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Chapter 3

Liberalization of Protective Restrictions: The 1960s

In this chapter I will deal primarily with the second stage of Phase IV which falls in 1962–68, and which constitutes a distinct episode in the development of Israel's policy of liberalization. This will be followed by a description of the policy pursued during Phase V, beginning in 1969—a policy still too recent for an analysis of its outcome; and by a summary of the liberalization process in Israel.

i. THE POLICY PACKAGE OF 1962

By the late 1950s or early 1960s, we recall, the setting of quantitative restrictions had little to do with general balance-of-payments considerations; the QRs were intended instead to serve as a protective device. Imports of raw materials and intermediate goods were by that time mostly unrestricted. Imports of final goods, on the other hand, particularly of consumer goods, were prohibited whenever they were considered competitive with local production, whether actually under way or merely contemplated.

In the absence of balance-of-payments considerations to stimulate or justify the QR system, much more attention started to be paid to its allocative effects. This concern gathered momentum after the mid-1950s, and by the early 1960s most policymakers were convinced that the protection system led to a substantial misallocation of the country's resources and would have to undergo a radical transformation. This conviction resulted in another "New Economic Policy" [1] (referred to officially as "the program for stabilizing the economy"), which was formally declared by Levi Eshkol, the then Minister of Finance, on February 9, 1962. The policy consisted of eighteen separate points, of which two constituted its backbone: formal devaluation and import liberalization.

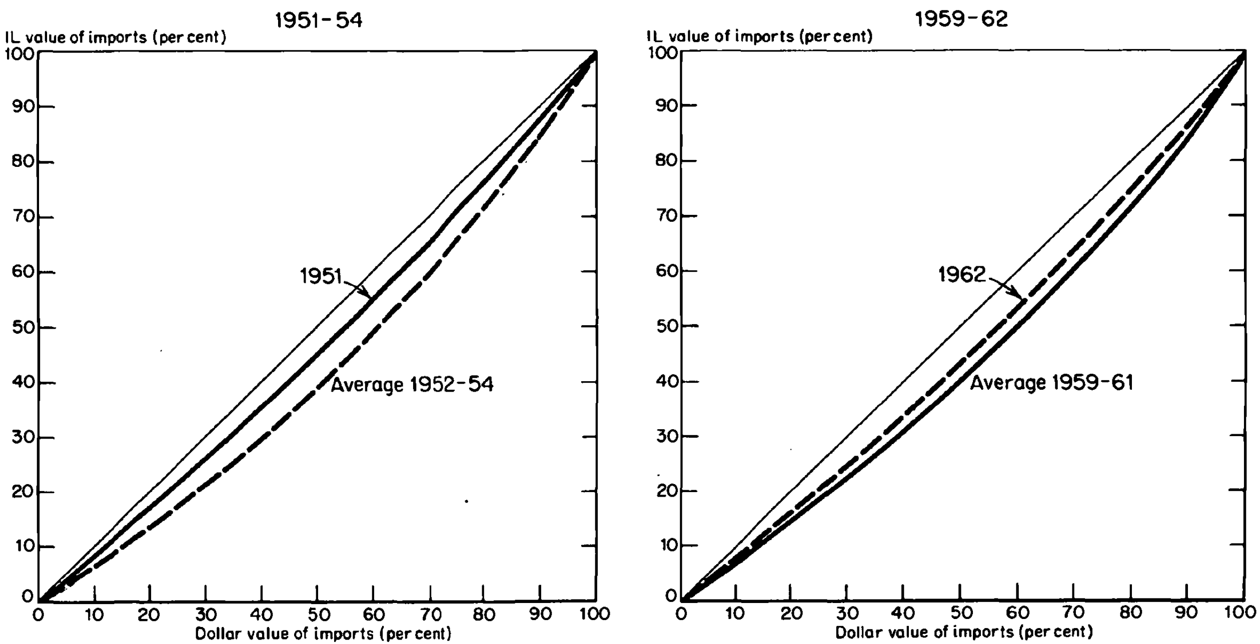
The devaluation of 67 per cent, from IL 1.80 to IL 3.00 per dollar, was described as being intended both to help in adjusting the balance of payments and to lead to a unification of the exchange-rate system by the abolition of various other charges or subsidies. The liberalization was described in the following words: "The government will gradually lower the walls of overprotection of domestic industry against imports. In order to make manufacturing and agriculture stand on the basis of cheap and efficient production, the government intends to restrict the ceiling on rates of protective tariffs and to eliminate the quantitative restrictions of imports. Local production will have therefore to compete with imported goods." [2]

The devaluation itself, together with other price adjustments which accompanied it, was clearly used to lower the degree of diversification and discrimination involved in the exchange-rate system. Indeed, it seems that this was the purpose of the devaluation, at least as much as the effective increase in the rate of exchange. While the formal increase in the foreign-exchange rate was close to 67 per cent, the increase in the average effective rate of exchange for exports (that is, in the reward per dollar of value added of exports) was only about 13 per cent. The effective rate for imports increased more substantially—by about 37 per cent—but was still considerably less than the increase in the formal rate of exchange.

On the export side, the difference between the formal and effective rates of devaluation was achieved by the abolition of most export subsidies. Since the subsidies had been applied partly in a discriminatory fashion, their abolition resulted in greater uniformity of the effective-rate system in exports. From the 1962 devaluation date until 1966, the effective rate of exchange applied to most exports was roughly equal to the formal rate of IL 3.00 per dollar. Even when export subsidies were reintroduced, in 1966, the system remained much more uniform than it had been before the 1962 devaluation.[3]

In imports, the lower rate of increase of effective rates—compared with the rate of formal devaluation—was due to the lowering of many tariff rates (as well as the automatic decline of rates which were specific rather than ad valorem—although this factor was not very significant in Israel). The result of this adjustment of tariff rates was a considerable increase in the uniformity of the exchange-rate system, similar to the development in exports—although the import system remained much more heterogeneous and discriminatory than that for exports. The coefficient of variation of effective rates for imports went down from 0.435 in 1961 to 0.268 after the devaluation in 1962. Another impression of this lowering of dispersion in the rate system can

CHART 3-1
Distribution of Importers' Exchange Rates, 1951–54 and 1959–62
(Lorenz curves)



SOURCE: Michael Michaely, *Israel's Foreign Exchange Rate System* (Jerusalem: Falk Institute, 1971; in English), p. 103.

be seen in the Lorenz curves presented in Chart 3-1. The 1962 curve is materially closer to the diagonal than the curves applied to the three years preceding the devaluation—1959, 1960, and 1961 (in which the curves were similar enough to be represented by a single curve). An interesting point is that this pattern is quite contrary to the one observed for the preceding formal devaluation (1952–54). As the Lorenz curves presented in Chart 3-1 show, the earlier devaluation served to widen the dispersion of the rate system, rather than to narrow it.

