should at regular intervals review the regulatory framework to check that it continues to encourage innovation and competition for trustworthy AI in line with OECD AI Principle 2.3b (OECD, 2019[1]).

Access to data is central to AI development. This area, long identified as a challenge (Israel Innovation Authority, 2019[34]), received priority status in September 2024, as part of the adoption of the second phase of the National AI Programme, which is welcome. The country’s adherence to the OECD Recommendation on Artificial Intelligence contributes to the objective of fostering adoption of trustworthy AI. The legal framework has been strengthened through the adoption of AI Policy Principles in December 2023, the revision in August 2024 of the privacy law and the signature in September 2024 of the Council of Europe framework convention on artificial intelligence and human rights, democracy and the rule of law.

The privacy protection framework is evolving. The review currently underway about the use of AI in financial services (see below) may result in recommendations on measures for privacy and data protection that could provide a framework to address the privacy implications of AI systems in other sectors. In particular, the August 2024 legislative revision put in place privacy-protection obligations backed by the threat of potentially large fines under the watch of the Privacy Protection Authority. The authorities should monitor the effects of this regulation to guarantee a proper balance between on the one hand protecting privacy and on the other hand facilitating data access and sharing while providing legal certainty to businesses. Establishing tight co-operation between the national centre for AI regulation and the Privacy Protection Authority would be a way of fostering coherence between the two regulatory activities.

Box 2.2. The National AI Programme

The National AI Programme gathers the institutions and ministries responsible for AI policy: the Israel Innovation Authority, the Ministry of Finance, the Ministry of Innovation, Science & Technology, the Council for Higher Education and the Directorate of Defence Research and Development. Launched in February 2023 through Government Resolution No. 173, the program “aims to secure Israel’s position as a global leader in AI innovation and technology.” It rests on three pillars: a government strategy, investments in AI infrastructure and the promotion of AI adoption across the economy.

After the adoption of its second phase in September 2024, the Programme aims to:

- Integrate AI in public service delivery
- Foster research by
  - establishing a National AI Research Institute and
  - launching a “moonshot” challenge to fund AI projects aiming at scientific breakthroughs and their application in the industry and defence sectors.
- Build human capacity by
  - Expanding academic research and advanced degree programmes
  - Developing a specialised AI training program in the Israel Defence Forces (IDF)
- Facilitating access to data, especially government datasets
- Encouraging transformative AI ventures, including by facilitating experimentation in heavily regulated fields by temporarily removing barriers while monitoring results (“sandboxes”).

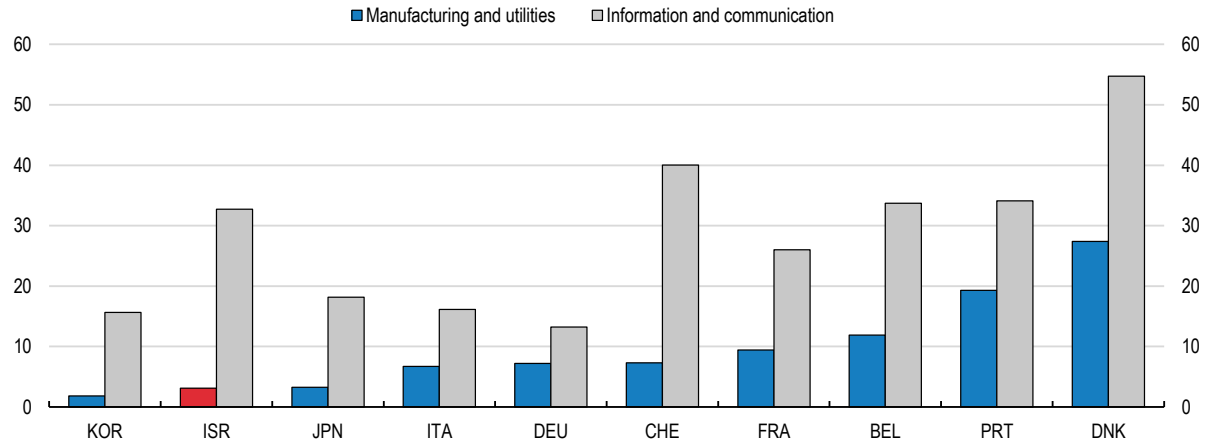
2.3. Preparing the broader economy to maximise gains from AI

AI represents a major change in the digital revolution, transforming many tasks and reshaping large planks of economies and societies. Firms and workers report across a wide range of surveys conducted in many countries that the use of AI has considerably enhanced their productivity (Filippucci et al., 2024[35]). The promise of AI goes beyond productivity with users reporting that the technology has improved their job enjoyment as well as their mental and physical health (Lane, Williams and Broecke, 2023[36]).

The deployment of AI across sectors is particularly challenging in a dual economy such as Israel's. While skills, productivity and pay are elevated in the high-tech sector, two thirds of workers are employed in sectors where productivity is below the OECD average (Koelle, 2023[37]). Digitisation, including the spread of AI, has been lagging in conventional industrial sectors such as manufacturing and utilities (Figure 2.7).

Figure 2.7. A large gap in AI use separates high-tech from traditional industrial sectors

Shares of AI users in ICT as well as manufacturing and utilities, 2020 or latest available year



Note: The survey was conducted in 2020 in most of the countries (2018 in France and 2019 in Germany, Japan and Korea).
Source: Calvino, F. and L. Fontanelli (2023[38]), "A portrait of AI adopters across countries: Firm characteristics, assets' complementarities and productivity," *OECD Science, Technology and Industry Working Papers*, No. 2023/02.

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Policy settings matter, as the impact of AI is far from given. The aggregate-output effects of AI are highly uncertain: anticipations range from a cumulative output *level* increase over ten years of 1% (Acemoglu, 2024[39]) to a rise of 18% over the same period followed by a permanent boost to the *growth* rate of one percentage point (Baily, Brynjolfsson and Korinek, 2023[40]). A recent OECD study points to permanent effects on output *growth* in the order of 0.25 to 0.6 percentage points (Filippucci, Gal and Schief, 2024[3]). Besides reflecting uncertainty, the higher numbers across these studies hinge on assumptions that the technology spreads widely and fast while also boosting the innovation rate. In other words, realising the potential of AI across the economy depends on having framework conditions and policies that facilitate its adoption across the economy (Filippucci et al., 2024[35]).

AI is likely to matter for a large number of workers though with very different implications depending on whether AI tools complement or replace the tasks that workers execute. Estimates using the sector and occupation structure of the Israeli economy suggest that as many as 30% of workers are highly exposed to AI with AI complementarity while 23% are highly exposed with high substitutability (Figure 2.8 Panel A).

The role of public policies varies between situations of complementarity and substitutability.

- Where AI complements workers' activity, the effect is higher productivity, which opens the potential for higher wages and profits: incentives are in this case aligned between workers and employers.

As identified in previous *Economic Surveys*, Israel is lagging behind in the digitisation of its non-high-tech sector with considerable scope for improving framework conditions for the take-up of digital technologies, among which AI, through quality education, lifelong learning and competitive product markets. Management and business skills have been identified as most in demand among occupations that are highly exposed to AI, a finding that provides an orientation for public efforts to support lifelong learning programmes (Green, 2024[41]; Borgonovi et al., 2023[42]). Training can also help build support for AI use, since AI users who have received training are more likely to expect AI to lead to higher wages (Lane, Williams and Broecke, 2023[36]).

- Where AI can substitute for workers, the onus for policy is on easing reallocation, to reap the economy-wide gains from AI, while creating new opportunities for displaced workers. Maintaining, and where possible strengthening, the policies that have led to a vibrant labour market with low unemployment is essential to facilitate reallocation. It is also important to ensure that workers, especially those that are potentially or actually displaced, can benefit from training opportunities and other active labour market programmes.

Impacts from AI deployment is set to differ across sectors. AI is likely to be most important for education, finance, ICT and real estate (Figure 2.8 Panel B). This heterogeneity has implications for public policy regarding specific sectors. For education, since the sector is largely publicly run, this calls for the authorities to embrace the roll-out of AI. For finance, the potential of AI will be more likely to be realised if authorities allow competitive pressures to operate in particular by facilitating the entry of fintech companies into retail markets. The regulatory framework for the use of AI in finance is currently under review to encourage innovation while preserving privacy, financial stability, accountability and absence of discrimination as well as mitigating cybersecurity, third-party and misinformation risks (Interagency Task Force, 2024[43]). The review focuses on critical areas in the financial sector that are likely to be most affected by AI such as investment advice, portfolio management, consumer credit and insurance underwriting. This review exemplifies the current regulatory approach in Israel: sector-by-sector regulation with the objective of fulfilling the potential of AI while protecting privacy and other public-policy objectives (including financial stability in this case). Besides, the large substitutive potential of AI for labour in finance and insurance also means that accompanying policies, including through retraining opportunities, are essential.

The level of education also matters for the worker-level effects of AI. The occupational structure of the Israeli economy implies that high-skilled workers are overall more exposed to AI than middle or low-skilled ones with an impact that for the vast majority will be complementary (Debowy et al., 2024[44]). This contrasts with previous waves of technological innovation, such as automation, the impacts of which concentrated more on middle-skilled workers in manufacturing and typically more substitutive. This means that, for most high-skilled workers, AI is likely to bring greater productivity and potentially higher wages. As mentioned above, however, there may be exceptions in sectors such as finance and insurance, where substitution may dominate.

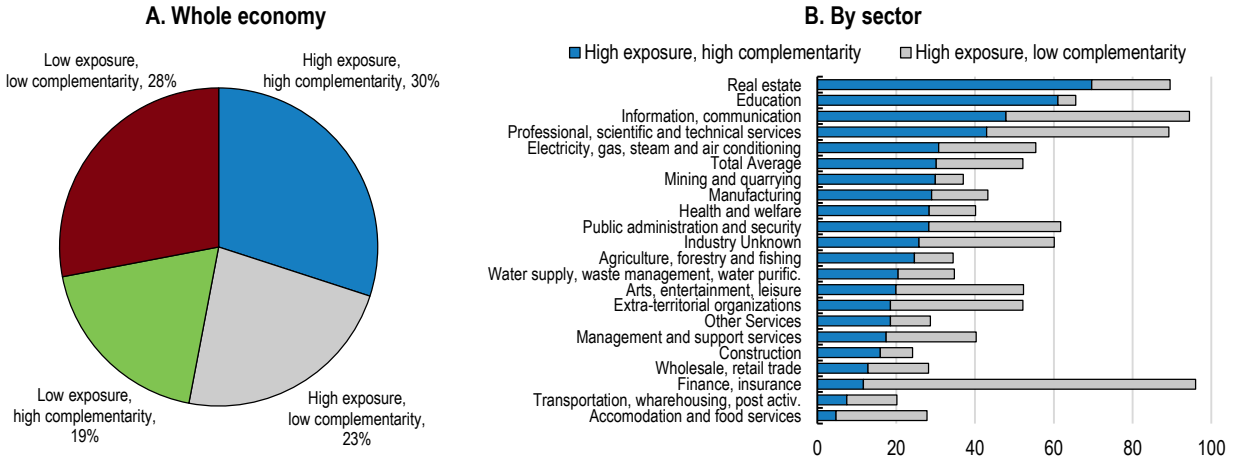
The policy settings that matter for AI adoption while enhancing social inclusion very largely overlap with the ones that determine successful digitalisation. This observation re-emphasises the relevance of the recommendations made in the previous *Survey* to broaden the use of digital technologies across the economy (Table 2.2).

A central requirement for widely beneficial AI use is to bridge digital, mathematics and literacy divides. Internet use varies more between low and high-education groups than in most other OECD countries (OECD, 2023[20]). This reflects to some extent choices by some groups to refrain from internet access at home or smartphones for religious reasons but also geographic disparities in the availability of high-quality digital infrastructure. Israel has a comparatively low stock of public ICT capital given its GDP (Axelrad, Sumkin and Haver, 2022[45]). Fibre-optic connections however are being deployed apace across the country, narrowing spatial gaps in access to very high-speed internet. Remarkably, the share of fibre connections in total broadband has risen from 5.5% in 2019 to 48% in December 2023, which places Israel

above the OECD average (43%) though still well below top performers (with above 85% rates in Iceland, Korea and Spain).[1]

Figure 2.8. AI is anticipated to have widely contrasted impacts across workers and sectors

Estimated level and nature of AI exposure across the economy, 2018-2023



Note: See the source for the methodology.
Source: Debowy et al. (2024[44]), *Artificial Intelligence and the Israeli Labour Market*.

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Table 2.2. Past OECD recommendations on digital development and action taken

Recommendations in past surveys	Actions taken since April 2023
Closely monitor the development of fibre broadband connections in underserved areas and align subsidies with actual deployment costs if needed	The share of fibre in total broadband connection has risen from 19% in 2021 to 48% in 2023
Introduce more flexibility to the public wage system by allowing higher wages for occupations with recruitment problems such as IT specialists	The public sector wage agreement reached in May 2023 includes a clause to facilitate technology deployment
Consider replacing the current system of preferential tax rates for IP-based income with a broader system of tax credits for R&D expenditure with cash refunds or carry-forward provisions	No action taken
Systematically collect and disseminate data on the adoption of digital tools by firms	Preparations for a new wave of the survey on digital adoption, which were underway before the 7 October 2023 terror attacks, have been paused.
Evaluate existing grants for technology adoption and digital training and expand effective programmes targeted towards SMEs in traditional sectors	An impact assessment is underway.

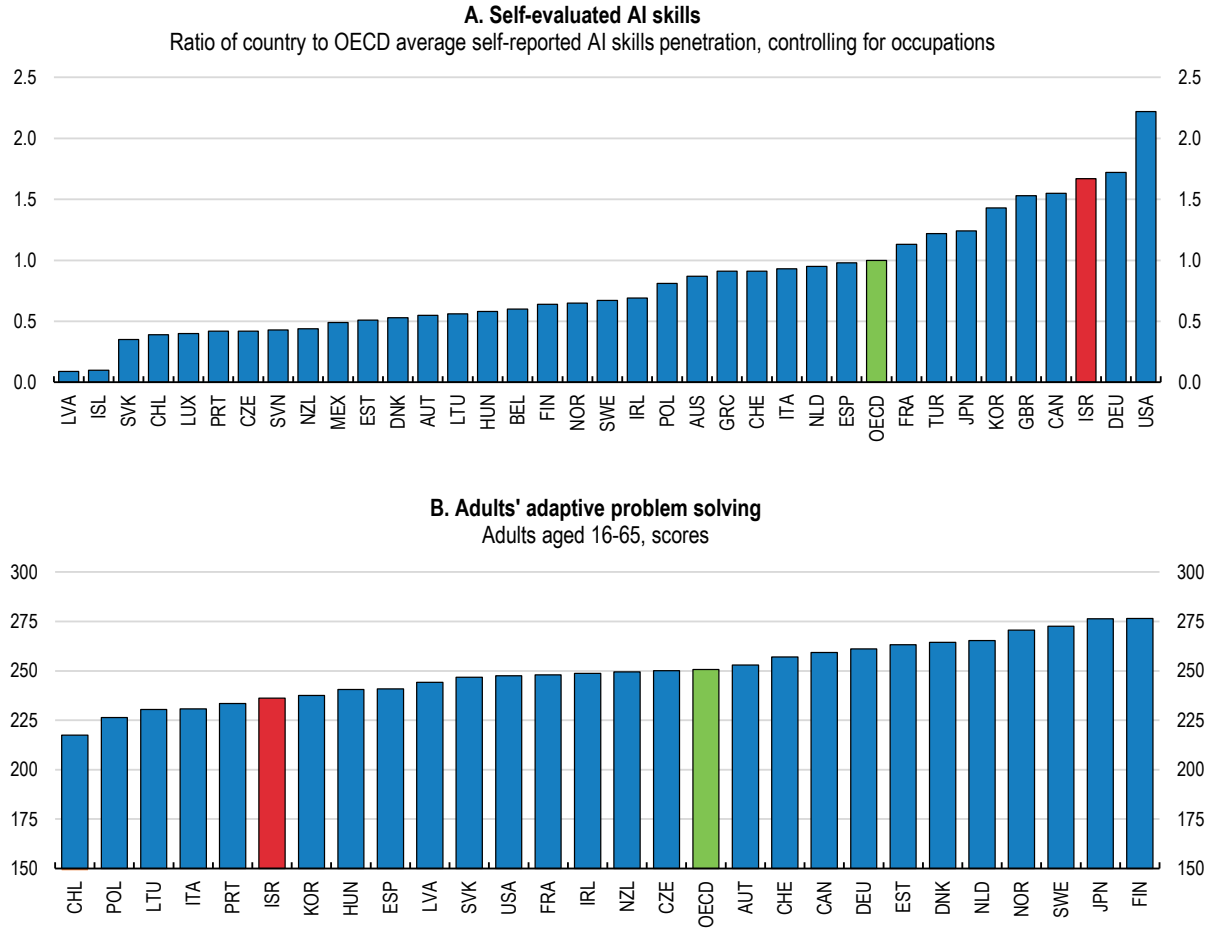
Average digital skills among adults are low by international comparison, including for young people. Only 35% of the surveyed 25-to-35-year olds proving able to solve problems in technology-rich environments against an OECD average of 45%; the average achievement gaps are much larger among the ultra-Orthodox and Arab groups (OECD, 2023[20]). As discussed in the previous *Economic Survey*, digital upskilling requires improvements to early, primary and secondary education, strengthening links across the different education streams, enhancing teacher quality and strengthening work-based vocational education as well as facilitating lifelong learning in this area. Efforts that are currently underway to incorporate initiation to AI in secondary education are welcome, as they can encourage pupils to choose relevant fields later or take up AI more easily in their professional life.

Israel distinguishes itself by having workers that are among the likeliest in the OECD area to report possessing AI skills, even after controlling for the large share of the high-tech sector in Israel (Figure 2.9,

[1] Source: OECD Broadband Statistics database.

Panel A). This self-evaluation contrasts with the relatively low share of adults identified as possessing digital skills in the 2015 PIAAC survey. While this apparent contradiction might partly stem from limitations intrinsic to international surveys, it reflects a positive attitude of Israeli workers towards taking up AI across the economy.

Figure 2.9. Many workers report having AI skills but assessed adaptive problem-solving skills are low on average



Notes: Panel A chart shows the prevalence of workers with AI skills – as self-reported by LinkedIn members from 2015-2022 – by country and against a benchmark set at the OECD average. A country's AI skills penetration of 1.5 means that workers in that country are 1.5 times more likely to report AI skills than workers in the benchmark. Average from 2015 to 2022 for a selection of countries with 100 000 LinkedIn members or more.

In Panel B, Adaptive Problem Solving (APS) refers to the ability of adults to adapt to new circumstances and learn throughout life. This new domain in the 2023 Survey of Adult Skills replaces the assessment of problem solving in technology-rich environments in the previous cycle of the Survey.

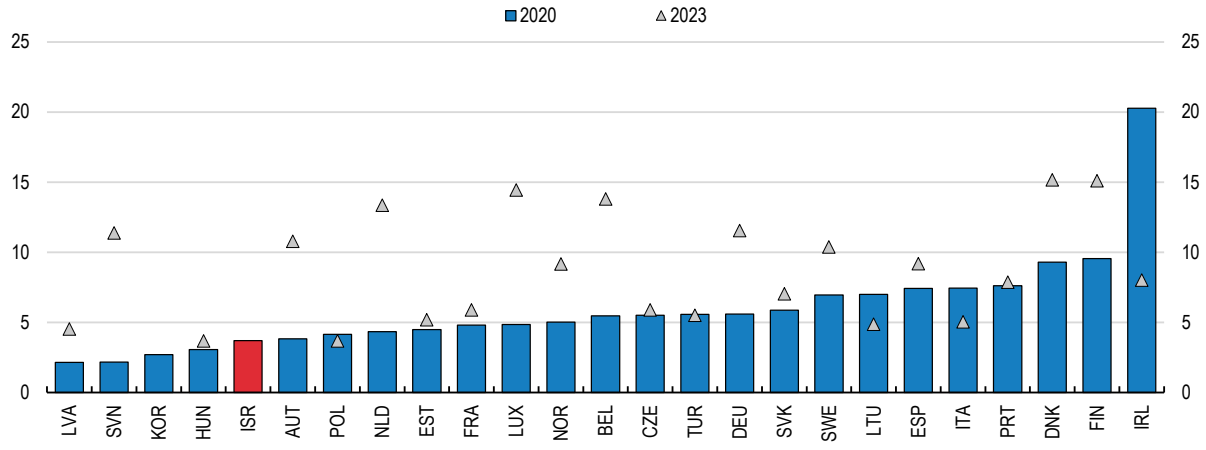
Sources: OECD AI Policy Observatory (OECD.AI); and OECD (2024), Do Adults Have the Skills They Need to Thrive in a Changing World?: Survey of Adult Skills 2023, OECD Skills Studies, OECD Publishing, Paris, https://doi.org/10.1787/b263dc5d-en.

StatLink https://stat.link/ba67cr

This widespread readiness for AI reported by workers seems unmatched by take-up among firms (Figure 2.10). In 2020, when they were last surveyed on this subject, comparatively few Israeli firms indicated having deployed big data analysis, a required underpinning for many strands of AI (OECD, 2024[11]). A first step for the authorities to prepare to promote broader deployment would be to repeat the survey on AI adoption. Given how fast adoption has spread in other countries since 2019, newer indicators are required to ascertain the extent to which the issue remains.

Figure 2.10. AI use remained limited among Israeli companies

Businesses of more than ten employees using artificial intelligence (AI)



Source: OECD ICT Access and Usage by Businesses database, https://oe.cd/dx/ict-access-usage.

StatLink https://stat.link/9tjbmx

Public authorities can foster AI use among firms through a number of avenues, starting with legal security and stability. As for AI creation (see above), a policy framework that provides legal certainty over data access and AI deployment will facilitate its use across the economy, especially among SMEs that lack resources to evaluate legal risks.

The public sector can facilitate the take-up of AI tools by easing access to its data. Israel's national AI program includes a goal to facilitate the use of public sector datasets in line with OECD recommendations (OECD, 2008[46]; OECD, 2016[47]; OECD, 2021[48]). Government Decision 1933, adopted in 2016, includes an "Open by Default" policy, which materialised through the data.gov.il platform under the responsibility of the Israel National Digital Agency (then named the National ICT authority). Furthermore, the Ministry of Health has been managing a platform providing access to health data for researchers, with privacy protection and security safeguards, including employing privacy-enhancing technologies.

Programmes are currently underway to encourage the use of government data. The Ministry of Innovation, Science and Technology in collaboration with the National Digital Agency has in recent years launched calls for proposals for data-based applied AI research in collaboration between academia and public bodies. The government allocates funds to the researchers and coordinates the access to public sector data sets. Nevertheless, the use of big data, which is key for many AI deployment cases, remains limited among AI companies: there is scope to further enhance data availability, with appropriate safeguards such as privacy-enhancing technologies, as a way of fostering broader AI use (State Comptroller of Israel, 2024[10]).

Furthermore, it should be noted that in the context of LLMs and adoption of AI tools by the local market, the Hebrew language can be a challenge. AI developers in other countries have little incentive to develop models for a small market. A benefit of the government promoting development based on public sector information is to encourage the development of AI tools based on Hebrew language datasets. This can facilitate the emergence of Hebrew-fluent tools that local firms and SMEs can more readily adopt.

Reinforcing education at all stages will ease AI deployment, with a particular role for lifelong learning to facilitate AI take-up by the existing workforce. As pointed out in the previous *Economic Survey*, however, workplace training is generally low in Israel, and a fragmented accreditation system complicates the recognition of qualifications across the economy. Expediting plans to establish a National Qualifications Framework would help to define clear learning outcomes, providing greater transparency about the skills acquired (OECD, 2023[20]; OECD, 2024[49]). Especially if integrated with high-tech skill initiatives by the

Innovation Authority and the Ministries of Labour and the Economy, such a framework would make it easier for firms to hire staff with skills useful for rolling out AI while sharpening incentives for workers to acquire them.

Key skills for AI deployment go well beyond the scientific and ICT competencies that are central to the creation of new AI products. A survey conducted by the OECD across ten countries identified that management and business skills are the most demanded ones in occupations with high AI exposure (Green, 2024[41]). Social and digital skills are also found to be in strong demand in high-AI-exposure occupations. These results underline that, alongside a knowledge of digital technologies, managerial competence, including the social skills required to promote successful business transformations, are essential to the take-up of AI.

A possible option to accelerate the take-up of AI, especially by small and medium-sized enterprises (SMEs), is to implement support programmes targeted at them. When considering AI adoption, many SMEs face barriers regarding technical, managerial and legal skills (OECD, 2021[50]). Over one in four SMEs point to bottlenecks including training (OECD, 2024[51]). Access to finance does not appear to be a major barrier owing to the widespread availability of AI technologies in the form of software-as-a-service with data hosted through cloud computing, which allows costs to be scalable by comparison with in-house solutions (OECD, 2021[50]). Against this background, government support appears to be particularly valuable if geared at facilitating access to data and training in digital and managerial skills (OECD, 2024[52]; Kergroach, 2021[53]). It is preferable to target businesses by criteria other than size, such as the age of the firm, to avoid creating disincentives to scale up (OECD, 2020[54]).

Government institutions can also take advantage of AI to improve the quality and efficiency of their services. The national AI programme (Box 2.2) promotes the integration of AI technologies across the public sector to improve public services by making them more easily accessible and personalised, enhance decision-making processes through greater use of data, and increase public-sector efficiency. Besides reducing costs, the automation of repetitive cognitive tasks can allow public-sector employees to focus on activities that require human judgement or creativity. Many initiatives are already being implemented with most at early stages of development but one already providing highly promising results in the fight against VAT fraud (Box 2.3).

Scaling up AI initiatives to modernise government however raises the challenges of developing digital skills in the public sector and attracting skilled human capital with high-tech skills. The National Digital Agency is operating a digital training school that enables public-sector employees to train in big data management and AI deployment. Specific AI training programmes are also available for local-government officials. As regards hires, the OECD (2021[55]) review of public sector pay and previous *Economic Survey* highlighted that the rigidity of the government wage structure makes it difficult to attract highly skilled professionals in areas of need: in particular, pay rises in one job classification typically trigger pay rises in other job classifications. Public authorities should use the flexibility clause introduced by the May 2023 wage agreement to offer higher wages when seeking professionals with the skills required for AI deployment.

Box 2.3. Examples of AI uses by the Israeli public sector

The "Israel Invoices" programme

An operational AI project is providing strong results in the tax area. On May 5, 2024, the Israel Tax Authority started the operational implementation of the "Israel Invoices" programme, aimed at reducing the issue of fictitious invoices. Fictitious invoices allow criminals to receive VAT refunds for sales of goods or services that never occurred. These fictitious invoices also reduce the amount of income tax businesses need to pay at the end of the year, as the associated apparent spending on intermediate products reduces their profits. It is estimated that the system could yield NIS 2.5bn (0.1% of GDP) in VAT revenue that is currently lost to fictitious-invoice fraud (State-Comptroller, 2024[56]) .

Under the programme, tax authorities' issues assignment numbers for tax invoices through an online system. These allocated numbers are required as a condition for deducting input tax in transactions exceeding the ceiling established by law (NIS 25,000, around USD 7,000, for 2024). With the new system, every real-time transaction goes through the credit clearing system to the tax authority. An artificial intelligence system applies ten (unpublished) criteria ("suspicious indicators") to determine the genuineness of each transaction, on the basis of which it then assigns a grade. If a transaction raises a certain number of red flags, it receives no automatic number.

Every day, between 50,000 and 100,000 invoices exceeding the minimum amount are submitted for approval. As of mid-September 2024, the total value of fictitious invoices detected in real-time was NIS 9 billion, which has avoided NIS 1.5 billion in VAT loss due to fraud. In September, a first arrest was made following fraud detected by the system, amounting to potentially 135 million shekels (USD 37 million). Following the success of the program, the ministry of finance approved an increase in manpower at the Tax Authority by about 100 employees, including some to fill technological positions.

New government AI projects launched following a national competition

In 2023, the ministry of innovation launched a competitive mechanism for national projects to incorporate AI in the public sector. The ministry of innovation offers budgetary and professional support alongside the National Digital Agency, which, attached to the ministry of the economy, promotes and pilots AI use by government departments. Priority was given to cloud-based projects relying on the government's central cloud platform (Nimbus, run by the National Digital Agency). Among the nine selected projects, initiated in March 2024, a remarkable one is an initiative by customs authorities to automatically classify goods based on the import invoice. This project is expected speed up goods arrival as well as reduce storage fees, taxes and administrative costs: as developed in Chapter 4, advances in trade facilitation can reduce the cost of living. Another promising project, by the ministry of transport, intends to use AI to improve the identification of priority areas for traffic-enhancing investment. The ministry of justice plans to develop an AI model to help detect non-profit organisations that might launder money or finance terrorism.

Source: Government Resolution 173 of February 24, 2023, (Ministry of Innovation, Science & Technology, 2024[57]), (Israel Tax Authority, 2024[58])

Table 2.3. Recommendations to expand the production and deployment of artificial intelligence

MAIN FINDINGS	RECOMMENDATIONS (key in bold)
Relatively limited domestic computing power narrow possibilities for AI academic research and early-stage AI startup activity.	Fully and swiftly implement plans to build an AI high-performance computing laboratory. Evaluate if further public support for investment in computing is warranted.
The Israel Innovation Authority is supporting high-tech startups (half of which are AI) through direct investment and enhancing the yield of institutional investors providing venture capital.	Regularly assess the results of subsidisation programmes to accordingly adjust funding levels and reprioritse among them.
Higher education, including at the master level, is central to the acquisition of competencies needed to create AI systems. The share of young people obtaining masters in AI-relevant fields has remained stable at a low level by international comparison.	Expand higher-education capacity in mathematics, physics, statistics and ICT including especially at the post-graduate level.
The high salaries in AI jobs can allow the development of privately funded higher-education programmes in AI-relevant fields.	Allow the establishment of private-sector higher-education programmes in AI-relevant fields with their accreditation only subject to academic quality.
The long military service makes it more difficult to pursue master and PhD-level studies for those who wish to start working at a given age.	Expand blended-learning post-graduate programmes in AI-relevant fields.
Employment rules applicable to public-sector universities complicate the retention of AI scholars given strong business demand.	**Allow faculty members in AI-relevant fields to work in industry alongside part-time academic duties.**
The AI gender gap is very large with women performing 23% of professional-level AI-production jobs. Women make up 29% of graduates in mathematics, statistics, physics and computer science.	Evaluate and, if successful, expand the initiative to encourage more female pupils to opt for academic studies relevant for high-tech jobs.
The regulatory environment is generally supportive with a flexible approach that assigns responsibility for complying with overall policy objectives, including OECD AI Principles, to sector-level regulators.	**Maintain a flexible, innovation-friendly stance in AI regulation.**
AI deployment, as well as development, requires confidence about legal risks especially from big data use. The spread of big data remains limited. Legislation passed in 2024 strongly tightens privacy regulations, introducing potentially large fines for non-compliance. The existence of legislation can provide legal clarity and stability if properly balanced.	Implement privacy protection rules in ways that safeguard privacy while facilitating data access and sharing. Promote access to public-sector datasets and public-private cooperation for data access and sharing.
Limits in very high-speed connectivity worked as an obstacle to digitalisation including the spread of AI tools. Fibre deployment accelerated in 2023.	Maintain the recent high pace of fibre-optic network extension towards rapid coverage of under-served areas.
The average level of digital skills is relatively low in Israel outside the high-tech sector. Managerial and business skills are also essential for successful AI deployment. Lifelong learning is limited, with the recognition of skills complicated by a fragmented accreditation system.	Create a National Qualifications Framework defining clear learning outcomes ensuring a proper coverage of AI-relevant areas including management and business skills alongside digital skills.

