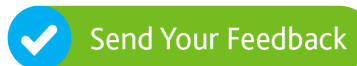


ISSUER COMMENT

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Government of Israel

Planned judicial changes could weaken Israel's institutional strength

On 4 January, [Israel's](#) (A1 positive) coalition government¹ presented a package of reforms that would represent substantive changes to the country's judiciary system. The scale of the changes and the speed with which the government attempts to push them through parliament have led to widespread criticism from civil society groups, opposition politicians and the international community. Israel has seen continued large-scale protests since January 2023. It remains to be seen whether the proposed changes will be implemented in their current form or whether some sort of compromise will be reached.

In our view, if implemented in full, the proposed changes could materially weaken the strength of the judiciary and as such be credit negative. The planned changes could also pose longer-term risks for Israel's economic prospects, particularly capital inflows into the important high-tech sector.

The government's proposals include the following:

- » **Introduction of an "override clause"**. The proposal would allow the Knesset, Israel's parliament, to re-enact any law rejected by the Supreme Court for violating one of its 13 Basic Laws by a simple majority of 61 votes out of the 120-seat Knesset.²
- » **Changes to judicial appointments**. Two representatives from the Israel Bar Association on the Judicial Selection Committee would be replaced by two "public representatives" chosen by the justice minister.³ A majority of seven of its nine members is needed to appoint Supreme Court judges, ensuring broad consensus (a single majority suffices for other courts).
- » **Cancellation of the "test of reasonableness"**. The changes would prevent the Supreme Court from challenging Knesset legislation, appointments or other government decisions on the grounds of them being "unreasonable".
- » **Transformation of ministerial legal advisors into political appointees**. Ministers would gain the ability to appoint their own legal advisors. Decisions from legal advisors would no longer be binding – instead they would only offer legal advice.

After passing its first reading in the Knesset on 21 February, the bill has returned to the committee stage before its second and third readings in the Knesset, in which the government has a comfortable four-seat majority. Prime Minister Netanyahu has pledged that this is the time for dialogue. The Israeli President has offered to help broker a compromise and recently signalled that a compromise could be imminent.

Proposed reforms could weaken institutions and negatively impact its sovereign credit profile

In our view, the proposed judicial reforms risk weakening Israel's institutions and governance, if implemented in full. The government has argued that the reform would restore the balance of power between the different branches of government and that the Supreme Court has sometimes exceeded its authority. For instance, proponents of the cancellation of the test of reasonableness argue that the test has contributed to judicial overreach. Similarly, ministerial legal advisers are appointed by politicians in many other democracies. In this context, many observers agree that the separation of powers and the role of the courts could be better defined and delineated.

However, the introduction of an override clause would effectively make most laws passed by the Knesset immune to judicial review and thereby change the balance of power in favour of the legislative and at the expense of the judiciary. In conjunction with the proposed full removal of the test of reasonableness and the power to appoint judges, the overall reform package could materially alter judicial independence and effective checks and balances between the various branches of government which are important aspects of strong institutions.⁴ Israel has no second chamber of parliament to review legislation, the president's role is largely ceremonial and lower levels of government are comparatively weak. Also, we typically expect a highly-rated government would implement major institutional reform on the basis of broad consensus and through extensive dialogue and clear communication.

As of now, we consider Israel's institutions to be a supportive factor for its credit profile, assigning a score of "a1" to the country's institutions and governance under our methodology, in line with countries such as the [United Kingdom](#) (Aa3 negative) and higher than several member states of the [European Union](#) (Aaa stable), including [Spain](#) (Baa1 stable), [Italy](#) (Baa3 negative) and [Poland](#) (A2 stable). The score reflects our assessment of the quality of executive and legislative institutions as well as of the strength of the judiciary and civil society, which we score at "aa" and "a" respectively in our analysis. If the proposed judicial reforms were to be implemented in full, there could arguably be downward pressure on those scores.

To recap, we [assigned](#) a positive outlook to Israel's A1 rating in April 2022, mainly driven by faster-than-expected fiscal improvements and the implementation of credit-positive structural reforms by the previous government that we expected to be maintained and continued irrespective of the composition of the new government. We continue to believe that there is broad political consensus on the direction of economic and fiscal policies despite the fragmented political landscape. However, stronger fiscal and debt metrics may not be sufficient to offset weakening institutions if the content of the judicial reforms and the way they are passed point to such weakening.

Over the longer term, judicial changes could also damage Israel's strong economic growth potential and raise geopolitical risks

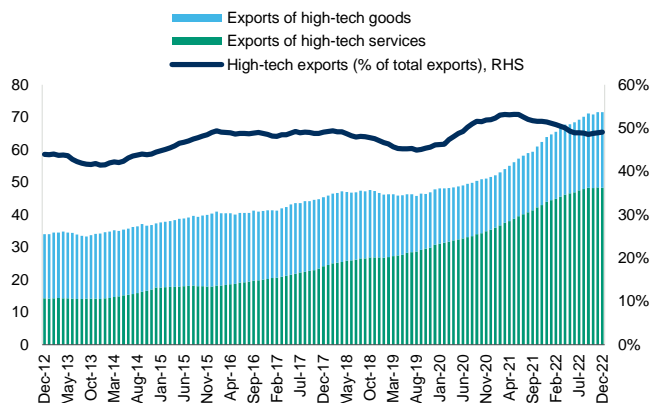
We do not expect that the reforms will have a material economic impact in the short term. However, currency volatility, which has increased since the reforms were unveiled, could slow the expected easing in inflationary pressures. Greater economic uncertainty could also delay investment decisions.