It is thus clear that changes in the price system—the devaluation itself and the adjustment of tariffs and subsidies which accompanied it—led toward greater uniformity in the exchange-rate system. These changes were not relevant, however, to those imports which were effectively regulated not by tariffs or other price components but by administrative quantitative controls. That category was the object of the liberalization plan, which was the second major policy step declared, the first being devaluation. But, here, it appears that the government was not immediately prepared to state how the declared policy would operate. It evidently had no clear idea of what steps it wanted to take, what the time schedule would be for the introduction of liberalization, or what mechanisms and processes should be involved. As soon as the policy declaration was made, a considerable amount of interministerial negotiations, and even bickering, started over these issues. Within a few months, the following machinery was established.

Liberalization was to be governed by a "Public Commission," consisting of representatives of several government ministries (primarily the Ministry of Finance and the Ministry of Commerce and Industry) and a few organizations (primarily the Histadrut and the Manufacturers Association). The commission, which started its work in May 1962, was to discuss each good separately on the basis of data and recommendations prepared by subcommittees. The latter were to consist of government representatives only, and their work was to be coordinated by the Ministry of Commerce and Industry. The Public Commission was not to initiate discussions, but to consider cases as they were presented by the subcommittees (i.e., by the Ministry of Commerce and Industry). No a-priori time schedule was set for these deliberations. The commission would in each case make a decision on both the quantitative restriction and the tariff level. With regard to the first aspect, the commission could decide to lift restrictions, leave them intact, or leave them intact temporarily pending further discussion on a predetermined date. The commission could *not* mitigate the degree of severity of the restriction, that is, it had to make an "all or nothing" decision, and could not go part of the way. However, the commission was free to determine tariff levels as it saw fit. It could make a once-and-for-all decision on the tariff level; or decide to reconsider the rate within a specified period; or—as it did in a few rare cases—determine a priori a scale of duties decreasing with time. All the commission's decisions were subject to appeal before (jointly) the ministers of Finance and of Commerce and Industry, a recourse which was used only rarely.

The machinery for the introduction of liberalization contained an obvious bias against the declared intention of the liberalization. It assigned a prominent role to the Ministry of Commerce and Industry by giving its representatives a leading position on the Public Commission, including its chairmanship; by yielding only to the ministry the initiative for bringing items before the commission; and by leaving to the ministry the decisive function of preparing all the material for the commission's deliberations. Given the fact that the Ministry of Commerce and Industry stood rather openly against liberalization (and even more emphatically against the devaluation), its prominent position in the machinery must have been very relevant to the process. Moreover, as has been mentioned, no time schedule was set for the introduction of liberalization. In addition, representatives of some of the bodies which were bound to be damaged by each step of liberalization were given a place on the commission and a voice in its deliberations. The machinery in itself was thus not conducive to rapid liberalization.

Liberalization came to be interpreted, at that time, as a process consisting of two stages. The first, which may be termed "nominal liberalization," was a change in the form of protection rather than in its degree or structure: the replacement of the QR system by a system of tariffs or other levies which maintained imports at the same level as under the QR system. The second stage was the reduction of the level of protection through the lowering of tariffs imposed during the first stage of the process. The Public Commission was implicitly or explicitly expected, at least by the Ministry of Commerce and Industry, to handle the first stage only, and to carry out a primarily nominal liberalization.

The commission's work was for the most part completed by the end of 1966—more than four years after this mechanism of liberalization was put in motion. During 1967 and 1968, a few more goods were liberalized. By then, the process of conversion of the system from use of administrative controls to protection by tariffs was supposed to have been concluded. Since then, the second stage of lowering protective import duties has been carried out. The following analysis relates only to the process during the nominal stage, which was carried out by the Public Commission. Later in this chapter, the lowering of duties following this stage will be surveyed.[4]

ii. GUIDING PRINCIPLES IN THE INTRODUCTION OF LIBERALIZATION [5]

In the debate—mainly within the government—which preceded the establishment of the Public Commission, a few principles for the introduction of liberalization were suggested. None of these, however, was formally adopted, and the terms of reference of the commission did not specify any guiding rules or principles for its work. However, the very structure of the mechanism suggested some principles. Others became clear as the commission's work started and progressed. The following is a summary account of the main principles thus revealed.

First, the nature of the mechanism dictated a separate discussion of each good. Thus, the commission was not supposed—nor did it try—to form any general policy or policy rules. No efforts were made, for instance, to determine any over-all protection level leading toward (or away from) uniformity of tariff rates, and so on. It was not bound—and, as a rule, probably did not try—to consider each good within the general context of the economy. From this basic fact, many of the other principles followed.

One guideline, quite often stated explicitly, was "efficiency rather than elimination." That is, the commission's decisions about each industry were supposed to lead to greater efficiency and cheaper production in the industry, but not to its abolition. The commission's concern was thus with technical efficiency, as expressed in the operation of each plant or industry, but not with the economy's efficiency in allocating its resources. The major outcome to which free (or freer) trade would have led thus could not be expected to result from this process of liberalization.

From the rule on efficiency, there followed obviously one that tariffs should not be uniform. This appeared both from the commission's decisions, as will be demonstrated soon, and from explicit statements of the commission's members.[6] The commission appears to have adopted the following procedure in its work: it would try to establish the cost of production of the good, on the assumption that production was handled in an "efficient" way, and then determine a tariff level such that, given the local cost, domestic production would be competitive with imports.[7] Very often, when the tariff level thus required appeared to be extraordinarily high, the commission preferred to leave the administrative prohibition intact rather than replace it by a tariff. On the other hand, in accordance with the preceding principle, in no case did the commission decide that local costs were so high as to justify the admission of imports with an accompanying substantial reduction or elimination of the local industry.

Still another principle, less clear-cut, was that the level of protection depended to some extent on the promised intentions of the industry (this was relevant, of course, mainly when the industry consisted of a single firm). "Good behavior" merited a higher level of protection. Such behavior could be demonstrated in a variety of ways. One was the promise to lower local prices. Another was the submission of plans, usually for technological modernization, which were supposed to reduce the cost of production. A third was, quite often, a plan—sometimes prepared on the initiative of the government—to organize an industry that consisted of several firms into a cartel, on the assumption that this would lead to greater efficiency and lower costs. In other words, determination of the level of protection was often used by the government as a tool to lead the industry to take steps which the government wanted it to adopt.