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3 Strengthening decarbonisation and climate change adaptation efforts

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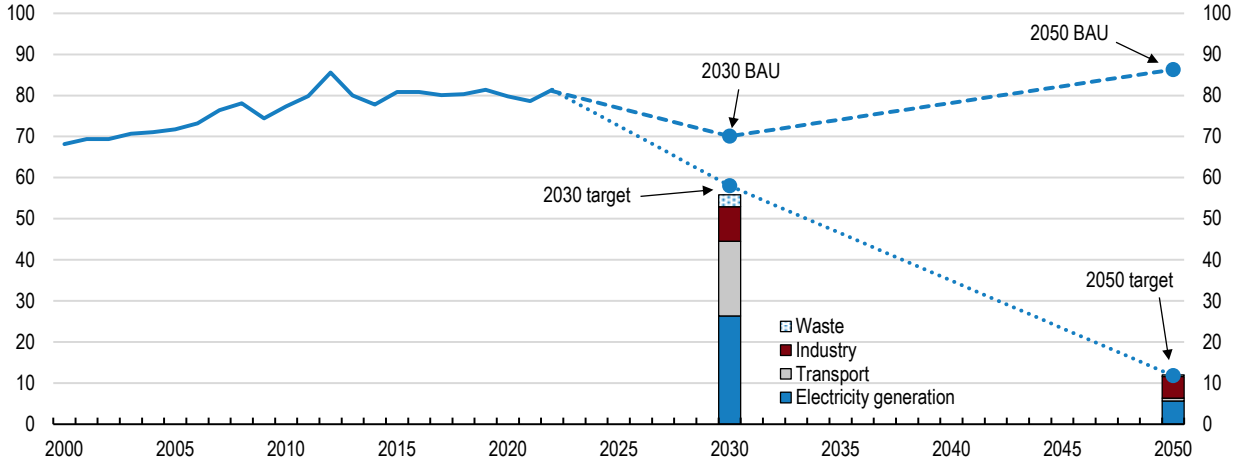
Progress towards net-zero greenhouse gas emissions by 2050 will require important efforts across all sectors of the economy. While taxation levels are high in transport, they are much lower for electricity. Reducing overall emissions will therefore require decarbonising the production of electricity. Pricing the carbon content of fossil fuels used in power generation is key in this regard. In addition, improving the energy efficiency of buildings is essential. Policies that would help Israel achieve this goal include standards, energy performance certificates, competitive markets for efficient appliances and tight integration between land-use and transport planning. Preparing well in advance for the coming adverse effects of climate change reduces the cost of adaptation. Risk-mapping exercises provide a strong basis for the design of adaptation strategies. Public investment is needed alongside insurance markets, which can help to cover costs while providing price signals encouraging households and developers to adapt to changing climate risks.

3.1. Efforts towards net zero will require deep changes

The authorities have pledged to contribute to global efforts to curb greenhouse gas emissions. Greenhouse gas (GHG) emissions reached 11 tCO2e per person in Israel in 2022 against 6.8 tCO2e per person globally. In 2021, the government adopted objectives to bring emissions down to 58 MtCO2e of CO_2e by 2030 and 12 MtCO2e by 2050. However, according to Israel's first Biennial Transparency Report, the 2030 targets are unlikely to be met, although the report indicates that this gap could be closed, and even surpassed, if additional measures are implemented. A bill that passed its first reading in the Knesset in April 2024 sets a target of net zero emissions by 2050 but is not currently scheduled for final approval. Reaching this objective will require considerable action over business-as-usual developments (Figure 3.1). Irrespective of forthcoming global emission reductions, Israel will also have to adapt to the changes in climate that have started to occur and are set to intensify (see last section).

Figure 3.1. Meeting the 2030 and 2050 targets will require substantial new measures

GHG emissions: trends, projections and targets, Mt CO_2 equivalent



Notes: GHG emissions excluding land use, land-use change and forestry (LULUCF). Dashed lines refer to emissions projections according to business-as-usual (BAU) scenario. Dotted lines refer to trajectories towards 2030 and 2050 GHG reduction targets with abatement measures according to Government Decision 171/2021.
Source: OECD (2023[1]) *OECD Environmental Performance Reviews: Israel 2023*.

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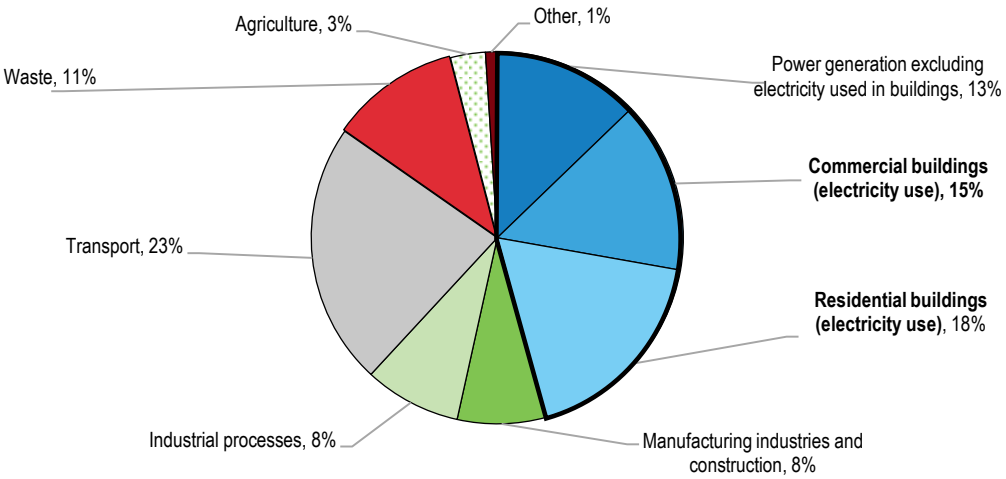
The two largest single GHG emitting sectors in Israel are transport and buildings, when taking into account emissions from generating electricity used in these sectors (Figure 3.2). High fuel taxes imply high levels of effective carbon pricing in transport by comparison with other sectors and the OECD average, although road transport also entails local pollution and congestion (Figure 3.3). By contrast, GHG emissions occurring when producing electricity, 69% of which is used to power buildings, are not subject to GHG emission permits and before 1 January 2025 were untaxed. With the carbon tax on natural gas phasing in gradually at low rates (see below), power generators face very limited economic incentives to reduce emissions. The availability of large natural gas reserves means that before-tax gas prices are likely to remain lower than in many countries, where transport costs are bearing on gas prices.

Policy action to put power-generation emissions on a trajectory compatible with net zero is all the more important given forthcoming increases in electricity needs. The shift to electric vehicles, which is well underway in Israel, and the rise of power-hungry AI will boost electricity demand (see Chapter 2). Over time, many industrial processes will also have to electrify in order to decarbonise, further contributing to electricity demand.

Figure 3.2. Electricity accounts for half of GHG emissions

Greenhouse gas emissions sector shares, 2021



Notes: Emissions excluding land-use, land-use change and forestry (LULUCF) and farming sources other than energy-related. Public-sector buildings are accounted for within the commercial category.
Sources: OECD Environment Statistics database; Ministry of Environmental Protection; and OECD calculations.

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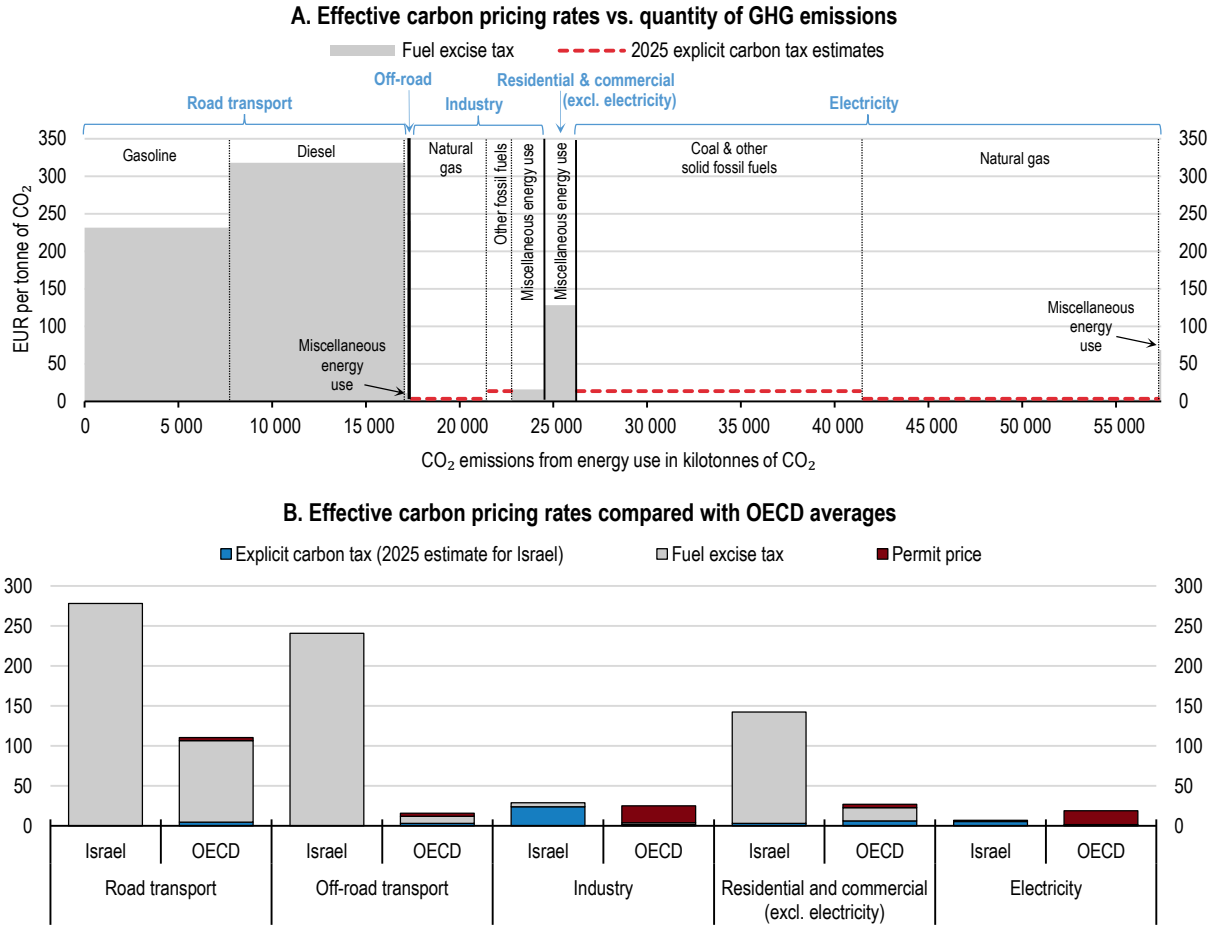
The buildings sector, the largest user of electricity, accounts for a third of overall GHG emissions. Making buildings energy efficient will help to contain electricity use, facilitating the transition of the power sector towards net zero. There is also a need to tackle built-sector emissions unrelated to electricity such as from construction and the use of fossil fuels (mostly liquefied petroleum gas - LPG) in buildings.

Furthermore, the urban fabric also has to undergo deep changes to attenuate the impacts of climate change. This chapter looks in turn at the power-generation sector, energy efficiency in buildings, other real-estate sources of emissions and policy avenues to adapt buildings to climate change.

Figure 3.3. Effective carbon pricing rates remain low for electricity

Effective carbon tax rates across sectors, 2023 data and 2025 illustrative estimates



Notes: Panel A: Effective carbon pricing rates in Israel consist of fuel excise tax only on 2023 data (as explicit carbon tax and permit price were equal to zero; see Figure 3.6 for values from 2025 to 2030). Illustrative estimates have been added to indicate the 2025 effective level of the carbon tax, but it should be noted that, by contrast with the 2023 data, these estimates reflect a simplified fuel mix assumption and that the split between different fuels (such as coal and gas in electricity generation) has evolved between 2023 and 2025. The levels are exact however where a single fuel is involved (e.g. natural gas). Off-road refers to emissions from miscellaneous energy use (241 EUR per tonne of CO_2) Panel B, for each sector, effective carbon tax rates are average of the rates by energy source weighted by emissions. Residential and commercial also includes the public sector. The numbers shown for "explicit carbon tax" in Israel are estimates for 2025 based on simplified fuel mix assumptions for illustrative purposes.

Source: OECD (2024), Pricing Greenhouse Gas Emissions 2024: Gearing Up to Bring Emissions Down, OECD Series on Carbon Pricing and Energy Taxation, OECD Publishing, Paris, https://doi.org/10.1787/b44c74e6-en.

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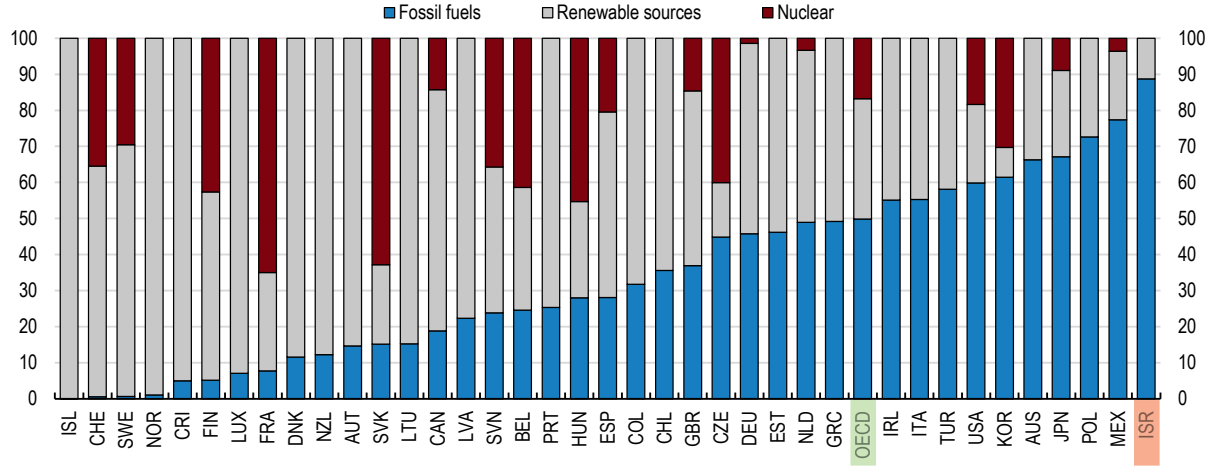
3.2. Getting to carbon-free power generation

3.2.1. The carbon tax is an effective tool to accelerate electricity decarbonisation

Among OECD countries, Israel has the highest share of fossil fuels in its power-generation mix (Figure 3.2). Historically based on coal, the fuel mix since the turn of the century has switched to natural gas, with an acceleration since the discoveries of the large Tamar and Leviathan fields in 2009-2010 (Figure 3.7). The share of renewables in electricity production is among the lowest in the OECD area, reflecting lack of hydro resources and space for wind power compared with other OECD countries (Figure 3.2). However, with favourable climate conditions, Israel produces the second-highest amount of solar photovoltaic electricity per square meter among countries covered in IEA PVPS (2022[2]).

Figure 3.4. Power generation relies predominantly on fossil fuels

Electricity output by source, %, 2023



Source: IEA World Energy Balances database.

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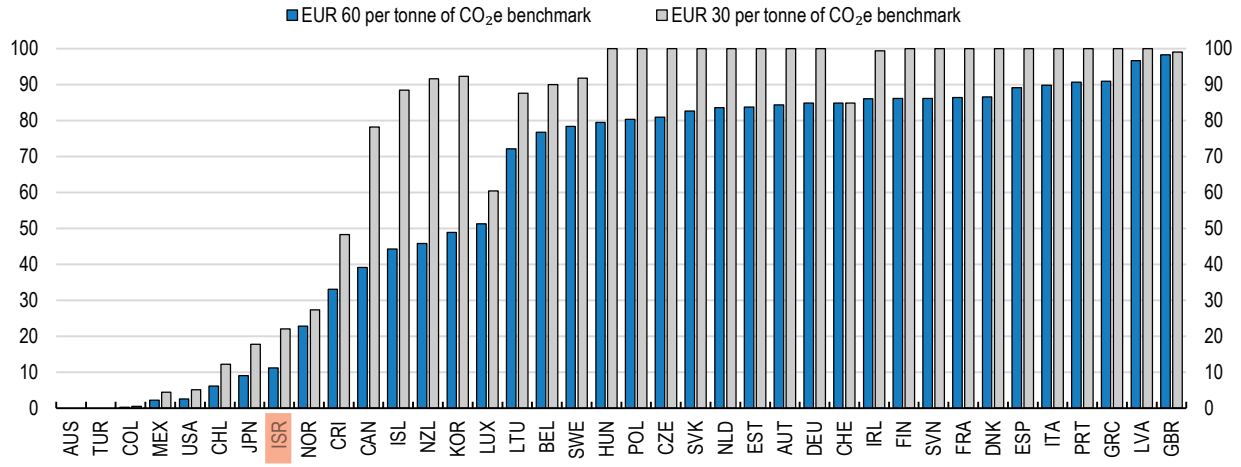
GHG emissions from power generation are strongly underpriced by international standards (Figure 3). According to OECD (2023[3]) estimates, only a tenth of CO_2 emissions from the production of electricity in 2021 attracted taxes amounting to more than EUR60 per tCO_2e, an estimate of the carbon pricing rate necessary to achieve net zero by 2050 and a mid-range benchmark of current carbon costs (OECD, 2021[4]).

Figure 3.5. The pricing of emissions from power generation is very low in international comparison

Share of sources used to generate electricity priced above the benchmark rate, %, 2021



Note: A score of 100% means that all sources are priced at or above the benchmark rate.
Source: OECD Effective Carbon Rates database.

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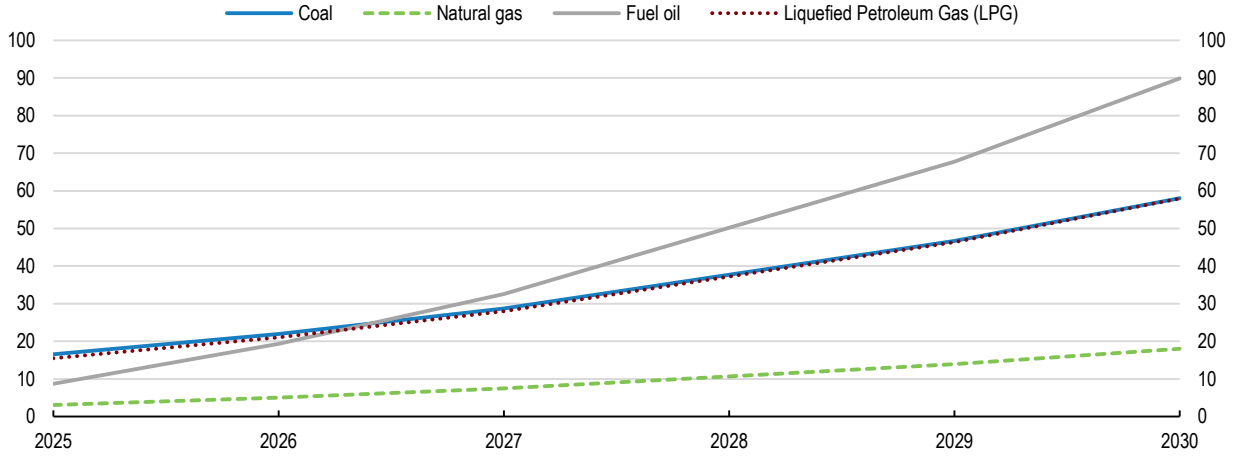
The new carbon tax provides a basis to encourage emission reductions, but its rate is low and uneven across fuels. The introduction of a carbon tax, which the previous *Economic Survey* recommended, is welcome (Table). Since 1 January 2025, this tax applies to fossil fuels used across the economy including in power generation. Carbon tax rates are below the above-mentioned EUR60 per tonne of CO2 benchmark. The rate on natural gas is particularly low and set to remain so, increasing very gradually to reach the equivalent of EUR 18 per tCO2e in 2030 (Figure 3.6).

Figure 3.6. The carbon-pricing rate implied by the carbon tax remains low for natural gas

Implied effective tax rate by fuel, EUR per tonne of CO_2



Note: The implied effective carbon-pricing rates are taken by applying standard emission factors to the tax rates per tonne of product foreseen in Government Decision No. 1261 of 14 January 2024.
Source: OECD calculations.

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The carbon tax needs to apply at sufficiently high rates across all fossil fuels used in power generation, including natural gas, to be environmentally effective and economically efficient. First, taxing all fuels according to their carbon content will penalise coal and fuel oil, which emit much more CO_2 per unit of electricity generated than natural gas, accelerating their exit from the fuel mix. Second, taxing natural gas at a rate consistent with other carbon sources will avoid over-investing in natural-gas-based power generation. Third, applying a high-enough carbon rate will encourage the deployment of carbon-free technologies such as renewables or carbon capture and storage (CCS), provided that the carbon tax offers relief if CCS is used.

Creating appropriate conditions for other sources of electricity relative to natural gas is crucial for overall decarbonisation efforts. Emissions from power generation did not increase after the turn of the century despite massively increased production of electricity thanks to the substitution of natural gas for coal and oil. However, as the switch from coal and oil to natural gas comes to an end, a proper pricing of the carbon emissions from natural-gas turbines prepares the ground for the ulterior replacement of natural gas by carbon-free sources. In the short term, it is important to complete the phase-out of coal in electricity generation before 2026 as planned (State of Israel, 2022[5]).

Deviating from carbon content in fossil fuel taxation entails costs for the budget, purchasing power or both. If natural gas continues to be undertaxed relative to its carbon content, the expansion of renewables would require subsidies or feed-in tariffs to be deployed. Subsidies involve budgetary costs, while electricity users cover the cost of feed-in tariffs from their utilities bill. Budgetary support or feed-in tariffs are more costly to taxpayers than the pass-through of carbon tax to end users, because any miscalibration of subsidies or tariffs compared with the most cost-efficient mix will translate into higher costs for users, in addition to the costs of managing the schemes.

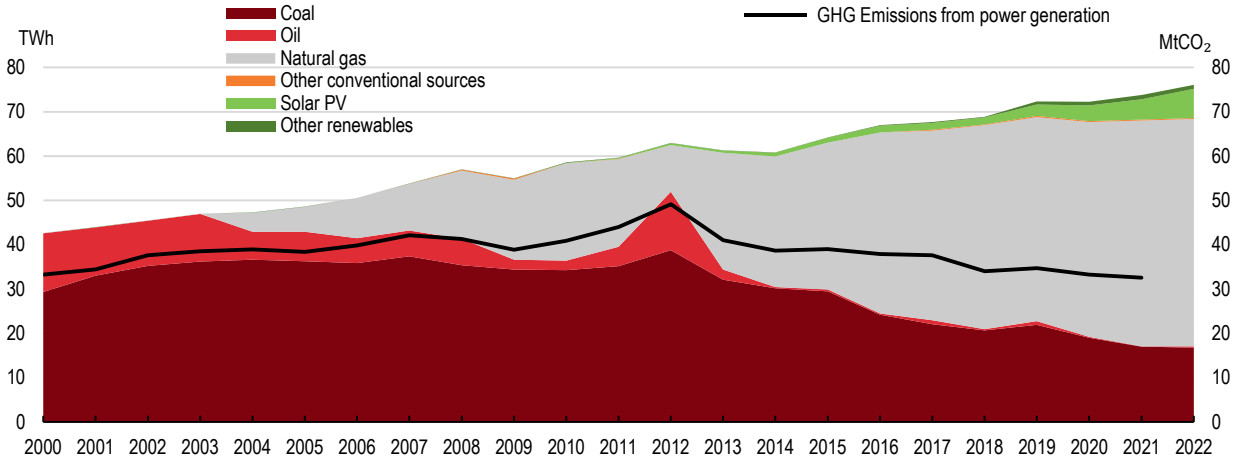
Taxing power-generation input fuels according to their carbon content creates incentives for deploying the most efficient technologies to reduce emissions. The subsidisation of carbon-free electricity through grants or guaranteed feed-in tariffs also biases the selection of these carbon-free sources. The reason is that these public supports typically target specific technologies (e.g. solar panels).

Table 3.1. Recommendations in previous economic surveys on decarbonisation

RECOMMENDATION	ACTION TAKEN SINCE APRIL 2023
In the medium-term, gradually increase excise taxes on non-transport fuels that reflect environmental costs and introduce consistent carbon pricing across all sectors.	The government in January 2024 (Decision No. 1261) approved a gradual hike in the rate of the tax applied on each type of fossil fuel from 2025-2030. A specific provision however limits the increase on the tax on natural gas. The tax is in force since 1 January 2025.
Partially use environmental tax revenues to mitigate distributional impacts, enhance energy efficiency and improve public transportation.	While there is no provision to directly use part of the future carbon tax revenues, the ministry of finance has put in place budgetary support for energy efficiency in industry and for assistance to vulnerable households.
Streamline permit procedures and increase public land available for utility-scale solar installations while further strengthening incentives for distributed solar installations.	Calls for tenders have been concluded for large-scale projects, after having made more public land available for them. Subsidies have been put in place for residential solar installations.
Accelerate investment in the distribution network and storage capacity.	The Electricity Authority has proposed a major (NIS 20bn) development and upgrade plan for the distribution grid. The Electricity Authority is expected by January 2025 to complete tenders for utility scale storage at a total capacity of 1000 MW. The electricity system operator (NOGA) is in the process of authorizing 2500MW in distributed storage. There have also been a number of provisions to incentivize small-scale storage systems connected to the distribution grid. For example, a hike of 0.06 NIS per KWh of storage electricity generated within urban areas.

Figure 3.7. The large emission savings from the switch to natural gas in power generation are coming to an end

Electricity generated by source (left-axis) and GHG emissions from power generation (right-axis)



Note: TWh stands for terawatt hours while $MtCO_2$ for million tonnes of CO_2-equivalent.
Sources: International Energy Agency (IEA), World Energy Statistics database.

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By contrast, market forces that operate in the presence of consistent carbon pricing allows for the spontaneous emergence of the most efficient technologies. A first step can be the substitution of more fuel-efficient combined-cycle technology for simple-cycle gas turbines. A much more transformative change would be the deployment of carbon capture and storage (CCS), which could provide an attractive option for the country given Israel's large natural-gas reserves. Building a gas power plant including CCS was estimated on 2019 data to be economical when taxing CO2 emissions in the range of EUR40 to EUR115 (Baylin-Stern and Berghout, 2021[6]). This suggests that a tax set at EUR 60 per tonne of CO2 would fall in this range, making it more profitable to build a gas plant with CCS rather than without it (provided that the carbon tax exempts CCS-equipped power generation). Another important example is

solar energy. Calls for tender for the establishment of 365MW power plants attracted in July and August 2024 bids at 20EUR per MWh, below half the wholesale price of electricity in Israel. The price information provided by these projects however does not allow determining a carbon-tax rate prompting solar energy to systematically replace natural gas at all times, as the question of nighttime power supply would remain given the limits of current electricity-storage technologies.

Taxing carbon involves costs for users of fossil fuels and electricity produced with them. These costs can exacerbate income vulnerabilities among households that struggle to pay their energy bills. For this purpose, the carbon tax framework incorporates plans to allocate a budget of NIS 700 mn (EUR 190 mn) to assist vulnerable populations. International survey evidence indicates that mitigating adverse effects on low-income households enhances support for carbon taxation (Dechezleprêtre et al., 2022[7]).

3.2.2. Dual use of land and grid investments can facilitate the spread of renewable power generation

With high population density, Israel has limited land available to install photovoltaic panels, which raises the benefits of using building rooftops for this purpose. Current regulation requires the use of solar energy in new multifamily buildings. Building standards require multi-family buildings to set up photovoltaic panels of 1.25kW per dwelling (capped at 45kW for high rises, since the roof surface does not increase in proportion to the number of units) or an equivalent amount of solar thermal. Further regulation is being prepared to extend these requirements to single-family units and non-residential buildings, which is welcome. Sunlight can also be used to heat water, as has since long been widespread in the country, which also reduces energy demand.

Other developed and farm land are other potential places where to produce solar power. Ongoing plans are considering easing rules to facilitate the construction of solar power generation capacity above wastewater reservoirs and parking lots. An initiative launched in 2022 by the ministries of Energy and Agriculture is experimenting the dual use of farmland for the simultaneous production of electricity and farm produce across 100 villages.

Shifting the electricity mix massively towards renewables requires deep changes to the transmission grid, which are currently being planned. Solar photovoltaic energy, the central component of renewable energy generation in Israel, will for a large part develop in different areas from the ones where the largest current fossil-fuel power plants are based. More specifically, notwithstanding above-mentioned dual use, semi-desertic areas in the south of the country are better adapted to solar electricity generation than the more agricultural central areas where most existing plants are installed and around which the power grid is organised. Accommodating and facilitating this development involves developing high-capacity transmission capacity from the south to the centre, which, given the natural monopoly nature of transmission, requires strategic guidance by the public authorities. Such a process is underway, as the Electricity Authority has proposed a large-scale (NIS 20bn equivalent to EUR5.4bn) plan to reshape and upgrade the grid (Table 3.1).

3.3. Minimising electricity demand from buildings

Making buildings more energy efficient aims to reduce the amount of electricity required. Minimising energy consumption in buildings is important even if this energy is provided through low-carbon and ultimately carbon-free electricity, because large demand for electricity will come from transport and industry in the coming decades as they shift out of fossil fuels.

Energy efficiency means minimising the amount of energy used to provide the desired levels of cooling, cooking, heating, lighting, computing and other services. Most of the energy used in buildings serves to heat or cool them, with cooling the dominant use in Israel by contrast with the majority of OECD countries

(OECD, 2024[8]). This implies that insulation and energy design are central to overall energy efficiency. The other component is the energy-efficiency of appliances and other electrical equipment used in buildings.

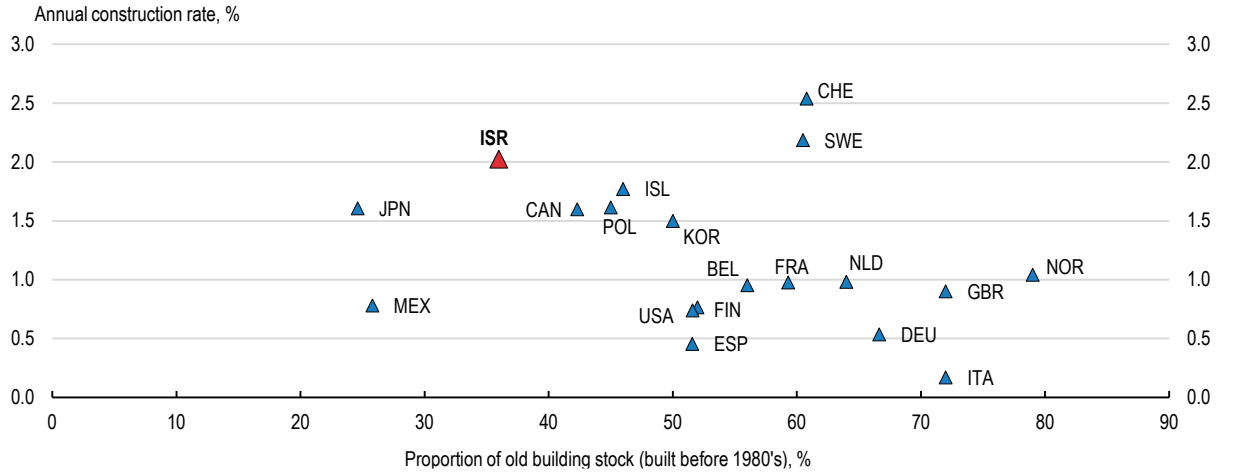
The first step for more energy-efficient housing is that new buildings comply with standards compatible with very long-term decarbonisation objectives. Buildings are among the longest-lived assets in the economy. Furthermore, improving the energy-efficiency of an existing building is much more expensive than at the construction stage, in addition to being disruptive for its users.

From this perspective, the green building standards that have recently been adopted in Israel are an important step in the right direction. Standards applicable to new construction are particularly important in Israel, where new construction is high relative to the existing stock comparatively with other OECD countries (Figure 3.8). Since September 2023, all new mid and large-sized constructions must exceed minimum levels of insulation and performance of appliances under Standard 5281. This regulation applies to all permits for new residential constructions of more than six units, and non-residential buildings (including for the public sector) of more than 1000 square meters. Specific thresholds of 1200 and 3000 square meters apply to hotels and hospitals. The requirement also applies to heavy renovations.

This standard marks an important, welcome step, which can be taken further.. Even if individual and small residential buildings make up little of new construction, it is desirable to apply efficiency requirements to buildings of fewer than six units. The additional costs associated with the regulation are estimated below 1% of construction costs. Technological innovation in construction can improve the energy-efficiency enhancements achievable at a given cost.

