Master Thesis

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The Israeli Bill for the Diminution of Wage Disparities: Law and Economic Analysis of its Justifications

"No one goes into Wall Street to save the world, compensation is the motivating factor."

Meredith Whitney.

I hereby declare and confirm that this thesis is entirely the result of my own work except where otherwise indicated. I acknowledge the supervision and guidance I have received from Prof. Pierre Garello. This thesis is not used as part of any other examination and has not yet been published.

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A. Introduction

Since the early 90’s, the subject of high executive remuneration had been a hot topic amongst economists, legal scholars and of course, the public. The criticism had increased following the 2001 Enron and WorldCom financial scandals, which some claim were caused due to the 'hunger' of those firms' executives to award themselves with packets on the account of the firms and the shareholders they were allegedly serving.¹ The 2008 sub-prime crisis originated in the US, which its ripples are still felt in recent days' global economy, had also drawn the attention to executives' pay, since overly keen managers were blamed of creating short-term high profits, in order to increase their own personal gains.²

As a reaction to the sub-prime crisis, the US government had launched the Troubled Asset Relief Program (TARP) in attempt to stabilize the economy, firstly by giving financial aid to some of the largest firms, and secondly, by enforcing new orders on firms receiving such financial aid. Despite such limitations, the notorious case of AIG handing out $165 million in bonuses to its executives following the acceptance of $170 billion from the US government was made public and created another stir³.

Even today, four years after the commencement of the latest financial crisis, we are still witnessing phenomena of immense pays given to executives and increasing disparities between executives' pays and 'regular' workers' pays; to put across, in the

²Joseph Gross, Directors and Office Holders' Remuneration, Joseph Kassirer Institute for Accounting, Faculty of Management, Tel Aviv University, January 2010, 2.
US, the ratio of average CEO pay to average worker pay in 1980 was 1:44 as opposed to 1:344 in 2007.4

Also, the average CEO pay in S&P 500 Index increased by no less than 146% between the years 1993-2003. The increase of CEOs pay levels outstripped the average workers' in the US so that the growth in CEO pay was 45% whereas the average worker's growth was only 2.7%. In the Netherlands, the disparities are even greater: CEOs pay rose by 192% where growth of the average worker's pay grew only by 2.4%.5

This steep increase in executives' pay in the past 20 years can be explained by numerous reasons:

Firstly, a paradigm shift took place during the 90' where from a dominant voice with respect to directors' responsibility towards all stakeholders6, the winds changed, putting an emphasis on directors' and management's duties towards stockholders alone, and "the interests of other stakeholders [became] relevant as a derivative of the duty to the shareholders".7

Secondly, technological changes caused a rise in demand for excelling managers, which consequentially caused an increase in their pays: the knowledge required today for an

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6 John C. Coffee, Jr., "What Caused Enron? A Capsule Social and Economic History of the 1990's, Colombia Law School working paper. January 20, 2003, 5-6: "If one turned back the clock twenty odd years to 1980... The interests of different constituencies were balanced by professional managers, and... no special priority was assigned to the interests of the shareholders". Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=373581. Last visit: May 5, 2012. Also: "In 1990, the Business Roundtable, a group of CEOs of the largest U.S. companies, still emphasized in its mission statement that "the directors' responsibility is to carefully weigh the interests of all stakeholders as part of their responsibility to the corporation..." - see Lorsch and Khurana, 33.
7 Lorsch and Khurana, 33.
executive to be successful had changed: once, a very specific knowledge was required, which could have been obtained only when one knew the industry all around. Following many technological changes that made the relevant knowledge much more accessible, the knowledge once was known only to few executives in each industry, became available to all, and therefore a competent executive was able to easily transfer from one industry to another. As a result, a competitive market for excelling executives was created, conveyed by high pays⁸.

Similarly to the opening of the markets with the help of technological changes, globalization was also 'accused' of causing an increasing demand for competent executives causing a high rate of rotation: the rotation rate of CEOs in the 2,500 largest firms in the world between 1995 and 2006 had risen by 59%,⁹ and high pays became one of the means to tempt good executives to leave their current positions but also the means to preserve and keep them from leaving to work for others.

Another explanation for the surge in executives' pay in the recent two decades is related to the size of the firms: the size of listed firms had increased tremendously, and accordingly, the executives' pay.¹⁰ The larger the firm, the greater the responsibility the manager has, and therefore the better her level of skills must be,

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¹⁰ Gabaix and Landier claim that the reason why CEOs pays were multiplied by six between 1980 and 2003 is because the size of the firms was also multiplied by six. See Xavier Gabaix and Augustin Landier, Why has CEO Pay increased so Much, *Forthcoming in the Quarterly Journal of Economics*, April 9, 2007, 2. Available at: [http://economics.mit.edu/files/1769](http://economics.mit.edu/files/1769). Last visit: May 23, 2012.
which is compensated by high pays.\textsuperscript{11} Moreover, when the size of the firm increases, it usually means that the number of executives grows proportionately. If once, a CEO and a few other deputies would have sufficed, today a much larger, more responsible and high paid team is required, which basically pushes the CEO (as the highest paid) pay even higher.

\textit{Lastly}, the financial markets had flourished in recent decades, causing a high demand for talented people which was translated into higher pays. As a result, many talented people were enticed to prefer working in the financial markets. A research referring to the decade ending in 2004 showed that the percentage of financial market's executives in the top percentile of income earners is much bigger than the percentage of executives coming from other industries. The conclusion of such research was that executives' pay in other industries did not keep up with the pace of executives' pay in the financial market. Consequentially, all the other markets had to align to the high pays in order to make good executive stay (or to allure them to choose the other markets to begin with).\textsuperscript{12}

In the Israeli market, the combination of controlling shareholders in most of the largest firms alongside with its concentrated structure caused a huge rise in executives' pay.\textsuperscript{13} That, together with tremendous escalation in the cost of living and the effects of the financial crisis caused great social disparities between the top echelon and the rest, which brought the discussion on executives' pay to a boiling point. Many discussions

\begin{flushright}
\footnotesize
\textsuperscript{12} Kaplan and Rauh, 37.
\textsuperscript{13} A very recent survey shows that executives' pay in the largest 44 listed firms in Israel was doubled in the last six years. See Zvi Lavi, Within Six Years Executives’ Pay was Doubled, \textit{Ynet}, August 9, 2012. Available at: \url{http://www.ynet.co.il/articles/0,7340,L-4266270,00.html} (Hebrew). Last visit: August 9, 2012.
\end{flushright}
with respect to the reasons leading to the current situation were held and soon they were translated into actions, one of them is the Israeli (private) Bill for the Diminution of Wage Disparities (the "Bill"), submitted to the Israeli Parliament in 2008.

The Bill's goal was to create a more equal and just society by linking the highest and the lowest wages in each working place such that the highest will not exceed more than 50 times the lowest. Although the end-game is social justice, the reasoning behind the Bill was allegedly economical. In this work, I will analyze the Bill and examine whether it can really be justified from an economical standpoint.

Following the review of the global changes that led to the increase in executives' pay, I will establish the existence of a market failure (in the form of an agency problem) in the market for executives' remuneration. Following that, I will explore the three different agency problems and examine which of them is relevant to the Israeli market, according to its special characteristics. Finally, I will establish whether the Bill can be justified by efficiency means and whether it can resolve the agency problem I have detected existing in Israel.

My contribution in this dissertation is creating a clear and organized thought of the main agency problem existing in Israel. Many of the Israeli scholars and analysts are still disordered with respect to the correct identification of the problem, which, of course, projects on their ability to offer a suitable solution.

