



## Judicial Reform: Not Ideal, But Not a Disaster Either

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### **Reform Proposals Will Strengthen the Israeli Judiciary if Moderated**

Unlike the United States, Israel never had a Constitutional Convention and never adopted a formal method to ratify or amend its constitutional structure. Instead, the Knesset passed 13 “Basic Laws” piecemeal between 1958 and 2018. The Israeli Supreme Court asserted its right to interpret the Basic Laws as constitutional in two landmark rulings in 1992 and 1995. Prior to that time the Israeli Supreme Court was independent but did not exercise powers of judicial review.

Before proceeding further, I want to make it clear at the outset that I disagree with many of the more radical judicial reforms proposed by the current Israeli government. Almost all Israelis agree, as do I, that judicial and constitutional reform is warranted, but most hope the Knesset can craft a more reasonable compromise solution. Contrary to the increasingly vitriolic rhetoric, however, Israel will remain democratic and the judiciary independent even if the current package of reforms is passed without amendment or compromise.

The constitutional nature of Israeli Basic Law lacks widespread acceptance of its legitimacy. The U.S. constitution and its amendments were proposed and ratified by 2/3 of both houses of Congress and 3/4 of state legislatures. In contrast, Israeli Basic Laws were passed by simple majorities in the Knesset. In one particularly controversial instance, Israel’s Basic Law: Human Dignity and Liberty was passed by a 32 to 21 vote when a majority of Knesset members were absent from the chamber.

Israeli Supreme Court procedures also detract from its widespread legitimacy and acceptance. For example, although 15 judges sit on the court, panels of varying size are selected at the discretion of the court President to decide each case. The current government’s proposal is a radical change, but the status quo is also quite radical when compared to the United States and other democracies. At first the current government proposed a new system whereby all 15 judges must vote unanimously to strike down Knesset legislation. In response to public pressure, they lowered this onerous bar to 12 out of 15 votes. A compromise solution would perhaps land somewhere between a simple majority of 8 to a smaller supermajority of 10.

Without delving even deeper into the specifics of various proposed reforms I would argue that almost all of them are like the preceding example, warranted and potentially beneficial if softened from their current all or nothing stance. What seems to be missing in the rhetoric, however, is that the rule-of-law evolved and improved in Israel over time as Israel’s economic structure shifted from Socialism to Capitalism. Much of this transformation had nothing to do with Israel’s Basic Laws or the Supreme Court’s powers of judicial review. Even if the current government’s maximalist policies are adopted, the rule-of-law from an economic perspective will remain stronger than it was during most of the early decades following the War of Independence in 1948.



## **When Israel was Socialist, the Rule-of-Law was Weaker**

I have closely followed the Israeli economy and financial markets since the late 1980's. Until 2010, however, I did not feel comfortable launching the Israel Investment Fund, L.P. For most of Israel's history from the pre-state 1920's until privatization began in the mid-1990's the Israeli economy was either state-owned or owned by the politically powerful Histadrut labor union. During these years, only one third of Israel's Gross Domestic Product (GDP) was produced by privately owned businesses. Israel started to dismantle its Socialist legal and regulatory framework in the 1990s but significantly accelerated the process in the 2000s.

From 1948 through the early 2000's Israel was an electoral democracy, but its economic system was rife with political interference and conflicts of interest. Israel lacked an independent central bank, financial regulation was weak, private property rights existed but were often encumbered, intellectual property rights were quite feeble, auditing standards were loose, and the courts barely recognized concepts of fiduciary responsibility or director liability. Many of these concepts were not fully relevant to an economy lacking a separation of the state's regulatory function from its function as a business owner and operator.

Activities and conflicts of interest considered either corrupt or unacceptable today in Israel were commonplace well into the early 2000's. Political placement of executives in government or Histadrut owned companies or shifting money and resources from one enterprise to another despite contracts to the contrary were often considered necessity rather than corruption. During the early decades of the state Israeli economists sometimes referred to this politico-economic structure as a "schnorrer economy," Yiddish for robbing Peter to pay Paul. All Israelis understood that "Protektzia" or connections of bureaucratic patronage and protection were critical for career advancement or other important economic relationships.

## **Israel's Judiciary was Inherited from the British**

As a former British colony Israel inherited a well-established and independent judiciary. In many ways the judicial system provided a significant counterweight to the more radical inclinations of Israel's Socialist politicians, maintaining reasonable property rights and contract enforcement. Unlike the former Soviet Union and its satellites in Eastern Europe, government and Histadrut owned companies were required to execute transactions using British Common Law concepts familiar to Americans. The judiciary, however, was populated by ideologically homogeneous judges hailing from the Ashkenazi Socialist elite.