Figure 3.8. The building stock is comparatively new, with a high share of new construction

Existing building stock and annual construction rate



Source: OECD (2024[8]) Global Monitoring of Policies for Decarbonising Buildings: A Multi-Level Approach.).

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The new regulation also mandates the energy rating of new buildings. This measure tackles the market imperfection that arises from the great difficulty for buyers, especially in the residential and small-office-space sectors, to evaluate on their own the energy performance of a construction (Hoeller et al., 2023[9]). Buyers of existing buildings and new renters face the same difficulty: this underlines the case for extending this energy certification requirement to sales and new rentals of existing real estate while monitoring costs and encouraging competition in the energy rating sector to keep the cost of certification low and minimise adverse effects on low-income households. Such a requirement is in place in France and will be mandated across the European Union under the EU Directive on the Energy Performance of Buildings (OECD,

2023[10]; de Mello, 2023[11]). In France, furthermore, minimum energy performance standards apply to rental dwellings, including on-going contracts, since January 2025 (OECD, 2024[8]).

Improving the energy efficiency of existing buildings requires large upfront investment that pays off through lower energy bills only over a long period of time, raising funding issues for liquidity-constrained owners. In the absence of a well-developed segment in the capital market to fund these investments, many countries have put in place subsidies, especially in the residential sector. These schemes however have often raised concerns about high budgetary costs, particularly when they are broad-based rather than aimed at lower-income households, for limited environmental efficacy(Box 3.1). From this perspective, it is welcome that the support schemes introduced alongside the carbon tax, use part of its revenue to increase energy efficiency in the homes of low-income households.

Involving the financial sector is a condition to mobilise the large investment amounts required to retrofit existing buildings and to sharpen incentives to build new construction according to high energy performance standards. The Israeli authorities have since 2024 been developing a taxonomy to classify sustainable activities as a way of facilitating the emergence of financial products that can provide investors with certainty over the environmental quality of the underlying asset (Ministry of Environmental Protection, 2024[12]). It is important that, as planned, this taxonomy includes a building chapter with clear energy-performance criteria, as this can provide a strong legal basis on which green building finance can develop and accelerate the energy transition of the building sector.

One way of easing access to capital for energy-efficiency investment is to increase the international comparability of the green building standard. In its current form, the standard, which is specific to Israel, cannot be directly compared to the requirements applicable in the United States or the European Union. Greater comparability would make it possible for owners of green-standard-complying buildings, and their lenders, to resell, securitise or develop asset-backed products that could be then marketed internationally to investors looking for green investments.

Given the size of Israel, access to international green debt markets is much facilitated if local standards can be translated into global benchmarks. Creating conditions for interest by buyers of green assets could broaden demand for new construction and deep retrofitting of buildings according to high energy efficiency standards (OECD, 2023[10]). One straightforward way of easing cross-country comparability would be for Israel to adopt the same letter-based energy-performance rating of buildings as the European Union. Furthermore, although this has to be balanced against regulatory costs, gradually broadening the requirements to all buildings would also magnify the size of the potential pool of collateral against which green financial products could develop (de Mello, 2023[11]).

Another obstacle to energy-efficiency improvements can arise for rented residential real estate. In this situation, retrofitting incentives are split between renters, whose horizon in the dwelling is too short or uncertain to allow them to benefit from the payoff of enhancing energy efficiency, and owners, if they cannot recoup part of their investment from renters (de Mello, 2023[11]). The current dwelling rental contract flexibility in Israel allows landlords to adjust rent levels if they want to do so after conducting improvements, by contrast with many countries where rent regulation is more rigid. While framework conditions are currently revisited for the Israeli rental market, it is important to maintain this possibility of increasing rent levels following energy-efficiency improvements by an amount equal to all or part of energy bill savings from lower consumption.

Using highly efficient appliances also matter, especially for heating and cooling, the major sources of real-estate energy requirements. In 2024, Israel shifted from a specific domestic energy labelling for appliances to the EU system, a move that greatly enhances competition for the most efficient equipment given that most manufacturers globally get their products labelled for the EU market given its size. Moreover, it is important to keep zero tariffs and facilitate import procedures for heat pumps, which have huge potential to make cooling and heating more efficient (IEA, 2021[13]).

Box 3.1. Subsidy schemes for energy renovation in selected OECD countries

Energy-renovation subsidies aim to speed up the deployment of high-performance insulation and technologies by filling a financial gap. The programmes vary in structure and amount across countries (Table 3.2). The programme providing the largest support is Italy's Superbonus 110, which offers a 110% tax credit for improvements raising the dwelling's energy-efficiency level by at least two notches on the energy-performance certification scale. This programme has been very costly, involving government expenditure of around 4% of GDP to renovate only 3% of the housing stock (OECD, 2024[14]).

Table 3.2. Characteristics of some subsidy schemes

	Germany	France	United Kingdom	Italy
Name	"Deutschland macht's effizient", KfW's "Energy-efficient construction and retrofitting"	"MaPrimeRénov", now a part of "FranceRénov"	"Green Deal"	"Superbonus"
What is subsidised?				
- Energy advice	Yes	Yes	No	No
- Energy efficiency improvements	Yes	Yes	Yes	Yes
- Renewable energy	Yes	Yes	Yes	No
- Other	N/A	N/A	N/A	Seismic improvements
Energy performance and control	Ex-ante and ex-post.	Ex-ante and ex-post.	Ex-ante.	Ex-ante and ex-post.
Subsidies provided	Loans, grants, tax breaks.	Loans, bonuses, reduced tax rate	Grants.	Tax deduction.
Subsidy rate	Up to €25,000 for heating system improvement. Up to €120,000 for a complete renovation of a house.	€1,000 for heating system improvement. Up to €8,000 for the installation of solar thermal. €20,000 as standard maximum amount (insulation, heating, general works. €30,000 for extended retrofit works.	£5,000 as standard amount per household. £10,000 for low-income households.	110% on the tax base of the retrofitting costs before 2023, then 90%.
Does the subsidy rate depend on energy efficiency improvements?	Yes	Yes	No	Yes
Does the subsidy rate depend on income?	No	Yes	Yes	No before 2023, then Yes
Possible rent increase after renovation	8%	N/A	N/A	N/A

Notes: The programmes are described as of 2023. United Kingdom has a £3,500 cap on landlord participation in the financing of energy retrofits in rented properties, which means that the rest of the costs are borne by the renters or the state. The vouchers for the UK's "Green Deal" cover up to ⅔ of any chosen improvement.

Source: Hoeller et al. (2023[9]), "Home, green home: Policies to decarbonise housing", *OECD Economics Department Working Papers*, No. 1751

Ex-post analyses, though relatively rare, have cast doubt on the efficiency of renovation subsidies in reducing emissions. First, the rebound effect (better insulation leads to higher inside temperatures in the winter and lower ones in the summer) eats up some of the savings. Second, subsidies also fund renovation work that would have been undertaken anyway: empirical estimates put the proportion of deadweight losses at 40 to 85%. Third, there is a discrepancy between the energy savings anticipated before renovation and the ones observed afterwards. A recent assessment of 2.7 million energy retrofits subsidised by the French authorities over 2017-2019 found that these interventions achieved less than a third of the anticipated energy-efficiency improvements, implying marginal abatement costs of EUR 300 to EUR 600 per tCO2 (Wald and Glachant, 2024[15]).

These schemes are also sometimes justified from an employment perspective through the anticipation that they will lead to strong job creation. The above-mentioned renovation subsidy programme conducted by France appears to have increased employment, however at a cost of above EUR 700k per job created (Wald, Cohen and Kahn, 2024[16]).

Source: OECD (2023[10]), *Brick by Brick (Volume 2): Better Housing Policies in the Post-COVID-19 Era.*

Local governments occupy a central position in the decarbonisation of the building sector. Urban policies always have a strong local component, critically regarding land planning and use decisions. Policy tools such as the OECD checklist for Public Action to Decarbonise Buildings in Cities and Regions can help national and sub-national policymakers to align national and local actions to decarbonise buildings (OECD, 2022[17]). Examples in Canada, Japan and Korea underline the benefits of such coordinated approaches across government levels (Box 3.2).

Box 3.2. Examples of local approaches for building decarbonisation

Greener Neighbourhood Pilot Program in Canada

To accelerate the retrofitting existing buildings, a Canadian programme aims to retrofit homes and other buildings in an entire neighbourhood all at the same time. In 2022, CAD 35 million was allocated for five years starting from 2022-2023 to implement such retrofitting in up to six community housing neighbourhoods. This initiative follows the Dutch “Energiesprong model”, which relies on prefabricated facades, insulated roofs with solar panels, computer-controlled heating and ventilation.

Renewable energy use district in Japan

The Ministry of Land, Infrastructure, Transport and Tourism (MLIT) introduced a new system called “renewable energy use promotion district” in 2022 under the revised Building Energy Efficiency Act. Under this system, local governments can designate a specific district where to promote the installation of renewable energy facilities such as solar panels. A selected district or neighbourhood can receive a special permit that allows builders to be exempted from height restrictions, floor area ratio restrictions, and building occupancy rate restrictions to facilitate the renewable energy facilities installation.

Zero-energy pilot districts in Korea

The Ministry of Land, Infrastructure and Transport (MOLIT) and the Korea Land and Housing Corporation (LH) jointly coordinate “zero-energy pilot districts”. For instance, the Dangsu District 2 in Suwon was equipped in 2021 with novel heating technologies including heat pumps using hydrothermal energy with the objective of achieving a 50% energy-sufficiency rate. The ministries monitor outcomes together with local governments, academia and the private sector with the aim of scaling up up the measures, especially governance arrangements, to other districts.

Source: OECD (2023[18]) *Decarbonising homes in cities in the Netherlands: A neighbourhood approach.*

3.4. Tackling building-sector emissions from sources other than electricity

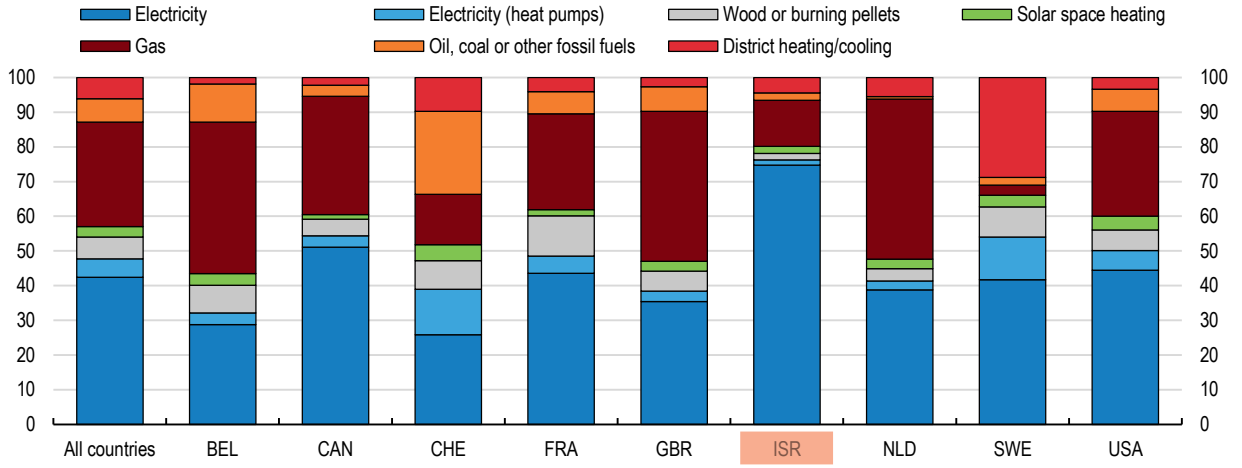
3.4.1. Reducing direct emissions from buildings implies a shift away from fossil fuel use

The use of gas for heating and cooking entails direct CO_2 emissions. Many households use liquefied petroleum gas (LPG) for cooking. A safety regulation mandates contractors to ensure that new residential buildings can be connected to LPG systems. Since decarbonisation implies a shift away from LPG towards electricity, this regulation will become obsolete, involving unnecessary costs. The authorities should consider repealing this regulation while maintaining safety.

A limited number of buildings, mostly in central urban areas, are connected to urban natural gas networks. Overall, gas (and oil) use in homes is much narrower than in other OECD countries (Figure 3.9). However, following the gas-field discoveries, the natural gas network has been extended to previously unserved urban areas. These extensions are questionable in relation of the decarbonisation objective, which requires that the burning of gas in buildings should ultimately be phased out.

Figure 3.9. A vast majority of households use electricity for space cooling and heating

Share of each response option



Note: This survey item asked respondents: "Which of the following energy sources do you use for space heating/cooling? Please select all that apply".

Sources: OECD (2023[19]), *How Green is Household Behaviour? Sustainable Choices in a Time of Interlocking Crises*, OECD Studies on Environmental Policy and Household Behaviour.

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Tax policy has a role to play to encourage the shift away from residual fossil fuel burning in buildings while preventing a potential spread of natural gas use in the current context of abundant domestic supply. To this end, the carbon tax would need to apply in full to all fossil fuels potentially used in buildings with equal rates per tonne of released carbon dioxide. The new carbon tax however applies a much lower rate to natural gas than liquid petroleum gas (LPG). The higher effective rate planned to LPG will encourage the end of LPG, but there is a risk of a switch by a number of buildings from LPG to natural gas rather than electricity. Increasing the carbon-tax rate on natural gas would mitigate this risk. Another condition for a switch away from burning fossil fuels in buildings is to keep the use of electricity untaxed or at levels ensuring that it remains competitive relative to natural gas. A more direct way of avoiding this risk is, as mentioned above, to stop new natural-gas distribution networks and over time retire existing ones.

3.4.2. Construction and demolition also have to reduce emissions

Additional CO_2 emissions occur when building as a result of the making of cement and other construction materials as well as their transport. Reducing CO2 emissions from cement-production is intrinsically difficult since they stem not only from the large required amount of energy, but also from the chemical reaction leading to cement. Demolition also has a GHG footprint, especially if refrigerant gases in cooling equipment are improperly captured.

The most direct way of reducing emissions from building is to use low-carbon materials. A number of countries have put in place requirements to account for all building emissions over their full life cycle (Box 3.2). To this end, one policy option is to require, as in Sweden since 2022, that new buildings come with a climate declaration which registers carbon emissions from producing and installing the materials used for construction (OECD, 2024[8]). Such a climate declaration, which also incorporates plans, facilitates the recycling and reuse of materials when the building ultimately gets demolished (OECD, 2022[17]). It also provides a basis for regulating or taxing the use of materials with high embedded carbon content. The Ministry of Environmental Protection has developed a database assessing the environmental impacts of construction materials (Ministry of Environmental Protection, 2024[20]). This initiative is welcome, as a national database gathering environmental declarations for construction products is an effective way of ensuring consistency and comparability in life-cycle assessments across the country (OECD, 2025[21]).

Box 3.3. Examples of regulating the carbon footprint of buildings over their life cycle

Evidence from the OECD Survey on Buildings and Climate

The OECD conducted in 2024 a broad survey on policies dealing on GHG emissions from buildings as well as their adaptation to climate change. One of the findings was that, in addition to more established policies that target emissions from the use of buildings, a group of countries are already regulating GHG emissions from buildings over their life cycle or including their construction stage (upfront carbon). Table 3.3 provides examples of such regulations.

Table 3.3. Examples of whole life carbon regulations in countries

Country	Finland	France	The Netherlands	Norway	Sweden
Year	2026	2022	2018	2023	2022
Regulation / standards	Building Act	RE2020	MPG	TEK17	Climate Declaration 2022
Target buildings	New buildings excluding detached houses.	New residential buildings and offices, and educational buildings.	New residential buildings, and offices.	New buildings, renovation for existing buildings.	New buildings.
Upfront carbon / whole life carbon	While life carbon.	Whole life carbon.	Whole life carbon.	Upfront carbon.	Upfront carbon.
Regulatory measures	Declaration, limit value.	Declaration, limit value.	Declaration, limit value.	Declaration.	Declaration.

Note: Countries that have reported having regulatory measures (mandatory declaration or limit value) for embodied/life cycle carbon in place.
Sources: OECD Global Survey on Buildings and Climate and (OECD, 2024[8])

3.4.3. Building patterns influence transport emissions

Urban form determines commuting patterns, facilitating or complicating public transport. Increased reliance over time on public transport is a central condition of the success of decarbonisation, as highlighted in the previous *Economic Survey* (OECD, 2023[22]). The prevalence of multi-family buildings in the residential stock puts Israel in a favourable position from this perspective by comparison with countries where housing

is more spread across single-family houses surrounded by gardens. Public planning should continue to facilitate high-density new development and the densification of already built areas: these ways of increasing supply (see Chapter 4) also facilitate public transport. Land-use planning and the allocation of building permits should be linked with transport planning to encourage higher-density development in proximity to existing or planned nodes of the public transport system (OECD, 2018[23]).

Buildings also need to contribute to the decarbonisation by allowing transport electrification. Since 2022, new residential buildings of six units and above need to be equipped with charging stations for every parking space, a requirement that also applies to commercial buildings since 2024. These are important regulatory advances, since the usual electrical fitting of large buildings is incompatible with charging many electric vehicles.

3.5. Adapting to a changing climate

Climate change has already started to impact Israel with effects that are going to intensify over coming decades, with buildings, especially homes, at the core of many sources of impact. The main threats to human well-being include extreme heat events, droughts and flash floodings, which are all becoming more frequent as well as more severe. The number of nights per year when the temperature stays above 20°C is anticipated to increase in Israel by 20 days over 2020-2050 from around 110 currently (Yosef et al., 2024[24]). Over the same period, the number of hot days - above 30°C- should rise by 12-20 days from 63 currently. The sea level could rise by more than one meter between 2020 and 2100 with a possible increase of nearly 1.9m in a worst-case scenario. Rainfall could fall by 10-24% over 2020-2100, especially in the northeast of the country. A systematic economic assessment of the impacts of climate change remains however lacking (State Comptroller of Israel, 2024[25]).

Public authorities launched in 2022 a vast whole-of-government effort to set up adaptation strategies. Government Decree 1902 foresaw that all ministries, as well as local governments, prepare adaptation plans by end-2024. The preparation of the plans led to a number of pilot initiatives including the incorporation of tree planting and shading in urban planning. Out of 258 municipal-level governments, 70 already finalised their adaptation plans in 2024 despite the difficult environment created by the war. Another 32 municipal-level governments are receiving financial and advisory support to complete their plans in 2025.

Adaptation is an important dimension of the newly mandatory green building standards alongside mitigation. The standards demand onsite rainwater run-off treatment to reduce the risk of flooding. They also encourage planting vegetation, which absorbs water and locally reduces temperature, and incorporating shading in the design of the building and its surrounding. Furthermore, the insulation requirements central to the standards have a dual function: while reducing energy needs for heating and cooling, they also provide a degree of protection against extreme heat events.

Urban planning also needs to evolve to prepare cities for climate change. The Israeli Planning Administration (IPA) in 2024 published a National Spatial Strategic Plan including a chapter on climate change adaptation to rising sea levels, precipitation reduction and extreme storms, desertification, and extreme heat. As laid out in the Planning for Urban Heat Guide also released in 2024, mitigating extreme heat requires adapted street geometry, shading, vegetation and the choice of light-reflecting materials. Land-use planning is also evolving to adapt the shoreline to a rising sea level and rivers' flood plains to an increasingly acute risk of flooding. The National Committee for Coastal Protection in 2024 updated its sea-level reference forecast implying specific construction restrictions in areas within 300 meters from the sea. Looking ahead, planning also should take account of the northward movement of the desert line and a rising risk of dust storms.

A large-scale risk-mapping exercise is underway to prepare these adaptations. Actively disseminating the results to the population can help people make forward-looking choices, which incorporate forthcoming effects of climate change, reducing subsequent adaptation costs. It is important that the results of the risk-mapping exercise, together with cost-benefit assessments of adaptation options, shape adaptation plans.

Furthermore, the management of run-off water is not only a matter for building standards but also for urban planning. The ratio of benefits to costs seems highly favourable for investment in this area (Israel Planning Administration, 2024[26]). Over 2013-2020, open claims filed against drainage authorities added up to NIS 793 billion (EUR 192 billion) while the estimated amount of required projects to manage them stands at NIS 6,6 billion (EUR 1.6 billion). Although projects of this nature typically cost more than initial estimates, often by a large factor, the benefits still appear to be large, even more so given the expected trend rise of flooding events. Nature-based solutions foreseen in the IPA Policy Guide for Run-Off Water Management, such as ensuring the presence of green space that can absorb run-off water, within urban areas combined with effective drainage systems, contribute to the management of run-off water for limited investment cost.

Besides public investment, adapting to flood risk is also a private-sector matter where insurers can facilitate action by providing price signals. Flood protection fully provided through public investment would prevent adjustment by builders and crowd out adaptation by landlords. Results would include unnecessary costs to the public purse and *de facto* subsidisation of building values while crowding out private insurance. Insurance markets can provide households with ways to buy protection from this risk while risk-based premiums create incentives to implement preventive measures or favour less exposed locations.

To the extent that intensifying climate damages imply increasing insurance premia over time, difficulties to afford home insurance can however arise for low-income households (Table 3.4). There can be scope for targeted public support to help low-income households to maintain coverage. It is important that insurance assistance does not blunt incentives to adapt. One way of doing so is to limit the amount of support to a fixed sum below the insurance premium so as to maintain incentives to implement protective measures and disincentives to build in highly exposed areas.

Table 3.4. Flood insurance affordability challenges: selected countries

	Evidence
Australia	Approximately 12% of Australian households are facing affordability challenges (premiums that cost more than 4 weeks of gross household income), among which approximately 14% may face unaffordable premiums due to high flood risk (as 50% or more of their premium is for flood coverage).
Belgium	Between 0% and 25% of households and businesses find flood insurance unaffordable.
Denmark	Between 0% and 25% of households and businesses find flood insurance unaffordable.
New Zealand	Insurance companies are, thus far, not broadly charging higher premiums to those at high-risk of flooding. Approximately 20% of high-risk households may face a premium charge of NZD 250 or more for flood coverage (approximately 10%-15% of average annual premium cost).
Romania	Between 25% and 50% of households find flood insurance unaffordable.
United Kingdom	One report estimated that the average premium paid by households in at risk areas is only about 10%-15% higher and only 4% of households decided to not purchase flood insurance because the premium for flood coverage was too high (and 3% because the deductible was too high) although FloodRe has indicated that this may be an underestimation as high-risk households can receive quotes that are 50-60% more costly. Approximately 14% of SMEs in at-risk areas chose not to acquire coverage for business interruption due to flooding as a result of high premium costs
United States	Approximately 30% of National Flood Insurance Program policyholders could face premium increases of more than 100% as a result of the transition to Risk Rating 2.0, leading 10 US states to initiate a lawsuit to block the premium rate increases.

Source: OECD (2026, forthcoming[27]), "The Design of Flood Risk Insurance Programmes."

Table 3.5. Recommendations to reduce GHG emissions and adapt to a changing climate

MAIN FINDINGS	RECOMMENDATIONS (key in bold)
Decarbonising power generation	
GHG emissions from power generation remain severely underpriced, as the carbon tax applies a low rate to natural gas.	**Increase the carbon tax rate on natural gas and gradually equalise effective tax rates per tonne of CO2 while providing targeted support to vulnerable adversely affected households .**
The power transmission grid is currently organised around fossil-fuel-fired power plants in the centre of the country while renewables will mostly expand in more peripheral areas.	Invest in the power transmission grid to accommodate future increases in renewable production.
Coal remains used to generate electricity (with a 17.5% share in 2023).	End the use of coal in power generation by 2026 as planned.
Building rooftops and already developed land are valuable locations for installing photovoltaic panels in a high-density country with scarce available land. A large-scale experimentation is on-going for dual use of farmland.	Facilitate the dual use of land for power generation.
Minimising electricity demand from buildings	
The new green building standards only apply to residential buildings of more than six units.	Extend the standard to individual houses and small residential buildings.
Building energy performance rating is mandatory only for new construction.	**Mandate the production of an energy performance certificate for sales of existing property and new rentals and consider gradually extending the requirement to existing buildings. I**
The development of a robust green building finance sector requires a reliable basis of shared and uniform definitions for high-energy-performance buildings	Complete the building chapter of the Israeli taxonomy for classifying sustainable activities.
The country-specific nature of the green building standard complicates the marketing of financial products backed by green buildings in international markets.	Enhance the international comparability and transparency of the green building standard. Consider adopting the same letter-based energy performance rating system as the European Union.
Tackling building-related emissions from other sources than electricity	
Using materials recycled from demolished buildings considerably reduces the carbon footprint of construction.	Consider requiring that every new building comes with a “digital passport” facilitating the recycling of its materials.
Built-environment geography largely determines commuting patterns as well as the deployment and use of low-carbon public transport. Land-use and public-transport planning remain incompletely linked.	**Tightly integrate land-use and transport planning including by promoting high-density development around nodes of the public-transport network.**
Adapting to a changing climate	
A large-scale climate-risk mapping exercise is underway. Local adaptation plans are being developed.	**Actively disseminate and integrate into adaptation plans the results of the ongoing climate-risk mapping.**
There appears to be a public infrastructure deficit for the management of run-off water, which is going to become increasingly problematic as episodes of extreme precipitation become more frequent and severe.	Ascertain needs for run-off management systems that are dimensioned with regards to future climate patterns and invest accordingly.

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4 Addressing the high cost of living

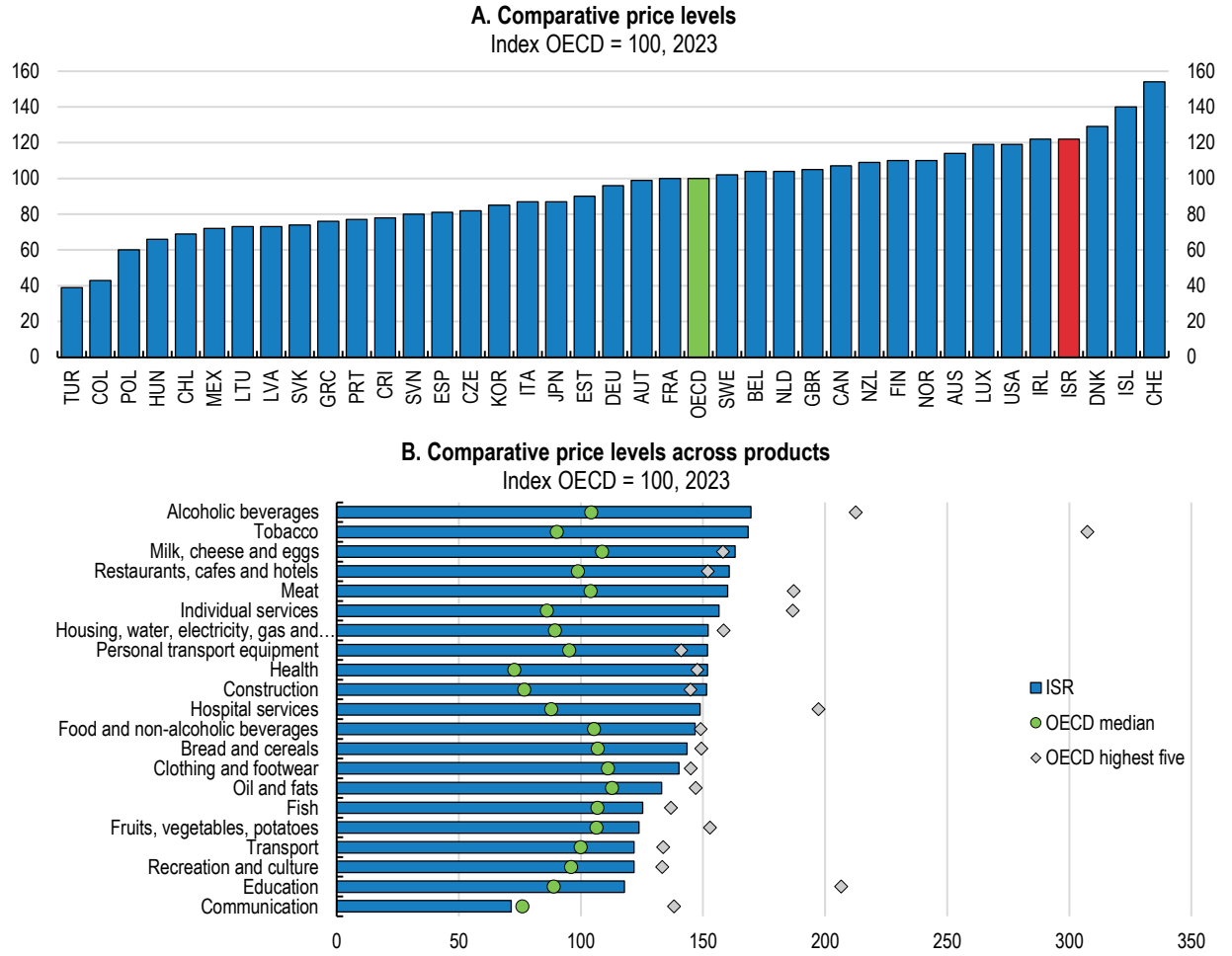
Erik Frohm, OECD

Israel has among the highest comparative price levels in the OECD, reducing welfare and spurring social tensions. A combination of geographical factors, trade barriers and stringent product market regulation have resulted in low competitive pressures, contributing to high prices of essential goods and services. Recent import reforms are expected to increase access to the Israeli market by enhancing border procedures and limiting technical barriers to trade. Continuing such trade liberalisation efforts alongside lower tariffs can help reduce import prices. Easing market entry and strengthening competitive pressures are essential to durably lower prices, strengthen productivity and increase incomes. Streamlining building and land regulations alongside changes to the taxation of properties could help increase the supply of housing, thereby reducing high housing costs.

4.1. Tackling the high cost of living to increase living standards

Over the past decades, Israel has significantly improved its living standards. GDP per capita has more than doubled since 2000, bringing it closer to the OECD average in 2022. Unemployment is low, and employment rates have rapidly improved. Inflation has been moderate, averaging 1.7% per year since the early 2000s, yet the price level of goods and services remains high in an international comparison. According to the OECD Purchasing Power Parity statistics, Israel's comparative price level is among the five highest in the OECD (Figure 4.1, panel A). Prices are comparatively higher than for the OECD median country for several essential goods and services, and among the highest in the OECD for food and housing (Figure 4.1, panel B). While international price comparisons are complex due to limited data collection, especially at more granular levels (see Box 4.1), methodological issues may not fully explain the relatively high price levels observed in Israel.

Figure 4.1. Israel has one of the highest price levels in the OECD



Notes: Comparative Price Levels (CPLs) are defined as the ratios of PPPs for private final consumption expenditure to USD exchange rates. They provide measures of differences in price levels among countries.
Sources: OECD Annual Purchasing Power Parities and exchange rates database; and OECD calculations.

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Box 4.1. Purchasing Power Parities to compare price levels across countries

Purchasing Power Parities (PPPs) are indicators that compare the relative value of currencies by measuring the amount needed to purchase a common basket of goods and services in different countries. While intuitive in theory and useful in practice, defining these common baskets, and collecting and comparing the necessary data, is challenging.

The OECD-Eurostat PPP-programme is part of the International Comparison Program (ICP), comprising more than 180 countries. In all, the OECD-Eurostat programme collects data under 189 basic headings, significantly less than most national consumer price indices (CPIs). In particular, the PPPs are constructed to measure price level differences across countries at a given point in time, and any price-level comparisons over time should be done with caution.

Overall, when measuring the price level domestically over time to asses the rate of inflation, it is more suitable to use the CPI. When comparing price-levels across countries in a given point in time, the PPP should be used. Although the PPPs are considered reliable at an aggregate level, comparisons for detailed sub-categories or products should be made with substantial care and consideration.

Source: (European Union/OECD, 2024[1]).

