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ASSAF HAMDANI

THE CREDIT CRISIS AND FINANCIAL REGULATION IN ISRAEL

The article considers the implications of the global economic meltdown on financial regulation in Israel. The global crisis affected the Israeli capital market mostly through the corporate bond market. It is, therefore, commonly assumed that the crisis uncovered a widespread failure of Israeli institutional investors, particularly pension funds, to appreciate the risks associated with these securities. This article, however, argues that the global crisis offers an opportunity to reexamine some of the basic assumptions underlying financial regulation in Israel and worldwide. The global trend of pension reform dramatically increased the power of institutional investors around the world. As the crisis demonstrated, this development created two important tasks for policymakers.

First, they should devise measures to alleviate the agency problem between those who make long-term investments through various intermediaries (pension plans or insurance companies) and their money managers. The academic literature studied in depth the mechanisms for addressing the agency problem underlying the modern public corporation, i.e., the conflict of interests between outside shareholders and management (or controlling shareholders). For the vast majority of the population, however, the more pressing concern is protecting their pension savings, i.e., ensuring that their pension savings are managed in their best interests. The article develops an analytical framework for regulating pension funds and the pension industry.

Second, policymakers should develop a framework for regulating not only the supply side of securities markets, but also the demand side. Lawmakers and scholars have traditionally focused on mechanisms for regulating the suppliers of securities, i.e., issuers, but given the increasingly important role of pension funds and other institutions as investors, regulating these institutions' investment activities (for example, imposing investment restrictions on pension funds) could also affect investor protection in the financial markets. The article analyzes the advantages and shortcomings of this demand-side approach for financial regulation and considers the questions that need to be addressed by future research.

URIEL PROCACCIA

ADAM SMITH AND THE ECONOMIC CRISIS OF 2008

The economic crisis of 2008 was triggered, for the most part, by the unbounded greed of corporate executives. The volume and composition of typical executive compensation packages provided the recipients with powerful incentives to opt for inefficient and risky corporate strategies, including some that involved expected negative values, because they were expected to yield handsome private payoffs for the executives. These corrupt practices were facilitated in part by a misguided interpretation of the Smithian concept of the "invisible hand". According to that interpretation, individual agents should not be stigmatized for attempting to maximize their own gains because the price mechanism, or the "invisible hand," can be trusted to transform individual gains into optimal social welfare. This article ponders over Smith's intention when he coined the concept of the "invisible hand." It shows that Smith took it for granted that individual agents feel a deep sense of "sympathy" (as he put it) with their fellow men, and even assumed that this altruistic trait is endemic to human nature. Where the wellbeing of others forms a part of each agent's utility function, it is easy to comprehend why he thought that individual maximization can be transformed into Social Good. This article substantiates this reading of Smith's work by a close reading of his entire output, as well as by highlighting the main ideas that captured his imagination.

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EFRAT TOLKOWSKY & ROY KREITNER

FROM FINANCIAL INNOVATION TO ECONOMIC CRISIS

The recent financial crisis had multiple causes, but this essay focuses on one in particular: the interaction between banking regulation and financial innovation, along with the implications of that interaction on risk in the world's credit markets. We claim that much of the financial innovation of recent decades focused on regulatory arbitrage rather than on generating genuine economic gains. Regulation of the financial sector must always balance between ensuring stability on the one hand and encouraging competitiveness on the other. The primary tool for attaining the goal of stability was setting capital adequacy requirements. Over the past several decades, financial innovation was geared toward creative engagement with regulatory requirements. New financial instruments were created that aimed at maintaining high ratings from the capital adequacy perspective, without sacrificing the potential attached to economically risky investments. In other words, financial innovation created a gap between the letter of the law (the specific requirements of the regulations) and its spirit (the ultimate goal of portfolios with limited risk). Financial regulation that relied on basic categorizations of asset risk ultimately motivated banks and other financial institutions to package assets in ways that did not reflect their true economic risk.

YOSEPH M. EDREY

TAXATION AND THE ENCOURAGEMENT OF FINANCIAL, SOCIAL, AND HUMAN CAPITAL INVESTMENTS

Dedicated to Itai Zilberschmid,
My son-in-law
Whose heart stopped beating, suddenly

1. The article focuses on examining common insights in the fields of public finance and taxation. It criticizes the growing tendency to provide financial capital with tax reliefs (on capital gains, corporate earnings, interest, dividends, and rent). The article offers reasons for that tendency; points at its economic, social, ethical, and constitutional deficiencies; and concludes that such tax reliefs should be eliminated or, alternatively, that similar tax reliefs should be extended to human capital.

