

UPDATE THE ISRAEL FREE TRADE AGREEMENT

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EXECUTIVE SUMMARY

Next to its younger cousins, the U.S.-Israel Free Trade Agreement looks simplified – something like the SparkNotes version of a novel. But in the 25 years since its signature in 1985, it has sped the transformation of an economic alliance, from a relationship defined by aid and tourism into a partnership among advanced economies founded on trade, investment, research, and regional integration. A generation after its launch, though, the agreement is showing its age.

Most of its tariff content is outdated, overtaken in the mid-1990s by rules set globally through the World Trade Organization. Meanwhile, it does not address the sophisticated issues – e-commerce, services trade, standards-setting, intellectual property – central to modern relationships among advanced economies. Thus its relevance to the U.S.-Israeli alliance is fading. As it approaches its 25th anniversary next August, the American and Israeli governments should revitalize it with supplemental agreements to cover high-tech issues and broaden its role in regional economic integration.

SUCCESS: THE US-ISRAEL FTA 1985-2008

Even the agreement's signatories – Ronald Reagan's chief trade negotiator William Brock and Ariel Sharon, in an unfamiliar role as Trade and Industry Minister – conjure up a different time. So does the agreement's text: it is a 20-page document, readable in a few minutes, which calls for zero tariffs by 1995, bans new import limits after 1990, tentatively suggests work-programs on services trade and intellectual property, and takes a bit of space to outline the beef trade implications of kashrut dietary laws. By contrast, the US-Singapore agreement negotiated 17 years later, though joining America with an economy of size and sophistication comparable to Israel's, takes 236 pages of text plus 406 more pages of annexes, side letters and tariff schedules.¹

The issues that caused concern in 1985 seem far away from the realities of US-Israel trade.

But though it looks modest today, in its time the agreement seemed radical. The United States had not attempted a bilateral free trade agreement since a brief, unsuccessful experiment under the long-forgotten President Benjamin Harrison in the 1880s, and the Reagan administration rightly termed the Israel accord “the first such arrangement in our history.” For Israel it was a more dramatic break with tradition, as a departure from both the Jewish state's early commitment to agrarian socialism and self-reliant development and its early orientation toward Europe.

Over the years, the agreement has paid off. In 1985, the relatively modest opposition it aroused focused on issues that are familiar today. The AFL-CIO's chief economist argued that Israel was a relatively low-wage economy, and that by eliminating tariffs on labor-intensive goods the agreement would arouse intense competition in jewelry, glassware, electrical gear, shoes and leather. Textile-

¹ <http://www.ustr.gov/trade-agreements/free-trade-agreements/singapore-fta/final-text>

industry lobbyists claimed it could lead to a gush of clothing imports, with a “devastating impact on the domestic textile and apparel industries.” California Congressman Bill Thomas, then a new member of the Ways and Means Committee, worried about competition for Fresno-area almond growers, asking whether “it is all right to sacrifice the economic base of a particular area as long as the U.S. overall benefits?”²

A generation later, the concerns of 1985 seem irrelevant. Israel is not a low-wage, inflation-prone and isolated economy reliant on garment factories and shoemaking; rather it is a developed nation which is negotiating to join the OECD, supports the world’s most ambitious commitment to research and development in proportion to GDP, and has begun tentative experiments in integration with its two peace partners. The typical U.S.-Israel transaction is not a boatload of shoes or almonds, but an aerospace-industry collaboration on a military project, or an American hospital’s purchase of a radiology lab outfitted by Israeli medical-technology companies.

The agreement deserves considerable credit for this, in two ways.

1. COMMERCE FIRST

First, since the 1980s trade has replaced aid at the center of US-Israel economic relations.

In 1985, Israel’s \$2.7 billion in exports to the United States were barely half the \$3.7 billion worth of American economic and military aid to Israel. With the agreement in place, trade surpassed aid by 1990. Today, Israel trails only Germany as a source of X-ray machinery for American clinics and hospitals, and the Israeli share of America’s radiology imports in general has risen from 1.5 percent to about 5 percent. In total, Israel’s \$25 billion in goods and services exports to the United States are now seven times military and economic aid combined, including a startling two-thirds of all America’s manufacturing imports from the Middle East.