Another prevalent rule was to tie the level of protection to some extent to the level of exports. A high proportion of exports of the industry's output presumably gave the industry a claim to enjoy a higher level of protection of its domestic sales against imports.

Still another principle was the prevention of "unfair" competition by

TABLE 3-1

Number of References to Guiding Factors in Specific Liberalization Decisions, by Industry, 1962–67

(total number of decisions involved: 179)

Industry	Infant Industry	Protection Against "Brand Name"	Protection from Dumping	Encouragement of Development Regions
Meat, fish, oil, and milk products		1		2
Other food		6	3	5
Textiles	3	6	2	9
Clothing	1			5
Wood and wood products	2	1	2	4
Paper, cardboard, and their products	1		1	3
Leather and leather products	5	2	1	5
Rubber and plastic products	5	9	10	1
Chemicals	3	10	12	8
Nonmetallic mineral products	7	6	5	6
Metal products	2	2	2	1
Machinery	6	9	10	1
Electrical and electronic equipment	4	5	2	6
Transport equipment	5	7	4	9
Total	44	64	54	65

SOURCE: Based on data compiled by Imry Tov from minutes of the Public Commission.

imports. This rule had a few variants. One of the best known concerned compensation for the "good will" of imports; sometimes good will was understood to reflect not just the reputation of a specific imported good but the general "snob value" of imports. It was claimed that an inherently equal local good was judged by the Israeli consumer to be inferior and would merit extra protection to balance this factor. Another significant aspect of this rule was the prevention of "dumping," either by retaining quantitative restrictions or by determining a tariff which would compensate for the dumping element. Dumping tended to be interpreted, in this context, in a fairly broad fashion. Sometimes it even took the form of statements that comparisons of local costs with foreign prices should not be made with the lowest-priced foreign imports, but with some average price abroad (very often, a statement such as "it is good enough if we can compete with European imports, and should not subject the industry to competition with imports from a highly industrialized country like the United States" was made and was accepted).

The major principles involved were not, as a rule, repeated in each of the commission's discussions. On the other hand, the factors relating to good behavior and unfair competition, were usually mentioned specifically in the commission's deliberations and decisions, when they were deemed relevant. The extent of references to these factors is indicated by the data in Table 3-1 which is based on the commission's reports.

iii. THE EXTENT OF LIBERALIZATION

Liberalization was to have been introduced gradually but was to apply, once the process was completed, to all imported items. One sector, however—agriculture—was left out of the process from the start. Since Israel at that time could not have any trade relations with its neighboring countries, all fresh agricultural produce, which made up much of the output of this sector, could not, in any event, be subject to import competition within any relevant price range; consequently the inclusion or exclusion of these goods could not be of much significance. Another important segment of agriculture was of the opposite variety: goods such as wheat, oil beans, animal fodder, and the like could not be produced locally within the relevant price range (at least in the marginal sense, i.e., where domestic production existed, it could not be increased significantly). These were semiliberalized all along: their importation was mostly handled by the government itself; but they were sold locally at something close to the formal rate of exchange and no unsatisfied demand was left. However, still other agricultural goods, such as milk products, sugar, or meat, were at neither extreme, and for these, the issue of liberalization was definitely relevant. After a heated debate on the issue, it was decided to exclude these goods from the scope of the Public Commission. Indeed, to this day (1973), liberalization has not been extended to these agricultural products. The process was thus confined to manufactured goods—admittedly, a much more important sector in its weight in the economy.[8]

TABLE 3-2
Extent of Liberalization, 1962–67
(Israeli pounds in millions)

	Total Value of Industrial Product[a] (1)	Value of Product of Items Added to Liberalization List During Year (2)	Col. 2 as Per Cent of Col. 1 (3)	Cumulation of Col. 3 (4)
1962	IL 3,785	IL 183	4.8%	4.8%
1963	4,469	475	10.5	15.3
1964	5,262	406	7.7	23.0
1965	5,744	692	12.1	35.1
1966	5,767	331	5.7	40.8
1967	5,721	45	0.8	41.6

SOURCE: Data from Imry Tov, "Protection of Domestic Production in Israel, 1962–1967" (M.A. diss., Hebrew University, 1971; in Hebrew).
a. Excluding diamonds.

Table 3-2 is an attempt to summarize the extent of liberalization; it requires, however, a few words of explanation. Column 1 is derived from industrial censuses but column 2 is based on estimates prepared for the discussions of the Public Commission. Comparability and consistency of the two columns are thus not ensured, although errors cannot be very large. It should also be noted that, strictly speaking, a comparison of the two columns is meaningful only if it is done for each year separately. On the other hand, a cumulative series based on column 2, and its comparison with the size of product indicated in column 1, is of very little significance, since both quantity and price changes which took place from year to year in the product of "liberalized" industries would be excluded. Column 3, on the other hand, can be made into a cumulative series if it is assumed that the *proportion* of the product of each good (or at least of the total of liberalized goods), in total manufacturing production, remains unchanged. Where large aggregates are involved such an assumption probably does not lead to grossly misleading estimates.

It appears from column 3 that most of the liberalization process took place between 1963 and 1965, that is, from a year to four years after the declaration of the liberalization policy. By the end of the period, local production in industries competing with liberalized imports amounted to roughly 40 per cent of the total value of the product of the manufacturing sector (excluding diamonds).

It thus seems that a very high proportion of domestic manufacturing—probably over one-half—remained outside the liberalization process.[9] Of these, some had been liberalized before 1963; but the overwhelming majority were still controlled, and thus remained free from import competition when the liberalization process was supposedly completed. Among these nonliberalized industries were the food processing industries classified in the censuses as "manufacturing" rather than "agriculture." The latter sector, as was mentioned earlier, had been explicitly exempted from liberalization when the machinery was set into operation. Also included—again by explicit decision—were all branches of the motor vehicles and motor parts industries. In numerous cases, exemptions from liberalization were granted by ad hoc decisions, owing to binding promises by the government to (usually foreign) investors to give them complete protection from imports for specified (sometimes, rather long) periods.[10] Other industries, estimated to have accounted for 10 to 15 per cent of total manufacturing production in 1967, were candidates for liberalization by the yardsticks used but, in fact, remained subject to administrative regulation (that is, usually, to import prohibition). Still another important segment, amounting to roughly 20 per cent of total manufacturing, consisted of industries which were labeled "irrelevant" for liberalization by the government and which, therefore, were not presented at all before the Public Commission.