2. This article is based on several significant premises:

A. Free market economy and the capitalist systems are quite different from each other. The former is a major component of the liberal, democratic and ethical regime, intending to promote the individual and the aggregate welfare of the community and its members. The latter prevents free competition, grants privileges and outstanding benefits to financial capital and its owners, and prevents efficient regulation and public control from correcting market failures.

B. The purpose of a wise and sensitive economic and social policy is to optimally balance between efficiency, equality, equity, and fairness.

C. The Israeli personal tax model is based on the progressive taxation of all income as measured against the individuals' economic ability and the benefit they derive from public goods and services.

D. Contrary to common belief, the Israeli model has recently turned into a regressive semi-consumption tax system (i.e., lower tax rates on capital and high-ability taxpayers, and higher tax rates on the middle class).

This system significantly contributes to expanding poverty as well as to economic and social gaps in the Israeli society.

E. Measuring the national / domestic gross product and economic growth is important, but such monetary indicators are markedly deficient and flawed as they do not concentrate on the wellbeing of individuals and the society. They ignore the significant cost of the production process and the depletion of the natural resources. (*e.g.*, economic, social, health, and environmental resources) Hence, various *alternative indicators* are introduced. These alternatives are more sensitive and accurate tools for measuring the people's overall welfare and the residents' ability to live long, meaningful, and healthier lives, with a reasonable degree of education and access to economic resources. Here I review the conventional ways and elaborate on the causes of economic growth, employing alternative indicators as auxiliary means that add weight to my main argument.

F. There are three factors-of-production in modern economic activity: financial capital, human capital, and social capital. All the owners of those types of capital are entitled to their fair share of the return on economic activities.

G. The government, as the responsible and chief provider of social capital, receives its return through a good tax system.

H. When the government favors one factor of production over the others, it inevitability harms the latter. In other words, favoring financial capital comes at the expense of human capital owners, who have to pay more taxes, and at the expense of social capital, since the government must reduce the scope and quality of public goods and services.

3. The article focuses on these factors of production: *Financial capital* – money and assets; *Human capital* – labor, personal technological knowledge, and the individual’s sense of welfare; and *Social capital* – *inter alia* comprising public knowledge; physical infrastructures; functional economic, social, and legal systems; a strong concept of the rule of law; a solid sense of solidarity; and domestic and national security. Social capital is mainly financed by taxes.

4. The society members' implied consent to pay taxes stems from their interest in purchasing public goods and services from the elected government. It derives from the following:

A. The synergic relationship between the individuals and the community in which they reside, operate, produce, and consume;
B. The “economic alligiance doctrine,” under which each member owes allegiance to the society that provides him with the conditions to produce, consume, and save;
C. The “Joint project theory” which treats taxes as a mechanism for sharing profit between the owners of the various factors of production .
D. The emerging principle of "single tax" i.e. any member should contribute "one tax", no more no less.

5. Tax reliefs are classified into three categories:

A. Those that stem from the government’s failure to provide its major public goods and services to a specific population group. In that case, this sector may therefore not consent to pay the full amount of taxes. Without consent, there is no obligation to pay taxes. Hence the members of that group should not pay as much as the rest of the population; since they are not getting what they should, they are accorded tax discounts or exemptions.
B. Those granted to certain taxpayers who directly execute and promote government goals at significant and outstanding outlays and cost to themselves. If these taxpayers were required to additionally pay the general taxes – which supposedly finance the same government goals – they would end up paying the same tax twice. Hence special expenses may be deductable by such taxpayers.
C. Those viewed as *tax incentives*, which intend to encourage taxpayers to act in certain ways while providing them or their activities with certain tax preferences and privileges. The focus of this paper is primarily on tax incentives.

6. The use of tax incentives to achieve or promote economic, social, and demographic national goals is quite dangerous and is riddled with deficiencies and difficulties. It creates constitutional problems, as it might violate the constitutional principles of equality, property rights, and freedom of occupation and contracts. It infringes on and threatens some

basic principles of the democratic process, since the general public is not aware of the full extent, meaning, and cost of those incentives. In addition, it exposes the public's agents to political pressure from powerful interest groups. The use of tax incentives for capital investment further creates economic inefficiency, *inter alia* due to the low cost of capital, which creates a “moral hazard.”