B. Executive Pay – A Market Failure?

After reviewing the possible causes to the (too) high executive pay, my goal is to verify whether it is a market failure that needs to be corrected or not.
According to the economic neo-classical approach, a market failure is "a general term describing situations in which market outcomes are not Pareto efficient [and therefore] provide a rationale for government intervention".\textsuperscript{14}

The basic argument is that the market, through which the executives' pay is determined, does not work properly, and therefore the pays are inflated. In a competitive market (with no market failure), the pay approved by the board would have been proportional to the value created by the executives. A competition between potential executives would have brought to the selection of the best candidates which combine value creation to the firm and a fair compensation, meaning, that the marginal cost of labor equals the marginal benefit created by the executive. The existence of such mechanism cancels out the need to evaluate the reasonability of the pay, since the mere fact that the pay was approved by the board is ares ipsa loquitur, implying that the allocation of resources is optimal (however not necessarily fair). This situation cancels out the common claim that any "multimillions pay" is evidence to a market failure, since as long as the executive provides a great benefit to the firm, it is also efficient to remunerate her accordingly, large as the pay may be.\textsuperscript{15} However, by agreeing with the economic theory that remunerates executives for their marginal productivity, we usually fail to isolate executives' contribution from the contribution of the rest of the workers (and the behavior of the market itself), meaning that executives' remuneration does exceed beyond the benefit they create. Therefore, the


reason for the high executives' pay must be the outcome of other influential forces, as I will show later.\textsuperscript{16}

In case executives are remunerated beyond their own contribution to the firm, it means that the 'invisible hand'\textsuperscript{17} of the market does not work properly, and a market failure is created. In such cases, it is customary to discuss the option of an intervention, usually of the regulator, as a second best solution for the failure. It is of course crucial to accurately define the failure in order to attach the right solution and to examine the resources, costs and the problematic incentives that might be created by such intervention.\textsuperscript{18}

C. The Agency Problems as Market Failures

The market failure in the case of executives' excessive pay is an agency problem,\textsuperscript{19} which "concerns the difficulties in motivating one party (agent), to act on behalf of another (principal) [...] The two parties have different interests and asymmetric information (agent having more information), such that principal cannot directly ensure that agents are always acting in its (the principals') best interests [...]. Moral hazard and conflict of interest may arise."\textsuperscript{20} In order to better control the agent's performance, the principal must monitor the agent's behavior, which is costly. Those costs of monitoring are called agency costs.

\textsuperscript{17} Adam Smith, The Wealth Of Nations, 1776. Book IV, Chapter II, p. 456, para. 9.
\textsuperscript{18} Ayal, 3.
\textsuperscript{19} The new market failure arguments consider the agency problem as a market failure. See Tyler Cowen and Eric Crampton, Introduction to Market Failure or Success: the New Debate, \textit{George Mason University}, p.5. available at: \url{http://www.cadep.ufm.edu/Seminarios/SeminarioEconomia/randallholcombe%20the%20ramsey_files/BookIntro.pdf} Last visit: July 1, 2012.
\textsuperscript{20} Wikipedia, Principal-agent problem. Available at: \url{http://en.wikipedia.org/wiki/Principal%E2%80%93agent_problem} Last visit: July 2, 2012.
Although the outcome is the same (existence of agency costs), the agency problem does not always present itself in the same manner, therefore it is important to distinguish between the structures causing different application of it. Putting that into the context of business firms, we can identify three main agency problems;

D. An Overview of the Different Agency Problems

i. Agency Problem between Shareholders and Managers

The first agency problem depicts the conflict between owners (principals) and hired managers (agents) which is common in dispersed ownership structure (seen mostly in the US and UK)\(^\text{21}\), where each shareholder holds only a small fraction of the firm's shares and therefore unable to control the firm's actions.\(^\text{22}\) A dispersed ownership structure occurs when there is no controlling shareholder and the public investing in the firm prefers to diversify its portfolios in order to avoid high dependency on one firm. This is why such shareholders develop rational apathy towards the firm and try to free-ride the decisions of the rest of the shareholders. Moreover, even if shareholders did wish to control managers' activities, the fact that they are many, increases the coordination costs and therefore makes it difficult to participate in a collective action.\(^\text{23}\) The outcome is a separation between ownership and control: shareholders own but managers 'navigate the ship'. Since managers and shareholders have different

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\(^{23}\) Armour, Hansmann and Kraakman, 4.
interests to begin with (each wishes to maximize her own utility), shareholders must align managers' interests with theirs so that agency costs will decrease.\(^\text{24}\)

In order to meet such alignment, an ex-ante linkage between managers' compensation schemes and shareholders wealth maximization agenda must be created\(^\text{25}\). Turning the compensation from lump-sum (non-equity) based into performance (equity) based pay creates the required alignment of interests since managers are incentivized to pursue the same agenda as the shareholders (maximize share value).

1) The Influential Forces Setting the Executives' Remuneration

Bebchuk and Fried referred to the two different approaches with respect to the organ that is in charge of creating such alignment between executives and shareholders, by deciding the executives' pay. As further shown, neither approach has managed to fully create an alignment; instead, distorted mechanisms that put an emphasis on short term results were created, causing market myopia.\(^\text{26}\)

The first approach claims boards are supposed to design an optimal compensation scheme in order to create an efficient incentive for executives to maximize share value (the "optimal contracting approach").\(^\text{27}\)

The problem arises since board members follow their own personal agenda (another principal-agent problem), which sometimes challenges their goal to create an optimal


\(^{27}\) Bebchuk and Fried, 73.
contract. Firstly, directors wish to be re-appointed to the board: since the list of nominees is prepared by the management, it provides the directors an incentive to favor the managers' interests over the shareholders'. Secondly, directors also wish to be portrayed as lenient so they will also be appointed as directors in other firms. Thirdly, directors know that the management can have an effect on the bonuses they receive from the firm. Fourthly, some directors serve as executives in other firms, so by approving the executives high pay, they are in fact promoting their own self-interest.28

The second approach assumes that not the directors are the ones who set the tone, but managers themselves.29 This approach refers to managers' ability to extract rents, hence the name: "managerial power approach". However, despite the fact managers can influence their pay, they would still consider the constraint of outsiders' "outrage" with respect to the offered contract, e.g., if a proposed compensation scheme angers shareholders (via bad media coverage, for instance), it might harm managers' and directors' (who proposed and approved it, respectively) reputation, lead to a reduction of compensation in following years or even to shareholders' support of the incumbent management's replacement in case of a takeover. Therefore, there is high importance to the way such schemes are perceived by outsiders since suboptimal schemes can be approved if not observed as outrageous. This is why managers try to lessen the outrage by camouflaging the rent extraction, which leads to distorted incentives and firms' inefficient performance.30

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28 Bebchuk and Fried, 74-75.
29 Bebchuk and Fried, 78, claimed that the managerial power approach is the dominant one that can more easily explain current suboptimal pay schemes. However, it is probably a mixture between the two approaches that depicts the complex reality.
30 Bebchuk and Fried, 76-77.
Since having managers set their own pay is akin to letting the cat guard the cream, regulators started supporting the replacement of the already high non-equity based pays with equity-based pays in order to align the incentives of managers with shareholders. De facto, managers took advantage of their influence and instead of giving up part of their non-equity based pay for the equity-based pay component, they enjoyed both worlds, giving up on nothing, and by that, increasing their compensations. Moreover, the options managers received as part of the performance-based pay allowed them to win windfalls related to the markets' behavior rather than their own ability to increase share value, as what happened during the 90’s, when most of the stock markets bloomed (taking with them even poorly performing firms), making it easier to justify the high pays and to win the pleased shareholders' support rather than their outrage.31

Supporting the managerial power approach is the compensation consultant, a function that was formed in order to simplify the growing complexity of executives' compensation schemes. Since many boards had neither time nor knowledge to tackle this matter, the consultant was to assist the board and management to come into terms with respect to the compensation arrangements.32 However, since consultants were hired by the HR departments which are subordinated to the management, they considered the management as their client, rather than the company itself, therefore strove to guard the management's interest, by justifying high compensation when the firm was doing well (executive pay should reflect the good performance) but also when the firm was doing poorly (high pay should reflect 'business as usual' to other firms in

31 Bebchuk and Fried, 77-78.  
32 Lorsch and Khurana, 32, claim that since compensation arrangements of CEOs were becoming ever more complex, the compensation consultants, as objective experts, were requested to assist boards who had "limited time and knowledge about compensation matters."
the industry). Also, consultants wished to keep the CEO pleased, as they had other businesses with the companies that they wanted to maintain.\textsuperscript{33}

\section*{ii. Agency Problem between Majority and Minority Shareholders}

The second agency problem presents the conflict between majority shareholders having control over the firm (agents) and minority shareholders, \textit{i.e}, the non-controlling owners (principals). As opposed to the first agency problem, this agency problem takes place mainly in continental Europe (Italy and Germany and several firms in France and as later to be shown, in Israel), where there is a shareholder (usually a family) controlling majority of the votes, mostly without actually owning majority of the cash flow rights.\textsuperscript{34} This \textit{separation between ownership and control} is typically achieved by a \textit{pyramidal structure} of firms, but also via shareholders' agreements and dual class shares.\textsuperscript{35}

The upside of a concentrated ownership structure is in the absence of the first agency problem, since here, managers are disciplined by (majority) shareholders (who have the power to set the executives' remuneration scope)\textsuperscript{36} and the agency costs of monitoring the managers are therefore much lower. Despite those clear benefits, this 'solution' is far from perfect.

