The Committee for Economic Advancement of the Commerce and Service Sectors

July 6, 2021

Ministry of Economy and Industry
Strategy and Policy Planning Department

Reichman University
Aaron Institute for Economic Policy
In the name of Aaron Dovrat z"l

Letter from the Committee Chairs

To MK Orna Barbivai

Minister of Economy and Industry

It is our honor to present to you the report of The Committee for Economic Advancement of the Commerce and Service Sectors, founded in December to address the labor productivity gaps in the Israeli economy in comparison to leading countries.

The committee focused on formulating recommendations revolving around the issue of increasing productivity in these sectors, and delineated three main vectors to concentrate on: (a) increasing competition and optimizing regulation; (b) encouraging innovation and investment in physical and technological capital; (c) human capital dimension. In addition, the committee discussed promoting revision of the organizational structure of the Ministry of Economy and Industry, to enable among other things the implementation of the recommendations in this report, and to correspond more closely with the distribution of the business sector industries which belong to the remit of the ministry. The work of the committee coincided with the outbreak of the COVID-19 pandemic, which plunged local as well as global economy into a crisis and has had a substantial impact on the commerce and service sectors. It is still early to predict the long-term consequences of the COVID-19 crisis, which was also discussed by this committee, but what is clear is that the crisis highlights and intensifies the need to accelerate steps aiming to increase productivity in the commerce and service sectors, as proposed in this report.

Propelling the commerce and service sectors towards a path of growth and increasing labor productivity requires planning and execution which are informed by a long-term perspective, combined with the introduction of significant changes in the existing government mechanisms. This report puts a strong emphasis on the issue of bureaucracy reduction and regulatory optimization, which has substantial impact on the low labor productivity in these sectors. The committee recommends taking steps to enhance and reinforce government activity in this regard; measuring the cost of bureaucracy and reducing the administrative burden on businesses in Israel; enacting comprehensive changes in the government's regulatory mechanisms; and adopting a new paradigm which is based on assigning the responsibility to the regulated party, while adopting international norms and mechanisms. In addition, the committee recommends discarding sectoral distinctions within the business sector as a consideration for eligibility to government assistance; taking steps to adapt human capital to the needs of the commerce and service sectors; and adjusting the activity of the Ministry of Economy to accommodate economic advancement of the commerce and service sectors.

We believe that implementing the recommendations of this committee would help to increase productivity in the commerce and service sectors, and enhance growth across the economy as a whole.

We would like to thank all committee members as well as the various bodies who took part in preparing and writing this report. Special thanks to the staff at the Strategy Department in the

Ministry of Economy and Industry, and at the Aaron Institute, for coordinating the work of the committee and writing this report.

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Summary and Key Recommendations

The commerce and service sectors constitute a major share of the Israeli economy: 60% of all employees and 65% of the gross value added to the domestic business product.[1] These sectors, like the rest of the economy, consist mostly of small and mid-size businesses, however they are mainly oriented towards the local market and are less exposed to international trade.[2] The large share these sectors have in the domestic business product illustrates their immense impact on economic productivity and on the cost of living. These sectors currently exhibit low productivity when compared internationally, with a gap of 44% in terms of GDP per hour worked,[3] compared to the benchmark countries.[4] The low levels of labor productivity in these sectors, as in other sectors of the Israeli economy, have a significant adverse effect on GDP per capita and the cost of living, and are caused by factors which will be discussed in detail below. Indeed, on a long-term perspective at a time when the Israeli economy has high employment, the GDP per hour worked is the main growth barrier facing the Israeli economy, and the reason Israel has remained at a low standard of living compared to leading countries.

Economic advancement of the commerce and service sectors has never before received direct government attention. Therefore, the Committee for Economic Advancement of the Commerce and Service Sectors was convened on December 2, 2018, at the initiative of the Ministry of Economy and Industry. **The mission of the committee is to draft recommendations for programs supporting economic advancement of the commerce and service sectors, with an emphasis on reducing labor productivity gaps vis-á-vis leading countries.** Economic research reveals that increasing labor

[1] Sectors in ISIC categories G, H, I, J, K, M, N; Aaron Institute groupings of 2019 data from Israel Central Bureau of Statistics (CBS).
[2] Apart from high-tech sectors.
[3] According to Aaron Institute analysis of OECD data.
[4] The 'benchmark countries' are similar in scale to Israel in terms of population and of the nature of economic growth, which relies on human capital, however they have higher levels of GDP per capita and labor productivity, and lower poverty rates. These group of countries include Austria, Belgium, Denmark, Finland, Ireland, Sweden, Switzerland, and The Netherlands. All of them have higher GDP per capita, and lower poverty rates, compared to OECD average.

productivity leads to a reduction in the cost of living. After the committee concluded its work and convened to draft the report, the COVID-19 pandemic broke out and plunged local as well as global economy into a crisis. The sectors most badly hit in the Israeli economy, due to policies of social distancing and sweeping lockdowns, were the commerce and service sectors, particularly hospitality and food service, retail, art, entertainment, and leisure. The damages caused by this crisis, evident mainly in reduced employment rates, are particularly accentuated in the commerce and service sectors, which have the highest rates of furloughed employees[5] and require immediate action in order to bring these employees back to the labor market. It is still premature to predict the long-term implications of COVID-19 crisis, but it is already clear that this crisis underlines and accentuates the need to step up measures aiming to increase productivity in the commerce and service sectors, as outlined in this report, and in particular to ease the administrative burden in a manner that would facilitate business reopening, a process which would drive renewed growth and job creation. This should be done in conjunction with guidance and cultivation of human capital in order to help job seekers – a population group characterized by low employability skills – to upgrade their professional capabilities and reintegrate into the labor market. Another necessary measure is the removal of barriers to investment in capital and technology, which is a key determining factor on productivity levels in the commerce and service sectors.