7. Special attention is given to the education and research systems as significant components of human and social capital. These factors ensure long term economic growth that both directly and indirectly enhance individual and collective human welfare (health, self fulfillment, self awarness, high involvement in the political process, etc.)

8. There is no empirical evidence to support the common claim that all tax reductions engender economic recovery and long-term growth. Part of the explanation is based on Keynes’s theory: aggregate demand is the sum of private and public/government consumption and investment. Indeed, although tax reduction increases net personal income, which leads to higher consumption, the total increase is lower than the tax reduction. On the other hand, under certain conditions, imposing higher taxes when coupled with efficient use of revenue by a good government, control the annual national deficit and enhance social capital and public demand. This compensates for the deadweight loss created by the tax. Hence, under certain conditions, tax hikes may lead to economic growth and mitigate the adverse effects of economic recessions and depressions.

9. Surveys and research indicate that while looking for foreign trade and business activities and investments, multinational companies first seek social capital, then human capital, and only lastly government subsidies and tax reliefs.

10. The article turns to study the Israeli tax system and its “wonders”: The huge amount of tax expenditures on capital investments, coupled with low tax rates on capital gains, interest, dividends, and rent on the one hand, and much higher rates on earned income on the other hand, turn the local tax structure into a regressive semi-consumption tax system.

11. In addition, I show that the tax authority's treatment also discriminates against labor and favors capital.

12. Tax incentives and government grants, offered by the Encouragement of Capital Investment Act do not promote the law's goals and purposes, while collecting a significant economic toll and violating constitutional principles. No wonder that these incentives are severely criticized also by the Bank of Israel's Research Department and the State Comptroller.
13. The current government policy indicates that Israel has engaged in an aggressive international tax competition. Such a policy is dangerous and harmful, and may be associated with empirical data which show that poverty is expanding, social gaps are deepening, a "brain drain" is growing, and generous subsidies produce inefficient use of financial capital – all of which harm Israel's social capital and endanger its social solidarity.
14. Based on prominent economic literature (*e.g.*, Solow, Becker, Galbraith, Denison, Stiglitz, Sen, and others), I provide justifications for the encouragement of education and research as economic tools, as well as for the use of fundamental components of the alternative indicators.
15. In addition, I demonstrate that the education system employees too are *entitled* to share the fruits of the economic growth.
The principal conclusion is that the preferential tax treatment of capital should be eliminated and a unified, lower tax-bracket system should replace it. Yet, reality has taught us that the policymakers are obsessed with the political and bureaucratic power that tax incentives provide. Hence, a second best solution is offered: To use the model of the Encouragement of Capital Investment Act so as to encourage human capital in Israel.

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DAVID HAHN

REMEDIES FOR PROTECTING CREDITORS OF INSOLVENT CORPORATIONS

An insolvent firm might be mismanaged and, as a result, its assets may be depleted, wasted, or wrongfully conveyed prior to the firm's bankruptcy. The law offers several causes of action to combat such waste of the firm's assets and protect its creditors' rights. Some of the actions focus on tracing and recovering assets, including voidable preferences, fraudulent conveyances, wrongful distribution of dividends, and the subordination of claims.

This paper explores the analytical common denominator of these causes of action, while expounding on the differences between them. The paper will also show that, under complicated circumstances, courts may combine several causes of action so as to adequately protect the creditors' interests.

Finally, the paper argues that, in light of the wide scope of these causes of action, the ultimate corporate remedy of piercing the veil should be used sparingly and only as a last resort.

MOMI DAHAN

ECONOMIC POLICY IN CRISIS: WINTER IS HERE, BUT THE ECONOMY IS DRESSED FOR SPRING

The main argument of this article is that while Israel's economic policy prepared the economy for a continuing economic spring, it left it exposed to harsh weather conditions, particularly to crises such as the one that materialized in 2007-2008. This paper illustrates the implications of that economic policy in three areas: the distribution policy, which unrealistically requires the labor market to be continuously at full employment; the pension policy, which needs a capital market that is constantly flourishing; and a taxation policy that tends to smoothen out less macroeconomic (less anti-cyclical) fluctuations. Thus, the Israeli economy is better prepared for an economic boom, but at the cost of more vulnerability to economic crises. In view of the recent global economic crisis, the Israeli decisionmakers have to rethink whether the high-risk / high-return policy, which has so far characterized the Israeli economy, matches the preferences of the Israeli public.