Indeed, it was earlier believed that creating a core of control will actually resolve the first agency problem, as it will enable controlling shareholders to be actively involved

\textsuperscript{33} Bebchuk and Fried, 80.
\textsuperscript{35} La Porta, Lopez-de-Silanes and Shleifer, 474. Also see Enriques and Volpin, 117.
\textsuperscript{36} Ayal, 5.
and perform close monitoring over the managers and therefore decrease the managers' discretion and their abusive utilization of the firm's resources (i.e., decrease agency costs). Such findings dared the existence of dispersed ownership structures in firms, nevertheless failed to deal with practical and theoretical challenges since it was later shown that cores of control only created a new agency problem since the controlling (majority) shareholders used their controlling powers to pursue their own interests which were not aligned with the minority's interests. In addition, another variation of the 'new' agency problem was later discovered - the entrenchment problem of the controlling shareholders, to be discussed below.

1) The Influential Forces Setting the Executives' Remuneration

Despite the managers' lack of power, a problem arises because, as aforesaid, there is no alignment between the interests of majority and minority shareholders: majority wish to enjoy private benefits of control, which can easily be done as they can affect the firm's conduct, thus influencing all shareholders. As part of controlling the firm's actions, the majority is also in charge of setting executives' pay.

The common way to enjoy private benefits of control is achieved by a pyramidal ownership structure, which occurs when the block-holder has control over a firm via other firms also controlled by her (see figure I). Minority shareholders provide capital but never gain control over any of the firms in the pyramid, so control remains in

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37 Enriques and Volpin, 117. Also see Morck, Wolfenzon and Yeung, 678.
39 Armour, Hansmann and Kraakman, 4.
40 Enriques and Volpin, 118.
block-holder's hands and her interests are served by "self-serving" managers\textsuperscript{42} who are compensated accordingly (further discussed below).

\textbf{Figure I\textsuperscript{43} - A Classic Pyramidal Structure}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{pyramid.png}
\caption{A Classic Pyramidal Structure}
\end{figure}

2) The Influence of Pyramidal Structures on Executives' Pay

The abuse of majority's power is articulated in three main forms: the first is "other people's money problem"\textsuperscript{44}: every firm in the pyramid dilutes the capital ownership of the block-holder in the 'lower' firms of the pyramid such that the block-holder's participation in the losses (or gains) of such firms would be relatively minor, \textit{e.g.}, if the block-holder holds 51\% of firm A and firm A holds 51\% of firm B which holds 51\% of firm C, it turns out that the block-holder will own a stake of 26.01\% (51\% out of 51\%)


\textsuperscript{43} Taken from Morck and Yeung, 382.

\textsuperscript{44} Morck and Yeung, 374.
in firm B and 13.26% (26.01% out of 51%) in firm C and so forth. Therefore, for every €100 spent (or earned) by firm C, block-holder will pay (or earn) only €13.26 whereas the minority shareholders will pay (or earn) the remaining €86.64. To put in context, majority shareholders will worry less about remunerating executives with high pays since the money coming out of their pockets for that cause is very little. In addition, it is also common that the high paid executives are the majority shareholders themselves or closely related people (by family ties or close friendships), which constitutes for another reason to take good care of the executives by approving their high pays.

The second problem, and the harshest one, stemming from the pyramidal structure is the "Tunneling" or, the "self-dealing": often firms within the group conduct business among themselves, sometimes even giving each other financial aid. This can be made under legitimate circumstances but it can also be the case where an asset or a service is transferred between two (or more) firms within the group, however its true value is not accurately reflected in its price (either too high or too low), meaning that profits are artificially transferred from one firm into another (e.g., if a buyer pays an exaggerated price, seller will earn artificially high profit and vice versa). This way, the block-holder can transfer profits from a firm lower in the pyramid (where she owns a relatively small fraction of the stake) into a firm at the top of the pyramid (where her

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45 Morck and Yeung, 374.
46 Morck and Yeung, 367.
48 However, self-dealing can also take place not only in pyramidal structures but also when the majority shareholder prefers to perform any transaction that is in conflict of interest to the interests of the firm. See Sharon Hannes, Options to Executives in the Capital Market with Concentrated Ownership: A Reassessment and a Discussion in the Israeli Case (Hebrew), Mishpatim l"v, 2005, 72.
stake is the largest). Since majority shareholder must get assistance from the management to do so, she will be inclined to compensate the "self-serving" executives for their actions, as they are sometimes requested to go against the interests of the firm which they are liable for and instead, to favor the interests of the entire pyramid.

The third problem known as the "entrenched management problem" comes from the fact that majority shareholders are entrenched and cannot be removed since they have control (as opposed to a powerful manager in dispersed ownership structure that can be more easily replaced). This problem depicts the stagnation of the second agency problem, since market forces such as takeovers cannot discipline the blockholders and prevent them from abusing their power (see discussion below).

iii. Agency Problem between Shareholders and Constituencies
The third agency problem demonstrates the conflict between the firm itself (the agent) and its contracting parties (e.g., creditors, employees and customers – the principals). The firm might abuse its power and behave opportunistically by appropriating creditors, abusing its workers or deceiving costumers. This may happen if, for instance, executives continue extracting their high pays even when the firm's financial 'safety cushion' is shrinking. The risk intensifies when executives' pay mostly consists of short-term options which incentivize them to take greater financial risks.

50 Ayal, 12.
51 Morck and Yeung, 374.
52 Enriques and Volpin, 122.
53 Armour, Hansmann and Kraakman, 4.
54 Ayal, 7.
Several scholars refer to another community that suffers from the actions of the firm - the general public; firms can cause negative externalities for the public, such as pollution, whenever the action is value increasing for the firm, and can sometimes evade the costs of internalization because of imperfect enforcement mechanisms. For example, a firm is about to profit from a polluting procedure €100,000 which its social costs are €150,000, however probability of being sued is 50%, so the expectancy of loss the firm sees is €75,000, therefore the firm will then pollute because even if caught, it is still expected to earn €25,000. The high pays (equity or non-equity based) drive executives to overlook the externality. One might claim that the high pays include a compensation for the executives who are willing to diminish the importance of personal and social values in order to meet shareholders' interests.\textsuperscript{55}

The common opinion is that corporate governance should not take into consideration the interests of the general public, since for that other laws have been drafted (such as environmental laws). However, the question is whether in an imperfect world, where communities are harmed by firms' actions because relevant laws do not provide the inclusive protection they ought to, the regulator’s intervention in executives' pay is needed, whether such intervention is in favor of the firms or not.\textsuperscript{56} Is this the case where social interests defeat business interests?