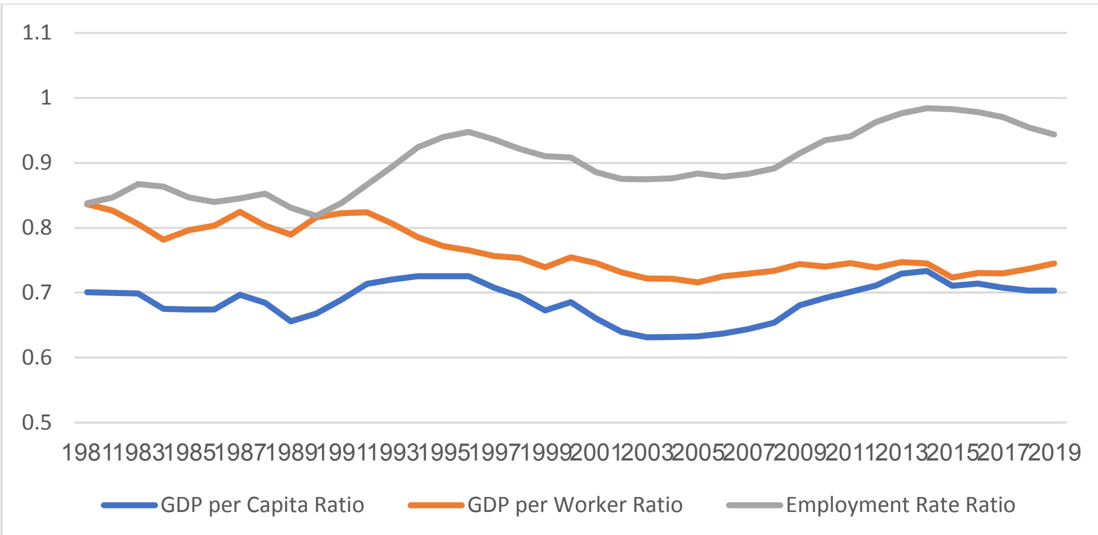
Economic background conditions prior to the commencement of the committee's work (Q2, 2019) were a consistent rise in employment rates throughout the Israeli economy over the last decade, bringing employment rates in Israel close to those of the benchmark countries. This rise, due in part to intentional government policy, was the main growth engine during those years. Thus, out of an average growth rate of around 3.5% per year during the last decade, the increase in hours worked (2.6% per year in average) contributed around 75% of growth, while the increase in labor productivity (only around 0.9% per year in average) accounted for just around 25% of growth. This data strongly suggests that even if employment rates in Israel return to pre-pandemic levels, this growth

[5] Source: CBS, results of the Survey of Businesses in Israel during the Coronavirus Crisis (5th wave).

engine has been nearly exhausted, while the gap in productivity per hour worked keeps growing.

<u>Figure 1: GDP per capita, labor productivity and employment rate ratios between Israel and benchmark countries*</u>

1981-2019



* The benchmark countries are Austria, Belgium, Denmark, Finland, Ireland, Sweden, Switzerland, and The Netherlands. Based on Aaron Institute analysis of OECD data.

The economic literature identifies several factors which influence labor productivity levels and their changes. These factors include the level and quality of human capital, stock of investments by firms in physical capital and technological innovation, and technological level and production efficiency of the factors of production in the economy ("total productivity"). **The stock of investments in the business sector is influenced by various factors, such as competitiveness and business environment, which are in turn determined by the legal infrastructure underlying the economy, the regulation and bureaucracy derived from it, and the tax system.**

The accepted analytical framework in the economic literature for analyzing the factors which hinder growth in labor productivity is based on comparing the levels of factors of production in the economy to those of reference countries – the benchmark countries. Macroeconomic analysis found that the productivity gap in the commerce and service sectors (26 USD) can be attributed, among other things, to low stock of investments in the business sector (30% of the productivity gap) and to the quality of human capital (29% of the productivity gap). The stock of investments per hour worked in the commerce and service sectors is very low in Israel: only 38% compared to the benchmark countries. In regard to the level of human capital, as measured by the proficiency levels of individuals (PIAAC Survey results), we would like to note that the rise in employment rates during the previous decade, prior to the COVID-19 crisis, was mostly notable in the commerce and service sectors. The increase in employment rates brought into the workforce less experienced workers, some of whom also have lower-than-average skills. The assimilation of these populations is beneficial for the economy, as it reduces poverty and inequality, however it diminishes the average labor productivity. This point further emphasizes the need to act towards raising productivity in these sectors, a process which would also manifest in rising wages.

This analysis helped the work of the committee by specifying the central vectors to focus on. **The three vectors (areas for action) highlighted by the committee were: (a) regulation and competition, (b) physical capital and innovation, and (c) human capital.** Since the commerce and service sectors encompass a wide range of industries, and in order to provide a clearer focus for the committee's work, it was decided to choose a few industries as focal points, taking into consideration each industry's contribution in terms of GDP and employment, as well as productivity gaps vis-á-vis benchmark countries. Therefore, it was decided to focus on the following industries: retail, wholesale, delivery and courier services, food and hospitality, professional services, and management and support services.

The work of the committee lasted around a year, and involved meetings with firms from the business sector in all industries and plenary meetings where relevant materials were presented, as well as studies and analyses related to the topics discussed. In addition, a procedure was initiated to involve the general public, along with issuing a call for views which invited the business sector to participate in a survey designed to map the main issues which were pointed out as hindrances to productivity. After examining all the materials and the information presented, the committee established that labor productivity is influenced by many factors which need to be addressed. **A pivotal factor which**

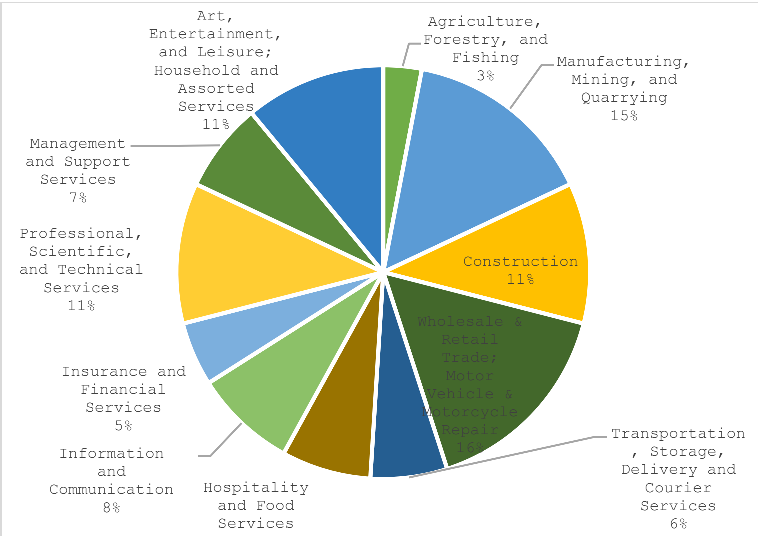
impairs labor productivity in all commerce and service sectors as well as the wider economy, whereas an overwhelming consensus exists on the need to address it, is the excessive regulation and the heavy administrative burden experienced by the business sector. The state of Israel has excessive regulation, combined with a bureaucracy which drives up the costs incurred on businesses. This structure entails that the regulator protects the interests which fall under its scope while minimizing the risks it is appointed to manage – <u>with insufficient consideration of the financial burden it imposes on the business sector, and consequently on the entire population due to low labor productivity and high product prices.</u> We would stress that extensive government efforts have already been devoted to that issue over the last decade, and the main measures which have been taken are described below. In general, however, the committee did not observe any significant relief in the administrative burden experienced by the Israeli service sector. The committee identifies a lack of basic implementation tools, which are essential for achieving significant improvement in the existing administrative burden.