Israel's legal institutions were much stronger than Communist Eastern Europe and perhaps stronger than certain wealthier Western European countries of the time such as Italy. Nonetheless, Israel fell far short of standards in the United States, Canada, Britain, or other developed Common Law countries. This situation started to change, however in the 1980s.

Beginning with the Economic Stabilization Plan in 1985, leaders across the political spectrum recognized Israel needed to change and improve. Reforms to macroeconomic and fiscal policies came first because 500% annual hyperinflation had to be contained. Next came Bank of Israel independence from political interference and then Histadrut privatizations in the 1990s. Privatization merely moved monopolies and conflicts of interest from the public sphere into private ownership. The new owners, dubbed "tycoons" by the Israeli public, exploited weak legal safeguards to raid banks, insurance companies, and pension fund assets to finance vast business empires of privatized companies.



## **Private Business Needed a Higher Quality Judiciary**

Israeli tycoons never morphed into Russian-style oligarchs because the legal and regulatory system rose to the challenge. Knesset legislation played the primary role, but the judiciary became a more prominent arbiter of rules important to private commercial and financial relationships. Regulatory functions unbundled from government owned business, motivating the courts to better define fiduciary standards and obligations. In the securities markets, auditing standards and regulatory enforcement powers evolved toward American and British standards.

In 2005 the Knesset passed watershed legislation recommended by the Bachar Committee. The Bachar reforms dismantled Israel's financial oligopoly dominated by Bank Leumi, Bank HaPoalim, and Israel Discount Bank. While under government ownership these three banks controlled almost all financial activity in Israel including commercial banking, pension management, asset management, securities underwriting, and investment brokerage. The new tycoon owners inherited and exploited the banks' monopolistic power and weak regulatory oversight. The Bachar legislation forced these banks to divest pension management, asset management, and curtailed their activities in the securities industry.

The Bachar legislation strengthened financial regulation and launched Israel's capital markets as a viable competitor to traditional banks. My decision to launch the Israel Investment Fund, L.P. was largely triggered by the Bachar reforms. Given the current acrimony in the debate regarding judicial reform it is important to note that most of Israel's improved economic and financial governance was enacted by Knesset legislation rather than court decisions. The courts certainly played an important role enforcing and interpreting the new laws, but the judiciary was not the prime mover.

## **Legal Improvement in Israel was Mostly Advanced by Knesset Legislation**

In 2013 the Knesset passed the "de-concentration law", an even more sweeping overhaul of Israeli economic regulation. This law prohibited common ownership of financial and non-financial companies, effectively bringing Israel's tycoon era to a close. The de-concentration law replicated American policies enacted during our trust-busting era of the early 20<sup>th</sup> century. Once again Knesset legislation was critical rather than court activism. The courts validated Israel's Socialist economic structure and weak economic governance for decades. As the Knesset reversed course, however, the courts began to interpret rules appropriate to an advanced market-oriented economy.

## **Israel will Not Become a "Junk" Credit like Greece or Turkey**

Contrary to some of the more inflammatory rhetoric, I do not believe the legal principles that undergird Israel's market economy will be reversed or corrupted. Nonetheless, Israel's constitutional uncertainty could bring Israel's extremely robust AA- credit rating down a notch. Some investors are clearly spooked a bit given the recent decline in the shekel/dollar exchange rate, but a longer-term perspective must be maintained. Israel is not at risk of becoming the next Greece or Turkey with "junk bond" credit ratings or currency collapse.

Institutional "checks and balances" should be a two-way street. Perhaps the judiciary asserted too much authority on issues important to large percentages of the public. Israel's constitutional system evolved over time and could benefit from the current debate. I also recognize that this debate will continue through multiple elections and that mistakes made now can and likely will be rectified when future governments take power. In this regard Israel experiences the ebb and flow of political cycles just like any democracy including the United States.



During IIA's 12 ½ years in business I constantly and explicitly emphasized Israel's legal and regulatory improvement in numerous reports and letters. These can all be accessed on the IIA website at [www.israelinvestmentadvisors.com](http://www.israelinvestmentadvisors.com). If you read any of them, you will see that I consider Israel's improved legal quality and judicial independence as one of the most fundamental reasons Israel joined the elite club of wealthy developed countries. Israel will remain a member of this club because its legal improvements were unrelated to the constitutional debate now raging in the Knesset and on the streets. I hope the current conflict results in healthy compromise, either now or in the coming years, but the hostile rhetoric overstates the downside by a wide margin.