E. The Israeli Perspective

So far I have discussed the three existing agency problems with respect to corporate governance and executives' pay. Now I wish to examine the Israeli market in order to


\textsuperscript{56} Ayal, 11.
understand which agency problem applies among the three, and examine its effects on the circumstances which led to the writing of the Bill. My analysis hereon will refer in general to agency problems in listed firms, as they involve more minority shareholders and thus affect the public in a more salient way, that, despite the fact that the Bill is addressing every place of business (including private firms).

i. The Israeli market Structure
The considerably small Israeli market (about 750 listed firms), is claimed to have highly developed mechanisms for investors' protection (as a minority) and has well-founded financial and governmental institutions, however the market is still highly concentrated, held by several controlling wealthy families (see figure II). The business groups' structure is pyramidal. Despite the existence of the high investors' protection (a developed market characteristic), the concentration of control is a characteristic more suited to countries where the investors' legal protection is low, such as emerging markets in the Far East. Most investments in those listed firms are made with the public's pension funds which are invested via institutional investors (with no 'say' for

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58 According to a sample taken between 1995 and 2006, about 70% of the firms listed in Tel Aviv 100 Index (the largest 100 listed firms) are held by a controlling shareholder. Note that this figure is subject to the definition of the controlling owner who "holds at least 25 percent of the company's capital apart from his being the largest from the aspect of holding relative to the amount held by the other two owners". This is unlike other studies that chose a lower benchmark for the definition of control. See Kosenko, 75, 78.

59 According to Konstantin Kosenko, 64, "the percentage of companies in the Tel Aviv 100 index that belong to business groups is [...] averages 52 percent. The companies in the Tel Aviv 25 index (which accounts for 75 percent of stock exchange tradability) are mostly controlled by business groups. Although only 16 percent of the companies are defined as affiliated under this classification [The definition of large groups is 3 or more publicly-traded companies], the majority of large companies in the economy (42 percent – on the Tel Aviv 100 and almost all the companies from the Tel Aviv 25 lists) are still defined as affiliated to business groups."

the public on where to invest the funds), which are part of the business milieu in Israel, and therefore do not go out of their way to serve the interests of the public.\footnote{A survey conducted in 2006 by the Hebrew University of Jerusalem with respect to 250 listed firms in Israel revealed that in fact, institutional investors, when voting on behalf of the minority shareholders, tend to approve transactions that may be affected by a conflict of interest. See Ido Baum, Institutional Investors Support most of Transactions affected by a Conflict of Interest, *The Marker*, January 18, 2011, available at: \url{http://www.themarker.com/markets/1.598207}. Last visit: August 18, 2012.}

**Figure II – A Comparison of Ownership Structures in Listed Firms\footnote{The graph represents the median holdings of the largest shareholder in listed firms in the different countries. Note, that *Teva pharmaceuticals Industries Ltd*, which has the highest market value in the Israeli market, interferes with the data as 95% of it are held by the public, which is very unique in the scenery of the Israeli financial market.}**

![Graph showing ownership structures in different countries](image)

*Source: A. Fyer, Ownership Centralization in Listed Firms: International Comparison, Ministry of Finance, Capital Markets Insurance and Savings Division (January 17, 2006).*

ii. **The Israeli Agency Problem**

Whereas in the Anglo-Saxon part of the world we see that high executives’ pay stems mostly from insufficient monitoring on the managers by the shareholders, in Israel, this argument is considerably weak, since, as explained above, most of the firms have a controlling shareholder that can easily control the actions of the executives\footnote{Evidence from the Israeli market of controlling shareholders’ ability to control the firm’s actions and to extract private benefits of control is in the high control-premium paid in an event of transfer of control. See Hannes, 53.}.
However, the ability of shareholders to discipline managers does not prevent high executives pay.\textsuperscript{64}

As it seems, the second agency problem is the relevant problem to the Israeli market. Executives are disciplined \textit{ab initio}, since they wish to maintain a good reputation in the eyes of the majority shareholders who decide not only about the executives' pay but also choose whether to keep employing them or not.\textsuperscript{65} Therefore, there is no need to pay executives with equity-based pay (see \textit{figure III}), as alignment of interests already exists (also, equity-based pays do not serve the majority's interest, since remunerating the manager according to her ability to create value for the firm will harm the chances she will agree to cooperate with self-dealing transactions that serve the interests of the majority but may harm the interests of the firm she is managing).

Indeed, most Israeli firms executives' pay is typically non-equity based,\textsuperscript{66} still, in recent years, the equity-based pay component of the executives remuneration schemes had considerably grown, but as opposed to other countries where remuneration schemes are well defined and outlined in advance, in Israel, the equity based portion is in most cases still subject to the board's discretion at the end of each fiscal year and not to predetermined mechnisms.\textsuperscript{67} This is yet another robust disposition showing that the controlling shareholder is the one holding the reins with respect to executives' pay, as the board members (usually appointed by the shareholders \textit{pro rata} to their holdings

\textsuperscript{64} Ayal, 5.
\textsuperscript{65} Having a reputation of a non-complying manager is costly not just because of the risk of losing the current job, but also because of the difficulty to find a new job once having such reputation in the Israeli exiguous business milieu.
\textsuperscript{66} A research made by the consulting group of PwC Israel based on the reports of listed firms in the Israeli Stock Exchange between 2007-2008 shows that more than 50\% of the pay in firms in the Tel Aviv 100 Index is non-equity based, whereas in the UK, for instance, only 25\% of the pay is non-equity based. See Gil Mor and Hili Krizler, Rewarding – The Remuneration Schemes of Public Companies in Israel, \textit{The Accountant}, Vol. 19, 2010, 110. Available at: \url{http://www.icpas.org.il/upload/articles/File/-1298.pdf} (Hebrew). Last visit: July 18, 2012. Also see Hannes, 117.
\textsuperscript{67} See Mor and Krizler, 110-111.
in the firm and therefore defending the appointing shareholder's stand) have discretion on whether to approve the equity based pays or not.68

Figure III – No Linkage between Performance and Pay in Israeli Listed Firms

F. The Bill for the Diminution of Wage Disparities in the Israeli Market

i. Specific Background

The goal of the Bill is to reduce wage disparities in Israel, since according to an OECD report from 2011,69 in the past two decades, there has been a change for the worse in Israel, in comparison to the rest of the OECD countries. The report shows that the average income of the top echelon in the most developed countries became 9 times greater than the lowest echelon, whereas in Israel, the gap between richest and

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68 Article 254 of The Israeli Companies Law 5759-1999 imposes fiduciary duties on all office holders who should act “in good faith and for the benefit of the company” which makes them refrain, inter alia, from any “conflict of interest between the fulfillment of his role in the company and the fulfillment of any other role...”, however, it is sometimes difficult for directors to ignore the interests of their appointers. See Hannes, 55.

poorest is 14 times greater, similar to the US and Turkey, both known for their high social disparities.\textsuperscript{70}

Furthermore, the report mentions Israel as having one of the highest and fastest growing rates of inequality. Since 1985, the financial situation of the lowest echelon in Israel had deteriorated more than any other OECD country. It is considered as the only country (save for Japan) in which its average income from the mid 80' and until 2008 had decreased for the lowest echelon by a yearly rate of 1.1% whereas the average income of the top echelon rose by 2.4%. In Japan, the lowest echelon's average income had also decreased but not as severely as in Israel (by a yearly rate of 0.5% alone).\textsuperscript{71}

Another survey regarding the inequality in Israel indicates that the productivity per employee in the business sector between 2000 and 2006 had increased by 9.1% whereas their wage had increased only by 1.8%. Also, managers' average cost of labor in listed firms had increased from 1.55 million NIS in 2003 to 2.09 in 2006.\textsuperscript{72}

Those poor figures led many Israeli legal scholars, economists and the public itself to demand a change, saying that "the captains of the financial policy in Israel must place the diminution of inequality as a main goal…"\textsuperscript{73} and that "In the past 20 years the Government had given a great aid to the financial sector assuming it will promote the growth of the Israeli society as a whole… however… in the last three decades the

\textsuperscript{70} The report shows that in Brazil, a developing country, the gap in income between the top echelon and the lowest echelon is 50 times.