The committee's report contains a series of recommendations, classified according to the vectors which guided the work of the committee. The aim of these recommendations is to bridge the productivity gaps in the commerce and service sectors vis-á-vis the standard in the benchmark countries, while reducing the cost of living. Along with recommendations for regulatory optimization and bureaucracy reduction, the committee outlines recommendations for encouraging innovation and integrating technology into the commerce and service sectors, given the exceptionally low investment in capital and innovation within these sectors (apart from high-tech industries). In addition, the committee discussed the topic of human capital advancement, which is a critical issue due to the low proficiency levels prevalent among workers in these sectors, as well as the negative effect of the quality of human capital on the investment of firms in capital and innovation, on labor productivity and wages per hour, and on the sectoral structure of the economy as a whole. In addition to those vector-specific recommendations, the committee identifies a pressing need to implement an adjustment in the activity of the Ministry of Economy and Industry, which would support economic advancement of the commerce and service sectors in a manner which reflects their growing contribution to employment and to the total business product. The aim of this proposed adjustment is to create a more balanced policy, and to provide a balanced response to the entirety of business sector industries which operate under the remit of the Ministry of Economy and Industry. The committee asserts that such a structural change would support the execution of operational plans for theses sectors, including the recommendations of this committee, as well as the establishment of mechanisms for ongoing conversation with businesses within these sectors, whereby the Ministry acts as the designated government bureau for appeals from the entire business sector regarding issues of regulation and bureaucracy.

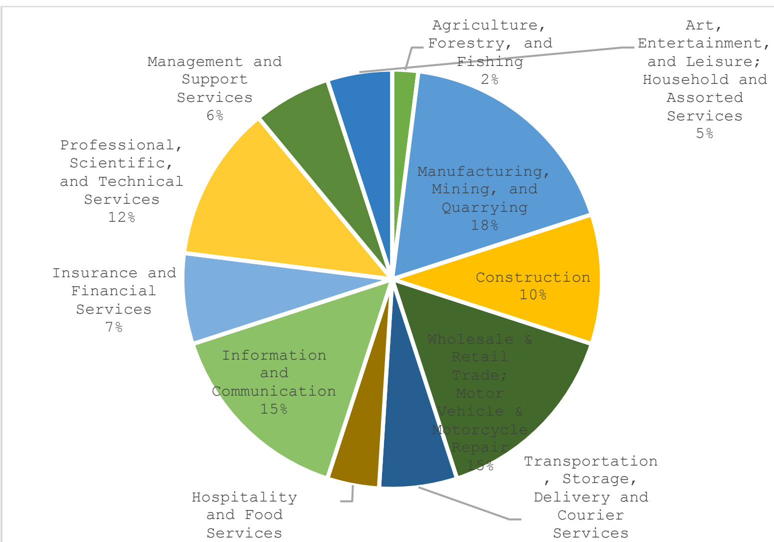
Figure 2: Distribution of Product and Employees in the Business Sector, by Industries

2019 data

A. Employees



B. Product



Source: CBS, 2019; Processed by the Aaron Institute

These calculations do not include the following sectors: real estate activity; electricity, gas, and water supply; sewage services; and garbage disposal.

1. RECOMMENDATIONS REGARDING PROMOTING COMPETITION AND OPTIMIZING REGULATION

The existence of excessive regulation and a heavy administrative burden came up in conversations with the business sector, and are also reflected in the relatively low ranking of Israel in prominent international indexes tracking this issue:

1. In the Ease of Doing Business Index, which is published by the World Bank and examines the costs in time and money of setting up and maintaining a business, Israel is ranked 21st out of 34 OECD countries, **a score which indicates that Israel imposes bureaucratic difficulties for procedures involved in founding and operating a business.**[6]
2. In the Services Trade Restrictiveness Index (STRI) of the OECD, which examines how conducive the legal environment is to open trade across 22 commerce and service industries, Israel's aggregate ranking is 34th out of 37 OECD countries. This score means that **Israel has regulatory and administrative barriers to entry, which affect international firms seeking to enter the local market as well as local competition.**
3. According to the indicators of Product Market Regulation (PMR) published by the OECD, which examine assorted regulatory criteria affecting sectoral competition, Israel is ranked low due to **regulation which creates barriers to competition**.

The existence of regulation is vital to any market. It is essentially a mechanism for market oversight and moderation, also intended to rectify market failures which distort the operation of the free market and create economic inefficiency. However, regulation often tends to keep expanding, unless it is bridled and assessed by a balanced supervisory body. As a result, it turns from being a useful policy tool which supports a beneficial business environment and economic growth into a burden which encumbers the business sector, suppressing competition and growth. Excessive regulation of the business sector manifests in two interconnected aspects. The first is regulation which creates barriers to entry, limits competition, and assigns disproportionate market power to businesses. The second is regulation which imposes heavy administrative burden on businesses, which also inhibits competition. Heavy administrative burden on opening businesses constitutes a tax on initial activity, while heavy administrative burden on ongoing activity acts as a tax on ongoing activity. Administrative burden poses particular difficulty for small to medium-

[6] It should be noted that this index did not take into account the expected impact of the business licensing reform, and the 10-year license extensions granted to most businesses.

sized businesses, due to the fixed cost element which is considerably affected by the administrative burden. **Competition is directly related to productivity, thus excessive regulation which inhibits competition is also detrimental to productivity,** since competition compels active firms to look for ways to increase their efficiency, a process which encourages innovation and investment, in turn improving productivity. Furthermore, competition which incorporates efficient firms into the industry acts as a selection mechanism which pushes inefficient firms out of the industry. **The negative economic impact of the regulatory burden in Israel necessitates a government policy of regulatory optimization, which means adopting policies towards removal of unnecessary regulatory obligations which create barriers to entry and inhibit competition both locally and internationally, and streamlining bureaucratic procedures in a manner which achieves the objectives of regulation at lower costs in terms of time, money, and effort. To resolve the fundamental problems underlying current government regulation, action must be taken towards a comprehensive revision of state regulation, aiming for structural changes which would thoroughly overhaul these mechanisms.**