The argument of irrelevance is open to doubt. There are obviously many goods which, due to high transportation costs, may be deemed nontradable. Examples often mentioned in the present context in Israel are industries such as clay and sandstone or repair services provided by small shops. A decision to liberalize imports of such goods would be immaterial—from the viewpoint of the local industries involved. Since definitions of goods and industries are usually quite broad, it is likely that in any "industry," some fraction would face import competition within the revelant price range. If the intention of policymakers was indeed to lead the economy toward liberalization, it would be rational to declare such imports free, rather than leave them restricted on the argument that the restriction is "irrelevant." It is therefore quite possible that a fraction of the supposedly irrelevant sector is indeed relevant and that these industries are effectively protected from import competition by quantitative restrictions. There does not seem to be, however, any feasible way of estimating the size of this fraction without undertaking an unduly large amount of very detailed work.

Table 3-3 contains, first, data for 1962–68 on the value of actual im-

TABLE 3-3

Imports of Goods Subject to Liberalization, by Industry and in Relation to Other Aggregates, 1962–68

(imports in millions of dollars)

Industry	1962	1963	1964	1965	1966	1967	1968
1. Food products	0.2	0.2	0.2	0.3	0.5	0.4	0.8
2. Textiles and textile products	8.5	6.8	6.7	6.1	7.1	8.9	11.6
3. Wood and wood products	0.1	0.3	0.5	0.4	1.9	1.3	1.9
4. Paper, cardboard, and their products	0.5	0.5	0.6	0.3	5.7	6.8	12.0
5. Leather and leather products	0.6	0.5	1.2	1.4	2.2	2.1	2.7
6. Rubber and plastic products	1.6	1.3	1.6	1.8	1.6	1.8	1.9
7. Chemicals	1.8	1.0	0.9	1.7	2.8	2.9	2.8
8. Mineral products	1.1	0.8	1.0	1.5	2.1	1.8	1.6
9. Base metals and metal products	6.5	10.4	11.9	11.8	29.1	25.1	24.3
10. Machinery and electric equipment	8.9	13.7	20.2	21.7	28.8	28.7	39.5
11. Optical and scientific instruments	0.5	0.6	0.6	0.8	0.9	0.7	0.8
12. Transport equipment	7.5	5.1	5.4	6.8	5.6	4.8	6.9
13. Miscellaneous manufactures	0.6	1.0	2.3	3.5	3.4	3.1	3.5
14. Total	38.4	42.2	53.1	58.1	91.7	88.4	110.3
15. Ratio of line 14 to total imports of goods (per cent)	6.0	6.3	6.3	7.0	10.9	11.3	9.8
16. Ratio of line 14 to value of industrial product (per cent)	3.0	2.8	3.0	3.0	4.8	4.6	5.2
17. Annual increase in line 14 minus rate of increase of GNP (per cent)		−2.3	11.5	1.1	52.5	−5.0	13.6

SOURCE: Lines 1–13—Compiled from working papers of Imry Tov, based on *Monthly Foreign Trade Statistics*, Central Bureau of Statistics.

Line 15—Total value of imported goods taken from Table A-10.

Line 16—Total imports (line 14) converted to pounds at formal rate of IL 3.00 per dollar for 1962–67; IL 3.50 per dollar in 1968. Value of industrial production, from Table 3-2, column 1, projected to 1968 on the basis of the increase in the index of industrial production in 1967 and 1968.

Line 17—Data converted to 1950 dollar prices using index of import prices, Table 6-5. Rates of change of GNP in 1955 IL prices are from Table A-2.

ports of the liberalized items, by industry,[11] and, in the bottom rows of the table, the size of these imports in relation to other relevant economic aggregates. By the yardstick of the quantitative impact of the liberalization on the size of imports it appears from the table that, although liberalized imports were not very substantial even by the end of the process, in 1968, the act of liberalization was probably not purely "nominal." The increase both in the absolute size of liberalized imports and in their relation to the total imports of goods, the value of industrial product, or the value of GNP took place mainly in 1966; and imports remained on the higher level of that year in the years following as well. It should be noted that, had the effective rate of exchange of these goods—almost twice the level of the formal rate, as will be seen shortly from the tariff data—been used in row 16, the size of liberalized imports in 1966 compared to 1968 would appear to be close to 10 per cent of the value of the local product against which these imports compete. This is not a high figure; it is considerably lower than equivalent figures which represent the weight of imports in the Israeli economy. But it does indicate that domestic production, at least in large sectors, became exposed to some competition from abroad.

iv. LIBERALIZATION AND THE DEGREE OF PROTECTION

The tariff accompanying the removal of administrative prohibition was intended to peg import prices at a level equal to local costs of production (or perhaps slightly lower, so as to force an "efficiency" effort). At these import prices—assuming the existence of equilibrium in the local market for each good before liberalization—imports would be forthcoming not at all or only in very small amounts, following the liberalization. To allow for the possibility of miscalculations, it was understood—although this was not formally part of the commission's decisions—that, should imports in a liberalized industry reach a level of 10 per cent of sales of the local product, this would provide an a-priori case for an appeal by the industry for revision of the commission's decision concerning either the principle of removal of restrictions or the tariff level fixed for the imported good.

Such a guiding principle would, of course, require the commission to determine *effective* rates of protection. In its decisions, the commission naturally imposed nominal tariffs on the final goods, rather than effective tariffs. It also seems that a precise estimate of the level of the effective tariff implied by any of the commission's decisions was not usually presented to the commission in its deliberations. From the minutes of the discussions of the commission it appears, however, that it did consider the level of effective protection. The material prepared by the subcommittees for the commission's deliberations always included an estimate of the ratio of value added in the total value of the final product. Most often, it could be assumed that the import component was free, or almost free, of import duties. In this way, an approximate idea of the level of the effective tariff implied by a given level of the nominal tariff could be gained with little effort. At the same time, it also seems clear that the commission did not, as a rule, attempt to tailor a precisely appropriate effective rate in each case. Rather, it worked within a few main broad categories of nominal tariffs, probably putting each good within that category which would bring the effective rate closest to what the commission considered to be appropriate.[12]

The rates of protection involved in the commission's decisions are presented in Table 3-4. A few of the findings may be highlighted:

First, the average level of the nominal tariff rates, which approached 80 per cent, is probably quite high in comparative terms. It is particularly high in comparison with the average level of import tariffs in Israel at the time of the introduction of liberalization. A simple calculation of averages would have shown an increase of the general level of tariffs resulting from the act of liberalization; but this, of course, would have little meaning, because tariffs replaced quantitative restrictions.