On the other side of the ledger, Israel has become an export market for about \$15 billion per year in American-produced goods and services. With a GDP of about \$200 billion, Israel’s economy ranks roughly 45th in the world. But Israel is 25th in the world as a buyer of American goods and services, and among the top ten markets for a string of high-value manufactured goods like optical technologies, telescopes, photographic equipment, navigational and directional equipment, radiological devices, calibration devices, audiovisual equipment components, several types of machine tools, and semiconductor manufacturing technology. In a comparative sense, Israelis buy more American goods than much larger European countries like Poland, Sweden, Spain or Russia; and as a buyer of goods, Israel in fact is not far behind entire regions, including sub-Saharan Africa, South Asia and eastern Europe. As a services-trade market, Israel rivals larger European states, and – with about 2 percent of the Middle East’s population – bought about a quarter of American services exports to the region.

2. REGIONAL INTEGRATION

Second, the agreement has been the foundation of a unique experiment in integration between Israel and its peace partners.

Advocates of the agreement in 1985 pointed, among other things, to the economic difficulties Israel suffered from the Arab League’s boycott program. The agreement has obviously not solved this

² Ways and Means Committee Hearing Transcript, May 14 1985 and June 13-14 1985.

issue, but has noticeably eased it.

In the 1990s, with tariff elimination complete, U.S. Trade Representative Charlene Barshefsky joined Israeli Trade Minister Natan Sharansky and the government of Jordan in extending the agreement to a series of “Qualifying Industrial Zones” (QIZs) in Jordan, where factories sometimes partially owned by Israeli businesses and sometimes using Israeli inputs make clothing, luggage and other light goods for export. The QIZs now supply over \$500 million a year in Jordanian textile exports to the United States. Fifteen similar zones in Egypt, opened in 2005,³ now account for \$900 out of \$2.5 billion in annual Egyptian exports to the United States. The zones are now home to hundreds of factories, employing almost 15,000 Jordanians by the Jordanian Labor Ministry’s most recent count and well over 100,000 Egyptian workers. Significant to these countries in economic terms, the QIZs also mark the first steps toward the economic integration, common interest and shared benefit which will be essential to any durable Arab-Israeli peace settlement.

2008 – 2020: FADING RELEVANCE

A generation after the agreement, then, the U.S.-Israel economic relationship has become a modern partnership among advanced economies. The agreement’s authors could reasonably take pride in this relationship’s evolution – but might also be surprised to learn that the agreement now applies to only a small slice of it.

TARIFF POLICY NO LONGER SIGNIFICANT IN RICH-COUNTRY TRADE

The main achievement of the agreement was to eliminate tariffs and quota limits on trade in physical goods – X-ray machines, pistachio nuts, cars and so on, with some agricultural exceptions. A generation later, tariff policy remains important in American (and Israeli) trade with poorer countries. But apart from agriculture, it is only a minor issue in America’s relationships with wealthy and sophisticated economies.

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This is because trade agreements in the 1990s eliminated most rich-country tariffs on high-tech goods and sophisticated manufactured products. Telecommunications equipment, for example, had a U.S. tariff of 8.5 percent tariff in 1985, and now has none.⁴ Medicines have likewise lost their 3.7 percent tariff, while X-ray machinery and related radiological equipment have lost tariffs of 2.1 and 2.5 percent respectively. The Uruguay Round agreements of 1994 which created the WTO, and the WTO’s Information Technology Agreement of 1996, eliminated these tariffs in the United States and in Israel too.

With tariffs gone or minimal, American importers of these goods (and probably the Israeli import-

³ http://www.qizegypt.gov.eg/About_QIZ.aspx

⁴ 1987 tariff schedule at <http://www.usitc.gov/tata/hts/archive/TSUSAintro.htm>

ers too, though data is scarcer) no longer bother to register them under the agreement. Thus they avoid the paperwork implicit in the FTA's "rules of origin," save some money, and get the advantage of more flexible supply chains.⁵ The diamonds that serve New York's jewelry firms are also duty-free from all sources, as are the computers and chips purchased by Silicon Valley's high-tech companies. In total, the agreement now applies to only about 14 percent of American imports from Israel.