1.1| Targets and Metrics

In order to achieve significant improvement with regard to regulation and bureaucracy, the committee proposes setting two measurable targets, to be achieved within a decade. Setting an ambitious target for reduction of the cost of bureaucratic procedures is a process which has been applied successfully in developed countries around the world. In light of this international evidence, and in a bid to reduce the administrative burden on businesses in Israel, to incentivize more competitive economy, and to boost the economy's growth potential, the committee advises the government to set multi-year targets in the following manner:

A. Improving Israel's ranking in the STRI to be among top ten countries by 2030

The STRI maps barriers to international services trade, examining 22 different commerce and service industries. The ranking of a country indicates its level of openness to market entry by foreign service providers across the different industries, as reflected in local regulation. This index is based on examination of dozens of laws which international firms must tackle in order to enter the market of a foreign country. These include the laws governing the registration of the foreign firm, laws restricting the entry of workers, or laws which grant an advantage to local firms. An analysis prepared as part of the committee's work shows that the current low ranking of Israel in this index, indicating that Israel had barriers to entry which prevent foreign firms from competing on the supply of goods to the economy, stems from several regulations that are considered severe in comparison to the international standard. Some of the laws which restrict entry of foreign firms are the requirement that a local resident serves as chair of the board, and restrictions on registering a firm in Israel (Companies Law, 5759-1999); restrictions on employing foreign workers, including expertise requirement (Foreign Workers Law, 5751-1991); and others.[7] Our analysis shows that the regulation which prohibits entry of foreign firms stems from several laws which are not interrelated, but collectively they create an entry barrier for foreign firms, inhibit competition, hinder productivity growth, and increase the cost of living across the Israeli economy. According to this analysis, along with simulations we conducted, the ambitious target of improving Israel's relative score to be ranked among the top ten countries is indeed feasible. To clarify, this index does not indicate the actual regulatory and administrative burden in practice, as it examines only barriers to entry which are due to regulation, hence it should be complemented by another index which reflects the cost of bureaucracy for firms already operating in the market or newly founded domestic firms. We would stress that economic analyses performed on the STRI, which is a relatively new index, show that improvements in this index are manifested in reduction of entry barriers and encouragement of competition within that industry, thus producing better outcomes. This is demonstrated in the banking and telecom sectors, as described

[7] Other laws include stay duration limit (Entry to Israel Law, 5712-1952); maximum limit on expert salary (Foreign Workers Law, 5751-1991); and the requirement to favor domestic acquisitions (Mandatory Tenders Law, 5752-1992; Mandatory Tenders Regulations, 5753-1993).

in detail later in this report. In light of these findings, the committee considers this index as an important economic metric where improvement would be beneficial.

B. Measuring the administrative burden on businesses using SCM: comprehensive and individual reduction

Similarly to the measurement of economic indicators such as inflation and employment, the administrative burden on businesses should also be measured regularly. The need to measure the administrative burden is also driven by the nature of the bureaucratic procedures imposed on the business sector, of which many are cross-ministerial. In the absence of a government agency tasked with monitoring and integrating the administrative burden, alongside the insufficient awareness of government offices regarding the direct economic costs of their decisions and their impact on the business sector,[8] bureaucracy tends to expand. The method commonly used in developed countries to measure the cost of bureaucracy employs the Standard Cost Model (SCM) methodology, which is based on a quantitative model which calculates the administrative burden involved in the rules and regulations imposed by the government on businesses, by breaking down legislation into bureaucratic obligations and measuring the time and the financial cost required to fulfil these obligations. The model was designed to provide a simple, consistent method for measuring the cost of bureaucracy imposed by the government, and it is used in many countries including Austria, Germany, Ireland, Latvia, Luxemburg, Britain, Norway, Sweden, Finland, Belgium, The Netherlands, France, Hungary, Italy, Czechia, Poland, and Estonia. **The committee recommends using SCM method to measure the bureaucratic impact of significant regulations while setting reduction targets, monitoring the execution of the measurement annually, and incorporating the tasks of reporting and contributing towards burden reduction into the yearly working plans of the relevant government bodies.** Measurement is to be done in relation to significant regulations where it is expected that the reduction in the cost of bureaucracy would yield a high return compared to the costs of measurement

[8] Report of the Committee for the Improvement of the Business environment in Israel, June 2018, Accountant General Department in the Ministry of Finance.

(examples of significant regulations include business licensing and the import of sensitive foods, as detailed later in this report).

To ensure the establishment of this measurement mechanism, the committee recommends the following structural changes. These recommendations are based on experience accumulated globally in advanced Western countries.

1.2| Structural Changes for Thorough Revision of Regulatory Mechanisms

A. Completing the organizational structure required for measuring bureaucracy – data collection and measurement oversight

International evidence shows that implementing a policy of systematic, supervised measurement of the cost of bureaucracy using SCM method requires a suitable mechanism which facilitates professional data collection to be used in measuring and in supervising the measurement. **Therefore, the committee recommends:**

a. Initiating measurement activity led by the Ministry of Finance and the Prime Minister's Office, in collaboration with the Israel Central Bureau of Statistics (CBS), which would include systematic, representative collection of the data required to calculate the cost of bureaucracy using SCM.[9]
b. Supervising and monitoring the measurement methodology for new regulation (RIA), and ongoing assessment of the measurement conducted by the departments for regulatory optimization at the various government offices, would be done by the Ministry of Finance and the Prime Minister's Office, drawing on measurement data and consultation with the regulators within those government offices.[10]

As mentioned above, data collection and oversight of the measurement process are key complementary measures to the positive efforts made over the last few years, specifically

[9] The process must involve the CBS as it is the only agency entitled by law to compel businesses to report, and also in order to ensure that the measurement process is reliable and meets the professional standard for a representative sample of businesses in Israel. To be clear, this recommendation does not negate the possibility for any government agency so inclined to conduct the measurement using SCM on its own accord, including the Ministry of Economy, drawing on Government Resolution no. 2318 "Enhancing Competition and Optimizing Regulatory Procedures in the Import Sector", specifically Section 13a regarding the obligation to consult with the official in charge of import legality.