The average level of effective tariffs is, naturally, above the average level of the nominal rates—over 150 per cent. The reason is that imported inputs in production are by and large free of tariffs. Since an import component of 50 per cent is quite common in Israel—most averages of import components of large groups of commodities usually reach a figure of about this size—the ratio of the two averages in Table 3-4 seems indeed very plausible. It may be noted that for all individual goods, without exception, the effective tariff exceeds the nominal tariff,[13] again because of the general absence of tariffs on inputs. The highest ratio of effective to nominal tariffs presented in Table 3-4 is over 3.5 (in the clothing industry). Among individual goods, however, rather than groups, as in Table 3-4, ratios in the range of 5 to 6 are not uncommon.

The average level of effective protection indicated by these calculations is rather high even in comparison with the existing general system of protection in Israel, although the figure of 150 per cent is "gross" rather than "net" protection. Some of this protection serves to compensate for the low level of the formal exchange rate, which was IL 3.00 per U.S. dollar until November 1967. The effective rate of exchange on value added in import substitutes as derived from the average level of effective tariff rates was IL 7.6 per dollar. This was much higher than any figure mentioned, within or outside the government, as an equilibrium exchange rate during this period. The effective rate for exports, to cite an important example, reached only about IL 3.50 per dollar of value added toward the end of the period (that is, prior to the devaluation of November 1967). Likewise, the general level of protection of import substitutes was considerably lower, as will appear from the discussion in the next chapter.

The averages involved are derived from arrays of rates containing a

TABLE 3-4

Means (M) and Dispersions (σ/M) of Nominal Tariff, Effective Tariff, and Effective Exchange Rate, by Industry, 1967

Industry	Nominal Tariff: M (per cent) (1)	Nominal Tariff: σ/M (2)	Effective Tariff: M (per cent) (3)	Effective Tariff: σ/M (4)	Effective Exchange Rate[a]: M (IL per dol.) (5)	Effective Exchange Rate[a]: σ/M (6)	Ratio of Col. 1 to Pre-liberalization Nominal Tariff (7)
Meat, fish, oil, and milk products	72.8	1.107	103.8	1.469	6.1	0.750	1.10
Other food	105.7	0.361	140.4	0.809	7.2	0.535	1.00
Textiles	91.7	0.733	240.6	0.608	10.2	0.429	1.73
Clothing	110.2	1.630	396.7	1.382	14.9	1.103	1.11
Wood and wood products	63.9	0.197	76.5	0.637	5.3	0.275	1.04
Paper, cardboard, and their products	55.6	0.700	74.2	0.766	5.2	0.328	0.95
Leather and leather products	57.7	0.179	78.0	0.336	5.3	0.147	1.12
Rubber and plastic products	88.7	0.537	118.5	0.760	6.6	0.411	0.76
Chemicals	72.9	0.876	132.8	0.956	7.0	0.562	1.72
Nonmetallic mineral products	63.3	1.030	79.8	0.910	5.4	0.456	1.31
Basic metals	39.1	0.497	84.8	0.561	5.5	0.256	2.68
Metal products	57.0	0.503	104.3	0.525	6.1	0.274	1.21
Machinery	55.8	0.254	97.0	0.452	5.9	0.223	1.08
Electrical and electronic equipment	133.2	1.081	253.9	1.052	10.6	0.755	2.18
Transport equipment	115.0	0.568	179.5	0.739	8.4	0.474	2.90
Miscellaneous manufacturing	90.3	0.704	143.2	1.062	7.3	0.572	1.23
Total	78.1	1.018	153.3	1.385	7.6	0.842	n.a.

SOURCE: Tov, "Protection," various tables.

a. Expressed in relation to value added; formal rate = IL 3.00 per dollar.

sizable amount of dispersion. It may be more a matter of curiosity than of importance to observe the *maximum* tariff rates involved in the commission's decisions. These are presented, by main groups of commodities, in Table 3-5. It appears that the nominal tariff rate was on occasion as high as 900 per cent;

TABLE 3-5
Maximum Levels of Tariff Rates, by Industry, 1962–67

Industry	Nominal Tariff Rate (per cent)	Effective Tariff Rate (per cent)	Effective Exchange Rate[a] (IL per dol.)
Meat, fish, oil, and milk products	540	982	33
Other food	290	634	22
Textiles	900	1,664	53
Clothing	900	4,000	124
Wood and wood products	138	499	18
Paper, cardboard, and their products	190	353	14
Leather and leather products	100	198	9
Rubber and plastic products	175	304	12
Chemicals	330	710	24
Nonmetallic mineral products	345	283	12
Basic metals	100	300	12
Metal products	220	400	15
Machinery	83	178	8
Electrical and electronic equipment	550	1,150	38
Transport equipment	177	828	28
Miscellaneous manufacturing	400	1,025	34

SOURCE: Tov, "Protection," Table 4. Data refer to decisions of the Public Commission up to 1967.

a. Expressed in relation to value added; formal rate = IL 3.00 per dollar.

and the effective rate, as much as 4,000 per cent! More interesting, perhaps, is the distribution of nominal tariff rates by industry, which is presented in Table 3-6. There, it seems that nominal tariffs imposed by the commission were concentrated largely (close to 40 per cent of the decisions, and over 50 per cent when weighted by value added of the good) in the range of 60 to 89 per cent. But the very high ratios of over 150 per cent were applied to as much as 10 per cent of the goods. As might be expected, the distribution of effective protection rates (not shown in the table) was more dispersed than that of nominal rates.