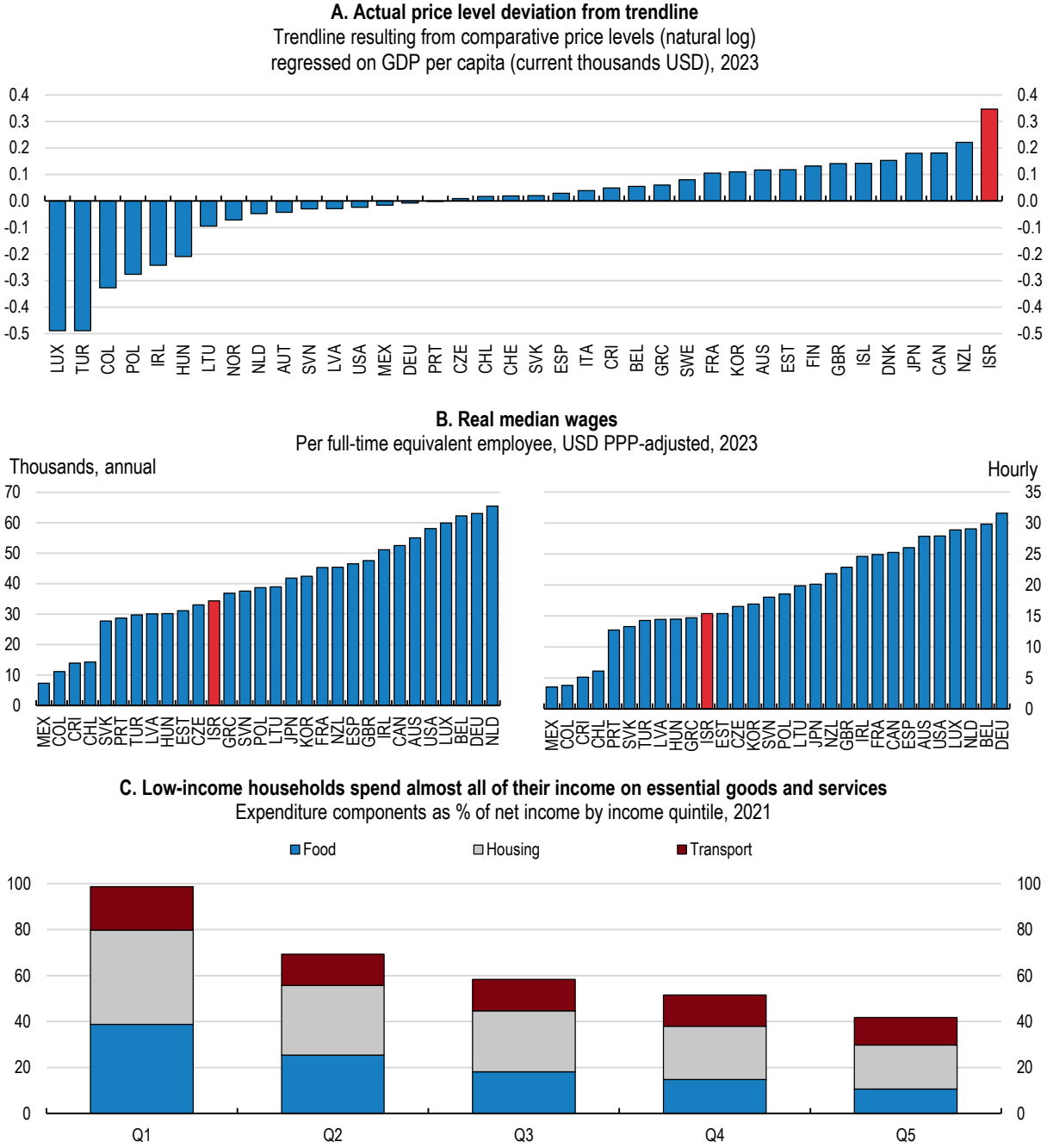
The high cost of living is a key challenge in Israel, leading to frequent protests and demands for solutions, notably the “tent” and “stroller” protests of 2011, and subsequent protests in the 2010s and 2020s. A survey conducted by the Israel Democracy Institute in May 2023, prior to the terrorist attacks on October 7, found that roughly one-third of respondents (the largest share) identified the cost of living as the most important policy concern (IDI, 2023[2]).

High prices are not necessarily evidence of economic distortions requiring policy intervention. Generally, countries with higher incomes have higher overall price levels. According to Balassa-Samuelson effects, this can be explained by productivity growth differentials between tradable and non-tradable sectors. Higher productivity in tradable sectors (like the high-tech sector in Israel) leads to higher real wages, which in turn drives up prices in non-tradable sectors. Economic welfare depends on the price of goods and services *relative* to incomes. However, Israel's comparative price level is also higher than expected based on its GDP per capita (Figure 4.2, panel A).

Other measures of households’ purchasing power are the average or median wages per full-time equivalents, deflated with the comparative price level for private consumption. Median wages per person or per hour are lower than the OECD average (Figure 4,2, panel B). Moreover, the share of full-time workers earning less than two-thirds of the gross median earnings of all full-time workers is among the highest in the OECD (OECD, 2023[3]). As such, high prices particularly impact lower-income households, who spend a substantial portion of their income on necessities, exacerbating inequalities. For example, households in the top fifth income bracket spend around two-fifths of their net income on essentials (housing, food and transport), whereas households in the bottom fifth spend almost all their net income on these items (Figure 4.2, panel C).

Several structural factors contribute to Israel's high prices. Challenging relations with some neighbouring countries limit trade and supply-chain integration, while creating geopolitical and economic uncertainties. Administrative red tape and planning obstacles reduce the supply of housing, a major household expenditure. Trade barriers and weak competitive pressures result in higher costs for companies and consumers. Limited competition and stringent product market regulations in many sectors hinders productivity gains that could translate into higher real wages and greater purchasing power. The economy is dual, with a highly productive high-tech sector alongside traditional low-productivity sectors employing most of the workforce (OECD, 2023[3]). To boost overall productivity and real wages, competitive pressures must increase and barriers to expansion be lifted.

Figure 4.2. Prices are higher than expected by GDP



Notes: In Panel A, Comparative Price Levels (CPLs) are defined as the ratios of PPPs for private final consumption expenditure to USD exchange rates. They provide measures of differences in price levels among countries. The comparative price levels are regressed on GDP per capita in 2022 for OECD countries. The bars show the deviation from the trend-line. Larger positive (negative) deviation indicates that prices are higher (lower) than what would be expected on the basis of GDP per capita.

Sources: OECD Annual Purchasing Power Parities and exchange rates database; OECD Annual National Accounts database; Israel Central Bureau of Statistics; and OECD calculations.

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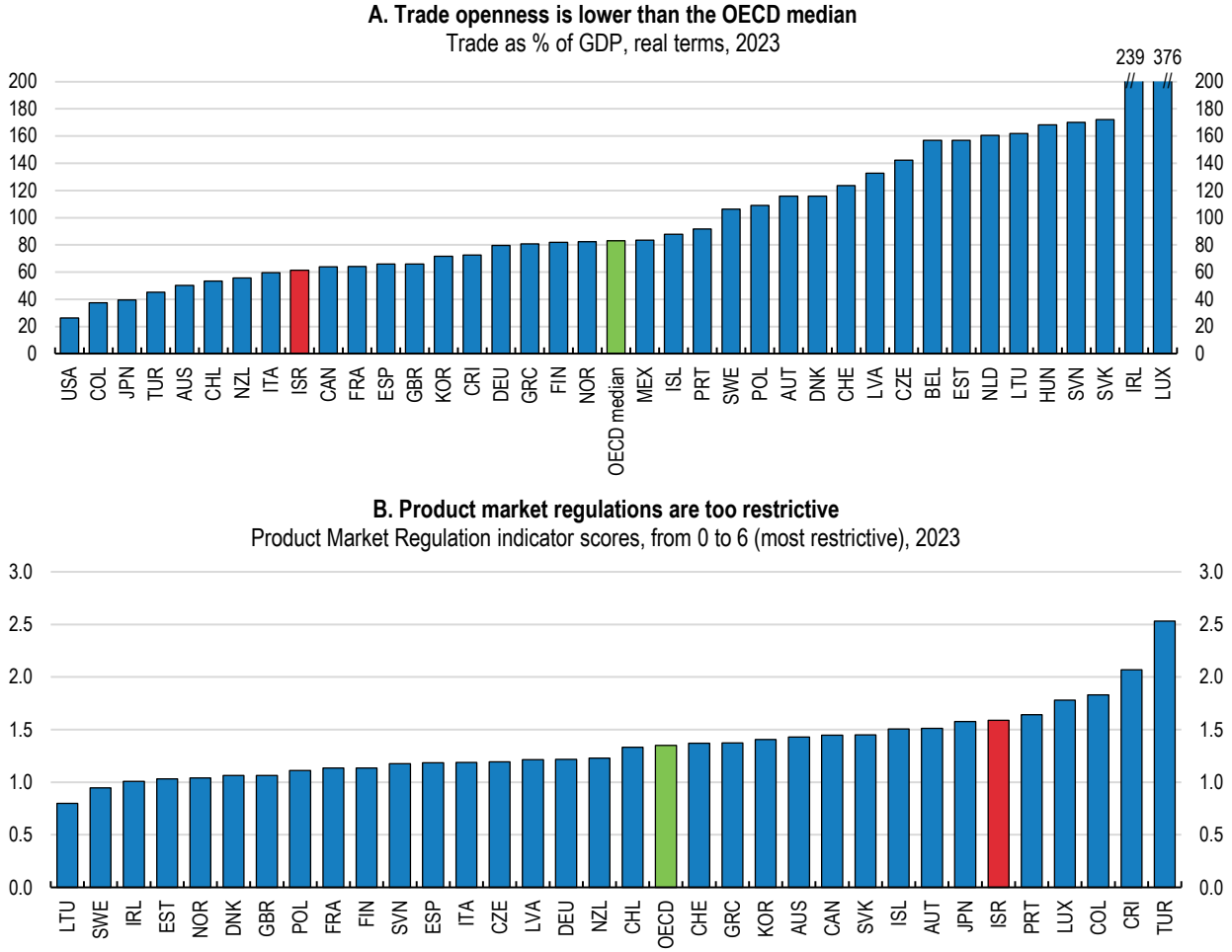
In real terms, Israeli exports have more than doubled since the turn of the century. Export volumes increased by 123% since 2000 and import volumes by 111%, broadly in line with developments in GDP (which increased by 124% over the same period). Israel's trade openness, defined as the trade-to-GDP ratio, is lower than the OECD median (Figure 4.3 Panel A). Despite improvements, barriers to trade and

investment remain, including tariffs, cumbersome administrative processes and red tape that increase import prices and diminish competitive pressures. Israel has pursed reforms in product markets over the past decade, yet scores poorly on the OECD's Product Market Regulation (PMR) indicator, pointing to substantial room for improvement to spur domestic competition (Figure 4.3 Panel B). Israel also lags behind many OECD countries in other rankings, such as the Fraser Institute Economic Freedom Index and the IMD World Competitiveness Ranking.

Addressing the high cost of living requires multiple approaches, including raising productivity to increase household disposable incomes, lowering import costs for companies, and fostering competition to pass on cost savings to consumers. Improving the supply of housing is crucial in reducing the largest expenditure for most households. A comprehensive policy package should focus on lowering trade barriers by implementing recent import reforms to enhance competition and reduce costs, streamlining regulations to facilitate market entry, and improve planning regulations to boost housing supply. These measures will help foster a more competitive and dynamic economy.

The next section will analyse policies to reduce trade barriers and lower import costs. The following section will discuss ways to reduce administrative burdens and increase competition. The final section will focus on policies to increase housing supply.

Figure 4.3. Trade openness is low and product market regulation stricter than among OECD peers



Notes: In Panel B, the Product Market Regulation (PMR) indicator is a composite index that encompasses a set of indicators that measure the degree to which policies promote or inhibit competition in areas of the product market where competition is viable.
Sources: OECD Economic Outlook: Statistics and Projections database; OECD Product Market Regulation database; and OECD calculations.
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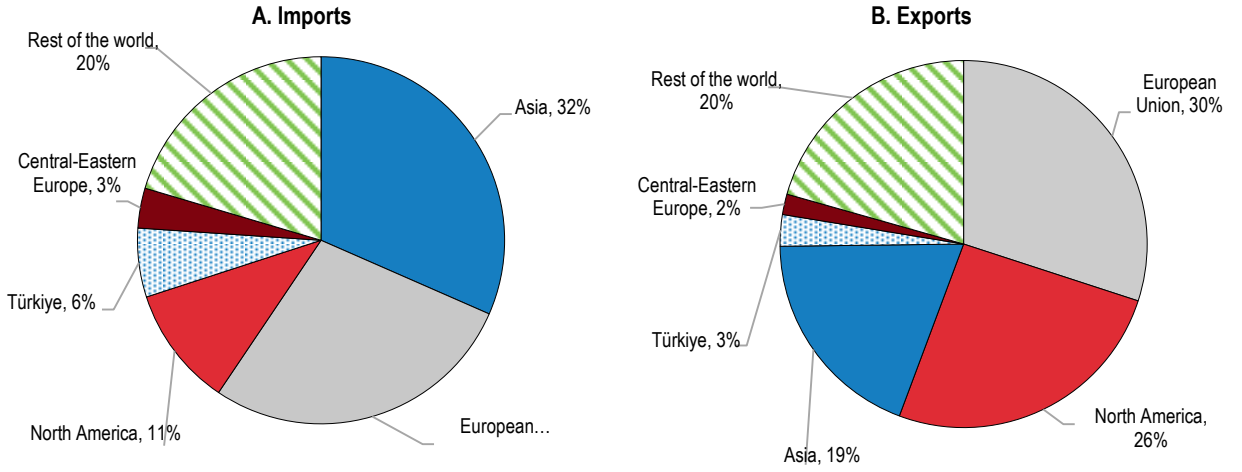
4.2. Lowering trade barriers to reduce import prices and boost competition

Israel has advanced in integrating into international trade and investment markets, in particular in the innovative high-tech sector. Exports of high-tech products accounted for 53% of total exports in 2023. The domestic value added from IT services in exports is among the highest in the OECD, highlighting the crucial role of high-skilled services in the Israeli economy. Israel's primary trading partners are EU member states, the United States, and Asian countries, notably China (Figure 4.4). Despite high trade exposure in certain sectors and substantial foreign direct investment, in particular in the high-tech industry (see Chapter 2 in this *Survey*), overall openness to trade and participation in global supply chains remains lower than in the average OECD country (Figure 4.5, panel A) and trade costs are comparably high (Figure 4.5, panel B).

Challenging relations with some neighbouring countries, geopolitical tensions and distance to key trading partners contribute to the low trade shares. Indeed, model-based estimates suggest that Israel's trade with other countries in the Middle East could be significantly higher, based on conventional gravity determinants (see Box 4.2). This considerable potential is confirmed by the surge in trade flows with signatory countries of the Abraham Accords following their signing in 2020 (see Box 4.3).

Figure 4.4. Israel's main trading partners

Trade in goods shares, %, 2023



Sources: Israel Ministry of Economy, Industry and Trade.

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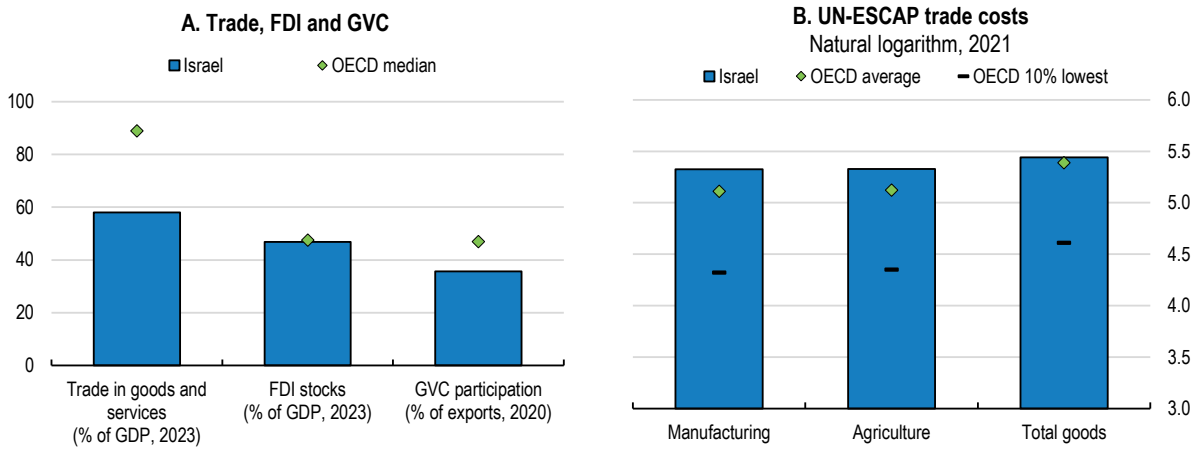
Israel has been been on a path of trade and agricultural liberalisation in the past decades and efforts are continuing (OECD, 2024[4]). The authorities have reduced central planning of agricultural industries, and changed the way production quotas, price controls and import protection are implemented. Major reforms in the agricultural sector began in the early 1990s to limit the role of the state in agricultural markets. Trade liberalisation efforts continued in the 2000s, with a focus on competitiveness and some efforts to limit interventions in the dairy and beef sectors, including by lowering tariffs. Free trade agreements have also been pursued to expand export markets and to increase import diversification. Since 2021, the government has renewed its impetus to boost imports by harmonising standards and simplifying customs processes to lower goods prices (OECD, 2024[4]).

Figure 4.5. Barriers limit trade



Notes: In Panel B, the effective trade costs are estimates of the costs involved with international trade relative to domestic activity from ESCAP-World Bank, averaged across destination economies in 2021.
Sources: OECD Economic Outlook: Statistics and Projections database; OECD FDI Statistics database; OECD TiVA database; ESCAP; and OECD calculations.

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Maintaining efforts to improve geopolitical relations and lowering barriers to trade through the implementation of recent import reforms would yield multiple benefits for the Israeli economy. It would lower the cost of importing goods and services further, increase competitive pressures, enhance productivity, and support wages and real incomes (Arkolakis, Costinot and Rodríguez-Clare, 2012[5]). Foreign competition would make markets more efficient, diversify imports, and lower prices (Bernard, Jensen and Schott, 2006[6]; Broda and Weinstein, 2006[7]). The gains from trade would likely benefit the poorest part of the population the most, as they typically spend more on imported goods (Fajgelbaum and Khandelwal, 2016[8]). The pro-competitive effects of reducing trade costs would likely drive out the least productive firms while encouraging more efficient ones to enter the market (Melitz, 2003[9]). To maximise the benefits of trade, it is essential to allow the dynamic reallocation of economic activity to ensure productivity gains are realised.

Trade costs can be further reduced through various measures. These include continuing to establish new free trade agreements, enhance existing ones, cut tariffs on agricultural products, further improve customs procedures, and reduce technical barriers to trade. Additionally, removing obstacles to foreign investment and services would increase competition, reduce import costs, boost productivity and lower the cost of living. Furthermore, improving the overall business environment, strengthening institutional quality and reducing corruption can serve as a comparative advantage in trade.

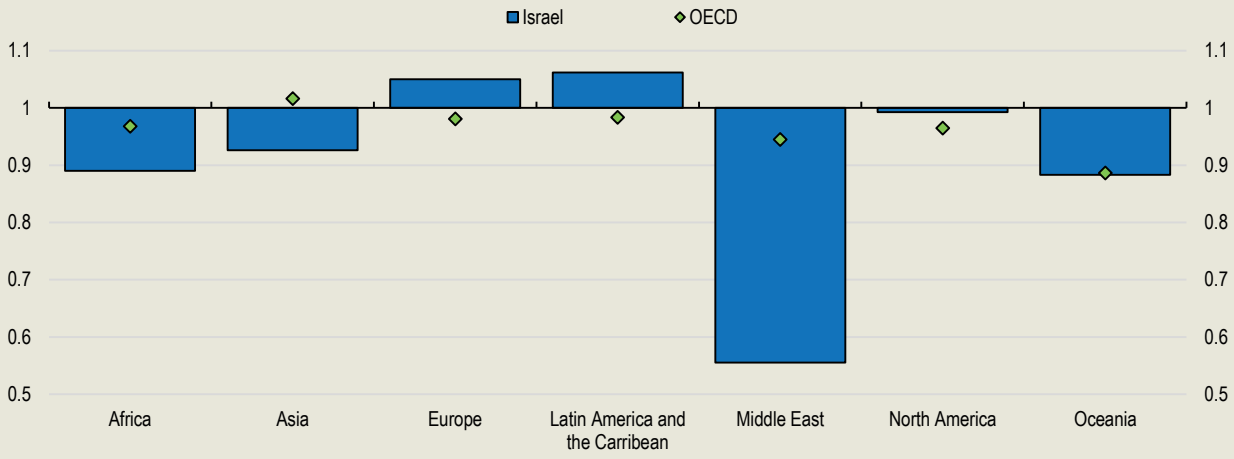
Box 4.2. Israeli trade in goods through the lens of a gravity model

The structural gravity framework is the main econometric tool to evaluate the effects of bilateral trade barriers on international commerce. The model, which uses a partial-equilibrium framework, relates trade flows between country pairs to total expenditures, output and total trade costs. By using data for 193 exporters and importers over 1996-2020 from CEPII's Gravity-dataset (Conte, Cotterlaz and Mayer, 2022[10]), this box leverages a standard empirical gravity model (Head and Mayer, 2014[11]; Yotov, Piermartini and Larch, 2016[12]) to examine Israel's trade with countries in different regions of the world. Bilateral trade costs are approximated by standard gravity variables (free trade agreement membership, the logarithm of geographical distance, as well as dummies for border contiguity, common colonial ties, the sharing of a language and religious proximity). Exporter-year and importer-year fixed effects control for multilateral resistance terms, capturing the relative ease or difficulty to trade between a given pair of countries in the context of their trade relationships with all other countries, as well as expenditures and output.

Figure 4.6 shows the ratio of actual to predicted trade flows, on average across years and countries in the sample, for seven geographical regions. If the ratio is equal to one, the model predicts trade flows perfectly and if the ratio is higher (lower) than one, actual trade flows are higher (lower) than predicted. The empirical model reasonably explains Israeli and OECD trade flows with most regions in the world. An exception is Israel's trade with countries in the Middle East, where trade flows are substantially lower than predicted by the model. One key reason is that challenging relations and geopolitical tensions that limit or prevent trade are not fully captured by the explanatory variables in the model. Based on conventional gravity determinants, there could be significant potential for trade with neighbouring countries as geopolitical tensions ease and relations improve. However, these estimates do not consider trade data after 2020, that saw the signing of the Abraham Accords and an expansion of trade with signatory countries (see Box 4.3).

Figure 4.6. Trade with the Middle East is lower than suggested by gravity determinants

Ratio of actual trade flows to predicted trade flows, in logarithms.



Sources: CEPII and OECD calculations.

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Box 4.3. Trade following the signing of the Abraham Accords

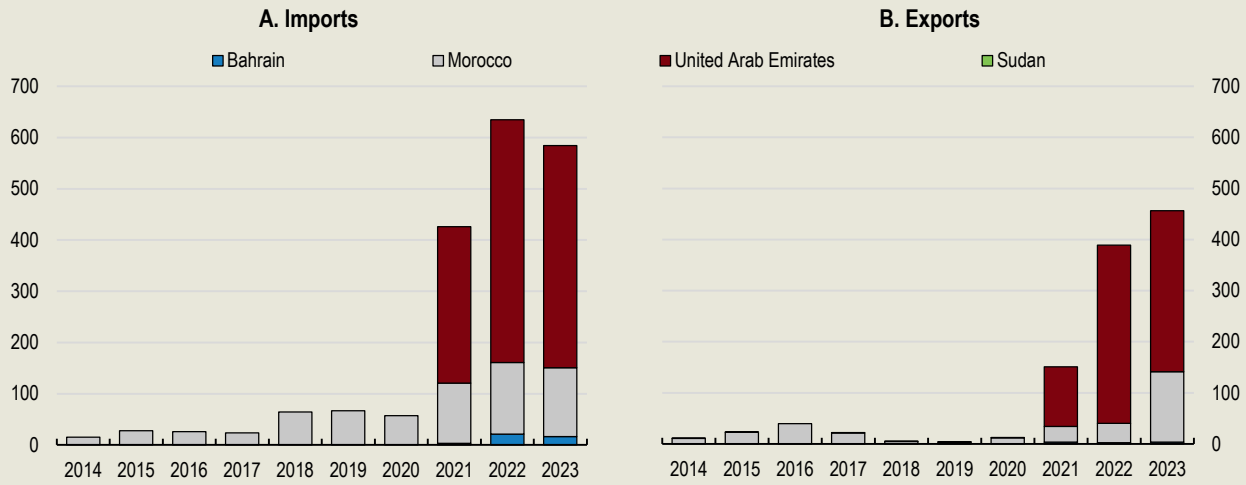
The Abraham Accords were signed in 2020, enabling diplomatic as well as other relations between Israel and signatory countries (Bahrain, Morroco, United Arab Emirates (UAE) and Sudan).

Participants in the Accords, as well as Saudi Arabia, began allowing Israeli airlines to use their airspace, enabling direct flights between the countries and shortening travelling times significantly. Moreover, the signatories commited to cooperation in tourism, security, communications, technology, energy, health, culture, and the environment. Travel and entry between Israel and the countries were made significantly easier. The tourism agreement includes provisions for family and economic tourism, as well as the creation of a joint tourism forum. The UAE also repealed a 1972 law that enforced an economic boycott of Israel and related sanctions. In 2023, a free trade agreement between Israel and the UAE came into force, further deepening relations.

Since the signing of the Accords, trade in goods between Israel and the signatory countries has surged, in particular with the UAE but also Morocco and Bahrain (see Figure 4.7). Due to threats from the Houthis in the Red Sea, land routes through Israel have become a less risky corridor for trade between Europe and Asia. As a result, the volume of cargo and goods passing through the Sheikh Hussein crossing (Israel-Jordan) and the Nitzana crossing (Israel-Egypt) has been increasing steadily. Even after the October 7 terrorist attacks, trade has remained resilient (AAPI, 2024[13]).

Figure 4.7. Trade has surged with Abraham Accords signatories

Trade in goods by partner country, millions USD



Source: Ministry of Economy, Industry and Trade of Israel.

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4.3. Deepening and extending new trade agreements

Signing new Free Trade Agreements (FTAs) and updating existing ones can substantially reduce trade costs and boost trade volumes (Baier and Bergstrand, 2007[14]; Bergstrand, Larch and Yotov, 2015[15]; Franco-Bedoya and Frohm, 2022[16]; Nagengast, Rios-Avila and Yotov, 2024[17]). Israel currently maintains 16 FTAs with 48 countries and economic blocs, including the European Union, the European Free Trade Association, the United States, and Mercosur. These agreements have generally led to significant increases in trade (Baier, Yotov and Zylkin, 2019[18]). Nonetheless, Israel's goods trade within its FTAs remains relatively low (Figure 4.8). Goods imports with FTA countries constitutes 53% of total goods

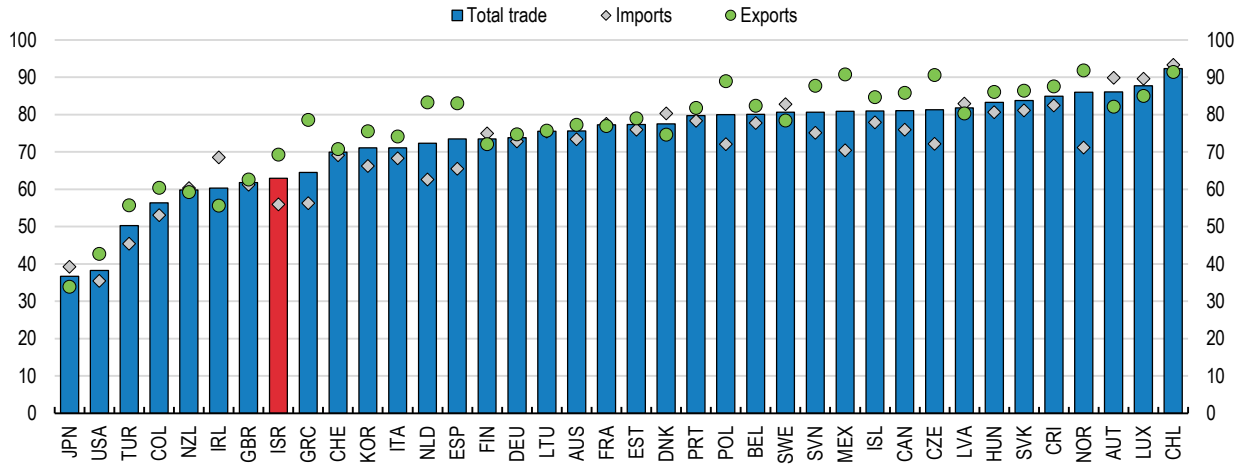
imports whereas exports within FTAs are higher, accounting for 70% of total goods exports. The relatively low share of trade in FTAs indicates potential for continuing to negotiate additional FTAs and deepening existing agreements.

The European Union is Israel's largest trading partner, governed by the EU-Israel Association Agreement in effect since June 2000. This agreement includes provisions on rules of origin, duties, services, industrial trades, cooperation in tourism, and transport, and prohibits customs duties on imports and exports between Israel and the EU. Agricultural trade was further liberalised in January 2010. Additionally, the Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA) in pharmaceuticals provides mutual recognition of pharmaceutical certification, removing barriers and facilitating trade. Furthermore, the EU's introduction of a carbon border adjustment mechanism could reduce the price competitiveness of Israeli exports to the EU unless Israel enacts more stringent environmental policies.

Israel's FTA with the United States was signed in 1985, eliminating duties on manufactured and some agricultural goods by 1995. However, the agreement allows both countries to protect sensitive agricultural sub-sectors with non-tariff barriers, such as import bans, quotas, and fees. The FTA contains detailed rules for merchandise trade, including investment and intellectual property provisions. The agreement also expresses an intent to eliminate barriers to trade in services like tourism, communications, and professional services, and a binding commitment to remove restrictions on government procurement.

Figure 4.8. Trade within free trade agreements is relatively low

Share of trade in goods with FTA-countries, %, 2022



Notes: The figure shows the share of goods trade within FTAs as a share of total goods trade, imports in goods and exports in goods respectively. The figures for Israel are from 2023.
Sources: BACI and Gravity database from CEPII and the Ministry of Economy, Industry and Trade in Israel.

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Israel and the United States concluded an additional temporary agreement on agricultural products in 1996, updated in 2004. Since 2009, this agreement has been extended annually through one-year extensions. Under the agreement, the United States grants Israel duty-free export access to 90% of agricultural tariff lines, while Israel reciprocates with duty-free access to 72% of agricultural tariff lines. Enhancing the share of duty-free imports from one of Israel's largest trading partners should be prioritised. This can be achieved by integrating the agreement into the Israel-United States FTA to solidify it.

The European Free Trade Association (EFTA) States (Iceland, Lichtenstein, Norway and Switzerland) signed an FTA with Israel in September 1992, which came into force in January 1993. Since then, the agreements have been modernised and expanded, notably through bilateral agricultural agreements effective from 2021. This FTA covers trade in industrial products as well as fish and marine products,

complemented by bilateral agricultural agreements with individual EFTA States, thereby creating a comprehensive free trade area.

Israel was the first country outside of the Americas to establish free trade with Mercosur. Israel's strong exports to Brazil materialised the trade potential in areas such as agro-tech. In efforts to strengthen import diversification and expand export markets, several new trade agreements have been negotiated and come into force in recent years. Since 2020, trade agreements have been signed and come into effect with Panama, Colombia, the Ukraine, the United Kingdom, South Korea, the United Arab Emirates (following the signing of the Abraham Accords), Guatemala and Vietnam. Moreover, Israel is currently negotiating revisions to its FTAs with the United Kingdom and is also pursuing new FTAs with several countries, including Costa Rica, Bahrain, China, and India. Continuing efforts to liberalise trade by extending existing agreements and finalising new ones is crucial for Israel's trade policy. The adoption of further preferential or free trade agreements that also include agriculture would continue to help diversify food import sources and increase export destinations.

4.4. Reducing agricultural tariffs to lower import costs

Over the past decades, import duties and tariffs have been reduced unilaterally across a wide range of products, with expected positive effects on prices and import volumes. For example, canned tuna duties were gradually reduced in Israel between 2013 and 2016 - from 27% to 12%. An assessment by the Israeli Competition Authority showed that consumer prices were substantially reduced and yielded NIS 38 million (USD 10 million) decrease in costs for households, compared to the NIS 11 million (USD 3 million) decrease in tariff revenues (Competition Authority, 2022[19]). In other cases, tariff decreases have not coincided with a reduction in prices (MoA, 2024[20]). Although a tariff reduction on specific goods or commodities may appear to have limited impacts on prices in the shorter term, their effects are likely to fully materialise over the medium to long term (Anderson and Yotov, 2023[21]).