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No such figure is readily available for Israeli imports, but the fraction is probably comparable. Of the United States' \$14 billion in exports to Israel in 2008, duty-free diamonds accounted for \$2 billion. Another \$1.3 billion reflects the sale of duty-free airplanes and airplane parts. Semiconductor manufacturing equipment, communications satellites and other duty-free information technologies add \$800 million; a half-billion more come from are duty-free scientific equipment, medical devices and medicines.⁶

The WTO's elimination of tariffs on information-technology and other high-tech products has made little obvious difference to U.S.-Israel trade. Both Israeli and American firms remain competitive in these fields. Israeli exporters of medical technologies in particular have gained market share at the expense of Europe and Japan, while Israel's diamond business has developed deep links with partners in New York. Likewise American makers of the semiconductor manufacturing equipment and aircraft that lead U.S. exports to Israel are succeeding without tariff advantages.

THE MISSING PIECES

America's trade with more recent FTA partners Singapore and Australia has evolved in the same way, with buyers and sellers of high-tech manufactured goods no longer using the agreements. But the agreements with these countries add complex chapters to encourage services trade, facilitate electronic commerce, ease cooperative standards-setting in newly emerging technologies, and address sophisticated intellectual property issues, making them foundations for relationships in higher-order services and research collaboration. By comparison, the U.S.-Israel agreement looks archaic and a bit threadbare.

It has no chapter on electronic commerce – which did not, after all, exist in 1985, when the Internet was barely more than a set of internal e-mail systems for defense agencies and computer enthusiasts.⁷

It has no "Technical Barriers to Trade" chapter to manage the complex questions arising from standards-setting and regulatory approvals for new technologies, such as nanotechnology and bio-

⁵ To qualify a product for the agreement, importers – e.g. a hospital buying an MRI machine – must show that 35 percent of the product's value reflects Israeli parts and labor.

⁶ <http://62.219.95.10/TaarifEnglish/TaarifList.aspx>

⁷ <http://www.ustr.gov/trade-agreements/free-trade-agreements/israel-fta>

technology, where the United States are among the world's most sophisticated economies and leading producers of patents. By contrast, the European Union is actively promoting its own standards in Israel; over time, this is creating disadvantages for American makers of automobiles and appliances and may presage larger disadvantages in emerging technologies like clean energy and nanotechnology.

It has only a rudimentary chapter on services trade, which accounts for about a tenth of all US-Israeli trade and an eighth of American exports to Israel. Here the agreement's text – advertised in 1985 as a conceptual breakthrough – is only 61 words long and speaks only of “the need to maintain an open system of services exports” without including any commitments.

And it does little to cover intellectual property rights, instead simply referring to compliance with the intellectual-property regime of the 1980s, which predates America's 1990 decision to join the Berne Convention on copyright, the WTO's 1994 Agreement on Trade-Related Intellectual Property Rights, and the two digital copyright treaties negotiated in 1999, and has little relevance to many modern commercial issues or to the terms Israel has been asked to meet in its application for OECD membership.

Thus, though a breakthrough in its time, the agreement has become antiquated – ignored in most of the manufacturing-trade sectors important to U.S.-Israel trade, and irrelevant to trade in services, standards-setting and other cutting-edge issues.

TOWARD A NEW APPROACH

The agreement's 25th anniversary is thus a chance not only to celebrate a success story, but to update it for a different age.

The agreement need not be rewritten from scratch, or even renegotiated. It covers lower-technology manufacturing, heavy industry and natural-resource trade well. Its simple “rule of origin” remains the right one for promotion of economic integration with Jordan and Egypt through the Qualifying Industrial Zones program. And the agricultural supplements negotiated in the 1990s and this decade work reasonably well. The U.S. and Israeli governments, in the coming year, should use the agricultural experience as the precedent for supplementary agreements in four high-tech issues:

- **Electronic Commerce:** Drawing on the Australia and Singapore agreements, an e-commerce annex should codify the decision not to impose tariffs or discriminatory taxes on electronic transmissions, create modern privacy and consumer protection guarantees, and ensure equal trade treatment for digital products as against physical versions of the same product, i.e. digitally downloaded music and compact disks.
- **Technical Barriers to Trade:** The “Notice and Consultation” feature of the existing agreement suggests U.S.-Israel consultation before either government develops trade policy vis-à-vis third countries that could create discrimination. This clause should be expanded in a new annex into a formal standards-setting arrangement like those in the Australia and Singapore agreements, which call for regular meetings between designated Coordinators to ensure transparency and notice before the adoption of new standards, and harmonization or use of accepted existing international standards whenever possible. This will help ensure that U.S. and Israeli industries continue to collaborate easily in development of new technologies, and are able to trade in the products that emerge from them.
- **Services trade:** The 1985 agreement's rudimentary chapter, antiquated especially given

Israel's membership in the WTO's Basic Telecommunications and Financial Services agreements, should be bolstered with a modern, 'negative-list' annex ensuring free flows of trade in telecommunications, entertainment and media; health services and research; new internet-based services; financial services; environmental services and other sophisticated, high-wage services industries.