The data in Table 3-4 also show a quite wide variation among averages of tariff rates of main industrial groups. Nominal rates varied from 39 per cent (for basic metal) to 133 per cent (for electrical equipment), whereas effective rates ranged from about 75 per cent (paper and wood) to close to 400 per cent (clothing). The average rates for industries would, of course, be of little significance if each of them consisted of a variety of widely dispersed individual rates. Dispersion within each group was indeed quite substantial. Yet, with

TABLE 3-6

Frequency Distribution of Nominal Tariffs Imposed by Decision of the Public Commission, by Industry, 1962–67

(number of decisions)

Industry	Exempt	Nominal Tariff Rate (per cent) 1–29	30–59	60–89	90–119	120–149	150+	Total
Meat, fish, oil, and milk products	—	2	2	3	1	—	2	10
Other food	—	2	4	1	3	2	3	15
Textiles	—	9	10	12	6	2	11	50
Clothing	—	3	1	9	2	2	5	22
Wood and wood products	—	—	2	11	1	4	—	18
Paper, cardboard, and their products	—	5	—	9	3	—	3	20
Leather and leather products	1	1	11	5	2	—	—	20
Rubber and plastic products	—	—	7	20	3	2	3	35
Chemicals	2	4	36	15	2	—	3	62
Nonmetallic mineral products	—	6	7	8	2	1	2	26
Basic metals	1	7	14	5	1	—	—	28
Metal products	—	11	23	43	6	2	3	88
Machinery	—	7	28	33	—	—	—	68
Electrical and electronic equipment	—	—	7	21	2	—	7	37
Transport equipment	—	—	1	2	—	1	1	5
Miscellaneous manufacturing	1	3	10	20	3	5	11	53
Total	5	60	163	217	37	21	54	557
Percentage distribution of total	.9	10.8	29.3	39.0	6.6	3.4	10.0	100.0
Weighted by value added of industry	.2	7.5	22.2	51.1	6.7	2.1	10.2	100.0

SOURCE: Tov, "Protection," Table 5; and compilations of other data assembled by Tov.

a few exceptions, the dispersion of rates within groups was considerably lower than it was for all individual goods combined, as may be seen from columns 2 and 4 in Table 3-4. Two important exceptions are the clothing and electrical equipment industries, where dispersion is particularly high. That is, the high average tariff rates in these industries, which were mentioned before, reflect not uniformly high rates within these industries but the impact of a few sub-industries with particularly high rates.

From column 7 of Table 3-4, it appears that the nominal tariffs determined by the commission were mostly higher—sometimes substantially so—than the preliberalization tariffs. This relation holds not just for averages of groups of commodities, which are presented in the table, but also for the overwhelming majority of individual goods. This phenomenon may be explained by the fact that preliberalization tariffs, which accompanied the administrative regulation (normally prohibition) of imports, were naturally not intended by and large to provide protection nor, for that matter, to affect the local consumer. They were imposed on a small amount of imports of each good, which were allowed to enter by special provisions, such as those applying to the transfer of capital by immigrants or by repatriating residents. These duties were thus not normally prohibitive by themselves. Hence, the commission usually found that a prohibitive tariff, in the absence of QRs, would have to be higher.

Had we comparisons of pre- and postliberalization *effective* protective rates which incorporated the implied tariffs in the QR system, they would be expected to show, if anything, the opposite difference. Effective rates could not be higher than those implied by the QR system, unless the commission miscalculated or left a wide safety margin for protection, in which case the explicit tariff would partly consist of an irrelevant portion ("water"). On the other hand, when liberalization is effective, the postliberalization effective rate would be lower than the implied preliberalization rate; this would not be true if an effectively liberalized good serves as an input in the production of another liberalized good, but these instances are of very little practical importance. The fact that the liberalization did lead to some increase in imports, as has been shown earlier, thus indicates a lowering, in many instances, of the level of effective protection.

Data about effective protective rates before liberalization do not exist. But the material presented before the Public Commission in its consideration of each good contained estimates not only of the proportion of value added in the good and its total size in the industry, but also of the price of the value added, i.e., an estimate of domestic resource costs (DRCs) in the industry. A comparison of this set with the figures for postliberalization effective protective rates derived from the very same source, that is, from the commission's decisions on nominal rates and the value-added ratios presented to the commission, shows that by and large postliberalization effective rates were higher, sometimes very much so, than the protection implied in the estimates of DRCs. On the average, effective exchange rates implied in the commission's decisions were about twice the estimated DRCs. This seems surprising, in view of the probable intention of the commission to afford each industry a level of protection just sufficient for it to operate at the existing costs in the industry. The discrepancy could have various explanations. One is simply that these are miscalculations, but this would not be consistent with the fact that both sets of calculations are derived from the same set of data as that which was available to the commission. Another is that there was a desire to allow wide safety margins; a corollary desire would be to provide margins not so much for the present as for future stages, when tariff rates were expected to be gradually lowered. Still another explanation is that the commission might have considered *marginal* DRCs to be higher than the estimates of *average* DRCs presented in the calculations, although this could certainly not account for the two-for-one ratio. While all these are plausible explanations, the main reason for the gap probably lies elsewhere, namely, in the unreliability of the estimates of DRCs. It should be recalled that one of the main criteria guiding the Public Commission's work was that of "efficiency": an industry "deserved" protection if it was "efficient." A low estimate of DRC was generally accepted as a proof of efficiency and of the profitability of an industry for the country's economy. In presenting its data, an industry (as well as, very often, government officials responsible for handling it) had a motive for showing a low estimate of DRC. At the same time, it was very common for an industry to demand an effective protective rate which far exceeded that low estimate. The inconsistency was sometimes reconciled by claiming that the estimated DRC reflected not actual costs, but a potentiality that would be realized shortly if the industry were allowed to bloom under continuing protection. In many other instances it was reconciled by the "good will" and "brand name" argument; that is, the DRC estimate was attributed to the "true" value of the local product which was the same as the value of the foreign product with which the local product was being compared, and it was argued that the local consumer unjustifiably discounted from this value in his own evaluation of the two competing goods. In many other instances the inconsistency in the claims was not explained at all, an oversight which was probably helped by the fact that what was explicitly discussed and decided upon was not the effective, but rather the nominal, tariff rate of the good.

v. THE PROGRESSIVE LOWERING OF PROTECTION SINCE 1968

By 1969, what was defined as the first stage of the liberalization process—the period of primarily nominal liberalization—was completed. Since that time, quantitative restrictions have been lifted on imports of several goods still subject to them in 1969. According to estimates of the Ministry of Commerce and Industry, imports competing with 92 per cent of industrial production were liberalized by the end of 1969, and the ratio climbed to 95 per cent by the end of 1972. These figures are probably biased upward; and agricultural produce, we recall, remained subject to quantitative restrictions to a greater extent than manufactures. Yet, it is quite safe to conclude that by 1969, quantitative restrictions were of only small over-all significance.