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RON HARRIS

FROM LOW-RISK TRANSACTION TO GLOBAL CRISIS: ON THE FAILURES OF THE AMERICAN HOME MORTGAGE MARKET

Secured by a residential house, the home mortgage was until recently perceived as one of the least risky loans on the credit market. Over the past decade, however, the American residential mortgage market underwent a fundamental transformation in terms of the borrowers' characteristics, loan terms, and types of credit products it offers. The market crashed in 2007. The number of foreclosure proceedings crossed the 3-million line and some 10% of the houses in certain counties in Arizona, California, and Nevada have reached foreclosure stages. As the economic crisis evolved, the real estate market collapsed, financial institutions went bankrupt, and the global recession expanded. How did the failure of a seemingly traditional, conservative, and safe mortgage market trigger the most significant economic crisis since the Great Depression?

This article focuses on failures in the pre-crisis mortgage market through a micro-analysis of the market structure, transaction terms, and players' incentives. The article deals only with the bottom of the food chain - namely, the mortgage market itself - and not with other financial markets that trade mortgage derivatives, or with players higher up on the food chain. I argue that fundamental failures developed in the mortgage market over the years leading to the crash despite tight state and federal regulation of major market components. The article identifies five important and intriguing failures, each of which demonstrates a theoretically different type of failure. The first touches upon the agency problem and the distorted incentives of several players, notably mortgage brokers and executives in mortgage originating firms. The second is the cognitive bias of borrowers, which lenders exploit by offering them grace periods and adjustable interest rates. The third is due to misdiversification

of risks. The fourth is manifested in improper asset partitioning, as non-recourse loans were handed out without analyzing their adverse effects on strategic foreclosure at times of negative equity. The fifth and final failure discussed here is the transfer of mortgage risks, through securitization, to ultimate investors who were not fully informed of the risks they were undertaking. The analysis offered in this article demonstrates how lacunas and shortfalls in state and federal regulation lead to a global crisis.

RAN I. SHORRER & ESHCHAR BEN-SHITRIT

OLD PARADIGMS AND NEW REALITIES: REMNANTS OF PAST REGULATORY POLICY AND THE PRESENT CRISIS IN ISRAEL'S FINANCIAL MARKETS

The shocking financial meltdown that the world witnessed in 2008 found its way, albeit somewhat moderately, into Israel's economy. The Israeli version of the international crisis led to the realization that a deep and thorough thinking process is needed to fully understand what drives Israel's financial markets, as well as what spins them out of course. This article focuses on the role of financial brokers, mainly consultants and capital managers, who presumably make the most important link between the public and the complicated and somewhat risky world or worlds, as the case may be, of financial instruments. We will demonstrate briefly how, in two instances, the remnants of old and to some extent anachronistic regulation still have a hold over the current regulation. This is true in the case of the complete separation between long term savings (pension) and investments. The conceptual separation of these two fields - in terms of legislation, regulation and the possibilities of advisory services - leaves the Israeli markets and public with insufficient tools for dealing with the complicated reality. We will try to show that with a few simple steps, which are consistent with recent developments and reforms in regulation, much can be done to merge these separate fields. The second instance of the old ways of thinking that control regulation and legislation is the attitude towards "risk." We will briefly show that, due to a need to limit risk-taking by capital managers, the Israeli public is left with inadequate tools for controlling those who manage their money. The Israeli legislature barred the possibility of linking the managers’ fee with performance in almost every type of financial instrument that involves managing other people's money or, as we show here, mismanaging it. Here too, the regulation is inconsistent with the contemporary understanding of what risk is and how it should be

controlled. Linking fee with performance is not only an incentive that motivates managers to take excessive risk, but a powerful tool that can correlate the manager's general attitude towards risk with that of the client.

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DORON TEICHMAN

JUSTICE, FAIRNESS, AND EFFICIENCY IN CORPORATE LAW: A FEW COMMENTS IN RESPONSE TO CA 4263/04

Ruling on the *Mishmar Ha'emek* affair, the Supreme Court established that insufficient capitalization of a company justifies subordinating the debt of the shareholders. The Court further indicated that insufficient capitalization justifies piercing the corporate veil, thus assigning all of the corporation's debt to its shareholders. This Essay presents a critical analysis of this ruling. From a positive perspective, the Essay will suggest that the Court's ruling does not reflect the policy adopted by the legislature as it is manifested in Article 6 of the Corporate Code. From a normative perspective, the Essay will argue that the Court should have focused on promoting efficiency, rather than on promoting fairness and justice, when establishing ground rules that apply to consensual-business settings. This mistake led the Court to a problematic outcome, which is expected to raise legal uncertainty and impede parties from taking efficient risks.