[10] For details of the preferable institutional structure commonly used in countries which conduct measurements of the administrative burden, see Sumkin, Sergei (2019), "A Mechanism for Reducing Administrative Burden Using SCM Method", Policy Paper, Aaron Institute for Economic Policy.

the development of a mechanism for reducing administrative burden and optimizing regulation, which comprised the establishment of the Regulatory Optimization Unit in the Prime Minister's Office as well as regulatory optimization departments in various government offices.[11]

B. Appointing a Director Generals' Committee

The problem of excessive regulation and heavy administrative burden encompasses several government offices, and comprises a plethora of administrative procedures and details. In order to optimally address the regulatory issues imposed on the business sector, a senior committee should be appointed, consisting of the Director Generals of the Prime Minister's Office and the Ministries of Finance, Economy, and Industry.[12] The director generals' committee would serve as a platform for round table discussions regarding underlying issues which arise from appeals by businesses and from an ongoing conversation with the business sector. In addition to that role, the committee would formulate the detailed government response towards implementation of this report. The committee would be coordinated by the Ministry of Economy and Industry, in its capacity as the designated point of contact (POC) for businesses.[13]

In the course of its discussions, the committee examined the possibility of founding an independent government agency to be tasked with supervising regulation in Israel, although these discussions did not yield a final recommendation. At the time of the writing of this report, the Ministry of Justice held a comprehensive, comparative review of the regulatory processes in developed countries that have high rankings in international indexes of regulatory quality, which showed that these countries employ a supervisory body as mentioned before. Consequently, the foundation of such a body is currently examined by government task forces. This committee would like to point out that in case such an agency is indeed founded, the operation of the aforementioned director generals' committee should be reassessed.

[11] According to Government Resolution no. 2118 of October 22, 2014, on Reducing the Regulatory Burden.

[12] This committee will act in collaboration and synchronization with the Director Generals' Committee founded as a result of The Committee for the Improvement of the Business Environment in Israel, pursuant to the recommendations in that committee's report from June 2018.

[13] For additional details, see the chapter on Structural Change in the Ministry of Economy and Industry.

1.3| Comprehensive Changes in Government Regulatory Mechanisms

The committee's work revealed several fundamental regulatory problems which encumber the business sector, as today there is no integrative government outlook on the business sector. Each regulatory body sees businesses through the narrow prism of its own regulatory function, thereby lacking a holistic view of the aggregate regulatory environment experienced by the business, including the whole range of regulations imposed on businesses, the overall costs, and the cumulative implications of the full set of requirements which must be met.

Addressing the underlying problems of the government regulatory infrastructure requires action towards a fundamental change in the conduct of government regulators. Below are the basic principles which the committee recommends for enactment by all the various regulatory bodies, aiming to promote comprehensive changes across all government regulatory mechanisms:

A. Adopting International Mechanisms and Norms

Comparison of principal, significant regulatory processes in terms of competitiveness, productivity, and cost of living, shows that the regulatory requirements in Israel are overly strict compared to the norm in Europe and the US. This is evident, for example, in the very detailed stipulations listed in the standards for food storage; in the method used to enforce the legality of imported goods, which focuses on enforcement prior to marketing due to an emphasis on sensitive food; in the different requirements concerning business licensing which vary for different licensing items; and in the regulatory requirements for obtaining a permit for a foreign worker visa – all are issues where the committee found that Israel applies overly strict regulatory standards.[14] The importance of smart regulation, which achieves the objectives of regulation at low bureaucratic costs – thereby stimulating enterprise, investment, and employment – is clearly evident in the era of global economy, when many countries compete to attract businesses and investments from all sources, whether domestic or foreign. Therefore, the committee recommends instructing the

[14] For comparisons see Appendix 5 and figures 20-22.

regulators to adopt international standards and norms in their jurisdiction, according to the regulatory practices employed in developed countries.[15]

B. Utilizing Risk Management Mechanisms and Shifting Responsibility to the Regulated Party

Optimal regulation needs to strike a balance between specific, detailed rules which minimize major risks, and general principles which leave room for consideration and self-regulation by businesses. The distinction between unwanted conduct of micro-regulation which compels businesses to adhere to precise rules on the one hand, and setting principles to be met while shifting responsibility to the regulated party on the other, draws on models of risk management which differentiate between businesses according to their risk level. Currently, in key regulatory procedures such as business licensing[16] and the import of sensitive foods, there is insufficient differentiation between businesses. Lacking distinction between the risk levels inherent to various businesses, strict and uniform requirements are imposed even on businesses whose activity does not involve high risk levels, and they are obliged to meet an unjustifiably high standard of regulation, specifically when applied to small and medium-sized businesses. Indeed, the committee holds that even when dealing with high-risk businesses, it is possible to fulfil the purpose of regulation with a lower administrative burden, as indicated by international comparisons. The committee recommends that regulators incorporate models of risk management into their regulatory practices by using a wider array of regulatory tools, ranging from extensive and strict regulatory intervention (i.e., advance approval and required licensing) to limited intervention which assigns more choice and control to the regulated party (i.e., transition to market enforcement). We would like to stress that effective implementation of market enforcement requires augmenting and improving the existing enforcement apparatus. Risk management activity is to be led by the Regulatory

[15] Government Resolution no. 2318 of December 11, 2014, regarding "Enhancing Competition and Optimizing Regulatory Procedures in the Import Sector", refers to adopting the standards applied in developed countries, but only in regard to import. The committee holds that efforts towards the adoption of international mechanisms and norms should be broader, and extend to other regulatory areas.

[16] On July 10, 2018, the Knesset ratified Amendment no. 34 to the Business Licensing Law, titled "Differential Business Licensing", which aims to enact different licensing processes suited for different types of businesses. This reform should have been in force since January 1, 2019, but is yet to be implemented.

Policy Department in the Prime Minister's Office, which has developed different methodologies for risk assessment and management.[17]

C. Revising the Personal Legal Liability Currently Assigned to Regulators

The mechanisms currently in place maintain high personal liability of regulators on the areas under their regulatory responsibility. Such liability, which extends to legal, personal, and damages liability, leads to a policy which focuses on risk minimization rather than risk management. Therefore, as a vital step towards regulation which assigns to the regulated party more choice and control, as well as greater responsibility, the committee recommends revising the personal legal liability currently assigned to regulators. Initial steps already taken in that direction, led by the Regulatory Policy Department in the Prime Minister's Office, include State Attorney Directive no. 2.37: "Prosecution Policy on the Decision to Indict on Charges of Involuntary Manslaughter and Manslaughter by Negligence".[18] In addition to this measure, the committee proposes legislation which applies explicitly to the legal umbrella provided by the state, including among other things the issue of risk management and the extent of the regulator's liability.