The stage of gradual lowering of the tariff protection afforded to the "liberalized" sector started at the end of 1968, although a reduction of the tariffs involved, by 10 per cent of the level of each tariff rate, had already commenced in November 1966. This stage had been assumed all along to follow the first stage of nominal liberalization. Its execution was apparently helped by two factors. One was a change, in 1965, in the personalities and approach in the Ministry of Commerce and Industry; the new ministers were more disposed to liberalization. A more important factor was probably the state of the economy. The recession years 1966 and 1967 were considered an inappropriate time to expose domestic production to further competition from abroad, whereas by the end of 1968, full employment had been restored.

In October 1968, a reduction of 15 per cent in the level of each tariff took place. A few months later, in January 1969, a further reduction was carried out, this time in a progressive manner. Tariff rates below 35 per cent were left intact; rates between 35 and 50 per cent were lowered by 10 per cent (of the tariff level); rates in the range from 51 to 75 per cent, by 15 per cent; rates in the range from 76 to 100 per cent, by 20 per cent; and rates exceeding 100 per cent, by 30 per cent.

In August 1969, the government adopted an explicit program of lowering of the protection afforded to liberalized industries, the main guideline of which was the gradual approach toward a uniform "target" rate of *effective* protection. The target effective rate of foreign exchange for value added in import substitution was set at IL 5.50 per dollar. Since the formal rate of exchange was then IL 3.50 per dollar, the implied target rate of effective protection was thus 57 per cent. The rate of IL 5.50 per dollar exceeded the effective rate of foreign exchange for value added in exports in 1969 by about 35 per cent, a figure quite close to the 25 per cent which was very often mentioned in government circles, throughout the years, as the extra premium which import substitution deserved. The target rate was scheduled to be reached by early 1975, through a tariff reduction in six equal installments in January of each of the years 1970 to 1975. The "equal" installments referred to the levels of *effective* protection, which meant, of course, unequal annual reductions of nominal tariffs. The levels of effective protection involved in the existing tariff system are calculated, in the machinery specified in the 1969 decision, by industry subcommittees of the Public Commission, although the full commission as such ceased to have a function in the process of liberalization. Prices of imports from Europe—but not necessarily from the potentially cheapest source if it was outside Europe—are to be taken as "international" prices for the calculations of effective protection rates. In addition, imports considered to be sold at "dumping" prices are expected to be discriminated against by special levies or by quantitative restrictions. Likewise, in cases where imports are considered to have a "snob appeal," the target effective exchange rate is raised by IL 0.5 per dollar of value added. All these provisions resemble, of course, the principles observed in the earlier deliberations of the Public Commission in carrying out the process of nominal liberalization.

The first round of tariff reductions within this declared program occurred in January 1970, when nominal tariffs were lowered by 5 to 15 per cent of the tariff levels. In January 1971 a similar reduction took place, although it applied only to a fraction of the imports concerned, since the act was intended on that occasion to take into account tariff concessions made during 1970 in connection with Israel's agreement with the European Economic Community. This was true also for the third reduction (delayed from January to April of 1972), in which tariff rates were lowered by 5 to 18 per cent of the nominal tariff level. Another tariff reduction, in the same degree, was undertaken two months later, in June 1972. Following the formal devaluation of August 1971, in which the exchange rate was raised from IL 3.50 to IL 4.20 per dollar, the target effective exchange rate was raised by about the same proportion—from IL 5.50 to IL 6.50 per dollar of value added; that is, the implied effective protection rate came close to 55 per cent—about the same level as before the devaluation.[14] In January 1973, tariffs were lowered so as to result in a reduction of the excess of the effective exchange rate for value added over the new target rate by 35 per cent. Finally, effective May 1973 but promulgated in February 1973, tariffs were further lowered across the board by 15 per cent of the nominal tariff levels (or 10 per cent of the specific tariffs).

Since the tariff reductions have been made on changing bases, it is impossible to compute the total reduction by simply adding up the whole sequence of individual reductions; an estimate of the total reduction would require careful research, which has not yet been carried out, because most of the tariff reductions are of very recent vintages. As a guess it may be assumed, on the basis of the quantitative description here, that since the end of 1966, and primarily since late 1968, effective protective rates have been lowered by over half of their excess in 1966 or 1968 over the implied target rate.[15] It may be assumed that some, perhaps many, tariff rates had "water" in them; so reductions of these tariffs within a given range had no impact. Yet, the tariff reductions undertaken thus far within this stage of the liberalization process seem impressive and significant in lowering the average level and the dispersion of rates of protection of industries formerly shielded by quantitative restrictions. Likewise, it appears that the declared policy of 1969 has been carried out approximately as scheduled; it may thus be expected that by 1975, the major fraction of the element of discrimination in the system of protection of liberalized industries will have disappeared.

An element which may be working in the opposite direction should, however, be noted at this point. Since 1968, military purchases of locally produced industrial goods have grown very substantially; although their size has not been disclosed, there is no doubt that they constitute a significant proportion of the country's industrial output. As will be pointed out in the next chapter, purchases of military imports have always been made at a low rate of exchange. Usually, this has meant the formal rate; that is, military imports have been free of duty; but since August 1971, they have been subject to the general import levy of 20 per cent which was imposed a year earlier. Details of the purchasing policy for military goods are not publicly known. It seems that purchasing agencies are generally instructed to buy from the cheapest source. If such a policy is carried out universally, it would mean that the relevant local industrial sector faces competition from imports at a low effective rate of exchange which includes no tariff duties beyond the general 20 per cent levy. It is believed, however, that the purchasing agencies are allowed to deviate from the "lowest-cost" principle when they see a reason for preferring to maintain local production of a specific military good, and that they have a wide discretion in interpreting this rule. It is thus possible that some military purchases of local goods are made at prices which imply high rates of effective protection—although, again, not much evidence is available on this point. To the extent that this phenomenon is widespread, the expansion of domestic military purchases serves to raise the level (and dispersion) of effective protection.

vi. GENERAL REMARKS ON THE PROCESS OF LIBERALIZATION

Severe quantitative restrictions on imports were imposed in Israel in the late 1940s and early 1950s, due to very intensive pressures on the balance of payments. The progressive devaluation of 1952–54, which was part of the shift to the use of the price mechanism, relieved most of these pressures. The absence of a general balance-of-payments motivation for quantitative restrictions since the mid-1950s led, indeed, to a rapid liberalization of most of the country's imports, including a large majority of the imports of raw materials and most imports of investment goods. These became effectively free of meaningful restrictions within a short span of years.