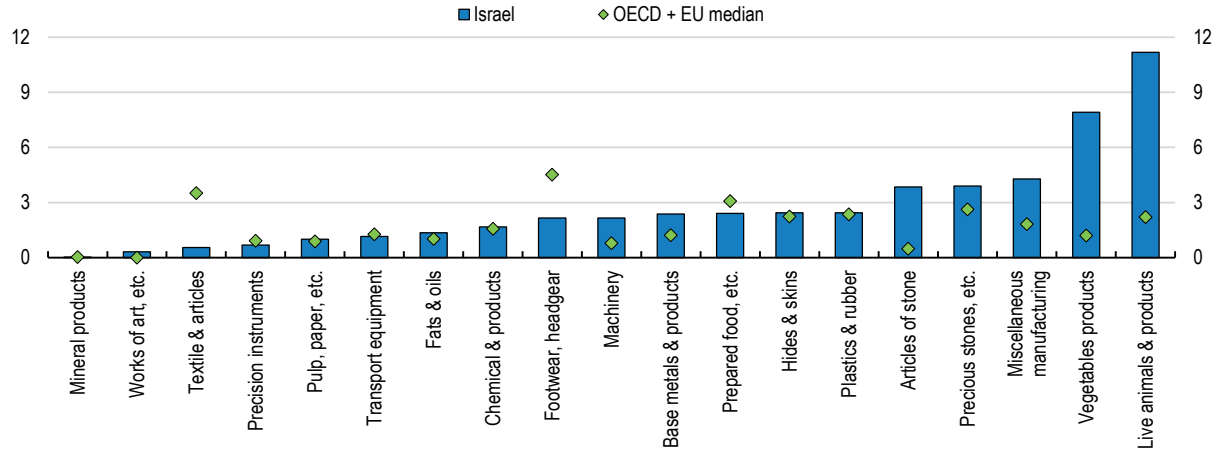
While overall tariffs have progressively decreased, many agricultural goods still face significantly higher tariffs than the OECD average, including animal products (such as poultry and sheep meat), various agricultural goods (dairy products and eggs), and certain fruits and vegetables (Figure 4.9). Trade barriers and price interventions have resulted in Israeli agriculture producer price levels being 12% higher than international prices between 2021 and 2023 (OECD, 2024[4]).

Half of agricultural imports entered Israel duty-free, primarily through Most Favoured Nation (MFN) access and preferential agreements (notably with the European Union and the United States). However, the Israeli tariff system remains intricate, involving specific, compound, or mixed duties (OECD, 2024[4]). In 2022, approximately one in five imported agricultural products were subjected to non-ad valorem rates, compared to around 3% for all goods. Except for beef, poultry, mutton, and their products, there is no legal requirement for imported food and agricultural products to be Kosher. However, products without Kosher certification command a much smaller market share (further details can be found in the next section of this Chapter) likely due to consumer preferences.

In 2022, the government introduced tariff reductions for several varieties of fruit, vegetables, and agricultural inputs to mitigate shortages and lower prices. Tariffs were abolished with immediate effect for specific vegetables and fruits (e.g. garlic, pineapple, avocado, mango) and agricultural inputs (plant propagation material, fertilisers and pesticides). For seven other selected fruit varieties and vegetables, duties were scheduled to decrease gradually over a five-year period to 10% of their January 2022 levels (OECD, 2024[4]). However, the planned tariff cuts were revoked in December 2023, due to concerns about domestic production capacity and divisions regarding support to farmers, with no resumption plans. Reinstating the planned tariff reductions would further liberalise the market for vegetables and fruits, thereby increasing supply and reducing prices.

Figure 4.9. Tariffs are high for agricultural products

Average effectively applied tariffs, %, 2022



Notes: Effectively applied tariff is defined as the lowest available tariff. If a preferential tariff exists, it will be used as the effectively applied tariff.
Source: World Bank, WITS-TRAINS database.

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Tariff protection and non-tariffs barriers shields Israeli agricultural producers from competition. One rationale for protecting the agricultural sector from foreign competition is the perceived necessity to secure domestic production of essential goods. Although such concerns may be persuasive, trade protection diminishes valuable competitive pressures, raising consumer prices and hampering productivity growth in the sector. Recent studies emphasise that lower trade integration reduces welfare (Cerdeiro et al., 2021[22]; Góes and Bekkers, 2022[23]; Attinasi, Boeckelmann and Meunier, 2023[24]). Furthermore, studies underscore that countries have more volatile GDP when trade is more restricted and conversely less volatile GDP when trade is more open (Arriola et al., 2020[25]; IMF, 2022[26]). This is because more open trade makes markets "thicker", by expanding the number of possible suppliers and buyers, helping companies to deal with supply-related risks if they occur (IMF, 2022[26]). Trade in agricultural products can also help ensure economic security in times of extreme weather events (Adenäuer, Frezal and Chatzopoulos, 2023[27]).

Efficiency gains in agriculture are vital, especially given the limited land in Israel, which has highly valued alternative uses such as housing construction or energy production. Despite innovation, the overall productivity of Israeli agriculture, as measured by total factor productivity (TFP), declined between 2011 and 2020 (OECD, 2023[28]).

By 2050, the Israeli population is projected to increase by 2 million (UN, 2024[29]). Failing to boost the supply of agricultural products will not only drive prices higher but may also result in shortages, as has occurred with butter in 2019 and 2020 and milk products in 2022 and 2023. Dairy products are heavily protected by tariffs in Israel, with milk facing about 40% tariffs, and are subject to centralised planning and government-approved quotas (see the next section). As milk prices are regulated and input costs rise, dairy farmers become reluctant to increase output, preferring to shift their sales to dairy products not subject to government control, leading to shortages of price-controlled milk.

To alleviate these shortages, the government approved temporary dairy tariff cuts in July 2023 to encourage cheaper imports, which were extended until January 2024 due to the October 7 terrorist attacks. These cuts should be made permanent to increase the supply of dairy products and reduce prices. Overall, agricultural tariffs should be reduced, and the tariff system should be simplified by eliminating non-ad valorem tariffs. Support to farmers could be shifted towards targeted direct payments in lieu of tariff protection, if needed. Such support should incentivise farmers to apply more sustainable practices and invest in productivity-enhancing equipment (OECD, 2024[4]).

4.5. Easing border processes and lowering service barriers to facilitate trade

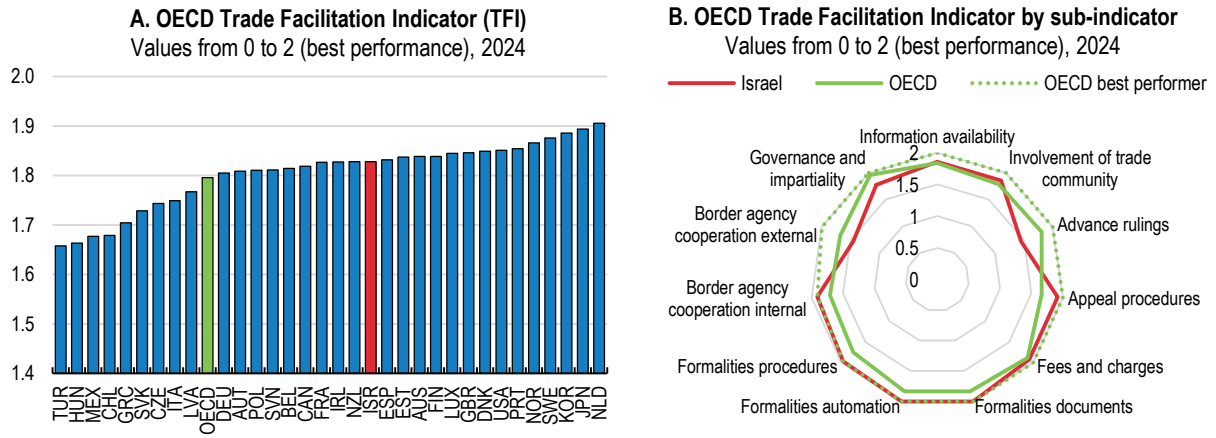
4.5.1. Improving trade facilitation

Cumbersome regulations and difficult border procedures are impediments to goods trade and raise import costs. To address such obstacles globally, the World Trade Organisation (WTO) introduced a Trade Facilitation Agreement (TFA) in 2013 that came in force in 2017. The OECD's Trade Facilitation Indicator (TFI) captures countries' progress on the TFA and its implementation.

Between 2012-2024, Israel improved its value on the TFI by roughly 0.1 index points per new wave. Several reforms have been undertaken over the past decade, further facilitating trade. Notably, the "Cornflakes Law," enacted in 2016, aimed to ease the importation of dry goods such as rice, crackers, and cereals (hence its nickname). This legislation authorised importers to declare items without prior regulatory or foreign manufacturer approvals. This streamlined process enabled importers without exclusive agreements with foreign food manufacturers to source goods from alternate suppliers. The legislation also facilitated swift customs clearance (within one day) upon submission of accurate and pertinent documentation.

Since the last collection of the TFI in 2022, changes in several areas covered by the indicator have been undertaken. In particular, the "No stopping at the Port" reform entered into force in July 2024. With the changes, thousands of products imported to Israel that previously had to comply with mandatory standards checks are no longer stopped at the ports for inspections, or for the issuing of approval certificates. Instead, the Israeli authorities use market monitoring based on risk assessment, like the approach used in other developed markets. Additional reforms entered into force in January 2025, further easing border procedures alongside an alignment with international technical standards for consumer goods, food and cosmetics.

Figure 4.10. Trade facilitation has improved



Notes: "Trade facilitation" refers to a specific set of measures that streamline and simplify the technical and legal procedures for products entering or leaving a country to be traded internationally. Trade facilitation covers the full spectrum of border procedures, from the electronic exchange of data about a shipment, to the simplification and harmonisation of trade documents, to the possibility to appeal administrative decisions by border agencies.
Sources: OECD Trade Facilitation Indicators (TFIs) database.

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Information accessibility has improved, appeals procedures and document formalities become more streamlined and collaboration among border agencies have been enhanced (Figure 4.10, panel B). Achieving even better border cooperation with more neighbouring countries may pose challenges in the current environment, yet it remains a priority.

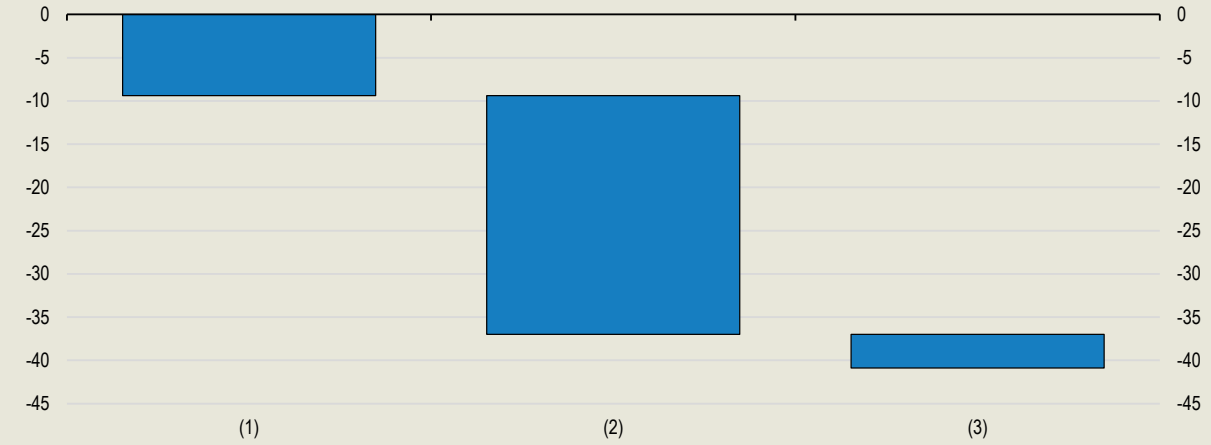
Box 4.4. Reducing trade costs through trade facilitation

This box draws on findings from (Frohm, Forthcoming[30]) to quantify potential reductions in trade costs achievable through enhanced trade facilitation measures in Israel. Using illustrative scenarios, this Box assesses the trade cost reduction that could be implied by import reforms that altered Israel's Trade Facilitation Indicator (TFI) between 2022-2024, and the additional gains that could be had from improving towards that of top-performing OECD countries.

The estimates suggest substantial reductions in distance-related trade costs. The change in the trade facilitation-related measures between 2022 and 2024 is estimated to have reduced distance related trade costs by 9% (Figure 4.11). Improving the Israeli TFI towards the OECD top 5 performers, excluding external border cooperation, has the potential to lower trade costs by an additional 28 percentage points. Also improving external border cooperation towards the OECD top 5 performers would slash trade costs by an additional 4 percentage points.

These illustrative scenarios underscore the pivotal role of Israeli customs procedures in either facilitating or hindering trade. Unlike traditional trade policies such as tariffs, which often encounter political contention, enhancing administrative processes through improved trade facilitation measures may encounter fewer divisions. Streamlined customs procedures that are straightforward to navigate can minimise distance-related trade costs and enable Israel to realise the full benefits of international trade.

Figure 4.11. Estimated trade cost reductions of improving the Israeli Trade Facilitation Indicator



Notes. (1) represents a simulated change in the TFI between 2022-2024. (2) would be the additional impact of improving the TFI towards that of top 5 OECD performers. (3) is the estimated additional effect from improving external border cooperation towards the OECD top 5 performer.
Source: Frohm (Forthcoming[30]).

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While both small and large companies typically benefit from an improved trade facilitation environment, smaller enterprises tend to experience greater advantages (López González and Sorescu, 2019[31]; Fontagné, Orefice and Piermartini, 2020[32]). Enhancing trade facilitation can thus facilitate further internationalisation of SMEs, while streamlining border procedures would reduce costs for businesses and stimulate trade. The changes in Israel's TFI from 2022 to 2024 are estimated to have reduced distance related trade costs by around 9%. If Israel would further improve its TFI towards the OECD best five performers, across all domains except external border cooperation, its distance-related trade costs could decrease by 37% in total (see (Frohm, Forthcoming[30]) and Box 4.4).

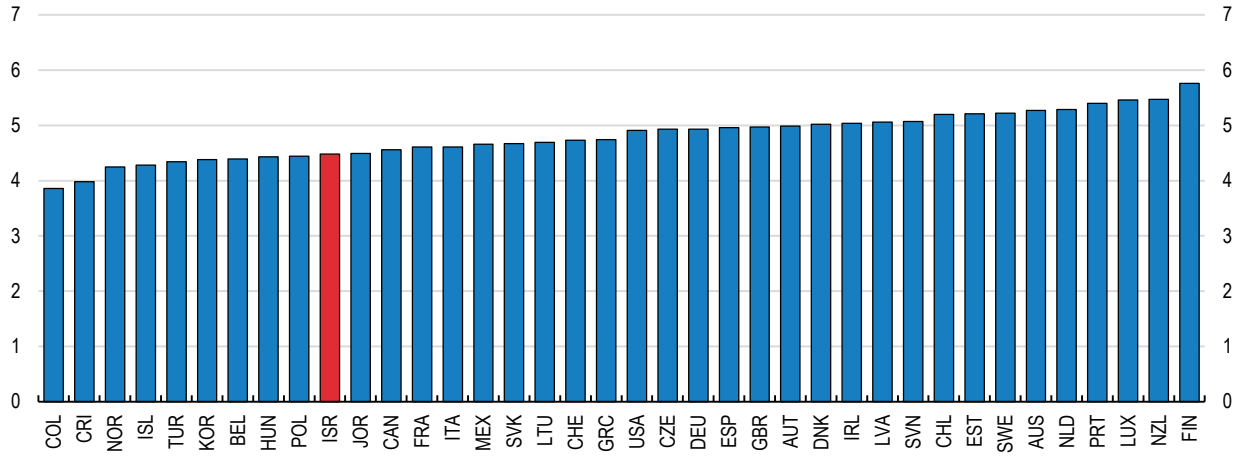
To streamline border procedures further, additional support for companies in utilising advance rulings systems, particularly SMEs, could prove beneficial. Several OECD countries like the United States, Canada, and Japan as well as the European Union utilise advanced rulings as part of their customs processes. Within the EU, member states offer binding decisions for up to three years, enhancing trade predictability for importers across the region. The systems help streamline cross-border trade by providing certainty and reducing potential delays or disputes at borders (European Commission, 2024[33]). Extending the validity period of advance rulings and expanding the coverage of the Authorised Operator programme to encompass more companies and SMEs would ease imports.

4.5.2. Reducing transactions costs by addressing technical barriers to trade

Israel imposes several technical barriers on imports. Regulatory standards and labelling requirements often differ from those of its major trading partners and are specific to the Israeli market (WITS, 2016[34]). A higher share of respondents in the World Economic Forum's Executive Opinion Survey responds that non-tariff barriers limit the ability of imports to compete in the domestic market than in most other OECD economies (Figure 4.12). Due to its relatively small market size, technical divergences diminish incentives for potential exporters to trade with Israel, as they increase costs associated with adapting product descriptions and content labelling. Such barriers restrict market entry, suppress trade volumes, and elevate prices (Fontagné et al., 2015[35]).

Figure 4.12. Non-tariff barriers are impeding import competition

Prevalence of non-tariff barriers indicator, from 0 to 7 (least impeding), 2019



Notes: The *Prevalence of non-tariff barriers indicator* is built on information collected through the World Economic Forum Executive Opinion Survey, more specifically on the following question: "In your country, to what extent do non-tariff barriers (e.g., health and product standards, technical and labelling requirements, etc.) limit the ability of imported goods to compete in the domestic market?" and on the following possible range of answers: from 1 = "strongly limit" to 7 = "do not limit at all".
Source: World Economic Forum Global Competitiveness Indicators (WEF-GCI).

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The authorities have made significant strides in addressing technical barriers to trade. The import reform of 2022 marked a shift in standards implementation, moving towards declaration-based processes rather than border inspections for various products (children's products, electronic products, and eyeglasses), while simultaneously enhancing market enforcement. Previously, all products required approval from relevant regulators prior to release, whereas the reform enabled certain products to enter without prior regulatory clearance. For food and cosmetics, the import reform in 2022 expanded the number of products available for a declaration-based track, instead of inspected, and was implemented in 2023, with a significant reduction in bureaucratic burden and time savings (MoEI, 2022[36]). The legislation adopted EU regulations on chemical and biological pollutants, pesticide residues and mercury compound residues, with

exemptions for certain fresh goods, fruit and vegetables. Building on this success, the import reform of 2024 expanded the range of non-sensitive products eligible for declaration-based processing. The import reforms are welcome and will reduce barriers to trade, ease importing of non-food and food products, reduce red tape and help reduce import prices.

Additionally, the "What is good for Europe is good for Israel" reform approved by the Knesset in July 2024 and in force since January 2025 seeks to align Israeli regulatory requirements with those of the EU for multiple product categories (roughly 90% of consumer products, foods and cosmetics). This initiative entails that products deemed safe for consumption or use in the EU would not require separate testing in Israel if importers can demonstrate their legal market status within the EU. Moreover, the legislation aims to encourage parallel imports to compete with importers with exclusive arrangements. A parallel import is a non-counterfeit product imported from another country without the permission of the intellectual property owner. For example, the European Union generally allows parallel imports under the principle of "exhaustion of rights," meaning once a product is sold within the EU by the trademark owner or with their consent, it can be freely resold within the EU. Other OECD countries, such as Australia, New Zealand and South Korea, also treat parallel imports as a means of promoting competition and consumer choice.

The Israeli government estimates that full implementation of the reform can generate savings of NIS 6 000 per year (USD 1 600) for an average household. Implementation of the new legislation is planned for January 2025 and the reform represents a significant step towards reducing bureaucratic hurdles in trade and significantly facilitating imports from Israel's primary trading partner. Maximising the inclusion of products under this reform and minimising exemptions is crucial to heightening competitive pressures and lowering import prices. The reform requires line ministries to flag non-aligned Israeli-EU regulations by early 2025 and then adjust them to match EU standards. It is important that these changes are prioritised to remove regulatory barriers and make imports easier. Failing to do so would lessen the expected positive effects on product variety and prices.

4.5.3. Lowering barriers to services trade and investment

Services trade in Israel is more restricted compared to the average OECD country, as indicated by the OECD Services Trade Restrictiveness Index (STRI) (Figure 4.13, panel A), with modest progress observed over the past decade. The most significant constraint lies in barriers to foreign market entry, affecting all sectors. This is reflected in a high value in the OECD FDI Restrictiveness Index and a relatively low presence of foreign multinational enterprises in the Israeli market (Figure 4.13, panels B and C).

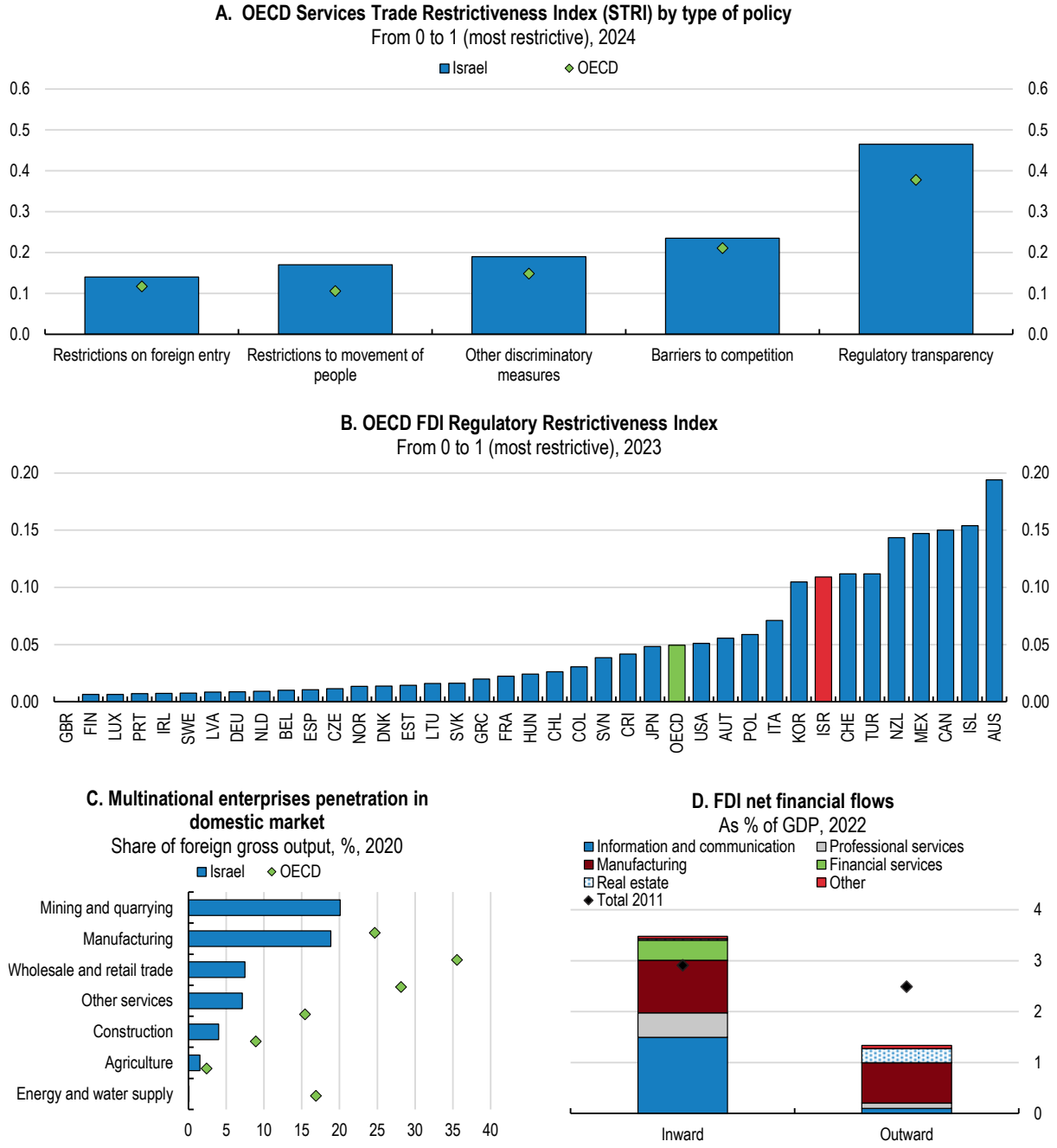
Openness to FDI allows capital and ideas to flow, contributing to innovation. By contrast, barriers to FDI hamper an important source of productivity spillovers. In Israel, inward FDI flows have increased steadily over the 2010s and 2020s, and been relatively resilient following the October 7 terrorist attacks (see Chapter 1 in this *Survey*). An important destination of inward FDI is the high-tech sector including for AI development over the past decade (see Chapter 2 in this *Survey*).

New entrants or their potential entry can heighten competitive pressures and reduce prices in relevant markets. While the short-term impact on trade from liberalising services may be modest, the long-term effects are typically substantial (Benz, S et al., 2023[37]). Services also serve as inputs in other sectors like manufacturing, thereby playing a pivotal role in coordinating the flow of goods, capital, and knowledge across different locations. Reducing trade costs in the services sector can thus spill over to other parts of the supply chain and enhance efficiency across sectors (Benz and Jaax, 2020[38]).

Israel could draw lessons from several OECD members that have implemented specific visa schemes for contractual services suppliers and independent professionals to liberalise services trade. For instance, the EU-Canada Comprehensive Economic and Trade Agreement (CETA) and the EU-UK agreement include provisions that facilitate cross-border services trade. Extending the duration of stay for all service providers and issuing work permits for spouses would enhance the attractiveness of the market for foreign service

providers. Another example involves mutual recognition of regulations and domestic standards, akin to the UK-Switzerland Mutual Recognition Agreement for financial services in 2023 (Gov.UK, 2023[39]).

Figure 4.13. Barriers to services trade and foreign direct investment are relatively high



Notes: In Panel A, STRI indices take the value from 0 to 1. Complete openness to trade and investment gives a score of zero, while being completely closed to foreign services providers yields a score of one. In Panel B, the OECD Foreign Direct Investment Regulatory Restrictiveness Index (FDI RRI) measures four types of statutory restrictions on FDI: 1) foreign equity restrictions, 2) screening and prior approval requirements, 3) rules for key personnel, and 4) other restrictions on the operation of foreign enterprises. The FDI RRI is a composite index that takes values between 0 and 1, with 1 being the most restrictive. In Panel D, information and communication together with professional services make up most of Israel's high-tech sector.

Sources: OECD Services Trade Restrictiveness Index (STRI) database; OECD FDI Regulatory Restrictiveness Index database; and OECD Analytical Activity of Multinational Enterprises (AAMNE) database.

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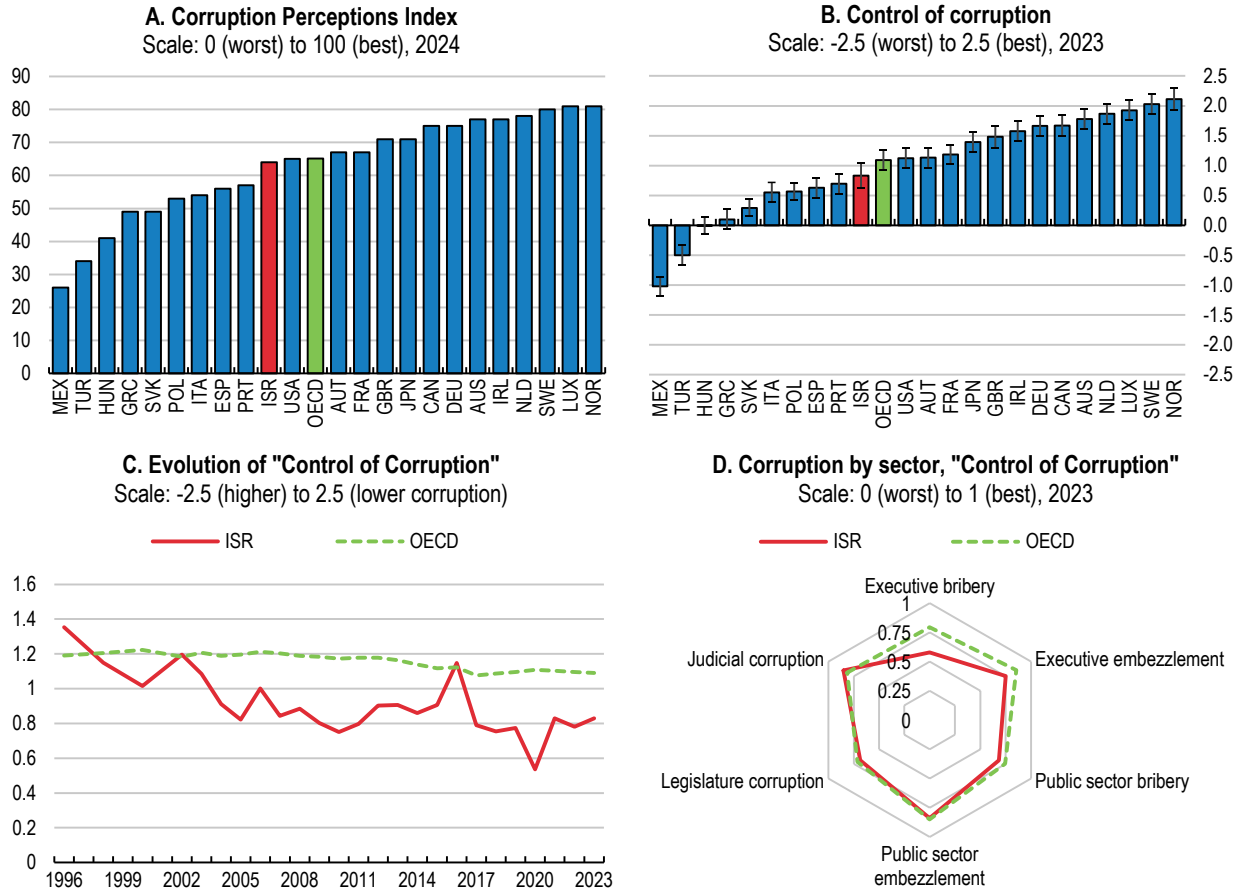
4.5.4. Continuing to reduce corruption to strengthen trade and growth

Ensuring the rule of law is a key foundation of economic growth. By contrast, corruption hampers economic development and erodes public resources. Judicial independence and checks and balances are vital for a strong anti-corruption and public integrity framework, laying the foundations for a solid business environment. Moreover, a strong anti-corruption and public integrity system can help lower trade costs (see Box 4.5), by ensuring that public resources are efficiently allocated and businesses operate in an favourable environment. This helps to attract investments and reduce transaction costs, both domestically and externally, by fostering citizens' trust in public institutions (OECD, 2022[40]; OECD, 2024[41]; OECD, 2023[3]). In Israel, perceptions of corruption are at the OECD average (Figure 4.14).

Figure 4.14. Perceptions of corruption are at the OECD average



Notes: Panel B shows the point estimate and the margin of error. Panel D shows sector-based subcomponents of the "Control of Corruption" indicator by the Varieties of Democracy Project.

Sources: Panel A: Transparency International; Panels B & C: World Bank, Worldwide Governance Indicators; Panel D: Varieties of Democracy Project, V-Dem Dataset v12.