D. Promoting Digitalization of Government Services

Digitalizing the processes of regulation, supervision and reporting which are imposed on businesses, and using digital means to augment the flow of information between businesses and the government and its subsidiaries, would help to streamline the bureaucratic procedure and reduce its cost. Digitalization of government services, in particular licensing procedures and digital access to various certificates which businesses are required to obtain, has positive external effects since alongside the bureaucratic procedure itself, government digitalization also encourages businesses to adopt technology for broader use, thereby contributing to accelerated innovation in the business sector. Furthermore, accelerating digitalization of business licensing and other procedures would enable regulatory bodies to use the knowledge thus acquired, conduct

[17] https://www.gov.il/he/departments/general/risk_management (Hebrew).
[18] For State Attorney Directive no. 2.37, see https://www.justice.gov.il/Units/StateAttorney/Guidelines/02.37.pdf (Hebrew).

pertinent analyses, draw insights, identify failings, monitor service targets and process duration, and facilitate effective action with regards to businesses.

1.4| Specific Issues Requiring Optimization

A. Removing Import Barriers and Reducing the Cost of Bureaucracy

The import sector has significant barriers to entry, since the enforcement method of import legality which is employed in Israel is time-consuming and bureaucracy-laden, appended costs which constitute entry barriers into this sector, as well as a "bureaucracy tax" on ongoing activity. This bureaucracy is particularly detrimental to small-scale importers, while strengthening large importers and augmenting the centralization of markets. The immense positive impact of import on increasing competition and productivity, as well as reducing the cost of living, accentuates the need for substantial reduction of the administrative burden, and indicates that this sector should receive high priority for introducing measurements, with a proposed reduction target of at least 75% of the cost of bureaucracy.

In light of the above, the committee proposes the following steps, bearing in mind that **ensuring adequate progression of the reduction process requires yearly measurement of the cost of bureaucracy through SCM method** and publication of the outcomes:

- **Adopting the European method for import legality enforcement:** transition from a model of entry gate enforcement to a model of market enforcement – adopting the method of legality enforcement prevalent in Europe, which eliminates regulatory procedures at the import stage, whereas the regulator relies on a declaration by the importer that the product meets required regulations. This step should be accompanied by risk management in the form of periodic enforcement activity in the markets, along with conferring the necessary powers to enforce and punish for false declarations.
- **Adopting the technical standards accepted in developed countries** with substantial markets, so that no adjustments would be necessary for imports into

Israel, thus allowing products designed for sale in the European Union or the US to be sold in Israel as well without exceptional modifications.

- **Improving transparency of the regulatory process and making the information accessible to importers:** action should be taken to improve public access to the information regarding the bureaucratic process involved in importing goods. The current uncertainty impedes the ability of importers to make informed decisions, and may create disparity among different importers in the administrative burden they experience.
- **Reducing the cost of bureaucracy for import of sensitive foods:** steps taken recently to reclassify products as "regular food" rather than "sensitive food" should be expanded upon, in accordance with European Union regulations. Other recommended measures which might reduce the administrative burden include reducing the frequency of sampling sensitive foods, further reliance on declarations in the import stage, and adjustment of existing regulations in accord with the accepted norms of developed markets.
- **Adopting international standards in regard to informal binding standardization:** issuing an instruction to adopt international standards (in a similar manner to that of formal standardization), establishing a mechanism for orderly mapping of the changes stemming from international non-binding aspects, and devising a protocol for the approval procedure of informal standardization.
- **Removing barriers to parallel import:** the present situation in many sectors necessitates direct contact with the manufacturer in order to import goods to Israel. This requirement practically prevents parallel import which is known to increase competition and improve productivity. The committee recommends disallowing regulators to demand contact with the manufacturer as a prerequisite to import, along with other requirements which prevent parallel import, and to find other regulatory solutions, based on risk management, with the aim of encouraging parallel import.

B. Business Licensing and Modifying Requirements Along the Duration of the License

The complexity and heavy administrative burden involved in the business licensing process have been well-known for many years, and stem mainly from the great variance among types of businesses and individual business features, as well as the profusion of government agencies concerned with licensing whose various demands are often in conflict with each other, or with regulatory requirements engendered by other rules. This complexity leads to a prolonged and cumbersome licensing process which involves a lot of uncertainty, creating an incentive to open unlicensed businesses. This situation already gave rise to several reform attempts,[19] however most of them have not been actualized, and ultimately had no palpable impact on the heavy administrative burden.

The committee recommends proceeding with efforts to implement reforms which have already been introduced, in particular the enactment of unified specifications and differential licensing protocols. Enacting these reforms would ensure reduction in the administrative burden for businesses and increased certainty throughout the process, while applying risk management mechanisms. In regard to the reform towards publication of unified specifications, out of 200 licensing items, 65 specifications have been issued since 2012, of which 20 were issued just in 2020. Since the 30 most common licensing items cover around 80% of the total number of businesses which require a license, efforts should be concentrated around publication of specifications for these licensing items, particularly common licensing items which do not involve high risks. We would like to note that the licensing items already published are not necessarily among the most common ones. In addition, considering the major delay in the progress of issuing these specifications, measures should be taken to pinpoint the regulators who hinder publication and the barriers which obstruct the resolution of this issue, taking into account the long-term benefits to the wider economy from publication of these specifications. **As stated above, the business licensing process should be one of the main procedures measured using SCM method, with an ambitious reduction target.** The committee also recommends incorporating digital processes into this procedure, in a

[19] Business Licensing Law (Amendment no. 27, 2008) – publication of unified specifications; Business Licensing Law (Amendment no. 34, 2018) – differential licensing protocols.

manner which would generate massive reduction in the cost of bureaucracy associated with this regulatory procedure, and would create consistency in the requirements imposed on businesses, and in their enforcement.

Furthermore, those specifications which have been published are long, cumbersome, and disproportionate, and tend to present excessive requirements concerning risk management, in comparison to the internationally accepted requirements. The committee recommends mandating the Advisory Committee on Regulation, appointed pursuant to the Business Licensing Law, to take action to improve and optimize these specifications, thus making them more accessible to the business sector.