This did not apply, however, to imports which compete with actual or potential local production, mainly imports of finished or semifinished manufactures of consumer goods, none of which were liberalized during the 1950s or early 1960s. Only in 1962 was a policy of liberalization of such imports declared. And even then, it appears that the actual execution of this policy will have taken close to fifteen years. Of these, some seven years—from early 1962 to late 1968—were required for the first stage, which was primarily a nominal liberalization consisting of a switch from QRs to equal protection by tariffs; and seven or eight more years—from late 1968 to, as it seems now, 1975 or 1976—for the effective abolition of this protection or its drastic reduction. In general, if the rest of the liberalization process is carried out roughly on schedule, competitive imports will be effectively liberalized—not just in the sense of switching from one form of protection to another, but in the sense of removing entirely the protection originally afforded by the QRs —more than twenty years after the original balance-of-payments motivation for the QR system has disappeared.

The stage of nominal liberalization of competitive imports carried out between 1962 and 1968 was certainly much longer than was either necessary for technical reasons or anticipated at its inception. Indeed, when the liberalization policy was declared, in February 1962, such a stage was not contemplated. There is also no logical reason why an effective liberalization should necessarily consist of two stages—a nominal stage and a stage of tariff reduction. Yet it would be wrong to conclude that the period of nominal liberalization was a complete waste.

First, despite the general lack of effectiveness, in several instances liberalization was effective rather than purely nominal: it led to lower protection, an increase of imports, and probably some reallocation of domestic resources.

Much more important, however—and less easily measured—was the effect on new industrial ventures. Even though protection of established enterprises remained mostly intact, it was no longer the general practice to afford protection by total import prohibition to any investment in a new industrial enterprise. Since the introduction of liberalization, protection had to be afforded mainly by the imposition of tariff duties; and such protection very often could not be as high as that which would have been obtained by total import prohibition.

This points to another favorable aspect of the liberalization, one which, again, is not subject to measurement but is probably of considerable importance. Nominal liberalization, achieved by limiting imports by levying tariffs rather than by administrative regulation, makes explicit the *price* involved in the protection. This helps to strengthen public resistance to the granting of protection. It probably results in setting some ceilings to the protection afforded to new industries and contributes to stronger pressures for the lowering of existing protective rates.

Thus, while there is indeed no logical need for an effective liberalization to be implemented in this way, rather than by a single act, the gradual approach taken may prove to be a more feasible process, owing, partly to the benefits of making protective rates explicit. When these rates are known, it may be easier to estimate the effect on each industry of reducing or eventually eliminating tariffs. This also facilitates the *gradual* introduction of import competition; and it is hard to expect any import liberalization of goods whose local production has been sheltered all along to be implemented in any but a gradual fashion.

If any more general lesson can be learned from the Israeli experience, it is that once an economy has been subject to exchange control and import prohibitions for a long period, and its whole industrial structure has been determined accordingly, it is very difficult to introduce changes which open the economy to import competition. As long as liberalization *raises* effective protective rates, as liberalization of imports of raw materials most often does, it may be easy to implement. But an effective liberalization of finished or semifinished manufactured goods, which generally lowers effective protection, faces strong objections from a sizable fraction of the economy's industries. Even if governments were entirely free to act, such liberalization would have to be introduced only gradually, owing to the quite high costs involved in the short run in the transition from one industrial structure to another.

NOTES

1. Often referred to in Israel as the "Second New Economic Policy," to distinguish it from the policy act of February 1952.

2. From the text of the policy declaration of the Minister of Finance on February 9, 1962.

3. The development of the system of export premiums will be described in the next chapter. It will be noted there that even before the 1962 devaluation, the variance of effective exchange rates was much smaller in exports than in imports. Substantial movements toward uniformity of the effective rates of exchange and rates of protection could thus emerge primarily from changes on the import side.

4. As will be mentioned, some lowering of tariffs also took place between 1966 and 1968, while the transformation of the "nominal" stage was still under way. These tariff changes are abstracted from in the following quantitative analysis.

5. The discussion in this section and the next two draws to some extent on Haim Barkai and Michael Michaely, "More on the New Economic Policy" (in Hebrew), *Rivon Le'Kalkala* [Economic quarterly] 39 (August 1963): 2–24; and more substantially, on Imry Tov, "Protection of Domestic Production in Israel, 1962–1967" (M.A. diss., Hebrew University, 1971; in Hebrew). Most of the dissertation was published in Nadav Halevi and Michael Michaely, eds., *Studies in Israel's Foreign Trade* (Jerusalem: Falk Institute and Hebrew University, 1972; in Hebrew), pp. 129–173. Part of the study appeared in Tov, "Import Liberalization Policy in Israel, 1962–1967" (in English), Bank of Israel *Economic Review* 37 (March 1971): 28–51.

6. A typical quotation: "To open trade in all goods at a uniform tariff would be the utmost absurdity. It must be realized that one industrial branch or industrial good is never like the other" [A. Dovrat (director of the Ministry of Commerce and Industry's Industrial Division), *Symposium on Problems of Domestic Protection* (Jerusalem: n.p., 1963; in Hebrew), p. 2].

7. A similar working rule, in the operation of the Indian tariff commissions in the 1950s, has been noted by Padma Desai, *Tariff Protection and Industrialization: A Study of the Indian Tariff Commission at Work, 1946–1965* (Delhi: Hindustan, 1970).

8. It will be recalled that by 1970, the share of manufacturing in the national product was about 26 per cent versus 6 per cent for agriculture; the corresponding shares of the two sectors in employment were 26 and 9 per cent.

9. As was mentioned earlier, some goods were liberalized during 1968, while Table 3-2 only covers the period up to the end of 1967; but these cases were very few.

10. Such promises very often also included the commitment to assure the investor a completely monopolistic position by preventing the local establishment of any competing plant during the specified period.

11. To be precise, these are annual imports of 1,029 items which had been liberalized by 1968; in each of the preceding years, some of these items were not yet liberalized. The table thus shows both the effect of additions to the list of goods liberalized in each year and the cumulative effect of liberalization in earlier years.

12. Since the mid-1950s, protection has generally been discussed by industry, government, or academic economists in Israel in terms of effective rather than nominal tariff rates.

13. This difference does not appear in Table 3-4, which is confined to categories rather than to individual goods.

14. After the 1971 devaluation the average effective exchange rate for value added in exports was about IL 5.20 per dollar. The target rate in imports thus exceeds the current export rate by 25 per cent, instead of the 35 per cent found in the comparison for 1969.

15. If we make the reasonable assumption that the target effective exchange rate of IL 6.50 per dollar of value added is roughly the same as the present equilibrium exchange rate, then the implied target "net" effective rate of protection would be zero. See the discussion in the next chapter.