\textsuperscript{71} The inequality is measured by the Gini Index, which describes the income dispersion in a country in values of zero to one, where zero describes perfect equality (everybody earns the same income) and one describes perfect inequality (where only one person earns all incomes). According to the Gini index, the inequality in Israel had grown from 0.33 in 1985 to 0.37 in 2008.

\textsuperscript{72} See the Bill's explanatory notes.

\textsuperscript{73} A quote by Prof. Momi Dahan, Head of the Federmann School of Public Policy & Government at the Hebrew University of Jerusalem: Dafna Maor, The Inequality had Grown in Most Rich Countries – Especially in the US and Israel, The Marker (Israel), December 5, 2011. Available at: http://www.themarker.com/misc/article-print-page/1.1583497 (Hebrew). Last visit: July 31, 2012.
economic ideology was that the State should not intervene, so we got a financial sector who is only minded about its own profit and not about the promotion of the Israeli society.”

ii. The Bill

The Bill submitted to the 18th seat of the Israeli Parliament asks to cap executives’ pay in every place of business not by limiting it to a certain wage, rather than by linking it to the lowest wage paid to the worker in the same place of business, such that the highest pay will not exceed 50 times the lowest (the "50 times ratio").

According to the explanatory notes attached to the Bill, the rules of the free market will be kept intact, since there is no actual limitation on how high the executives’ pay should be, and every firm wishing to raise the pay of its executives will be able to do so, as long as they raise the lowest pay accordingly. In this way, employees with low pays will enjoy a fraction of the firm’s financial success, the social inequity will be reduced and a natural mechanism for the restraint of executive pay will be formed.

74 A quote by Dr. Shlomo Svirsky, Director of Adva Center (Information on Equality and Social Justice in Israel).
76 The Bill refers to all executives in every place of business, as defined under the Israeli Companies Law 5759-1999: “office holder” – a director, general manager, chief business manager, deputy general manager, vice-general manager, any person filling any of these positions in a company even if he holds a different title, and any other manager directly subordinate to the general manager”. Available at: http://www.isa.gov.il/Download/IsaFile_958.pdf
77 The definition of ‘Every Place of Business’ given in the Bill refers to all businesses including private (non-listed) firms and businesses where employees and sub-contractors work (sub-contractors sent by a contractor to a certain place of business are considered as workers of the place of business they were placed to work at, for the purposes of this Bill). However, most of the discussion in Israel revolves around capping executives’ pay in listed firms, as this is the discussion brought up by the Neeman Committee.
78 The example given in the explanatory notes shows that in a firm where the lowest salary is 4,000 NIS, the executives’ pay must not exceed 200,000 NIS.
The explanatory notes also mention that *economic efficiency* would be reached by the Bill in two ways. The *first*, the restraint of executive pay is said to increase the profits of the small investors in listed firms (e.g., the general public who is invested in the market via its pension funds). The *second*, low paid workers who will get more frequent raises will help boost the economy as they spend 100% of their pay on consumption products. I will later address those claims and examine if they hold water.

As seen above, the discussion about income inequality in Israel is not without merits, however the real question is, whether the ideas behind the Bill can be justified from an economic standpoint or not.

In my view, the Bill's main problem is that its main agenda is promoting egalitarian, perhaps even Rawlsian ideas (as most of the attention is on the lowest class workers\(^79\)) while trying to justify such ideas by using unconvincing economical efficiency reasoning. Since in most cases social justice comes at the expense of economical efficiency, the attempt to kill two birds with one stone does not succeed.

### iii. Following the Bill's Submission

Two related committees were formed as a result of the Bill's submission and the wide public discussion it spurred:

1) **The Neeman Committee**

Following the submission of the Bill, Benyamin Netanyahu, the Israeli Prime Minister, instructed the formation of a special committee comprised of financial and legal experts, headed by Yaakov Neeman, the Israeli Minister of Justice. The committee's goal was to explore the local situation with respect to executives' pay in listed firms.

\(^{79}\) The Bill asks to 'pull up' the low wages earners in each working place, whereas the Bill could have taken another benchmark, such as the average salary, as was suggested by the Neeman committee's memorandum.
(although the Bill addressed both listed and private firms) and to come up with an alternate bill (as the government asserted that the application of the Bill was not feasible).

In November 2010, the committee presented to the government a memorandum regarding its suggested regulatory solution (the "Memorandum"). The committee admitted that a problem of excessive remuneration exists in Israel due to its unique structure, however it did not embrace the Bill and recommended a softer regulation:

The committee did not ignore the general tendency of increasing growth in executives' pay in Israeli firms, and admitted it is not necessarily related to the firms' performances (as shown in figure III), and therefore proposed to increase shareholders' ability to intervene in determining the firms' remuneration policies which would be manifested by allowing the shareholders to have a non-binding vote in the general meeting, prior to the board's final approval, in a mechanism similar to the 'say on pay' mechanism enacted in the US and UK.

However, the committee asserted that a more severe problem is the one with respect to firms held in a pyramidal group structure. A survey conducted by the Israeli Securities Authorities showed that executives in 'lower' firms down the pyramid get

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80 In Israel, a memorandum is sometimes distributed by a governmental bureau, prior to its publication as a bill in the official records. It includes a first draft of the bill, accompanied by detailed explanatory notes using as the basis for the discussions held by the governmental offices and other consulting offices.


82 According to the say on pay mechanism in US and UK, shareholders get an advisory (non-binding) vote after the board has already approved the remuneration scheme (or any other issue). Therefore, the shareholders' vote cannot change the board's decision, however, it uses as a signal to the board whenever its actions are unaccepted by the shareholders. This kind of signal may bring to the replacement of the directors appointed by the public in a dispersed ownership structure. For the UK case, see Ferri, Fabrizio and Maber, David A., Say on Pay Votes and CEO Compensation: Evidence from the UK (November 24, 2011). Review of Finance, Forthcoming. Available at: [http://ssrn.com/abstract=1420394](http://ssrn.com/abstract=1420394). Last visit: July 25, 2012.
higher pays than the ones at the top of the pyramid, showing that tunneling is rewarded in Israel.\textsuperscript{83}

According to the committee, pyramidal structure is the only case where a true agency problem between minority and majority arises, therefore a 'stronger' intervention by the minority shareholders' side is justified. And so, as opposed to the abovementioned case where it was suggested that shareholders will have a non-binding vote at the shareholders' meeting, in 'grand-daughter' firms which are part of a pyramidal group, the committee suggested that minority shareholders will have a definite say, with no option to overturn it by the board\textsuperscript{84}.

In addition to the aforementioned, the committee further requested to (i) disrupt the linkage between the executive pay and the influences of the markets' high tide on the pay (meaning, capital earned by the firm due to a general rise of the market will not be taken into consideration when calculating the equity based pay); (ii) force firms to set clear considerations and caps to bonuses and retirement grants; and (iii) have firms set provisions according to which executives may be required to return part or all bonuses or grants in case they were given based on a wrongful information or in case of a fiduciary duty breach ('claw back' provision);\textsuperscript{85}.

\textsuperscript{83} Ido Baum, What is the Linkage between Executives pay and Centralization in the Market, The Marker (Israel), published February 24, 2011. Available at: \url{http://www.haaretz.co.il/misc/1.1163740}. Last visit: July 11, 2012.

\textsuperscript{84} The problem set in front of the committee was to determine the definition of a pyramid in order to decide which company shall be considered part of a pyramidal group and which shall not. Therefore, it was decided to delay the final draft of the Memorandum in order to receive the recommendations of the committee for Diminishing the Centralization in the Israeli Market and to Increase Competitiveness, which was appointed in October 2010, as further discussed below.

\textsuperscript{85} The aspiration is that the board's obligation to reveal such ratio and to rationalize the approved remuneration scheme would suffice to serve as a restraining force. The same goes for the linkage between pay and long term performance and the obligation to cap grants and bonuses. The idea is to create soft regulation that would rationalize executives' pay. See Meirav Arlozorov and Žvi Zarchia,
At the time of writing these lines, the Memorandum has yet to turn into an obliging act in Israel.