Moreover, if the judicial changes were to more fundamentally weaken the attractiveness of Israel as an investment destination and weigh on the country's growth potential, it could eventually also change our view of the sovereign's economic strength. The country's high-tech sector has become the key engine of growth for the economy, accounting for 49% of total exports and generating around 15% of GDP in 2022. It is also a magnet for foreign direct investment, with venture capital investment flows into the sector at \$15.5 billion in 2022, the second highest year after 2021.⁵

The sector is also a key contributor to the government's budget: a quarter of all income tax is estimated to be paid by employees of high-tech companies, who represent 10% of workers. Some companies in the sector have already announced their intention to reduce investment or withdraw funds from Israel. While those announcements are probably rather symbolic at this stage, there is a risk that new Israeli companies will choose to locate elsewhere rather than in Israel.

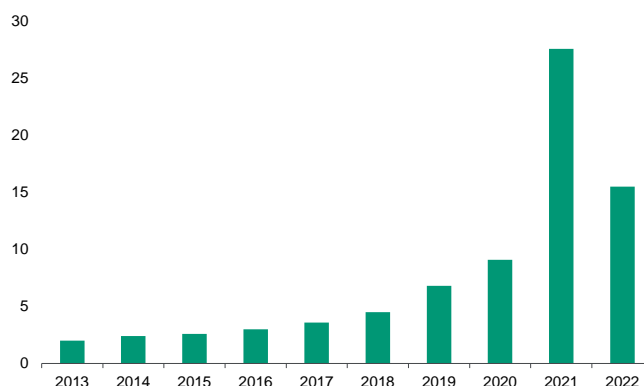
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Exhibit 1
The high-tech sector generates half of export receipts...
US\$ billion



Source: Bank of Israel and Moody's Investors Service

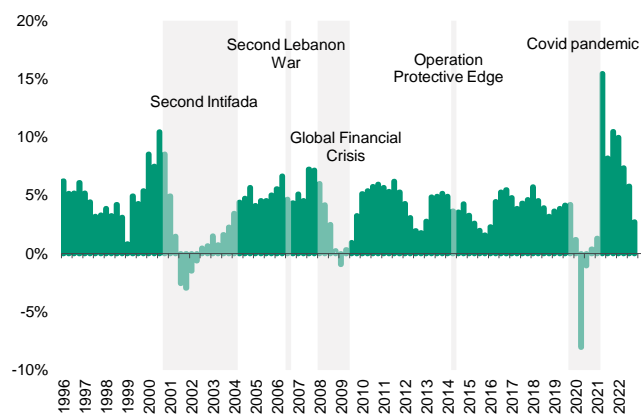
Exhibit 2
... and is a large source of foreign investment
Venture capital investment (US\$ billion)



Source: Start-up Nation Central and Moody's Investors Service

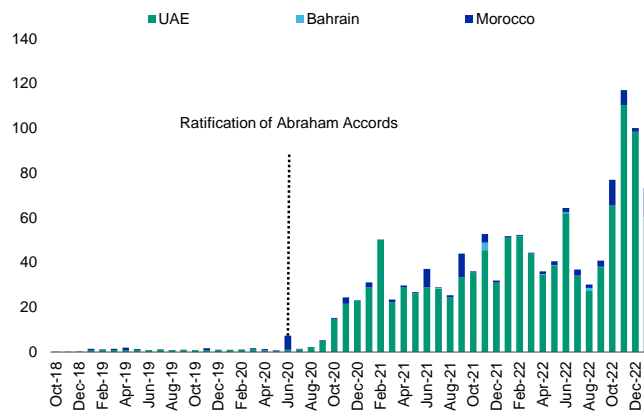
Separately, renewed violence in the Palestinian territories and the focus of some of the coalition partners on promoting Israeli settlements could lead to a deterioration in relations with Arab neighbouring countries. While such conflicts have in the past not had a long-lasting effect on the Israeli economy, which has shown strong resilience to external and internal security threats (see Exhibit 3), the positive impact from the signing of the Abraham Accords might turn out to be more limited than expected if the larger countries in the region, [Saudi Arabia](#) (A1 stable) in particular, do not move ahead with normalising diplomatic relations with Israel. Countries that signed up to the Abraham Accords, such as the [United Arab Emirates](#) (Aa2 stable) and [Bahrain](#) (B2 stable), might become less inclined to advance relations further (see Exhibit 4).⁶

Exhibit 3
The Israeli economy has recovered swiftly from shocks
Real GDP growth (year-on-year % change)



Source: OECD and Moody's Investors Service

Exhibit 4
The Abraham Accords have boosted trade with the UAE, albeit
from a low base
Exports by destination (US\$ million)



Source: Central Bureau of Statistics and Moody's Investors Service

Endnotes

- 1 The coalition is made up of the following parties: Likud, Religious Zionism, Shas and United Torah Judaism.
- 2 Israel has no formal constitution but rather a set of thirteen so-called Basic Laws that organise the division of powers and define some basic human and civil rights. Currently, the Supreme Court can strike down a law passed by the Knesset if it contradicts one of the Basic Laws.

- [3](#) Currently, the Judicial Selection Committee consists of three Supreme Court judges (including the Supreme Court president), two representatives of the Israel Bar Association, and four elected representatives (two ministers and two Knesset members).
- [4](#) See for example the recent [opinion](#) of the Venice Commission of the European Council, of which Israel is a member.
- [5](#) In 2021, venture capital investments amounted to \$27.6 billion according to [Start-up Nation Central](#).
- [6](#) Morocco and Sudan were the other two countries in the broader region to normalise ties with Israel under the Accords.

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