C. Increasing Competitive Edge Against Personal Import

In view of the growing trend towards online shopping in general, and personal import (AKA self-import) in particular, measures should be taken to ensure even competition between personal import and retail trade. Currently, personal import enjoys VAT exemption which puts local retailers at a competitive disadvantage as their income is fully subject to VAT. Therefore, and in light of technological advancements and the current trend in developed countries to remove exemptions for personal import, the committee recommends setting up operative provisions for cancellation of the current VAT exemption for personal import. A precondition for this step is the existence of a simple, accessible payment system serving both consumers and providers to facilitate payment of the tax owed, similar to the model already employed in other developed countries which have taken, or intend to take, steps towards cancelling the VAT exemption.[20]

D. Price Display

According to the Israeli Consumer Protection Law, Section 17b, retailers are obligated to display prices on each and every item sold in their store.[21] The regulation requiring price marking was originally intended to help consumers bridge information gaps, in order to

[20] The administrator in charge of import legality does not support updating the maximum threshold for VAT exemption on personal import, claiming that the current conditions are not ripe for updating the maximum threshold, both in operative and economic terms.

[21] For the Israeli Consumer Protection Law (in Hebrew), see https://www.nevo.co.il/law_html/law01/089_001.htm.

prevent retailers from exploiting their market power. However, this regulation (which is unique to Israel) imposes costs on the retailer and **prevents introduction of alternative technologies, thereby necessitating employment of low-productivity workers.** In a vast majority of advanced countries around the world – including all European Union countries, Canada, and all but five US states – the law allows displaying the price on a shelf tag, rather than on each individual item. Among OECD countries, only Israel requires the price to be marked on every item.[22] One of the potential risks of regulatory concessions regarding price marking is a possible disparity between the price scanned on checkout at the time of purchase to the price displayed on the shelf, which may cause the customer to inadvertently pay more than they intended. Such a possibility is averted when the price is marked on the product itself at the time of checkout. Many countries which allow displaying prices on the shelf also have specific regulations meant to mitigate this risk, as well as hands-on enforcement and punitive measures against retailers. The committee recommends allowing the price marking requirements to be fulfilled by digital means as well, as practiced in developed countries, and to accompany this step with market enforcement and deterring punishments in order to prevent price disparities between the shelf tag and the price scanned at checkout as well as inaccurate or confusing display of prices on shelves. The committee further recommends tasking the Consumer Protection Authority with the execution of the proposed change, while taking care not to hurt consumers.

2. RECOMMENDATIONS REGARDING ENCOURAGING INNOVATION AND INVESTMENTS OF PHYSICAL AND TECHNOLOGICAL CAPITAL

[22] For a comprehensive international review of this topic see: Levy, Daniel, Price Marking Law: International Overview, Apparent Trends, and Assessment of the Law's Impact on Retail Prices (2008), a provisional review commissioned by the Ministry of Economy and Industry.

The benefits of innovation and integration of new technologies and workflows include a major boost to the productivity and efficiency of the business, as well as increased competition across the industry. Furthermore, in recent years there has been growing recognition that innovation is not limited solely to technological developments, and non-technological innovation, such as the development of new business models or management methods, can also contribute to the productivity of firms. Insufficient investment in physical capital in general, and innovation in particular, is one of the reasons to the productivity gaps which exist in the commerce and service sectors. The overall stock of physical and technological capital accounts for 30% of the total productivity gap per hour worked in the economy as a whole, compared to the benchmark countries. Despite the great importance of capital investment, the investment in the commerce and service sectors is significantly lower in comparison to OECD countries.

Various market failures may lead to deficient investment of firms in innovation and in physical and technological capital. These market failures may be broadly divided into two categories: the first stems from the **ability** of firms to invest in, and integrate, physical and technological capital; the second from their **inclination** to do so, and the existing array of incentives encouraging such investments. The ability of firms to integrate technologies is determined in part by their access to funding sources, particularly for small or new companies; by low level of human capital, since the operation of technological capital requires knowledge and skills; and by lack of knowledge among senior executives regarding existing technological tools and the means to incorporate them, a tendency which is prevalent among small firms or those specializing in more traditional industries.

Alongside the ability of firms to integrate technologies, there are several factors which influence the inclination of firms to implement these transitions. One such factor is the competitive environment within the industry, which affects the motivation of firms to streamline their operations, and another is the market failure of externalities. The firm's decision-making process is only concerned with the impact of the investment within the firm itself, and lacks the perspective of the spillover effect which benefits the economy as a whole, thus the investment of a single firm in innovation does not take into account considerations of innovation spillover to wider spheres. Although these market failures also exist in the commerce and service sectors, there is evident sectoral differentiation in government policy response. **Therefore, the committee recommends the following measures:**

2.1| Matching Government Aid to Economic Contribution and Eliminating Sectoral Discrimination

Provision of government aid and stimuli for businesses should not be based on sectoral preferences, but on GDP contribution with an emphasis on overcoming market failures such as externalities. Presently, the allocation of these stimuli is based, among other grounds, on the Encouragement of Capital Investments Law (1959), and channeled exclusively to export-intensive manufacturing and service industries (particularly the high-tech sector); The committee asserts that this discrimination against some service and commerce industries is one of the factors prohibiting the productivity trend in these sectors from rising in a similar rate, as reflected in the data.

2.2 |Improving Access to Knowledge

Promotion and dissemination of knowledge to support the integration of technological as well as non-technological innovation, including management methods, in a manner tailored to the specific needs of the commerce and service sectors. This includes providing accessible knowledge regarding solutions and processes which are adapted to the needs of the businesses; initiating collaborations which would bring together firms in the commerce and service sectors with academic institutions and technological companies; forming communities of businesses; and so forth.

Support from the Israel Innovation Authority is offered to high-tech companies within the service sector, but rarely given to companies belonging to other service and commerce industries, which are not considered high-tech companies. This is mainly due to the fact that these companies do not engage in research and development, however part of the reason may be failure by the Innovation Authority to make the information sufficiently accessible to businesses. Therefore, the committee recommends that the Authority take action to publicize its support tools among these industries as well.