- **Intellectual Property:** The agreement's intellectual property chapter should be updated at minimum to bring into force the WIPO's digital copyright treaties, and on patents to support Israel's process of negotiations toward OECD membership.

Finally, the two governments should extend the QIZ programs in Jordan and Egypt, and launch similar objectives in other willing countries. Though high-tech tariffs are gone, American tariffs (and often Israel's too) remain relatively high on poor-country goods like clothes, shoes and some types of food. This means the QIZ programs do help businesses exporting clothes, towels and luggage from Egypt and Jordan. Egypt and Israel have already requested designation of new QIZs, while Jordan and Israel hope to ease limits on products eligible for duty-free treatment. A third opportunity may also exist in Turkey, based on textile and garment programs like those in Egypt and Jordan, or else on Mediterranean processed foods such as olives, dates and raisins.

CONCLUSION

Through the 2020s and 2030s, these updates would help the relationship grow in new fields, encouraging deeper cooperation in the research and innovation-based industries central to both countries' future growth, employment and security needs. And they would build upon the initial success of the QIZ program in creating ties of mutual interest and shared benefit among Israel and its peace partners.

The updates are not revolutionary change. Rather they are a modernization of a successful initiative, designed for a different era and now in need of rejuvenation. As the original agreement did in 1985, they would add new dimensions to an already strong alliance – deepening relationships among researchers and businesses; ensuring that the economic pillar of the U.S.-Israel relationship is as strong as the relationship in security; ultimately, strengthening the deep collaboration between governments and publics that makes the U.S.-Israel relationship strong and durable. Nothing would be more appropriate, and more in the spirit of the agreement's intent, than that.

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APPENDIX

TABLE 1: US-ISRAELI TRADE AND AID, 1985 vs. 2008

	1985	2008
US Goods Imports from Israel	\$2.1 billion	\$22.2 billion
... QIZ Imports	---	\$1.6 billion
Economic and Military Aid to Israel	\$3.4 billion	\$2.4 billion

TABLE 2: ISRAEL AND ITS NEIGHBORS, 2008

PARTNER	POPULATION	US GOOD IMPORTS, EXCLUDING OIL	US PATENT FILINGS
Israel	7 million	\$22.0 billion	4550
South Central Asia	1636 million	\$36.3 billion	2906
<i>India only</i>	<i>1166 million</i>	<i>\$25.4 billion</i>	<i>1879</i>
East/Central Europe	297 million	\$26.4 billion	1582
<i>Russia only</i>	<i>140 million</i>	<i>\$9.9 billion</i>	<i>547</i>
Sub-Saharan Africa	825 million	\$14.1 billion	277
Arab League & Iran	422 million	\$12.4 billion	286

TABLE 3: IMPORTS UNDER AND OUTSIDE OF AGREEMENT

PRODUCT	VALUE	(MFN TARIFF RATE)
Services	\$3.7 billion	(none)
Merchandise Imports	\$22.6 billion	
Outside Agreement:	\$18.9 billion	
<i>Diamonds</i>	<i>\$9.4 billion</i>	<i>0%</i>
<i>Medicines</i>	<i>\$3.6 billion</i>	<i>0%</i>
<i>Airplanes & parts</i>	<i>\$1.2 billion</i>	<i>0%</i>
IT goods	\$0.5 billion	0%
Imports Under Agreement	\$3.2 billion	
<i>Plates and sticks for cermets</i>	<i>\$0.2 billion</i>	<i>4.6%</i>
<i>Gas turbine parts</i>	<i>\$0.1 billion</i>	<i>2.4%</i>
<i>Silver jewelry</i>	<i>\$0.1 billion</i>	<i>6.5%</i>