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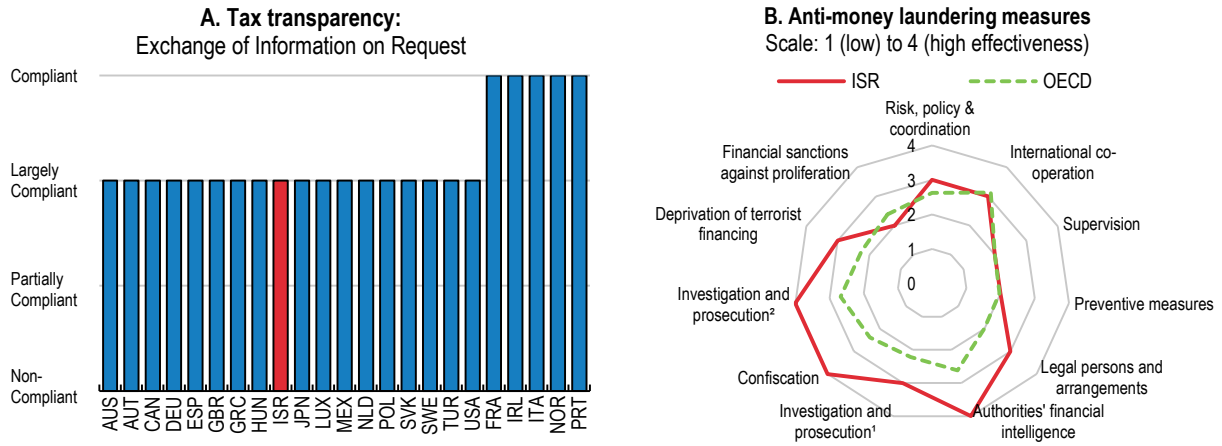
The latest OECD Anti-Corruption and Integrity Outlook provides an overview on the accountability of public policy making in Israel (OECD, 2024[42]). For instance, lobbying regulations are not fully in line with OECD standards, as the definition of lobbying and lobbyists is incomplete and fail to include sanctions for breaches of related transparency and integrity standards (OECD, 2024[41]; Broyde, 2021[43]; The Israel Democracy Institute, 2013[44]). Regarding conflicts of interest, the country has fulfilled almost 90% of OECD criteria in terms of regulations but has only implemented around 20% of standard practices, against OECD

averages of 76% and 40% respectively. However, sanctions for conflict-of-interest- related violations are prescribed and implemented in practice.

Rules are in place for "revolving doors". For example, cooling-off periods are mandatory for post-employment activities of public officials, which safeguards transparency and may help improve public trust in institutions (OECD, 2023[45]). In terms of transparency and integrity in political financing, Israel is also performing well. National regulations prohibit financial contributions from anonymous donations, foreign states/enterprises and publicly owned enterprises, which is not the case in a number of OECD countries, in particular as far as anonymous donations are concerned. Israel also has an independent body overseeing the financing of political parties. However, the regulation in this area should be accompanied by more effective enforcement measures: for example, even if political parties must publish financial reports, not all of them comply with this requirement (OECD, 2024[42]).

In the area of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT), Israel has made progress over the last two decades. It has evolved from being labelled a "non-cooperative" country to joining the OECD Financial Action Task Force (FATF) in 2018 as an official member. In 2002, Israel established an independent intelligence authority, the Money Laundering and Terror Financing Prohibition Authority (IMPA) within the Ministry of Justice, which has a leading role in AML/CFT and the application of the international standards set by the FATF (Government of Israel, 2024[46]). According to the latest FATF review in 2022, the country has achieved good results in tackling AML/CFT-related crimes, including through awareness of heightened risk exposure due to its geographical location, prosecution, effective use of financial intelligence, as well as expropriation of criminal organisations' assets (Figure 4.15). Nonetheless, the FATF found that supervision and prevention measures could be further improved (FATF, 2022[47]).

Figure 4.15. Anti-money laundering measures are effective in many areas



Notes: Panel A summarises the overall assessment on the exchange of information in practice from peer reviews by the Global Forum on Transparency and Exchange of Information for Tax Purposes. Peer reviews assess member jurisdictions' ability to ensure the transparency of their legal entities and arrangements and to co-operate with other tax administrations in accordance with the internationally agreed standard. The figure shows results from the ongoing second round when available, otherwise first round results are displayed. Panel B shows ratings from the FATF peer reviews of each member to assess levels of implementation of the FATF Recommendations. The ratings reflect the extent to which a country's measures are effective against 11 immediate outcomes. "Investigation and prosecution¹" refers to money laundering. "Investigation and prosecution²" refers to terrorist financing.

Sources: OECD Secretariat's own calculation based on the materials from the Global Forum on Transparency and Exchange of Information for Tax Purposes; and OECD, Financial Action Task Force (FATF).

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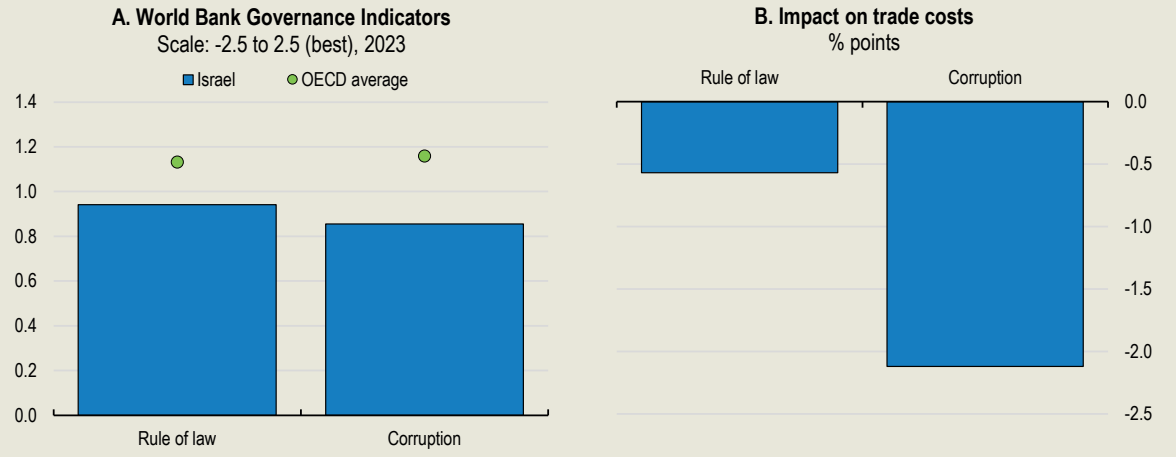
Box 4.5. Improving the rule of law and lowering corruption can help reduce trade costs

Good institutions can act as a source of comparative advantage, whereas poor institituional quality creates frictions that can hamper trade by raising transactions costs. This box utilises the empirical results from (Frohm and Quagiletti, Forthcoming[48]) to provide illustrative estimates of the long-term trade cost reductions that could be achieved if Israel improved some of its institutional qualities towards the OECD average. The analysis relies on the World Bank Governance Indicators developed by (Kaufmann, Kraay and Zoido-Lobatón, 1999[49]) which are widely used indicators in analyses of the effects of institutions on economic activity and trade.

Overall, Israel performs better than the OECD average in the World Bank Governance Indicators. At the same time, there is scope for improvement, for example in terms of rule of law and control of corruption (Figure 4.16, panel A). By leveraging the baseline empirical results from (Frohm and Quagiletti, Forthcoming[48])), based on data for 164 origin countries and 88 destination countries over 2001-2021, the illustrative simulations show that Israel may have scope to reduce its overall trade costs by 2.6 percentage points by improving its control of corruption and rule of law, see Figure 4.16, panel B.

Of these areas, bringing control of corruption towards that of the average could yield a two percentage points trade cost reduction, whereas improving the rule of law would yield roughly 0.6 percentage point in trade cost reduction.

Figure 4.16. Institutional quality and trade costs



Notes: Panel A shows Israel's and the OECD average score on select World Bank Governance Indicators. Panel B shows the estimated trade cost reduction that can be achieved if Israel would improve its score on the indicators toward the OECD average.
Source: (Frohm and Quagiletti, Forthcoming[48]).

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In terms of accountability of public policy making and AML/CFT, the country's system is broadly in line with the OECD and FATF standards (OECD, 2024[50]; FATF, 2022[47]). However, some progress could occur in areas such as the implementation of more effective enforcement measures in the context of financial reporting of political parties and conflict of interest, as well as in AML/CFT supervision and prevention measures. Overall, Israel should continue to strengthen its anti-corruption and public integrity system. This could also help to lower corruption perception and improve trust in public institutions, contributing to overall economic performance.

Persistent market inefficiencies and concentrated markets may initially limit the welfare gains when trade barriers are reduced. A low level of domestic competition and barriers to entry can enable companies to

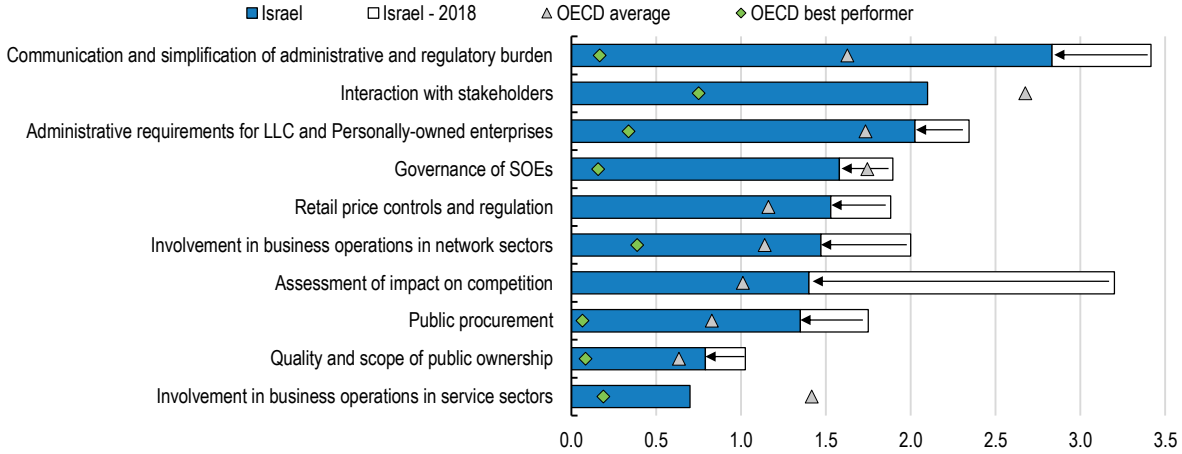
translate lower import costs into increased profits rather than passing savings on to consumers through lower prices. Improving the functionality of product markets and reducing entry barriers are critical steps towards fostering competition, boosting productivity and raising real incomes.

4.6. Enhancing competition to spur productivity and lower prices

Over the past five years, Israel has implemented several reforms to enhance the functioning of its product markets and to increase competition (Figure 4.17). In 2021, the governance of state-owned enterprises (SOEs) was strengthened by clarifying their financial objectives and establishing guidelines for setting mandatory financial indicators and targets. The establishment of the Israeli Regulation Authority in 2022 marked a further step towards improving regulatory quality by revising the quality of regulatory impact assessments (RIAs). Nonetheless, Israel performs worse than the OECD average in the 2023-2024 Product Market Regulation (PMR) indicators, indicating considerable scope to enhance competition in several areas.

Figure 4.17. Product market regulation has scope to become more competition-friendly

Product Market Regulation indicators, from 0 to 6 (most restrictive), 2023
(lower values indicate more competition-friendly settings)



Notes: The Product Market Regulation (PMR) indicator is a composite index that encompasses a set of indicators that measure the degree to which policies promote or inhibit competition in areas of the product market where competition is viable. The scale ranges from 0 to 3.5 for visibility. PMR values in 2023 and 2018 are the same for "Interaction with stakeholders" and "Involvement in business operations in service sectors".
Sources: OECD Product Market Regulation database; and OECD calculations.

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Streamlining regulatory processes, implementing pro-competitive reforms, reducing barriers to entry, and improving public procurement practices will help reduce prices and boost productivity, which is crucial for increasing disposable incomes (Égert, 2016[51]). Despite Israel's high-tech companies often being global leaders, productivity has been sluggish in most other sectors (OECD, 2023[3]). While productivity is not solely influenced by competitive pressures, competition is a powerful catalyst encouraging firms to innovate, take risks and use resources more efficiently. Well-functioning product markets support growth by incentivising new and innovative market entrants and pressuring existing companies to lower prices.

Competition authorities play an important role in ensuring competitive conditions in many OECD countries, by conducting market reviews, evaluating regulations and analysing the competitive neutrality of SOEs. In some countries like Germany, the Competition Authority have received additional powers to intervene in a market irrespective of infringement of antitrust law, but where competition has been disrupted.The new

powers fill a perceived enforcement gap in situations where harm to competition is not attributable to anti-competitive conduct but to other market characteristics, such as imperfect market structures. Such powers to impose remedies following a market investigation are also present at the United Kingdom's Competition and Markets Authority (OECD, 2023[52]). In Latvia, additional powers were given in 2020 to the Competition Council to ensure competitive neutrality between SOEs and private enterprises, giving the Council the ability to impose fines and legal obligations against SOEs that break competition rules. Such regulation ensures a level playing field for all businesses, regardless of their relationship with the government. It also prevents situations where government influence can distort market competition.

In Israel, the Competition Authority plays a vital role in fostering competitive conditions. Recent years have seen an expansion of its mission, beyond enforcing the Competition Law, to preventing and eliminating anticompetitive practices (OECD, 2022[53]). The Authority is increasingly engaged in promoting pro-competitive policies and regulations. It is now actively involved in legislative processes across a broad range of sectors, including food, energy, transportation, finance, and communications. The Authority also provides advice to various ministries on numerous matters. Prioritising healthy competition as a central element of reform is a positive development and should continue to be pursued.

4.7. Lowering the administrative burden to increase dynamism

Administrative and regulatory requirements in Israel remain cumbersome (Figure 4.18, panel A). Procedures for starting a company are more complex than the OECD average. Prospective business owners must contact four different government bodies to establish a limited liability company (LLC) and three for a privately-owned enterprise. In OECD countries like Canada, France, Greece, and Poland, it suffices to get in touch with one public body to start a business. Additionally, two of the mandatory registration procedures for starting a privately-owned enterprise in Israel must still be completed in person. Allowing all procedures to be carried out online would reduce some of the burdens on prospective businesses (OECD, 2020[54]).

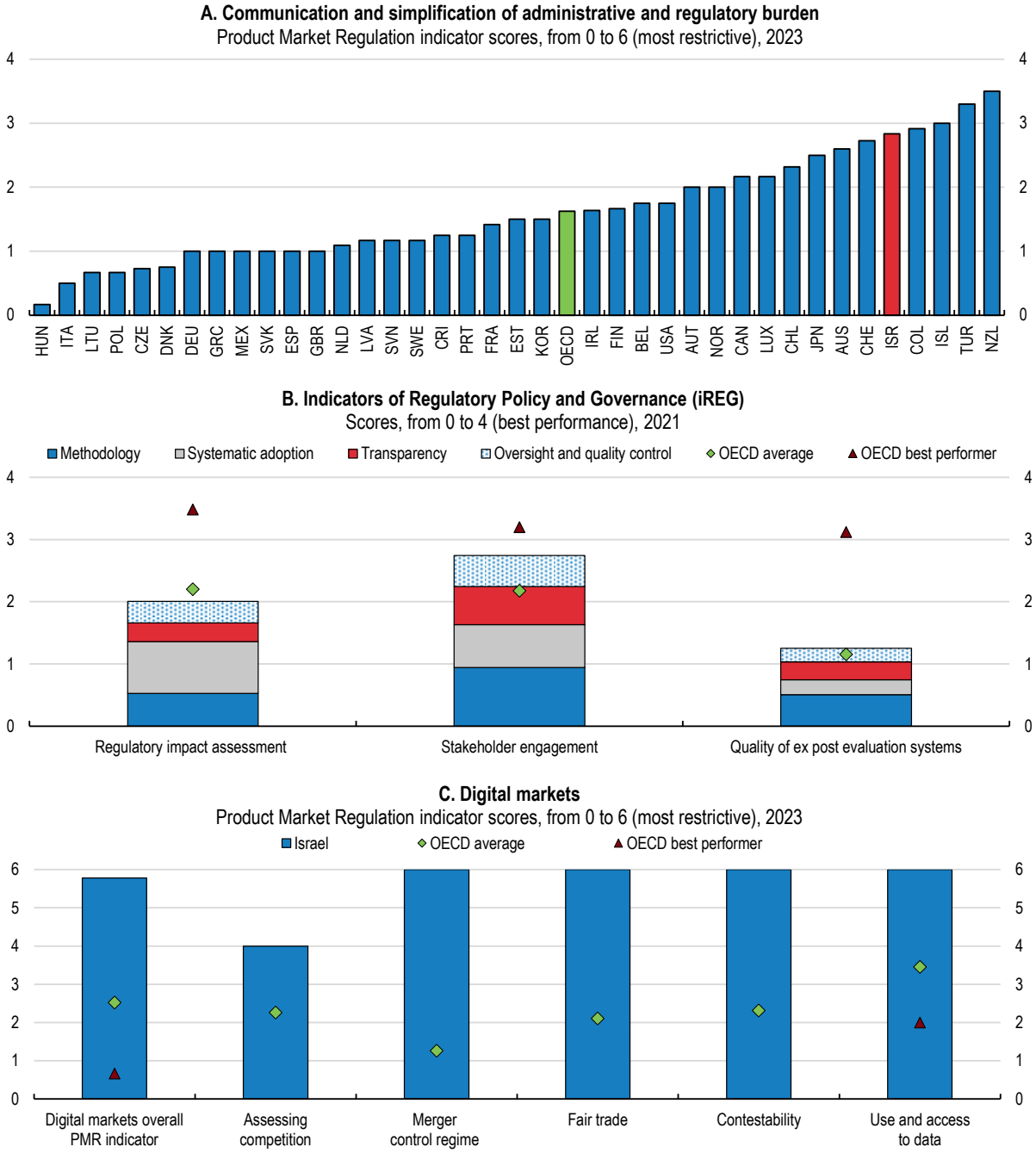
The Israeli authorities do not apply the "silence is consent" principle when issuing business permits and licenses. This practice, which helps to reduce administrative burdens, is utilised in more than half of the OECD countries. Although the total costs to complete all procedures to start a company in Israel are not particularly high, they could be reduced further. In approximately half of the OECD countries, these costs are zero. Furthermore, public bodies in Israel do not adhere to a maximum time frame for completing procedures. Establishing a clear timeline would provide certainty and facilitate planning for companies. In more than half of the OECD countries, laws or regulations specify a maximum time within which all or most procedures required to start an LLC must be completed by the relevant public bodies, as seen in Canada, Greece, and France.

While Regulatory Impact Assessments (RIAs) have been part of the Israeli regulatory management process for several years, there remains room for improvement (Figure 4.18, panel B). In this respect, Israel could learn from the experiences of other OECD countries in addressing regulatory challenges. For instance, Switzerland passed a Corporate Relief Act in September 2023, aiming to guarantee that new regulations are administratively lean and cost-efficient, thus reducing unnecessary barriers to company entry and growth (The Federal Council, 2022[55]; OECD, 2024[56]). The Act requires that all new regulations consider their burden compared to their benefits. Similarly, Sweden recently established a "Simplification Council" (Förenklingsråd) to identify and propose changes to laws and regulations to reduce the regulatory burden on companies (Tillväxtverket, 2024[57]).

Israel lags other OECD countries in its regulatory practices within digital markets (Figure 4.18, panel C). The rise of data-intensive markets, such as online marketplaces, search engines, and app stores, presents

new competition challenges and may necessitate the introduction of targeted ex-ante regulations to complement ex-post enforcement of competition law.

Figure 4.18. The administrative burden can be lowered



Notes: In Panels A and C, the Product Market Regulation (PMR) indicator is a composite index that encompasses a set of indicators that measure the degree to which policies promote or inhibit competition in areas of the product market where competition is viable. In Panel B, iREG scores are presented as an average of the results for developing primary laws and subordinate regulations. For Israel, results for regulatory impact assessment and stakeholder engagement apply exclusively to processes for developing primary laws initiated by the executive.
Sources: OECD 2023-2024 Product Market Regulation database; OECD (2023), Government at a Glance 2023, OECD Publishing, Paris, https://doi.org/10.1787/3d5c5d31-en; and OECD calculations.

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In Israel, parties to a "merger of companies" as defined under the Competition Law, are required to submit pre-merger notifications, including under the circumstances that one of the parties to the merger's market share exceeds 50% (in any sector in Israel) pre-merger, and regardless of the other merging party's market share or sales in Israel. This threshold is particularly relevant for digital mergers. The Competition Authority has analysed whether acquisitions of Israeli start-up's, by global digital companies, have prevented, eliminated or removed products or technological developments from the market, which may compete with the global companies in the future (so-called "killer acquisitions"). The analysis spanned the 2014-2019 period and covered 21 acquisitions, finding little evidence for such acquisitions in Israel (ICA, 2020[58]). The Israeli Competition Authority has also conducted a study on peer-to-peer (P2P) payment apps, illustrating how network effects can allow a single firm to dominate the market. Following this study, the 2023 Regulation of Payment and Payment Initiation Services Law was enacted, requiring P2P services to enable customers to receive funds from payers using different providers and to transfer funds to beneficiaries using other providers (ISA, 2023[59]).

The Competition Authority has proposed regulations like the EU's platform-to-business (P2B) regulation. The EU regulation (Regulation 2019/1150) aims at transparency and accountability in the relationship between platforms and businesses operating on them, by requiring clear terms, disclosure of ranking criteria, fair dispute resolution mechanisms, and transparency in data usage. Nonetheless, such regulations have not yet been incorporated into Israeli legislation.

4.7.1. Reducing the negative effects of state involvement in the economy

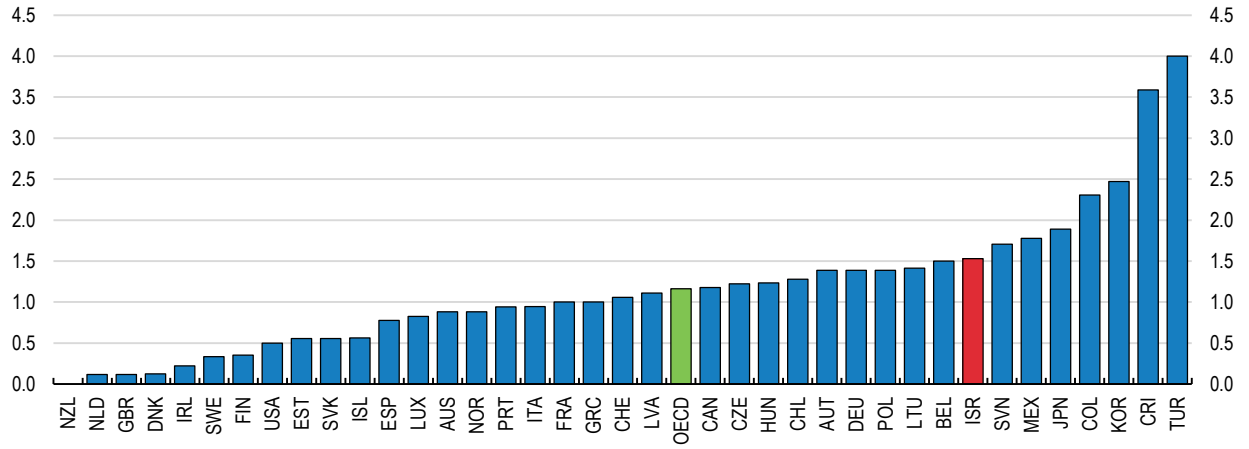
State involvement in the Israeli economy remains extensive. Price and quantity controls are applied to numerous products and services, many of which have been deregulated in most OECD countries (see Figure 4.19). For instance, 21 foodstuffs, including dairy products, and eggs, are subject to price controls. Milk prices are guaranteed and determined based on the average cost of production. Although these prices are regularly updated, they often diverge significantly from international market trends (OECD, 2024[4]). Similarly, wheat prices are guaranteed according to the Kansas market price, adjusted for quality and transportation costs. Quotas for egg production and border protection measures, provide price support to producers and form the basis for calculating maximum retail prices. Consequently, the share of potentially most-distorting forms of government support to the agricultural sector remains twice the OECD average (OECD, 2024[4]). Furthermore, prices are regulated for certain non-prescription medicines and taxi services, while professional service fees, such as those for lawyers, are subject to binding maximum fees for some activities.

Government-controlled prices and quantities are ineffective tools for ensuring affordability and equity. The absence of efficient price signals and responsiveness to changing conditions are key reasons why centrally planned systems often struggle to supply essential goods compared to market-based solutions. The Israeli authorities should work to progressively eliminate price and quantity controls to alleviate recurring shortages and allow market prices to influence consumer choices and economic behaviour more generally. The removal of price controls can be combined with targeted support to the most vulnerable households to ensure that inequalities are not exacerbated.

The Israeli government owns at least one company in 13 of the 24 sectors covered by the OECD Product Market Regulation (PMR) indicators. The Government Companies Authority, a subsidiary unit of the Ministry of Regional Cooperation, oversees government companies. This authority is responsible for more than 100 companies, including business and non-business governmental entities, subsidiaries, and jointly owned companies, such as the Israel Electric Corporation, Israel Aerospace Industries, Israel Railways, Ma'atz and Savings Funds. While the presence of SOEs does not necessarily indicate poorly functioning markets or a lack of competition, experience shows that SOEs can either promote or hinder economic and social development. This depends on the extent to which these companies operate within a sound regulatory and competitive environment, and whether the state acts as a professional owner.

Figure 4.19. Retail price controls are prevalent

Product Market Regulation indicator on retail price controls and regulation, scores, from 0 to 6 (most restrictive), 2023



Note: The Product Market Regulation (PMR) indicator is a composite index that encompasses a set of indicators that measure the degree to which policies promote or inhibit competition in areas of the product market where competition is viable.
Source: OECD Product Market Regulation database.

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While the governance of SOEs has improved, ensuring regulatory and competitive neutrality is an ongoing task, as markets and technology continue to evolve. Israeli SOEs have a formal rate of return target set by the ownership entity, which aligns with OECD best practices. However, there is still no requirement for having independent board members, and ministers are involved in the process of nominating the Chief Executive Officer of SOEs. Moreover, SOEs are not required to separate the services they provide in the framework of public service obligations from their commercial activities, and they do not receive adequate compensation for the fulfilment of public service obligations. Some SOEs also continue to have access to explicit government debt guarantees.

Regulatory agencies and the competition authority must continue to prevent market distortions and ensure the full and impartial implementation of relevant laws and regulations. Israel should continue to work towards aligning its SOE governance principles with OECD guidelines and towards best practice. For example, several OECD countries are reforming how they organise and exercise ownership of their SOEs. Nations such as Finland, Italy, Norway, Slovenia and Sweden manage their SOEs in accordance with international best practices, as outlined in the OECD Guidelines on the Governance of SOEs. These guidelines aim to: (i) professionalise the state as an owner; (ii) ensure SOEs operate with similar efficiency, transparency, integrity, and accountability as private enterprises adhering to good practices; (iii) ensure competition between SOEs and private enterprises occurs on a level playing field; and (iv) contribute to SOEs' sustainability, resilience, and long-term value creation.

4.7.2. Fostering competition among Kosher-certifying organisations

Most foodstuffs sold in Israel adhere to the dietary laws of Kashrut, which govern which foods may be eaten and how they must be prepared and combined. This is chiefly due to consumer preferences that steer demand towards Kosher products. Kosher certification is not a legal requirement for importing food into Israel, apart for beef, poultry, and other meats. Nonetheless, products without Kosher certification hold smaller market shares, as a significant portion of supermarkets and hotels prefer to offer only Kosher-certified goods as a supermarket or restaurant cannot be considered Kosher unless all the products they sell are Kosher-certified.

To be certified as Kosher in Israel, a manufacturing company, restaurant, or hotel must be certified by local councils approved by the Chief Rabbinate (see Box 4.6). A reform of the Kosher certification system was passed in October 2021, with full implementation planned for January 2023. Under this reform, the Chief Rabbinate would no longer award certifications directly but would instead act as a regulatory body overseeing public and private institutions that issue certificates. The reform represented an important step towards enhancing consumer choice and increasing competition among certifying organisations. However, the law was repealed in 2023 before it could be implemented. The authorities should consider a new reform to increase consumer choice.

Box 4.6. The Kosher-certification system

In Israel, the Chief Rabbinate's presidency supervises a council and a network of local chief rabbis and serves as the authority on matters of Jewish law, including Kosher certification. The Ministry of Religious Services appoints and partially funds municipal and regional religious councils, which administer Kosher certification to local rabbis, who in effect have a monopoly in their given locality. Typically, the council sends a staff member to conduct an initial inspection of the applicant's facility (such as a food producer or restaurant). If approved, the application is referred to the local chief rabbi, who formally grants certification by signing a certificate. The council then assigns a qualified inspector to provide ongoing supervision.

Certified businesses must pay annual fees to the local council to maintain certification, as well as the inspector's hourly wage set by the Chief Rabbinate. However, a company may also seek certification through private organisations, which may have even stricter interpretations of Kashrut than the local council. Under the current system, these companies must pay for the state-mandated Kosher certificate in addition to any other certificates to be branded as Kosher. One study found that just 12% of Kosher food products exclusively use the Chief Rabbinate certification (IDI, 2021[60]).

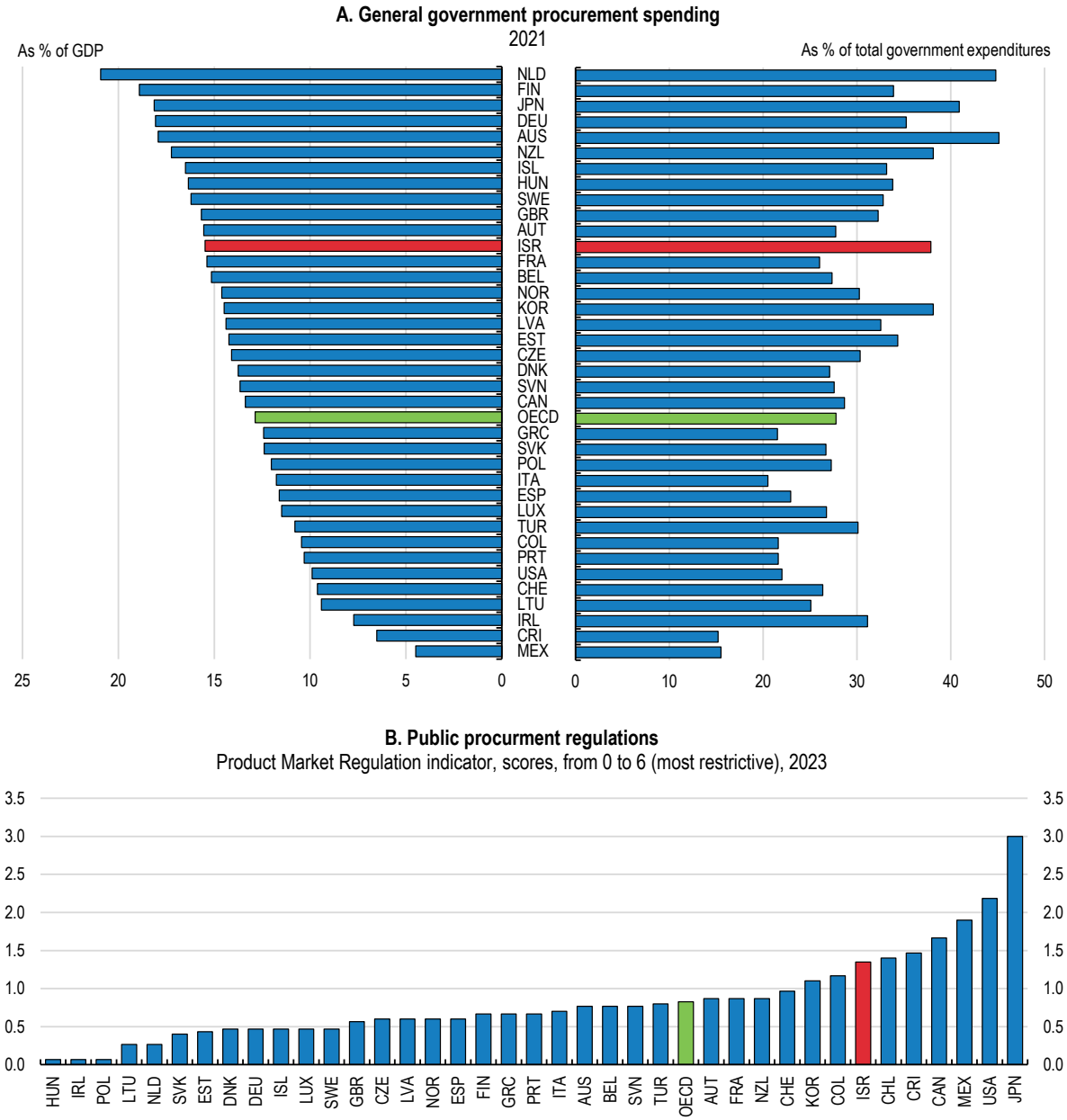
Foreign producers of foodstuffs and hygiene products wishing to be branded and sold as Kosher in Israel must also be certified by the Chief Rabbinate. A 2015 study by the Ministry of Finance estimated that consumers pay INS 2.8 billion (USD 750 million) directly and indirectly for the current system, with INS 600 million (USD 161 million) per year due to the monopoly of the Chief Rabbinate (RIC, 2017[61]). Another study by the Competition Authority in 2020 found that Kosher requirements on imports of dairy products increase costs by 1.9-9.9% (Competition Authority, 2020[62]).

