Overhaul of Israel’s Economy Offers Lessons for United States

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Americans may talk about income inequality, but Israel has done something about it.

The Israeli parliament, the Knesset, has voted to break up the country’s corporate conglomerates. The move followed mass protests in 2011 over the concentration of wealth in Israel.

The protesters, numbering in the hundreds of thousands, had focused their ire on the “tycoons,” a handful of Israelis whose holding companies control about 30 percent of the economy. Much of the tycoons’ business is done through “pyramids” — a family or individual who owns a public company that in turn controls many other public companies.

Take the heavily indebted IDB Holding Corporation. At its peak, the company, headed by Nochi Dankner, was Israel’s largest pyramid. It controlled numerous companies including the airline Israir, one of the country’s largest insurance companies and the Super Sol supermarket chain, while also finding the time to make a huge investment in Las Vegas real estate on the eve of the financial crisis.

A number of journalists at the Israeli newspaper Haaretz led the charge, claiming that Israel’s public shareholders often lost out as the tycoons used them to subsidize their collection of businesses. The tycoons could put down little money but control vast swathes of the Israeli economy. These pyramids also used their size to crowd out competitors and take on excessive debt by lending among their companies. The Israeli economy was viewed by some to be uncompetitive because the concentration of businesses arguably drove up prices and decreased competition. In the small Israeli economy, the pyramids were behemoths that some termed too big to fail.

Added to this witches’ brew was a growing bout of income inequality. In 2008, the Organization for Economic Cooperation and Development reported that the top 10 percent of Israeli income earners made 13 times more than the bottom 10 percent.

In October 2010, the Israeli government formed a committee of 10 government regulators known as the concentration committee to examine the issue of the tycoons’ control of the Israeli economy. The committee was advised by Lucian A. Bebchuk, a Harvard Law professor and occasional contributor to DealBook, who strongly advocated breaking up the more significant pyramids.

Committees are usually where things go to die, but the 2011 protests along with Haaretz’s sustained campaign kept the cause going. The concentration committee’s report was issued in 2012, and it struck directly at the pyramids, aiming to overhaul the Israeli economy. The committee recommended the breakup of the pyramids in the hope that if they were destroyed,
prices would come down in the wake of greater competition, helping the average Israeli and addressing income inequality.

The committee also recommended the prohibition of significant cross-holdings between financial and nonfinancial groups. To put this in American terms, this would mean that General Electric, for example, could no longer have its financial unit, which holds more than $500 billion in assets. The result would be that the pyramids could no longer fund themselves, using their access to cheap financing to give themselves an unfair competitive advantage over their rivals.

It also ensured that financial institutions did not bring down entire corporate groups if they imploded.

This was all well and good, but the big question was, what would happen when the bill was introduced into the Knesset? Indeed, a furious battle broke out as the big pyramids hired a slew of lobbyists and law firms to persuade lawmakers to either kill the bill or remove their own pyramid from its strictures. (Sound familiar?) The lobbyists’ attempts to influence legislators got so bad that at one point in a Knesset committee meeting, the lobbyists were asked to identify themselves and leave the room. It even got personal, with one lawyer for the tycoons claiming in an interview with an Israeli paper that Mr. Bebchuk had “hypnotized the committee.”

Then a funny thing happened. In light of the support of Israel’s regulators and many Israelis, the conservative government of Benjamin Netanyahu supported the legislation. The head of Israel’s central bank at the time, Stanley Fischer (now a leading candidate to be vice chairman of the Federal Reserve in the United States) also supported the final bill.

The case for breaking up the pyramids was also helped by the insolvency of IDB, which was brought down by bad investments, excessive borrowing and overly aggressive financing practices. A few weeks ago, a bankruptcy court removed Mr. Dankner from his controlling position, a move that rocked Israel.

In December, the Knesset passed the bill unanimously.

To be sure, the final bill was not as strict as some wanted. It did not completely separate financial and nonfinancial companies, a change that Mr. Fischer opposed in a speech by comparing such a restriction to recreating the troubled Greek economy. But at the end of the day, a populist movement was able to show it had the votes, and backed by strong economic arguments, the politicians couldn’t fight. The committee’s recommendation to break up the pyramids and separate significant financial and nonfinancial companies became law.

In other words, with a single bill and a few big changes in its corporate law, Israel is looking to overhaul its economy and hopefully reduce income inequality.

The new law sets up an interesting experiment. In the near term, the winners will be the lawyers and investment bankers who will now handle a wave of deal-making as the pyramids break up.

But the real question is whether all it takes is a breakup of a handful companies to make an economy more competitive and reduce income inequality.
And are there any lessons for the United States?

Certainly, in the wake of Bill de Blasio’s election as mayor of New York and recent speeches by President Obama, income inequality is an increasingly prominent issue. A large part of this argument is based on the fact that rich Americans are pulling ahead of their brethren. According to the Congressional Budget Office, the income of the top 1 percent of Americans rose 275 percent from 1979 to 2007, but only 18 percent for the bottom 20 percent.

This disparity has been accompanied by a concentration of the financial system in the hands of a small group of institutions. As of the end of 2013, the five biggest banks in the United States held 44 percent of the financial assets of the banking industry, or $6.46 trillion, according to SNL Financial. In 1990, the five biggest banks held only 9.67 percent.

Inequality may be a problem in the United States, and concentration of assets a problem in the banking sector, but the American economy is very different from Israel’s. In Israel, the economy is more like South Korea’s when its chaebols dominated or West Germany’s in the 1950s when family groups controlled a number of industries. In the United States, businesses are competitive, and outside the financial sector, there is vibrant competition. Even in finance, there are good arguments that a $15 trillion economy needs large banks.

Not only is the economy different, but the political system needed to revamp the economy is not present in the United States. For example, the Occupy Wall Street movement appears to have fizzled.

Still, while we await the outcome of Israel’s great experiment, it is clear that where there is the perception that harm is being done and where there is the will to change, a democracy can overcome even the most powerful corporate lobbyists. In Israel, at least.