2) The Committee for Diminishing the Centralization in the Israeli Market and to Increase Competitiveness

Almost hand in hand with the Neeman committee, another committee was formed in October 2010, to examine the problems of the Israeli market structure in terms of its high centralization (see figure IV). The data brought in front of the committee showed that only 16 families control about 50% of the local market (although their holdings sum up to less than 4% of the market value) through pyramidal holdings and cross ownerships which hold not only firms who raise money but also financial institutions that give credits, which allows firms within the pyramid to get loans under preferable terms. This is a classical example of firms (and financial institutions) serving the interests of other firms in the pyramid on the account of their own goals and thus creating inefficient inter-group markets. Not only that the public's funds pay the executives' generous remuneration, but also workers pay stay low, prices of goods and services sold by firms controlled by the tycoons rise (as they have market power), public's pension funds put at risk (because of high leveraged transactions and lenient debt arrangements given to the tycoons) and so forth. So far, the committee presented its conclusions and a first draft of a memorandum to the government prior


87 According to the Movement for Quality Government in Israel, in 2009, no less than 10 milliard New Israeli Shekels were ‘erased’ as part of a debt arrangement between the tycoons and the financial institutions that lent them the funds. Available at: http://www.mqg.org.il/%D7%A8%D7%99%D7%9B%D7%95%D7%96%D7%99%D7%95%D7%AA%D7%91%D7%9E%D7%A9%D7%A7/tabid/653/Default.aspx (Hebrew). Last visit: July 15, 2012.

to releasing it as an official bill. The memorandum addresses, among other things, the problem of pyramidal structures and asks to ban them. The discussion with respect to this committee goes beyond the scope of my work, however it is important to note that the pyramidal structure is an immanent problem of the Israeli market.

**Figure IV – Holdings of the Ten most Influential Families in the Markets (Percentage out of Market Value)**

![Bar chart showing the holdings of the ten most influential families in the markets.](image)

*Origin: The Israel Democracy Institute*

### G. Can Market for Control Resolve High Executive Pay in Israel?

Economic literature considers the *market for corporate control* a market force that may, under certain circumstances, discipline managers and decrease shareholders' agency costs, since it enables potential buyers to perform a hostile takeover on firms conducting in an inefficient manner, and therefore do not optimize their market value. Since managers know that the new controlling shareholders following a takeover will replace them with a new (efficient) management, they are allegedly disciplined not to
abuse their power to extract excessive pays and generally, to maximize the firm's value to make it less attractive to such potential buyers. This is relevant in firms with dispersed ownership structure (where buyers can gain control by purchasing shares from the public) and where there are no anti-takeover policies that lessen the managers' 'fear' of losing their positions this way. In Israel, since the market is characterized by having controlling shareholders, it is impossible to take over a firm, inefficient as it may be (buying all shares diffused among the public will not enable a transfer of control). The difference is that majority shareholders, as opposed to managers in diffusely owned firms, are entrenched and cannot be replaced (unless they agree to it in advance). Therefore, this disciplining power is weak to non-existent.

Parenthetically, another claim is sometimes heard by free market supporters with respect to the 'invisible-hand's' power to adjust high executives' pay by means of demand and supply. The claim is that in firms seen by the public as paying excessive pays to their executives, the demand for such firms' shares will decrease (as a result of their inefficient conduct in the eyes of the public), which will then harm their share value, credit rating and ability to issue bonds to the public. In this way, when the demand will go down, it would serve as a disciplining power for the firms to change their conduct and become attractive again for small investors. This claim has no relevancy to the Israeli market, since as aforesaid, most of the funds are invested by

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89 Bebchuk and Fried, 75, 79.
91 Kosenko, 57.
the institutional investors, that do not consult with the public prior to making investments. Therefore, the public is unable to vote with its feet.\footnote{See a position paper prepared by Parliament members Zehava Galon and Yitzhak Vaknin with respect to the Israeli market centralization problem and their recommendations to increase transparency and responsibilities of institutional investors towards the public in order to increase public’s intervention in the institutional investors’ decisions and to diminish their ability to approve transactions which are in conflict of interests. see עמדה לועדה לבחינת הריכוזיות במשק, (Hebrew), August 17, 2011, 2.}

After establishing that efficiency cannot be achieved by market forces, we must resort to a second-best solution – regulation.

H. Can the Bill be justified by Efficiency Means?

After establishing that the second agency problem exists in Israel, which causes, inter alia, excessive executives' pay, it is time to determine if the Bill can be justified in terms of efficiency, meaning, that its benefits exceed the costs.

The common scale used by neo-classical economists to examine efficiency is the \textit{Kaldor-Hicks Criterion}, according to which an outcome would be efficient in case a \textit{Pareto efficient} outcome is reached (i.e., if the action makes someone better-off and no-one worse-off)\footnote{Cordato, 393-394.} “by arranging sufficient compensation from those that are made better-off to those that are made worse-off so that all would end up no worse-off than before”.\footnote{Wikipedia, Kaldor-Hicks Efficiency. Available at: http://en.wikipedia.org/wiki/Kaldor%E2%80%93Hicks_efficiency. Last visit: July 2, 2012.} This, of course, does not measure any level of equality, since it potentially allows a situation where the rich get richer while the poor remain the same. The common notion of neo-classical economists is creating efficiency first (i.e., maximizing the 'size of the cake') and redistributing the created wealth later (first efficiency, then justice).\footnote{Robert Cooter, The Confluence of Justice and Efficiency in the Economic Analysis of Law, \textit{From the Selected Works of Robert Cooter}, University of California, Berkeley, December 2003, 6. Available at:}
i. Costs of Regulation

The explanatory notes assert that the rules of the free market will be kept intact following the enactment of the Bill. Is it so?

1) Costs of Enforcement

When regulating a certain issue, enforcement is ought to follow. However, the problem with enforcement is its price.97 It is imperative to take into consideration the costs of regulation and compare them against the costs of the market failure. Whenever the costs of regulation exceed the costs of the market failure, it might mean that the market is better-off with the failure.98

Applying that concept to the Bill means that its enactment will incur costs that may interfere with the rules of the free market. First, implementation costs: all firms and businesses will have to re-assess and re-draft their executives' remuneration schemes, investing time and money. Second, costs of compliance: firms will have to employ auditors and accountants in order to keep track after the firms' wages. Also, firms remunerating executives also with stock-options will have to make sure that the exercise price of the option did not cause the total pay to exceed the limitation of the Bill. For that, special 'claw-back' provisions would have to be drafted and inserted into the new remunerations schemes, increasing the bargaining costs between the firm and the executives. Third, maintaining costs: in order to enforce the Bill, the government will be required to allocate resources (financial inspectors) to certify that


firms are complying with the Bill. Forth, *distorted incentives costs (dead-weight costs)*: since the Bill will impose an unwanted condition on firms (or at least on controlling shareholders and executives), it will create incentives to bypass its instructions. Therefore, although the Bill is relatively comprehensive in terms of not allowing many obvious loopholes, still ambiguities may exist, which would help the firm to *contract around* the Bill. The best example for a regulatory demand gone sour is the US tax code change in 1993 enacted in order to limit outrageous executive pays' by setting a new level of tax deductibility of the executives' remuneration to $1,000,000 per month, excluding performance based pay. Instead of serving its purpose, the new code literally 'pushed' firms to use the loophole created by the legislator (who neglected to address the equity-based component) and to remunerate their executives mostly with stock-options which their value is difficult to determine. As a result, managers started taking high-risk decisions, in attempt to maximize their own personal gain. Another example is the Israel Securities Authority's decision to enforce a disclosure of office holders' pays in listed firms in order to put to shame the pays' 'celebrations'. Instead, it caused a "*ratcheting-up*" effect, making it easier for executives to renegotiate their pays with their employers and increase their pays even more. Applying the same concept on the Bill, majority shareholders and executives, who have more means than the average worker to escape this 'sore evil', will employ professionals who will assist them invent creative solutions so they could keep

100 The Bill applies to private and listed firms and businesses (although most of the discussion is on listed firms only) and also predicts the option of firms trying to evade its application by not taking into account sub-contracting workers who are usually low paid.
102 Bebchuk and Fried, 80.