Source: (Government of Israel, 2019[63]).

4.7.3. Improving public procurement practices

Israel's expenditure on public procurement exceeds the OECD average as a percentage of GDP and ranks among the highest as a share of government spending (Figure 4.20 Panel A). The country's health and education systems are predominantly publicly funded and governed by the public procurement law. Additionally, infrastructure and utilities, including electricity, energy, and transport, largely managed by SOEs. Given that the state owns most of the land, real estate development projects often involve public procurement procedures. Spending on security, emergency, and safety is also included within the scope of public procurement, as are social services. Given the significant size and relative importance of public procurement in the Israeli economy, it is crucial that these processes be well-organised and carefully implemented to maximise competition and avoid costly solutions.

Figure 4.20. There is scope to improve public procurement practices



Notes: In Panel B, the Product Market Regulation (PMR) indicator is a composite index that encompasses a set of indicators that measure the degree to which policies promote or inhibit competition in areas of the product market where competition is viable.
Sources: OECD (2023), Government at a Glance 2023, OECD Publishing, Paris, https://doi.org/10.1787/3d5c5d31-en; OECD 2023-2024 Product Market Regulation database; and OECD calculations.

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Compared with other OECD countries, Israel has less competition friendly public procurement rules and regulations (Figure 4.20 Panel B). The procurement law does not mandate that the time allowed for submitting tenders should be proportionate to their size or complexity. This makes it challenging for smaller companies and new market entrants to participate in the bidding process. Ensuring longer submission times for larger or more complex tenders would allow more companies to participate, thereby increasing competition in the bidding process. This is for example mandated in EU legislation (European Commission,

2019[64]). The Israeli government has worked to facilitate the participation of small and medium-sized enterprises (SMEs) in public procurement. In 2023, 36% of public procurement was awarded to businesses with fewer than 100 employees, reflecting a positive shift towards increasing SME involvement in the procurement process.

Furthermore, the current system does not always allow bids to be submitted through online platforms (e-procurement). Enabling all bids to be submitted online could increase participation and generate more bids, thus enhancing competition and the overall benefits of public procurement in addition to facilitating systematic ex-post assessment (Bosio, Hayman and Dubosse, 2023[65]). Additionally, it is common practice in Israel to publish reference prices in tenders, which can facilitate collusion and price coordination among bidders. This may hamper competitive pressures and diminish the effective use of taxpayers' money. Authorities should continue to align Israel's public procurement practices with the OECD Recommendation on Public Procurement.

4.8. Reducing entry barriers to increase competition

Lowering entry barriers is essential for enhancing market competition, fostering innovation, and reducing prices for consumers. It allows prospective companies to enter the market, thereby challenging incumbent firms and disrupting monopolistic practices. Even if new companies do not enter, the threat of potential entrants can contain uncompetitive behaviour and facilitate competition by making markets "contestable" (Baumol, Panzar and Willig, 1982[66]).

In Israel, barriers to entry remain high in many sectors covered by the OECD Product Market Regulation (PMR) indicators (Figure 4.21, Panel A). The country maintains a statutory state-owned monopoly in rail freight transport. Moreover, passenger rail transport services are not subject to competition. In contrast, rail freight transport has been opened to competition in all other OECD countries, and 90% of the countries allow private companies to provide transport services. Liberalising rail freight and passenger transport on some routes and enabling private companies to compete could provide consumers with more choices and lead to lower prices.

The competitive and monopoly parts of the Israeli electricity market have been legally separated since 2018, unbundling generation and retail supply from transmission and distribution, and separating system operation and design, to ensure independent decision-making and avoiding risk of discrimination in access to the monopolistic infrastructure. Since January 2024, power generators have been able to sell directly to electricity suppliers. These companies can now supply electricity through the grid, directly to customers across Israel. Consumers with a smart meter have been allowed to choose among retail suppliers and since July 2024, all consumers can do so. 18 companies with an electricity license are active on the market. An online independent price comparison tool facilitates price comparisons. Initially, switching rates were low as only about 15% of households with a smart meter could choose an alternative supplier. Since July 2024, all households could choose among electricity suppliers and more than 100,000 have switched, reaching or even exceeding the government's target of 100,000 customers by the end of 2024.

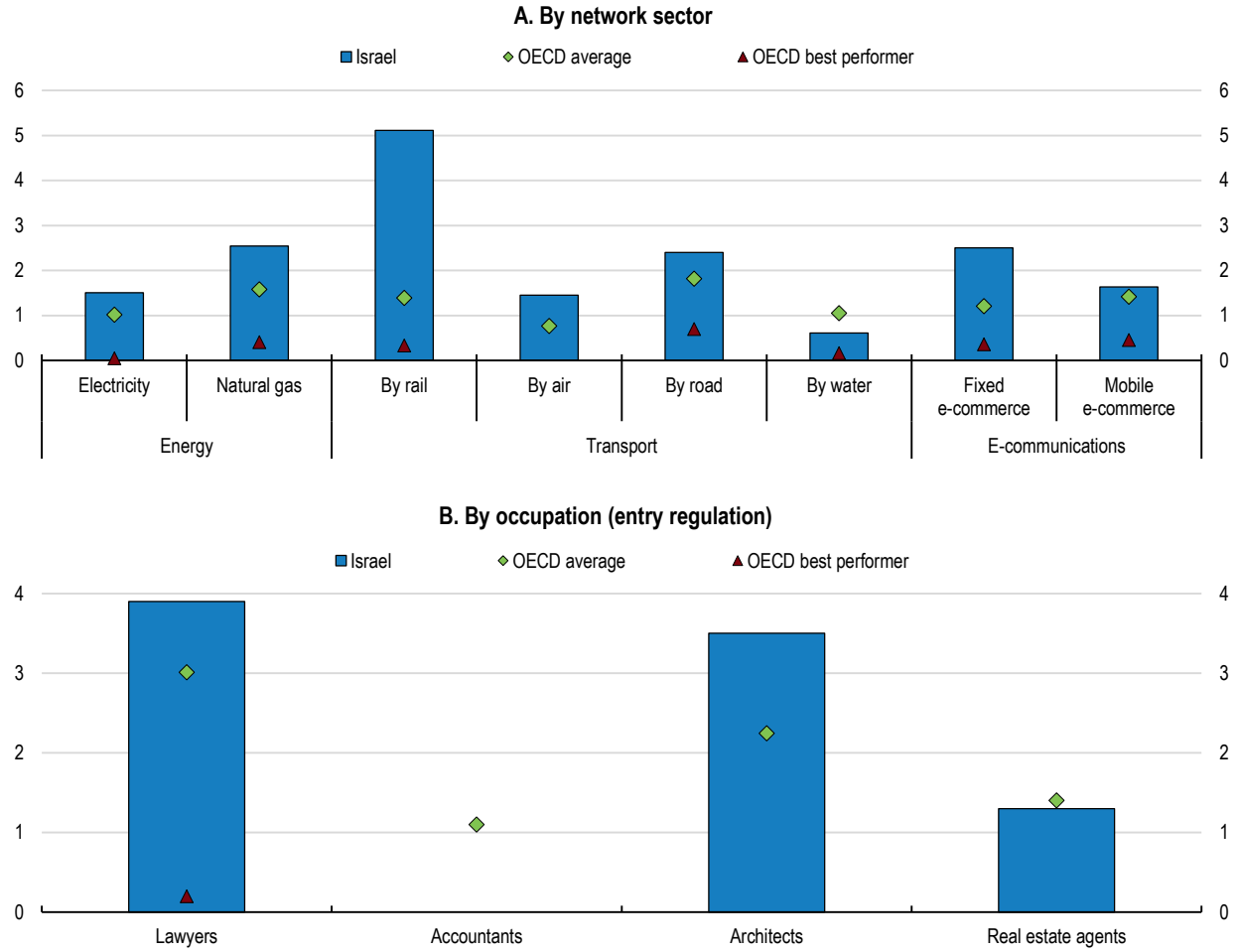
For the wholesale market, there is currently no organised market for the purchase and sale of electricity. However, bilateral transactions between sellers and buyers are possible. Establishing an organised wholesale market could facilitate the sale of electricity between industry participants, ease entry and contribute to price reductions.

Entry barriers are also significant in several professional services sectors, such as attorneys, architects, and real estate agents (Figure 4.21, Panel B). Legal firms cannot have limited liability, and only attorneys are permitted to hold ownership and voting rights, with business cooperation with other professions within the same company prohibited. Such restrictions inhibit market entry, new business models and innovative practices, and limit access to managerial skills and investment sources. While there may be valid reasons

for regulating entry into professions where specific competencies are critical and malpractice can lead to significant harm, these barriers can unduly protect incumbents, stifle business dynamism, and impede aggregate productivity, entrepreneurial initiative and innovation.

Figure 4.21. Barriers to entry are high in several sectors and occupations

Product Market Regulation indicators, scores, from 0 to 6 (most restrictive), 2023



Notes: The Product Market Regulation (PMR) indicator is a composite index that encompasses a set of indicators that measure the degree to which policies promote or inhibit competition in areas of the product market where competition is viable.
Sources: OECD Product Market Regulation database; and OECD calculations.

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4.8.1. Making it easier to become an importer

The wholesale trade sector in Israel remains highly concentrated for food products. Three food suppliers account for 85% of the market in 20 consumer products and importing is similarly concentrated (State Comptroller, 2024[67]). Despite progress in relaxing import procedures and rules (see the previous section of this Chapter), laborious and complex processes for importing continue to hinder market entry.

One reason in the food sector is the distinction and procedural separation made by the Ministry of Health between two categories of products: "normal " and "sensitive" foods (including dairy products, eggs, meat, fish, preserves, baby food, honey and nutritional supplements). While these standards aim to protect public health, they also result in additional costs that are passed on to consumers. The process for sensitive food involves more extended approval and inspection times compared to regular food. For example, the

approval process for regular food can take an average of 3 days, while the process for sensitive food may take between 74 and 111 days (State Comptroller, 2024[67]).

Amendments to the Public Health Law between 2021 and 2022 aligned some of Israel's food standards with health standards of the European Union, marking a significant step forward in food safety, quality and harmonisation of rules. However, there are still gaps. Products such as olive oil, chocolate, and honey are still affected by restrictive standards. Such products must have an Israeli standards expert to affix nutritional labels and ingredient lists that may differ from those used in global markets. In its 2024 report, the State Comptroller recommends that the Ministry of Health and the Consumer Protection Authority expedite their examination of food and consider adopting European standards for remaining products (State Comptroller, 2024[67]). Adopting standards and labelling requirements of large trading partners would simplify importing by reducing the need for additional testing and certification.

Import licences or permits under the Free Import Order are typically issued within 14 working days of receiving all necessary documentation. However, the Ministry of Health's National Food Service and Pharmacy Department or the Competent Authority in the Ministry of Transport, National Infrastructure, and Road Safety generally provides their decision within four working weeks of receiving all documents (Ministry of Economy and Industry, 2019[68]).

To reduce entry barriers and enhance competition, the rules and procedures for obtaining import licences could be made less stringent, and the validity of licences could be significantly extended. For instance, in the European Union, the Economic Operators Registration and Identification (EORI) number is permanently allocated to companies that remain in business. The process for receiving the EORI is straightforward for registered businesses and typically takes one day across EU member states if applications are complete (European Commission, 2022[69]).

4.8.2. Facilitating competition in the banking sector

The Israeli banking sector is relatively profitable (Figure 4.22, panel A) and has a more limited number of banks than in most OECD countries (Figure 4.22, panel B). Five banking groups account for 98% of total assets. Moreover, two independent banks and four branches of foreign banks account for only a small proportion of the domestic credit market, although concentration in the credit market has not materially changed over the past years (BoI, 2022[70]).

Following several decades during which the number of commercial banks declined due to consolidation in capital markets, a new independent digital bank began operations in 2022, and a banking licence for an additional digital bank was granted during the year. The introduction of digital platforms can reduce bank's markups and reduce concentration directly but also through the threat it creates for incumbents (Koont, N, 2023[71]; Doerr et al., 2024[72]), thereby increasing access to credit and reducing its cost.

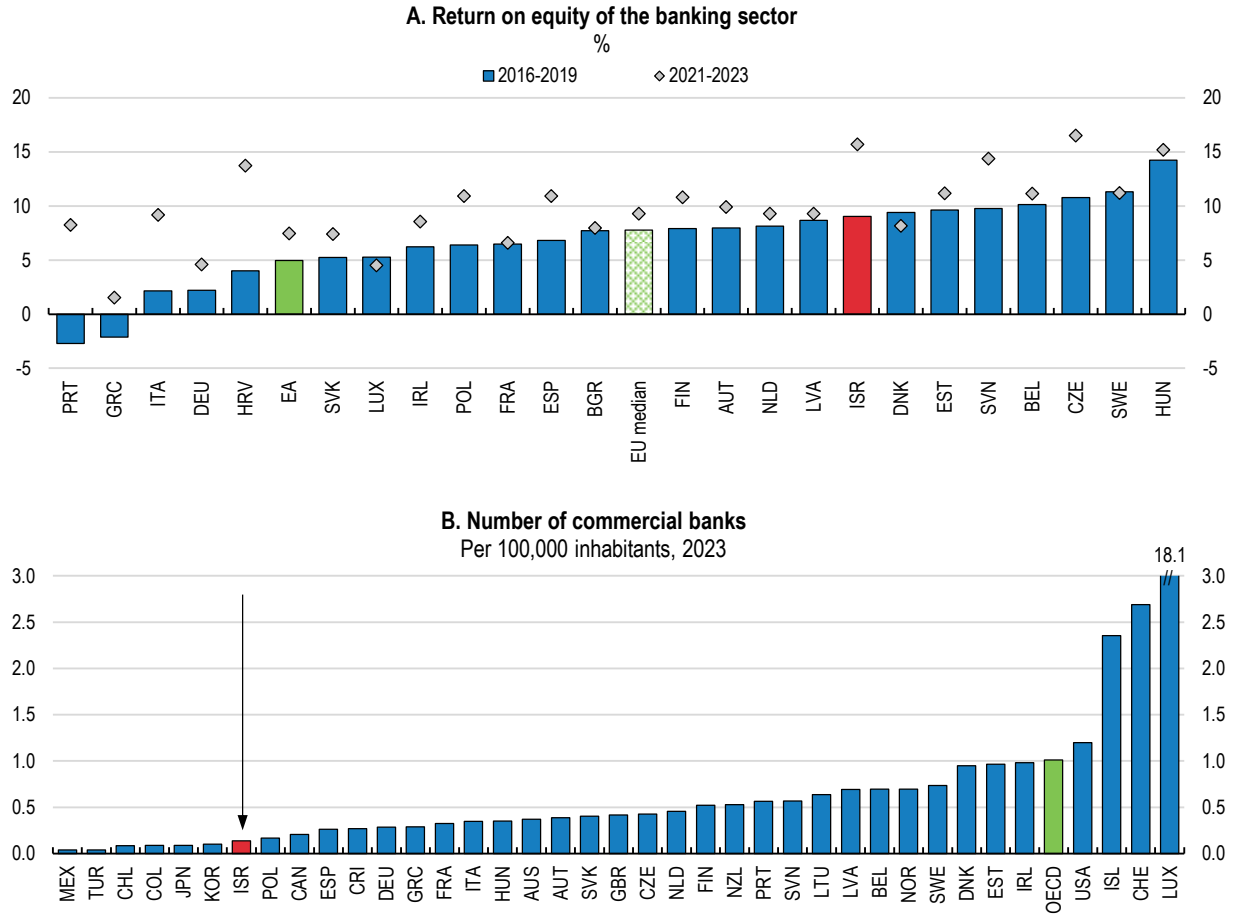
Increasing competition in the financial sector is a secondary objective for the Bank of Israel Banking Supervision Department alongside the primary goal of financial stability. A reform of the mortgage market in 2021 eased the comparison of mortgage offers across banks. In 2019, the Bank of Israel established a credit data register to reduce information gaps between large credit providers and smaller credit providers with a view to ensuring that customers can receive better priced credit offers. A study by the Bank of Israel found that the introduction of the credit data registers has significantly reduced interest rates for customers (Segev, Shaton and Bank, 2023[73]). Furthermore, credit card companies were separated from banks in 2018 and open banking was implemented, meaning that, with customer consent, information could be shared with third parties to improve services provided to the customer, encourage the entry of new financial players and increase competition in the sector. Moreover, the Bank of Israel website improves information availability by providing comparable data to the public,.

Since 2021 bank customers have also been able to switch banks online easily and at no cost. The switching process can be completed within seven business days. This reform represents significant progress in

simplifying the process of switching banks and is expected to enhance competition within the banking system. After one year of the reform, approximately 100,000 applications had been submitted to switch banks through the online system, and more than 65,000 customers had successfully changed banks (BoI, 2022[74]). Easing the process of switching banks can further encourage innovation and increase efficiency, and such efforts should continue. A review of competitive conditions in the banking sector could be considered to assess the impact of switching and new entrants.

The Bank of Israel, the Ministry of Finance, the Israel Securities Authority and other government agencies have also taken steps to advance innovation and competition in the payments market. The Regulation of Payment Services and Payment Initiation Law, 5783–20233 enables nonbank entities to obtain a license and to participate in the payments area. The law was passed in May 2023, and enables the Israel Securities Authority to issue licenses to nonbank entities to function as payment service providers. Enabling entry of new providers in the payments market is a welcome development and should be continued to be monitored and adapted to reduce barriers to entry while ensuring financial stability.

Figure 4.22. There are few commercial banks and they are profitable



Note: In Panel B, 2022 data for Ireland.
Sources: Bank of Israel; European Central Bank (ECB); IMF Financial Access Survey; OECD Population Statistics database; and OECD calculations.

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The Bank of Israel, the Israel Securities Authority and the Ministry of Finance has started a review of fees in the capital market (BoI, 2024[75]). Initial findings suggest that there are difficulties for consumers in comparing costs between different service providers due to variations in fee structures, limited accessibility to investment advisory services, and a lack of alignment between the services provided and the payment for them. A planned reform aims to improve the comparability of different offers and to increase

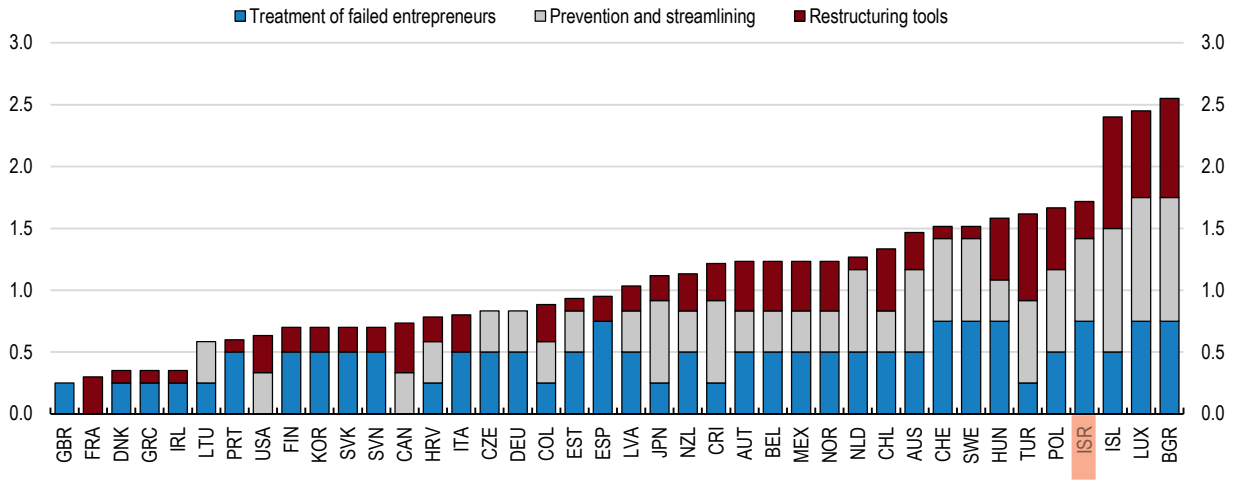
transparency around different pricing models. This review is welcome and can help increase competition in the market.

Reducing entry barriers is key to foster competition to raise productivity. Another important aspect of economic dynamism is the ease with which companies that are no longer viable can exit the market and release valuable resources (labour and capital) to more productive organisations. The insolvency framework is key in shaping companies' exit, and can facilitate corporate restructuring and promote entrepreneurship by offering a second chance to failed entrepreneurs. Sound insolvency frameworks can thus spur economic reallocation and productivity growth (Adalet McGowan and Andrews, 2018[76]).

In Israel, the insolvency framework indicator is above the average of OECD countries (Andre and Demmou, 2022[77]). The personal costs to failed entrepreneurs remains higher than the OECD average, due to relatively less efficient liquidation processes. Bankruptcy prevention and simplified insolvency procedures for micro, small and medium-sized companies MSMEs could be introduced to ease the exit of unviable firms. A new law that encourages debt restructuring passed first reading in the Knesset in December 2024, and aims to incentivise debt negotiations among companies and creditors at an early stage to increase chances of economic rehabilitation.

Figure 4.23. There is scope to improve the insolvency framework

OECD insolvency indicator main sub-components, 2022



Note: The scores for the three main sub-categories are scaled from zero to one, with lower scores indicating more favourable frameworks.
Source: OECD 2022 questionnaire on insolvency frameworks.

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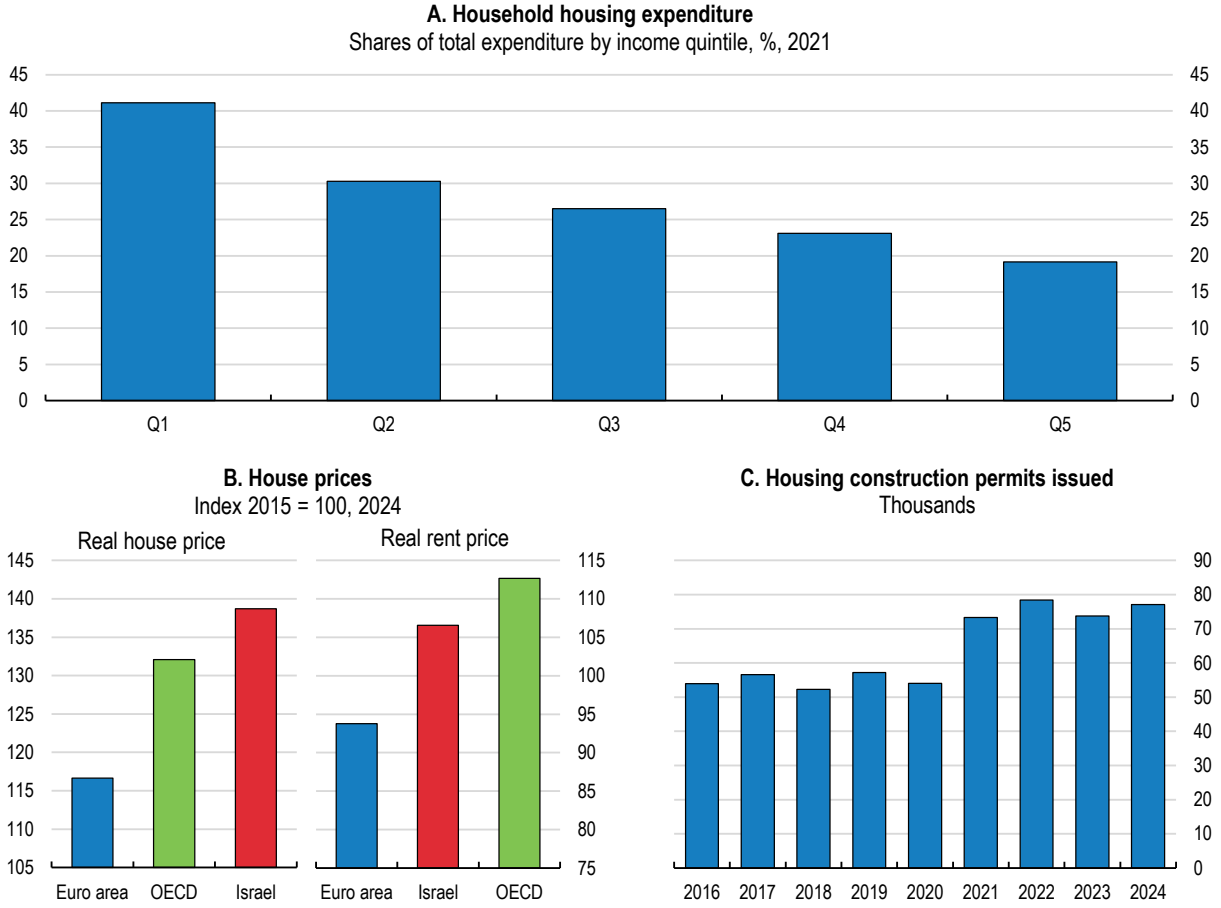
4.9. Increasing the supply of housing

Housing is a key determinant of the cost of living and often represents Israeli households' largest expenditure. On average, households spend about a quarter of their disposable income on housing, with higher-income households spending significantly less and poorer households spending considerably more (Figure 4.24, Panel A). The overburden rate - the share of the population spending more than 40% of their income on housing - is 54%, one of the highest in the OECD.

The high cost of housing has led to social unrest in 2011, when tent protests spread across major Israeli cities. Since then, housing has only become less affordable, sparking further demonstrations, such as in Tel Aviv in 2022. The combination of strong demand, low interest rates, high household savings and limited land availability has driven rapid house price growth over the past decade. Since 2015, real house prices

have risen by 39%, above the OECD average that rose by 32%, and rents by 7%, below the OECD average of 13%. (Figure 4.24, Panel B).

Figure 4.24. Housing accounts for a large share of total household expenditures



Note: Panel B, real house price data for the euro area refers to 2023.
Sources: Israel Central Bureau of Statistics; OECD Analytical house prices indicators database; and OECD calculations.

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In a well-functioning market, rising prices would typically incentivise more supply to meet demand. Housing supply in Israel has however historically been less responsive to price increases than in most other OECD countries (Cavalleri, Cournède and Özsöğüt, 2019[78]; OECD, 2020[79]). The sluggish response indicates market frictions, which harm social inclusion, as high prices make affordable housing increasingly inaccessible, particularly for low-income households (Grossmann et al., 2019[80]).

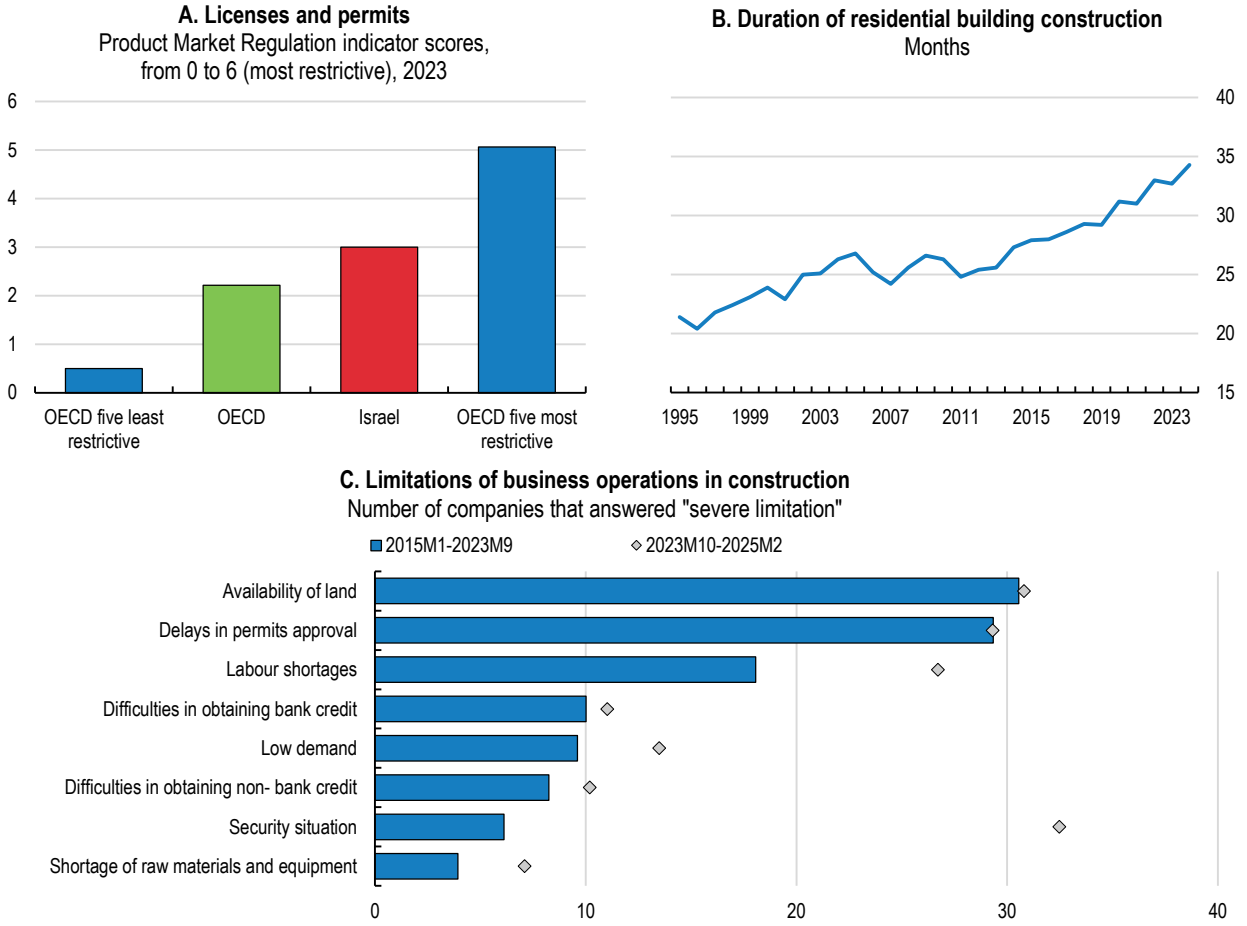
Following nearly a decade of stagnation, the number of building permits rose substantially in 2021-23 (Figure 4.24, panel C). It is however too early to determine if this increase is partly fundamental or mostly reflects a catch-up following COVID-19, even more so as the 7 October attacks and subsequent war disrupted housebuilding activity (see Chapter 1).

Increasing the housing supply is critical to reducing living costs. Simplifying restrictive planning regulations, boosting urban renewal projects and improving transport infrastructure as well as public transit to urban centres are essential steps. A better property tax-mix can incentivise housing construction. Over the medium term, housing supply creation also requires remedying construction worker shortages (see Chapter 1).

4.9.1. Streamlining planning and building regulations

Israel's planning and building regulations are cumbersome by international standards. The country scores above the OECD average in the number of licenses and permits required, according to the OECD's Product Market Regulation (PMR) index (Figure 4.25, Panel A). While permits aligned with building plans are legally required to be issued within 90 days, the average time to issue a building permit was 319 days (for permits matching approved plans) in 2019. For permits with requested modifications (concessions or special uses), the average time extended to 407 days (State Comptroller, 2021[81]).

Figure 4.25. Land availability and slow approval processes are hindering construction



Notes: In Panel A, the Product Market Regulation (PMR) indicator is a composite index that encompasses a set of indicators that measure the degree to which policies promote or inhibit competition in areas of the product market where competition is viable. In Panel B, weighted average, according to the number of apartments in the building. In Panel C, data refers to the number of answers of companies participating in the Business Tendency Survey conducted by the Israel Central Bureau of Statistics (CBS). Labour shortages values are an average of values for labour shortages for wet-work, non-wet work and non-skilled work.
Sources: OECD Product Market Regulation database; Israel Central Bureau of Statistics; and OECD calculations.