2.3 |Measuring and Monitoring the Integration of Innovation and the Quality of Management

In order to track the outcomes of government efforts in regard to innovation, and to provide policymakers as well as businesses with decision-informing data, it is crucially important to measure innovation levels in the economy. Indeed, there exists a systematic, internationally accepted methodology for innovation measurement, which is employed in most developed countries.[23] The CBS conducts ongoing, systematic measurement focused exclusively on the R&D dimension, accompanied by occasional topical surveys, but not in a consistent long-term manner.[24] This sporadic surveying produces an incomplete picture of the integration of innovation in the commerce and service sectors, including integration of technologies as well as non-technological innovations which constitute, as previously stated, a large share of the innovation mix in these sectors. Therefore, the committee recommends systematic measurement of innovation and management methods on a national scale – including dimensions of technology incorporation, non-technological innovation, and quality of management in the business sector – to be conducted by the CBS in a continuous, consistent, and sustained manner.

3. 3. RECOMMENDATIONS REGARDING HUMAN CAPITAL

The quality of human capital, as indicated by the proficiency levels of workers, is low in Israel and particularly in the commerce and service sectors. The quality of human capital has direct and indirect effects on labor productivity. In terms of direct impact, the individual's level and quality of education, as well as proficiency levels, affect their ability to carry out tasks efficiently and effectively. Indirect effects manifest in the influence of human capital levels on the decision of firms to adopt new technologies whose operation require skilled human capital. Furthermore, low proficiency levels across a large swath of the population which earns low wages, as exists in Israel and particularly in the commerce

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[23] The Oslo Manual 2018, issued by the OECD.

[24] In 2020, for the first time, a broader survey was conducted regarding technology integration – "Utilization of ICT and Cyber Protection in Businesses 2019" – which is due for publication in 2021, but as of now it is designated to be a one-off survey. Also, in 2014 the "Innovation Survey 2010-2012" was conducted, and contained substantial reference to innovation including non-technological innovation. That was the last year when this survey had been conducted.

and service sectors, allows low-productivity businesses to survive and affects productivity and sectoral structure in the wider economy.

Listed below are the committee's recommendations on this topic, which complement the other sections of this report, in particular the section discussing the need for innovation in the commerce and service sectors, and the adaptations in human capital skills needed to accommodate such innovation. In addition, this section touches on broader recommendations for government activity, in line with the recommendations of the Committee for Employment Advancement Towards 2030 (AKA Employment 2030 Committee), led by Prof. Zvi Eckstein and the Labor Division at the Ministry of Labor, Social Affairs, and Social Services.

3.1| Adapting the Vocational Training System to the Progressing Needs of the Commerce and Service Sectors

Designing study programs which match the demand for workers and the return on wages in the commerce and service sectors. Also, adapting existing training courses and/or designing new ones to accommodate trends which are expected to have significant mid- to long-term impact on these sectors, requiring development of digital skills, computerized logistics management, management of online retail platforms, and so forth. The revised courses should also incorporate acquisition of basic skills. This recommendation is in line with the recommendations of the Employment 2030 Committee, as endorsed by the Labor Division.

3.2| Establishing a Mechanism to Address Employers' Needs Regarding Human Capital

Establishing communication with employers, mapping their needs and synchronizing their interfaces with government agencies, in line with the recommendations of the Employment 2030 Committee, as endorsed by the Labor Division. Since the Ministry of Economy is responsible for the interface with the business sector, it should be a party to the procedures which concern involvement of employees in vocational training and employment schemes, and work in collaboration with the pertinent government bodies.

3.3| Promoting Employment and Job Training in the Commerce and Service Sectors

Given the disparities in job training volumes in the commerce and service sectors vis-á-vis the share of these sectors in the overall number of employees, the committee recommends promoting programs to groom human capital for high-demand positions within these sectors, including openings with high demands and rising wages, while prioritizing individuals who make their first steps in the professional labor market, the unemployed, and workers in need of retraining or vocational update. Training courses should incorporate general human capital studies and soft skills, which are integral to the development of human capital. This recommendation is in line with the recommendations of the Employment 2030 Committee, and the scope of vocational training which it proposed.

4. 4. STRUCTURAL RECOMMENDATIONS FOR THE MINISTRY OF ECONOMY AND INDUSTRY: ADAPTING THE MINISTRY'S ACTIVITY TO SUPPORT ECONOMIC ADVANCEMENT OF THE COMMERCE AND SERVICE SECTORS

The committee's report outlines a series of recommendations aiming mainly to reduce the productivity gaps in the commerce and service sectors. To ensure optimal implementation of these recommendations, ranging in application from the short to the long term, a government body should be tasked with tracking the implementation of these recommendations while cooperating with all government offices and other stakeholders.

The Ministry of Economy and Industry is a preeminent economy-oriented ministry, with a core mission of serving as the designated government office for businesses. This mission, in a similar manner to comparable government offices around the world, is meant to promote a comprehensive bird's-eye view aiming to enhance the growth of the business sector through removal of barriers, introduction of incentives, and other measures as necessary to achieve its purpose. **Below are the committee's recommendations for adapting the activity of the Ministry of Economy and Industry to support economic advancement of the commerce and service sectors:**

4.1 |Adapting the Organizational Structure of The Ministry of Economy and Industry to Match the Structure of the Business Sector

The committee recommends considering a change in the current organizational structure of the Ministry of Economy and Industry, aiming to accommodate among other things the implementation of the conclusions of this report, and to better match the distribution of the business sector industries which belong to the remit of the ministry.

We would note that prior and pursuant to the publication of the committee's summary recommendations in December 2020, the Ministry of Economy and Industry initiated the establishment of a senior department for commerce and services, tasked with developing the domains of commerce and services in Israel, including the buildup of sectoral expertise, reduction of regulation and bureaucracy, and improvement of the business environment of the Israeli commerce and service sectors.

4.2 |Reinforcing the Mechanism Establishing the Ministry of Economy as the Point of Contact for Businesses

Reinforcing the role of the ministry as the primary recipient for appeals from businesses and representative bodies, through the establishment of dedicated mechanisms; coordinating the processing of these appeals vis-á-vis regulators and various relevant authorities to provide comprehensive, exhaustive response to issues which emerge from the public; and raising issues and problems which require involvement of the director generals' committee in its capacity as a "round table" panel.

The Ministry of Economy and Industry should be equipped with adequate tools and authorities to maintain its POC apparatus in a manner which offers businesses substantial added value, through an all-encompassing outlook of the overall picture from the point of view of the business (360-degree perspective of the business). This would be achieved, among other measures, through demanding information and responses from the various regulators, setting reasonable timetables for replies, and consulting with the ministry during the drafting process of regulations which have considerable impact on the business sector. In addition, the ministry would convene discussions in the director generals' committee as necessary, to weigh in the implications for the business sector when making decisions.