\section*{2) Costs of Judicial Proceedings}
Since allocating resources to enforce the Bill is costly, it is assumed that regulatory inspections of firms' compliance will be random, leaving a window of opportunities for firms that wish to keep paying excessive pays to their executives. Unpleased employees and other activists will act as 'watchdogs' and will sue such firms. Also, firms that would be held liable for non-compliance will also be prosecuted in court. In those cases, the costs of the judicial proceedings, both to the firms and to the government as the prosecutor, are considerable.

\section*{3) Breaking the Linkage between Marginal Cost and Marginal Benefit}
"\textit{Given the managerial labor market, when the firm's reward system is not responsive to performance the firm loses managers, and the best are the first to leave.}"\footnote{Fama, 292.}
Although the market failure argument suggests that current executives' pays exceed the value they produce for the firms, meaning that their marginal cost to the firm is greater than their marginal productive contribution\footnote{Scott Elaurant, Corporate Executives Salaries – The Argument from Economic Efficiency, \textit{Electronic Journal of Business Ethics and Organization Studies}, Vol. 13, No. 2, 2008, 35. Available at: \url{http://ejbo.jyu.fi/pdf/ejbo_vol13_no2_pages_35-43.pdf}. Last visit: August 13, 2012.} (a situation justified by the \textit{tournament model} below), still, regulating the market such that the marginal benefit
may exceed the marginal cost of executives will initiate an adverse selection process: firms may not be able to remunerate managers according to their potential productive contribution, therefore, in case managers have an outside option (i.e., they can get a higher pay in markets outside of Israel), they will choose to leave the market.  

Remaining only with less qualified managers will cause a decrease in firms' share values following mediocre performances of the firms, which may cause losses for shareholders and even lead to unemployment that would take the market out of its equilibrium. Currently, French President, François Hollande, is promoting a similar limitation on executives' pay in France, however only in state-controlled firms, so the estimation is that it will affect not more than a dozen executives. China is the only country that actually has a cap on executives' pay, however only in state institutions. Therefore, it is clear that outside options to competent managers do exist.

4) The Tournament Model
According to Lazear and Rosen, there is an economic benefit in maintaining a non-regulated market, when executives are overly paid. Under the model, workers are incentivized to work harder, hoping to become high-paid executives themselves: they ask to beat the rest (being the ones who get the promotion, i.e., the tournament's prize), because only the best wins. Since winning the tournament is highly uncertain, the contestants would exert a great effort in order to win only if the prize of winning

107 Yarden Gazit, 5. However, Joseph Gross claims that although the phenomenon of managers 'stolen' by competitors who are willing to remunerate with a higher pay exists, still, there is relevance to social stands, therefore he assumes many of the executives will still be willing to work for a lesser pay and keep their status and interest in their work. See Gross, 5.


will be very high. This is why "the salary of the corporations' top executive may well exceed any measure of his marginal product and yet be economically efficient. Efficiency is secured by the generous top salary acting as an incentive to those lower down the corporate ladder who, in accepting wages at less than their own expected marginal product, willingly enter into a self-financing quasi lottery [...] where the main prize is the top executive's job. [...] contestants proceeding through the various rounds of the contest require ever-larger proportional prizes to motivate survivors [...]."

Therefore, according to this model, the Bill's suggestion to limit executives' pay will harm efficiency, as a lesser effort will be exerted by workers that otherwise would have been incentivized to work hard (and thus, increase the efficiency of the firm) in order to become high-paid themselves.

5) Loss of Governmental Income
The Israeli hi-tech industry\footnote{The Israeli Hi-tech industry has a significant role in the Israeli economy as its "exports from Israel are valued at about $18.4bn a year, making up more than 45% of Israel's exports, according to the Central Bureau of Statistics." See Katia Moskvitch, How Israel turned itself into a high-tech hub, BBC News Business, 22 November, 2011. Available at: http://www.bbc.co.uk/news/business-15797257. Last visit: August 6, 2012.} is extremely sensitive to wage limitations as the high executives' pay usually compensates them for the high probability of failure and the risk of losing their jobs (at least as long as the firm is going through the first phases of a start-up). Enactment of the Bill may bring entrepreneurs and investors to prefer establishing their start-ups outside of Israel, which will decrease government's income.

from taxes to the detriment of those relying on redistribution the most, which are the lowest-paid workers the Bill is trying to protect.\textsuperscript{112}

6) Negating the Bill's Claims of Creating Efficiency

On top of the claim that the free market will remain intact, the Bill's explanatory notes also refer to two alleged efficient influences: (i) it will increase the profits of the small investors in listed firms; and (ii) low paid workers who will get more frequent raises will help boost the economy as they spend 100\% of their pay on consumption products. In this way, economic efficiency will (assumably) be created.

In my view, both arguments can be contradicted: (i) executives' pay is a side effect of the main problem that harms the profits of small investors in listed firms and which is not resolved by the 50 times ratio: the second agency problem. It allows majority to control the firm's actions. Since managers are motivated to assist majority to extract private benefits of control (in the form of \textit{self-dealing} or any other value decreasing action) not just because of their high pays but also because of their reputationn and high social stand, capping the pays will not necessarily change the current situation; and (ii) since firms will be required to raise the pays of lowest-paid workers more often in order to raise the executives' pay, it would mean that firms will be required to remunerate employees with pays exceeding their marginal productivity. As hiring personnel that is more costly than productive is not economically justified, massive layoffs could happen\textsuperscript{113} and local economy might enter into stagnation, rather than get a 'boost'.

\textsuperscript{112} Gazit, 5.
\textsuperscript{113} See Joseph Gross' comment in footnote 106.
ii. Benefits of Regulation

"In theory, [...], under certain circumstances, the allocation of resources by means of the market mechanism is optimal. Because these conditions are frequently not adhered to in practice, the allocation of resources is not optimal and a demand for methods for improving the allocation arises. One of the methods achieving efficiency in the allocation of resources is government regulation [...]. It is the instrument for overcoming the disadvantages of [...] undesirable market results."  

1) Economic efficiency?

The Bill's regulatory correction of undesirable market results may be performed for reasons of economic efficiency, such as: (i) allowing low-paid workers to take part of the firm's success by raising their pays to keep the required 50 times ratio (assuming executives will keep receiving raises every now and then), may align the interests of workers and the firm, and may incentivize them to work harder and be more efficient (however, as aforesaid, firms enforced to increase wages of their low-paid workers may choose to downsize in personnel, causing unemployment and uncertain work environment); (ii) saving the excessive pays not paid to executives, firms may devote more funds to research & development that may increase the firm's earnings in the long run, or even decide to pay higher dividends for the satisfaction of all shareholders, including minority (however, as also abovementioned, controlling shareholders, not dismantled from their power to control the firm's actions, may choose to utilize the free cash-flow in other ways that are not beneficial to the minority).