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Currently, around 120,000 housing units are in various stages of the permitting process. The time taken to complete an apartment project, from planning to occupancy, is about 13 years, with the average construction time nearing three years, increasing by 0.4 months per year since 1995 (Figure 4.25, Panel B). Delays in permit approvals and limited land availability are the primary growth obstacles for Israeli construction companies (Figure 4.25, Panel C). Although several regulatory reforms have been introduced over the past decade, these issues remain consistent barriers since 2015, when the questions were first posed.

The Planning and Building Law (1965-5725) mandates multiple approvals from local planning and building committees before any construction can begin. This multi-layered approval process includes zoning verification, environmental impact assessments, and municipal plan compliance. While regulations are necessary to address externalities like environmental concerns and transport congestion, excessively lengthy permitting processes deter investment and slow construction.

In 2023 the Planning Authority released a set of new guidelines aimed at facilitating the transition between detailed local plans and the licensing process, by requiring adherence between planning and permitting. These newly established protocols are expected to improve the licensing procedures and shorten processes. Furthermore, Amendment 134 to the Planning and Building Law (1965-5725) enables a new licensing procedure titled “self-certification”, which grants authorised architects the responsibility to check and approve permits instead of the permitting authorities.

Furthermore, to ease the regulatory burden and accelerate permitting, the "plan plus permit" reform was implemented in 2024. The “Expedited Licensing Plan – Amendment 139 to the Planning and Construction Law” streamlines the approval process by allowing urban renewal plans and permits to be granted in a single hearing. This reform is expected to reduce approval timelines by one to four years. Under the new regulation, plan and permit applications will progress in parallel, and some procedural steps have been eliminated or combined to make the process more efficient. Close monitoring of the implementation will be crucial to ensure these changes lead to faster, less cumbersome approvals. Additionally, the existing permit backlog must be addressed swiftly under the new framework.

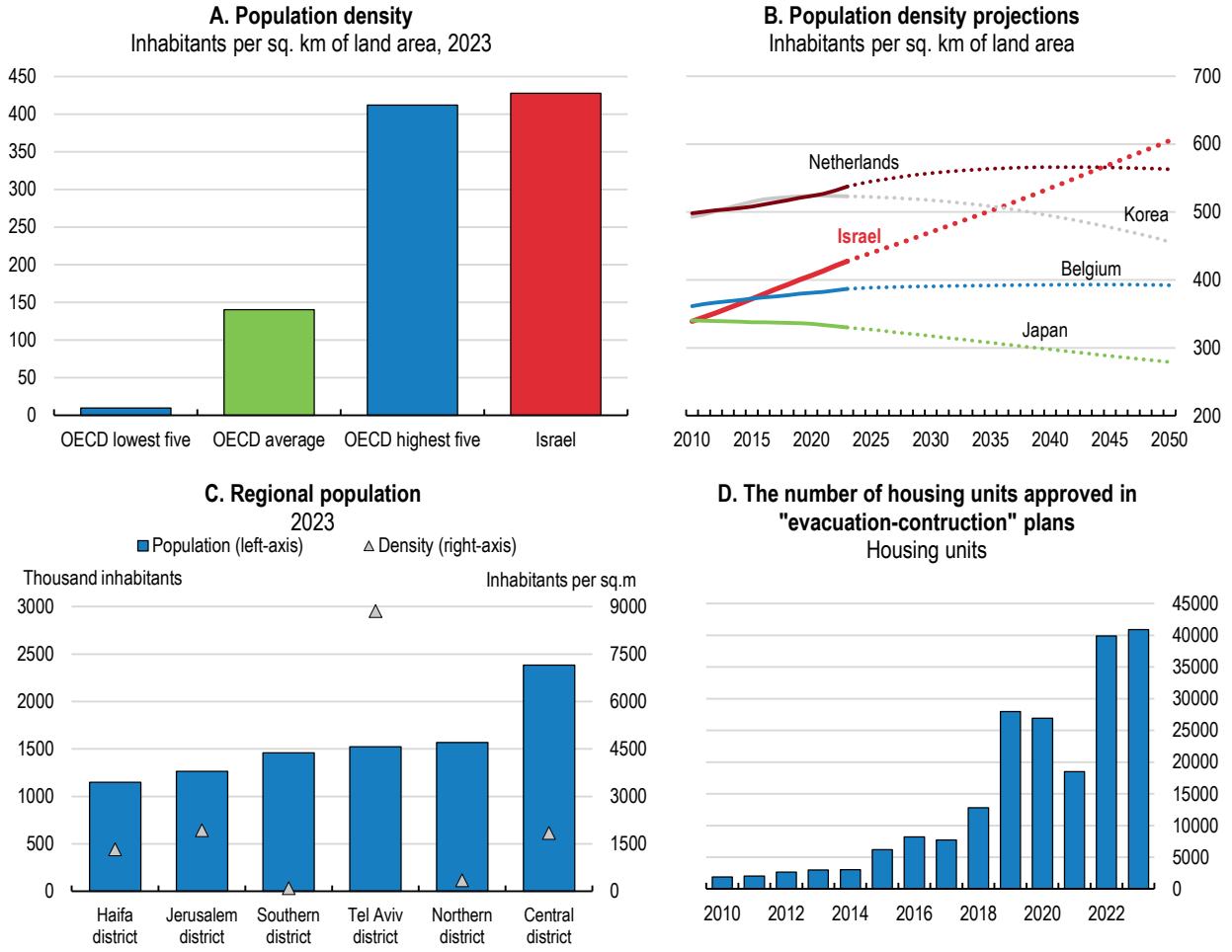
4.9.2. Maintaining support for urban renewal programmes

Given high population density (Figure 4.26, panel A and B), effective regulation is essential to make efficient use of space. Urban renewal is central to the government’s strategy to increase housing supply in densely populated areas like Tel Aviv (Figure 4.26, panel C). The Government Authority for Urban Renewal oversees laws aimed at streamlining the renewal process and removing bureaucratic barriers, while also protecting tenant rights in designated renewal areas. The authority works with localities to plan and promote these projects, which include both the renovation and reconstruction of existing buildings. Another aim is to increase the resilience of housing and infrastructure to security threats and natural disasters, which may increase in frequency and intensity under the impact of climate change (Chapter 3).

For a renewal project to proceed, apartment owners must agree by a two-thirds majority to hire a developer, reduced from 80% in 2021. Owners receive new, often larger apartments at no additional cost, while developers finance the reconstruction by selling additional units. The revenue from these sales is partially tax-exempt. Since 2021, urban renewal projects have increased, with roughly 40,000 units approved in 2022 and 41,000 in 2023 (Figure 4.26, Panel D).

The government should continue promoting urban renewal in high-density areas to add more housing units to the current stock. A benefit of this programme is that it enables expanding housing supply in areas of high demand without generating urban sprawl (OECD, 2018[82]; OECD, 2024[83]).

Figure 4.26. Population density is high and is set to increase further



Note: In Panel A, OECD highest five excludes Israel.
Sources: UN, World Population Prospects 2024; OECD Regional Statistics database; and "Urban renewal report 2023," The Governmental Authority for Urban Renewal, April 2024, https://www.gov.il/he/pages/urban_renewal_report_2023.

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4.9.3. Improving rental regulation and public housing policies

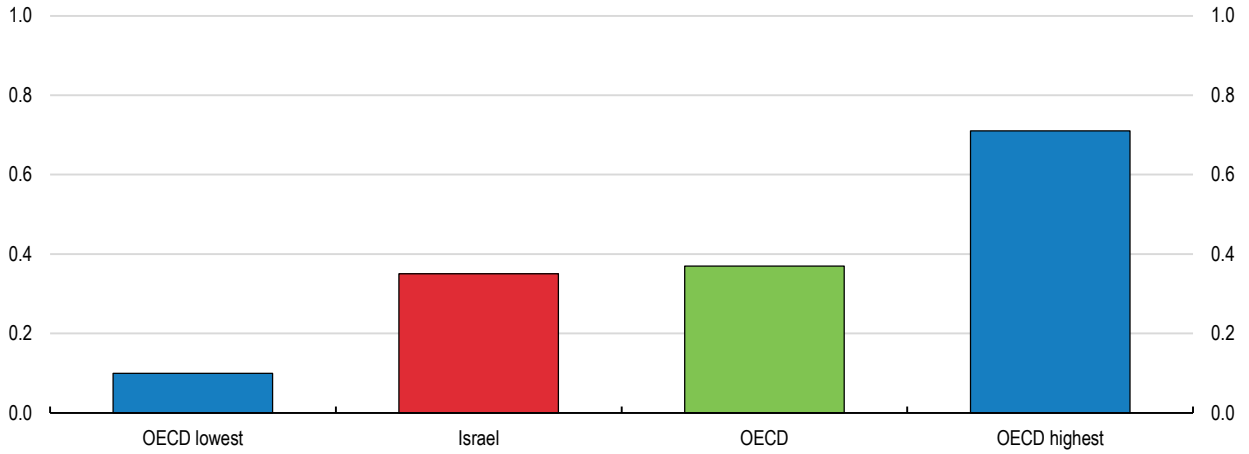
Israel's landlord-tenant regulations are less stringent than the OECD average, which supports economic flexibility and mobility (Figure 4.27). However, rental regulations must strike a balance between allowing landlords to achieve satisfactory returns and providing security for tenants, especially as more people spend longer periods in the rental market before buying homes. In 2023, about 795,000 rental units existed in Israel, comprising 29% of all housing units, up from 25% a decade earlier. It is estimated that two million Israelis live in rented dwellings, most of which are privately owned and managed by individual landlords.

The 2020 *Economic Survey* recommended that Israel increase rental price transparency by collecting information on local reference rents, as is done in Germany. Such a policy would provide clearer data on price developments in the rental market, reducing information asymmetries between landlords and renters. In August 2024, the Ministry of Construction and Housing announced a strategic plan for the rental market, which includes collecting and sharing rental market data, encouraging long-term rentals, and identifying land for rental housing projects. Currently, the government has only partial information about the rental market. Authorities are gathering data through platforms such as Yad 2 (Israel's largest second-hand marketplace) and the Israel Mapping Centre, along with data from about 220,000 households receiving

rental assistance and government-supervised companies renting out apartments. This increased data collection will facilitate price comparisons, increase market competition and potentially reduce rents.

Figure 4.27. Rental regulation is relatively flexible

Landlord-tenant regulation indicator, from 0 to 1 (most stringent), 2021



Notes: Indicator capturing the intensity of regulation related to tenants' protection from eviction, tenure security and deposit requirement. The indicator ranges between 0 and 1, with a higher number indicating greater stringency. Overly stringent landlord-tenant regulations tend to reduce residential mobility which could impair the functioning of labour markets.
Source: OECD Housing Policy Toolkit.

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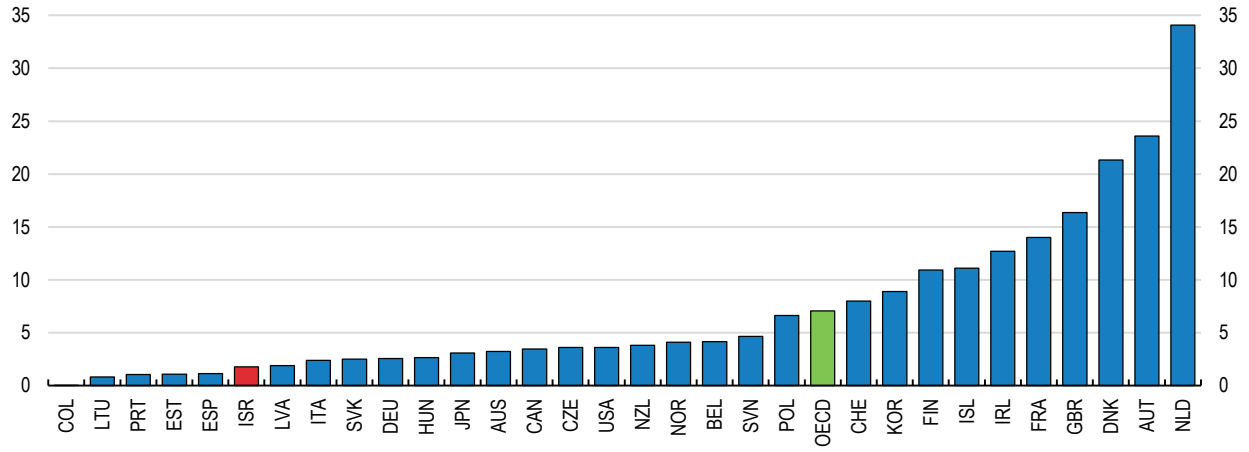
Social housing in Israel is relatively scarce compared with other OECD countries (Figure 4.28). Public housing units have historically been sold to tenants at discounted rates to reduce poverty and support private home ownership, which has diminished the social housing stock. Properly targeted social housing programs can alleviate the cost of living for those in need, but they must also avoid locking residents into neighbourhoods with limited employment opportunities (Chetty et al., 2014[84]). Therefore, social housing should be built in areas with good access to jobs and transport links (see the next section). Additionally, the government should frequently reassess eligibility criteria for public housing and consider promoting mixed-income neighbourhoods.

As of August 2024, new rent subsidies are available for low-income households. Previously, individuals waiting for social housing could receive increased rent assistance, but this assistance was withdrawn if they declined two social housing offers. Under the new policy, eligible citizens opting for private rentals will continue to receive increased assistance throughout their eligibility period. While targeted transfers are often preferable to direct government intervention, focussing on rent assistance in the face of rigid housing supply can boost rent levels and home prices, ultimately exacerbating inequalities by transferring wealth from taxpayers to landlords (OECD, 2021[85]). The government should prioritise expanding public housing units, targeted at low-income households, in areas with good public transport connections to the major urban centres with employment opportunities. To avoid undue burden on public finances in the future, revenues from public housing rents can be recycled into building more units through revolving financing mechanisms, where rents from older parts of the social housing stock be used for new investment (see Box 4.7).

Figure 4.28. Social housing could be expanded

Social rental dwellings, as % of the total housing stock, 2022 or latest available year



Note: Data for Israel refers to 2023.
Source: OECD Affordable Housing Database (AHD).

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Box 4.7. Different funding models of social housing in Austria and Denmark

Austria

- Revolving funds support the development and maintenance of the social housing stock. Approximately 40% of a typical project is financed through bank mortgage loans with a maturity of 25 years (1.5% interest rate), with the remainder financed with public loans (35-year maturity and 0.5-1.5% interest rate) and equity contributions from housing associations. A Limited-Profit Housing Act sets out the key governance principles for housing associations, including a limitation of nominal capital paid out to shareholders, a calculation of prices based on actual costs, a continuous reinvestment of capital and a regular audit of the efficient use of resources and the compliance with the Limited-Profit Housing Act. Any surpluses generated are strictly regulated.

Denmark

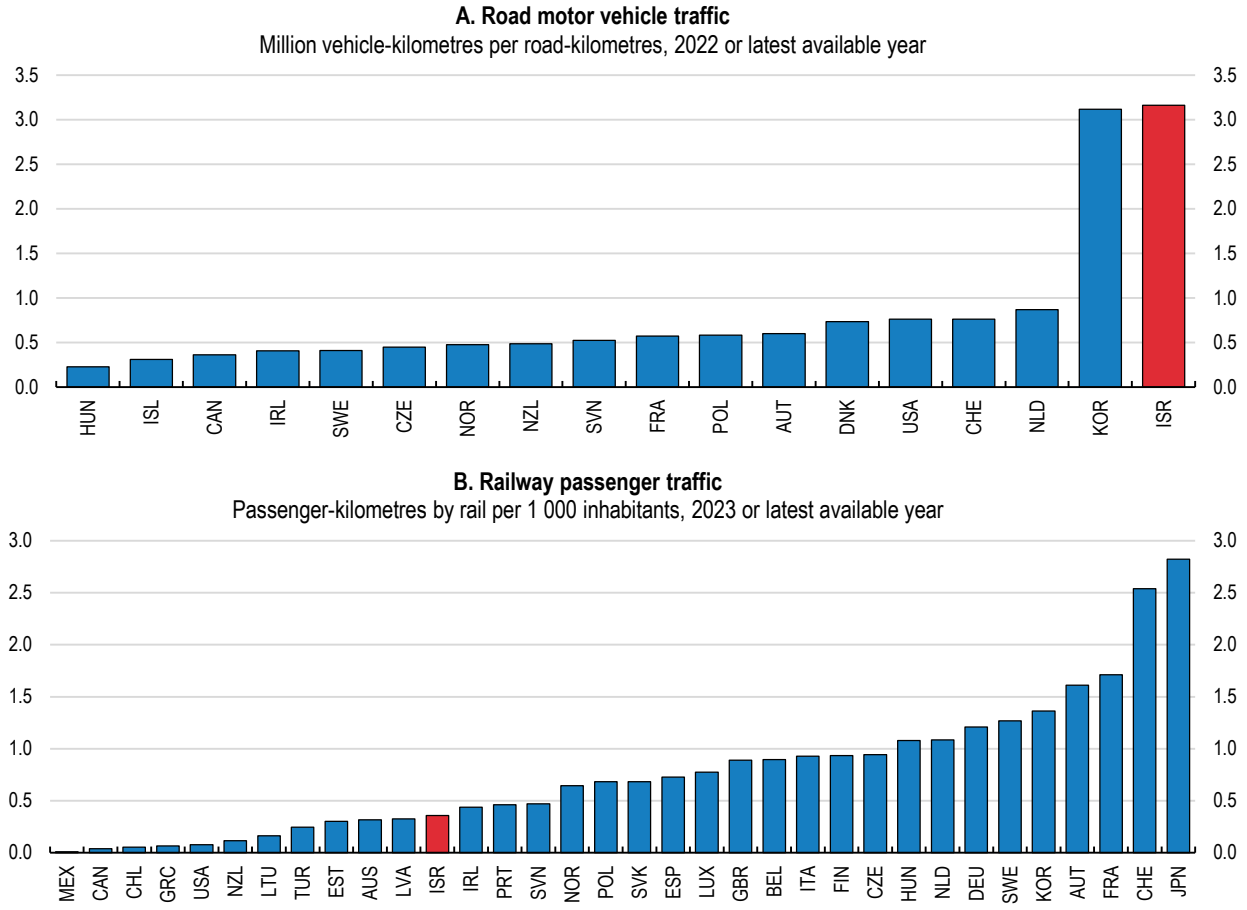
- The National Building Fund is an independent institution outside the state budget. Funding is based on a share of tenants' rents (amounting to 2.8% annually of the total acquisition cost of the property), in addition to housing associations' contributions to mortgage loans (approximately 2% of the property acquisition cost). Payments are adjusted annually for the first 20 years after loan take-up, and then by a slightly lower rate until the 45th year, after which they are maintained at the nominal level reached. A share of tenants' rent is used to pay off the housing agency's mortgage loan for the first 30 years (approximately), at which point the share is allocated to the state for another ten years. Once this period is over, the share is allocated to the National Building Fund. Approximately one-third of the Fund's resources are used to support the construction of new social housing. In this way, each housing organisation contributes to and can borrow from the Fund, which supports a wide range of activities, including renovation work in the existing housing stock.

Source: (OECD, 2020[86])

4.9.4. Investing in better transport infrastructure

Extensive and efficient transport infrastructure is vital for ensuring market accessibility, enhancing productivity, promoting labour mobility, and connecting communities. Good transport infrastructure allows people to live further away from city centres that are typically more expensive and, could boost housing construction in less expensive areas, thereby lowering housing prices.

Figure 4.29. Road transport is congested and railway-traffic low



Note: Panel A, 2021 data for Israel.
Sources: International Transport Forum (ITF) database; OECD Population Statistics database; and OECD calculations.

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Israel has one of the lowest road densities in the OECD, both in terms of population and land area. Most of the travel is done by road, with approximately 72% of the adult population owning a private vehicle, a significant increase from the 1970s when only 30% of vehicles were privately owned (INSS, 2024[87]). This rise in private car ownership has put pressure on existing road infrastructure and the environment, leading to widespread congestion (Figure 4.28 panel A). For instance, in 2021, Tel Aviv was ranked 16th out of 404 cities globally for traffic congestion, measured by the additional time lost to traffic compared to free-flowing conditions (TomTom, 2021[88]).

Israel lags particularly behind in public transport infrastructure, which incurs significant economic costs (OECD, 2023[3]). Limited access to public transportation, notably by train (Figure 4.28, panel B), and lengthy commuting times reduces incentives for workers, especially those from lower-income areas, to travel into metropolitan centres. It also reduces incentives to build housing in areas further away from those centres. In 2023, the Ministry of Transportation announced a five-year plan to enhance the country's

transportation network, focusing on upgrading public transit systems and roads. The plan, estimated to cost NIS 50 billion (USD 14 billion), marks a significant step toward addressing these deficiencies. Increased investment in public transportation, especially in urban areas, is crucial. Raising public investment in infrastructure by 1% of GDP can potentially boost GDP by 1.5% after four years, with even greater benefits depending on the efficiency of the investment (Abiad, Furceri and Topalova, 2016[89]).

However, delays in project implementation have hindered progress in Israel. For example, the completion of the fourth railway track along the Ayalon, initially slated for 2028, has been postponed to 2032, and the Green Line of the Gush Dan light rail system has been pushed back from 2027 to 2030. To expedite infrastructure projects, Israel must adopt a more coherent, predictable, and efficient regulatory framework. This requires better coordination of infrastructure policies across all levels of government, in alignment with the OECD Recommendation on the Governance of Infrastructure (OECD, 2020[90]). As recommended in previous Surveys, establishing metropolitan transport authorities can help improve coordination between the central and local government, and promote integrated transport and pricing solutions.

In tandem with increased investment in public transport, congestion charges can effectively reduce peak traffic, thereby reducing commuting times as well as lowering emissions. The Congestion Charge Law, passed in 2021, is set to be implemented in Tel Aviv in 2026. This law will create incentives for commuters to shift toward public transport and ensure a more efficient use of the road transport network, as private vehicles entering the city will be subject to tolls. To ensure successful implementation, the government must collaborate closely with local authorities. Moreover, to mitigate the potential impact on low-income households, the revenues generated from congestion charges could be reinvested in improving public transportation services including in low-income areas.

4.9.5. Improving the property tax-mix to incentivise housing construction

Recurrent taxes on immovable property in Israel constitute a significant share of total tax revenues (Figure 4.30, Panel A). At the regional level, property taxes account for more than half of all tax revenues (Figure 4.30, Panel B). As is common in most OECD countries, various taxes are applied to housing, depending on the type of housing investment. These include taxes on realised capital gains, transaction taxes, and recurrent property taxes (Thomas, 2021[91]). The details of the property tax mix can either help encourage more housing investment or discourage an expansion of the housing supply.

For example, rates of recurrent taxes on immovable property in Israel are typically significantly higher for commercial properties than for residential properties, incentivising municipalities to prioritise commercial over residential development. This incentivises developers to build commercial buildings rather than housing units, exacerbating the cost of living. As highlighted in previous *Economic Surveys*, these discrepancies should be addressed by lowering non-residential property tax rates and raising residential rates. Such reforms should be carefully designed following a thorough review of their potential distributional impacts across households and municipalities.

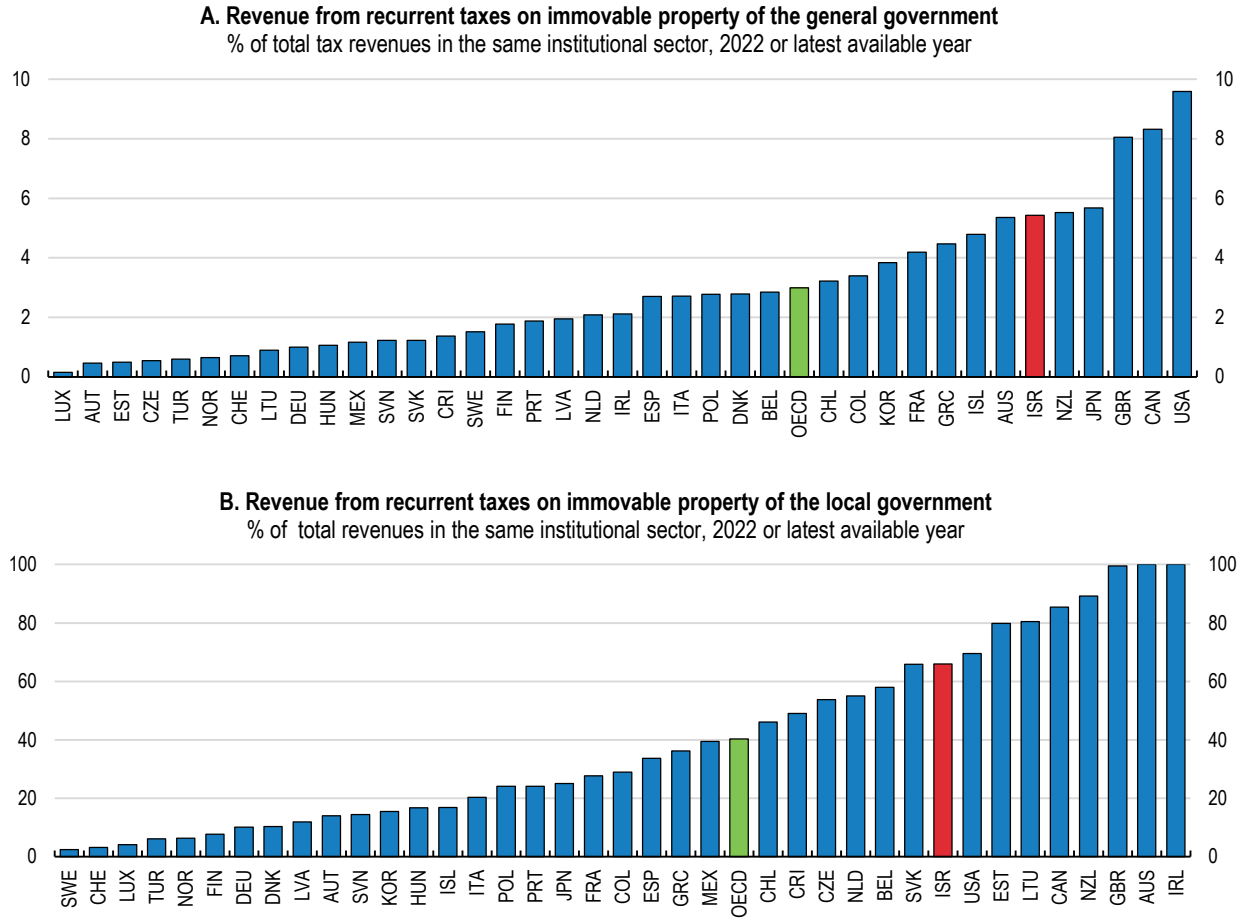
Israel applies a specific tax on housing transactions (Mas Rechisha), based on the purchase price of the property with progressive rates. Different rates apply for those purchasing their first property or upgrading a single property. While many other OECD countries impose transaction taxes on housing (OECD, 2022[92]), such taxes are widely regarded as inefficient, as they create distortions in both housing and labour market by disincentivising transactions and thus hampering an effective use of the housing stock.

A potential reform could involve eliminating transaction taxes on both first and second property purchases, and instead increase residential taxes on immovable property. This would help reduce distortions in the housing and labour markets, with any revenue loss offset by increases in recurrent property taxes and taxes on rental income. The current immovable property tax (Arnona) is a municipal tax levied on the user of the property. Unlike in many other countries, Arnona is not based on market value but on the size (square metres), location, and type of property, and is paid by the user rather than the owner. To increase

efficiency, reforms should aim to shift the tax base from property characteristics towards market valuations. A common objection to value-based taxation is the infrequent updating of property values. However, this issue can be mitigated through data-driven techniques, which use mathematical models or data from digital platforms listing properties for sale to estimate property values. This approach can reduce the costs associated with frequent property revaluations (OECD, 2022[92]).

A working group within the Israeli government has been established to analyse the structure of the current property taxation (Government of Israel, 2024[93]). One preliminary proposal is that unrealised real estate assets such as empty apartments or vacant land is taxed. A purpose of the tax is to promote residential construction in abandoned or empty areas and encourage property owners to use them for housing purposes. Such a proposal is welcome and the taxation of vacant property would help incentivise their effective use.

Figure 4.30. Property taxes account for a significant share of tax revenues



Source: OECD Global Revenue Statistics database.

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Table 4.1 Past recommendation on housing

RECOMMENDATION	ACTION TAKEN SINCE APRIL 2023
Require all property rental income to be declared and taxed, and consider moving to a single system of rental taxation based on net rental income taxed at marginal passive income tax rates	No action taken.

Table 4.2.Table of recommendations to address the high cost of living

Main findings	Recommendations
Lowering trade barriers to reduce import prices	
Trade barriers remain. Free trade agreements (FTAs) reduce trade costs and lowers uncertainty regarding trading relations. Israel's FTAs cover 48 countries, yet trade within those FTAs is low compared to the OECD average.	**Maintain efforts to negotiate new trade agreements and deepen existing ones to diversify import sources and expand export markets.**
Successive tariff cuts and reforms have lowered import costs. Yet, tariffs are still comparatively high for many agricultural products. A reform to reduce vegetable and fruit tariffs was repealed at the end of 2023 due to concerns of domestic production capacity.	**Lower trade restrictions on agricultural imports, including by cutting tariffs on vegetables, fruit and dairy.** If support for farmers is needed, provide this support in the form of targeted direct payments rather than tariff protection.
Border procedures are cumbersome, technical regulations burdensome, and product-standards are often different from the main trading partners, restraining trade.	**Continue to simplify border processes and remove technical barriers to trade. Implement planned import reforms, notably "What is good for Europe is good for Israel" and limit the number of products exempted from the reform.**
Perceived levels of corruption are in the OECD average. However, some progress could occur in areas such as lobbying, financial reporting of political parties and conflict of interest, as well as in AML/CFT supervision and prevention measures.	Continue efforts to fight corruption, including by strengthening lobbying regulations and implementing stronger enforcement measures for financial reporting and conflicts of interest.
Services trade is more restrictive than other OECD countries. Limits on foreign direct investment reduce the presence of foreign affiliates in many sectors, lowering competition.	Lower restrictions on trade in services, notably restrictions on foreign entry and movement of people.
Enhancing competition to spur productivity	
Administrative and regulatory requirements are among the most stringent in the OECD, hindering entry and growth.	**Reduce the time, cost and number of procedures required to start a new company and introduce an online one-stop shop.**
Price or quantity controls that have been deregulated in most OECD countries are applied widely for staple foods, distorting consumer choice and leading to shortages.	**Abolish price and quantity controls on food.**
Products and businesses can only be marketed as Kosher in Israel if they are certified by local councils appointed by the Chief Rabbinate.	Consider fostering competition among Kosher certifying organisations.
Entry barriers are higher than the OECD average in several professional services sectors. Importers of food face several cumbersome procedures and entry barriers.	**Reduce entry barriers for professional services and importers, notably by simplifying and extending import licensing.**
Public procurement represents a large share of GDP and government expenditures but is less competition-friendly than in other OECD countries.	Enable bids for public procurement to be submitted online and facilitate participation by foreign suppliers.
The banking sector is profitable and highly concentrated. Five banking groups account for 98% of total assets.	Conduct a review of competitive conditions in banking services.
Increasing the supply of housing	
Building permit procedures are cumbersome and lengthy. Slow permitting is perceived as a key obstacle to construction.	**Streamline building permitting procedures. Ensure implementation of the Expedited Licensing Plan to reduce permitting times.** **Adopt the "silence is consent" principle for approving building permits**
Rapid increases in housing prices have exacerbated inequalities. They have been associated with a growing disparity in housing affordability.	Expand social housing to the most disadvantaged households and provide them in areas of employment opportunities.
Public transport infrastructure spending has been low, resulting in high car dependence and significant traffic congestion in major cities. Major infrastructure projects have faced significant delays.	Establish metropolitan transport authorities in major cities to coordinate and manage planned public transport infrastructure investments.
The property tax system favours commercial over residential real estate, contributing to housing supply pressures. Property taxes are determined by property size, rather than market values.	**Reduce the difference between non-residential and residential property tax rates.** Replace the area-based property tax with a system based on regularly updated property market values.

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