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114 den Hertog, 225.
115 See explanatory notes of the Bill.
In addition, one of the explanations for high executives' pay refers to the 'opportunity cost': "the gains from increased efficiency for the firm [must] exceed the 'opportunity cost of the high executive pay'," meaning, there is no more efficient manner to achieve the same gains for the firm other than by paying the high executives' pays. Despite the adverse selection 'threat' once executives' pays are reduced, other considerations such as high stand in the community and interest in the job will keep some of the more qualified executives in the Israeli market,\textsuperscript{116} performing the same job for lesser pays. Therefore, limiting the high pays may increase efficiency by achieving the same gains with smaller costs (however, the implementation of the 50 times ratio will create large distortions in executives' incentives: cutting-off up to 70% of their pays,\textsuperscript{117} might decrease executives' efficiency).\textsuperscript{118}

Another argument in favor of reducing executives' pay is based on markets equilibrium: when there is a demand (here, for managers), prices rise, but then the market adjusts itself so that more resources will enter, and accordingly, prices go down. Markets that do not reach equilibrium are non-competitive and do not reach optimal efficiency. Although the demand for managers had grown with the growth of the markets,\textsuperscript{119} still it is claimed that the supply grew even larger. Reports from OECD countries show that more and more people choose to educate themselves in disciplines suitable for

\textsuperscript{116} See Joseph Gross' comment in footnote 106.
\textsuperscript{117} As of August 2012, the monthly minimum wage in Israel is NIS4,100 whereas the monthly average cost of labor for the 100 most highly remunerated executives in Israeli listed firms in 2011 was NIS690,000, which is 168 times higher than the minimum wage. See minimum wage tables at: http://www.hilan.co.il/calc/MinimumWageCalculator.aspx. For data regarding average executives' remuneration, see Lior Zano, Unreal – 830 Shekels to 100 Executives – 79 Times the Average Wage, The Marker, April 3, 2012. Available at: http://www.themarker.com/markets/1.1678124 (Hebrew). Last visit: August 14, 2012.
\textsuperscript{118} The affect is similar to the theory of optimal income taxation affect, according to which "an increase in tax rates discourages work and investment. Consequentially, the higher the level of taxation, the less wealth will be produced by society." See Cooter, 9.
\textsuperscript{119} One of the reasons for the escalation in executives' pay is the competitive markets created around excelling managers, following recent technological changes and globalization process (see the Introduction chapter).
becoming managers in the business sector. This is why a correction of the markets' price for executives' pay is due. However, this correction is not the tendency of the market: although there are no reports of scarcity in the market for managers, executives' pay remains high. This is why a correction by regulation may be economically justified (however it must be examined specifically in the Israeli market).  

2) Social efficiency! (The Real Justification for the Bill)
A correction by regulation can also be made to achieve corrective justice: although the achievement of economic efficiency is in doubt with respect to the Bill, a "socially efficient use of scarce resources" may still be achieved (at least for the short-run, until the market will react in the form of decreased efficiency of the firms and massive layoffs – see my discussion above). Regulation in such case strives to "correct [...] inequitable market practices." Usually, however, there is a tradeoff between social and economic efficiency.

The social efficiency justification for high executive pay is that it must be beneficial for society, not just for the firm (assuming that it is beneficial for the firm and does not stem from hidden agendas of the majority shareholders), i.e., when private marginal benefit exceeds social marginal costs it cannot justify the high pays in ethical terms: "even in beneficial activities [of the firm], improvements in economic efficiency may create negative externalities that are not internalized and lead to social harm." This

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120 Elaurant, 39.
121 den Hertog, 231.
122 den Hertog, 231.
123 den Hertog, 231.
124 Elaurant, 36. See also the discussion with respect to the agency problem between shareholders and constituencies.
argument leads to the discussion of the third agency problem (see above), which, in my view, is the context in which the Bill was drafted.

The legitimacy of the public's intervention in the firms' actions comes from the fact that it was the public that empowered firms to become separate legal entities in the first place, in order to better enable business conduct and thus create efficient transactions. Meaning, an artificial mechanism was created to induce firms' activities. Question is, whether firms, as creations of the public, are socially efficient for the public.125 If the high pays do not create "additional benefits to the society"126 they are not socially efficient (the link between the high pays and the additional social benefits is of course, extremely difficult to prove).127

Reality is, that the large listed (and private) firms in Israel have a great influence on the Israeli public, and mostly, not in a good sense.128 Therefore, the relevancy of scrutinizing their conduct to see if its beneficial for the Israeli society, inter alia, criticizing their executives' pay, as part of the firms' general conduct, is considered legitimate.129 And indeed, statements that are repeatedly heard with respect to high executives' pay in Israel refer to the disappointment from the behavior of the

125 Ayal, 16.
126 Elaurant, 36.
127 Elaurant, 36.
128 For example of firms' influence on the public sphere, see the case of Partner Communications Company Ltd., a listed Israeli firm that was recently re-sold to Hutchison Whampoa, a Hong-Kong conglomerate, in a transaction according to which the incumbent controlling shareholder, Ilan Ben-Dov, has made a profit, while debentures holders were demanded to waive 33% of the firm's debt towards them, which created a stir in Israel. Michael Rochvarger, Haaretz, June 5, 2012. Available at: http://www.haaretz.com/business/ben-dov-signs-deal-selling-partner-back-to-hutchison-1.434459. Last visit: August 17, 2012. Also see the background for the cottage cheese protest case against Tnuva, the largest dairy products manufacturer in Israel. Available at: http://en.wikipedia.org/wiki/Tnuva. Last visit: August 15, 2012.
129 Ayal, 16-17.
business sector that was given much leeway and did not 'return a favor' by taking care
of the Israeli society (see Dr. Shlomo Svirski’s quote above).\(^{130}\)

Other scholars, outside of Israel, also claim that "as a society, we have bought into a
system in which we ask little of corporate leaders beyond the aggressive pursuit of [...] self interest. For two decades, this model has formed the core paradigm taught to our business school students. 'Shareholder value' was of utmost importance. Notions of obligation to the society in which the corporation is embedded have been set aside, even mocked."\(^{131}\)

The justifications for the Bill come mostly from the realm of social justice, and therefore it must be taken under consideration, that the free market’s behavior will be harmed, as well as economic efficiency. Therefore, I believe that the Bill cannot be justified by economic efficiency means.

I. Conclusion

I have started this dissertation with defining the market failure causing high executives' pays and developed the three familiar agency problems in the world of corporate governance. A review of the Israeli market, its structure and the main agency problem stemming from it then followed. Afterwards, I have presented the Bill and the circumstances that led to its submission. Eventually, I have performed an economic analysis of the Bill and found the real justification for it.

The main market failure in Israel with respect to corporate governance is the second agency problem, where controlling shareholders abuse their powers to extract private

\(^{130}\) Also see Ayal, 16.
\(^{131}\) Thompson, 3.
benefits of control. Executives' high pay is only a *symptom* of such controlling shareholders' power to influence firms' actions for their own private benefit *on the account of social welfare.*\(^{132}\)

Trying to cure the symptom (high pays) rather than the disease (agency problem) does not resolve the situation, does not increase efficiency and may, in the long run, also harm social equity, as a result of the market's reaction.

In my view, the Bill's first and foremost goal was to create social justice in Israel, however the allegedly economic justifications were added in order to more easily recruit a greater parliamentary support, and were not thought out all the way.

In order to decrease agency costs and increase efficiency, optional regulatory solutions need to address the agency problem directly, for instance: (i) decentralization of the market and diffusion of pyramidal structures;\(^ {133}\) (ii) empowerment of boards by enhancing their duties towards the firm;\(^ {134}\) or even by (iii) increasing equity-based pays to executives in order to align their interests with the interests of the minority shareholders;\(^ {135}\) these solutions are beyond the scope of my work but I believe that they may better address the agency problem.

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\(^{132}\) Ayal, 16-17.

\(^{133}\) The Movement for Quality Government in Israel asserts that pyramidal structures and cross ownerships are causing a distorted market structure that hurt corporate democracy and the “one share – one vote” rule. The ideal solution, according to the movement’s stand, is to use system already proven efficient in other countries – dismantling pyramids of control and cross ownerships and allowing the public to regain power by strengthening the powers of minority shareholders, expanding the Israel Securities Authority funding, creating tax incentives to create self-regulation of pyramidal structures, creating monitoring of institutional investors' consultants and so forth. See Centralization, a Summary of the Problem, Consequences and Solutions, The Movement for Quality Government in Israel. Available at: [http://www.mqg.org.il/%D7%A8%D7%99%D7%9B%D7%95%D7%96%D7%99%D7%95%D7%AA%D7%91%D7%9F%D7%A9%D7%A7/tabid/653/Default.aspx](http://www.mqg.org.il/%D7%A8%D7%99%D7%9B%D7%95%D7%96%D7%99%D7%95%D7%AA%D7%91%D7%9F%D7%A9%D7%A7/tabid/653/Default.aspx) (Hebrew). Last visit: August 19, 2012.

\(^{134}\) Gross, 22.

\(^{135}\) Hannes.