"Government should not interfere in executive pay"

Professor Kevin Murphy is not excited by the pay gaps in Israel, believes that inequity also has some positive aspects and argues: "one can't compare CEOs pay to others' pay".

In recent years the Israeli labor market has become more polarized than ever. Average pay in Israel has recorded a modest nominal increase of 28 % in the recent 10 years, while CEO pay of TA100 companies almost doubled. The result: If a decade ago, Israeli CEOs earned 20 times the pay of salaried employees on average, nowadays the ratio is 30.

But while the public debate over CEO pay in Israel is at its peak, Professor Kevin Murphy, U.S. best-known expert on executive pay, remains unimpressed. In the US, he notes in the "Calcalist" interview, executives already earn 300 times the average pay. In general, he says, dealing with executive pay during a time of slow-down is a well-known and expected phenomenon". In the 90', when executive pay in the US increased dramatically, very little attention was paid to executive compensation because everyone became richer. Only when the economy deteriorated, executive pay evoked resent.

Is this anger justified? Murphy thinks not necessarily: "the fact that pay is high does not necessarily imply that it is exaggerated - at least when it is determined by competitive market forces." For Murphy, dealing with executive pay is marred by populism. The problem, he argues, is that public atmosphere causes the politicians to try and intervene with executive pay – yet these political interventions typically yield the opposite, i.e., undesired results.

Murphy is visiting Israel on the occasion of participating in the annual conference of the Raymond Ackerman Chair in Israeli Corporate Governance, headed by Prof. Beni Lauterbach, held at Bar-Ilan University. This year the conference focuses on the subject of executive pay, on which Murphy is considered a world-renowned researcher. In recent decades he has published many papers in the field, has advised the federal government and regulators and testified before the US Congress on related issues.

Murphy lists numerous examples demonstrating that government intervention led to undesirable results. Legislative initiatives intended to impose restrictions on pay, he says, have led to even higher pay levels as well as to some other unexpected results ".

"Government's role is small and basic," he says. "CEOs should not steal company's money, lie or cheat. We need to use legislation and courts to enforce it. However, the government should not be involved in fixing levels of executive pay".

Pay, according to Murphy, must be left for the Board of Directors' decision. In Israel, directors suffered a lot of criticism in recent years regarding the generous compensation packages that they continue to approve. However, in the US corporate governance functions well: boards of directors are more independent than ever, and it seems they don't hesitate to terminate CEOs who don't deliver", says Murphy.

In addition, says Murphy, executive's world also operates within the laws of supply and demand. "There is a global market for executive talents. A few decades ago, CEOs were appointed from inside the company. However, today, external successions are common - top executives tend to actively move from one company to another".

<u>Focus on stock compensation</u>

Market, according to Murphy, is working. The government, however, is focusing on CEOs' pay rather than ensuring they have appropriate incentives ". I accept that the government may have a role in amending market's shortcomings," Murphy says. "But existing regulation does little to correct such shortcomings or to make contracts better in terms of shareholders' perspective.

"Most people who criticize high executive pay, at least in the US and Europe, aren't the shareholders, but rather, outsiders. Shareholders or institutional investors care much more for the incentives included in the compensation package than for the pay level. They are much more interested in the question of whether shareholders' and CEO's interests coincide, and are less interested in the question of whether the CEO earns too much or too little".

So how can one ensure that executives serve the shareholders? Murphy supports compensation in the form of common stock, which executives can sell only in the long run. As Murphy puts it, "This is the best tool we've come up with." He stresses the importance of proper design of the compensation packages, and argues that the share value will prevent short-termism. "We do not want to compensate executives for playing with the company's revenues, or with analysts' expectations."

Furthermore, Murphy mentions that no matter how the Board constructs executives' compensation package, it does not absolve the directors from carrying out their duties: supervision of CEOs.

Murphy is not the only one who focuses on government's impact on executive pay. Renowned economist Thomas Piketty explained in an interview to "Calcalist" earlier this year that "there is a link between lowering income tax and the surge in executive pay: "When the top marginal tax rate was 80%", said Piketty, executives had little motivation to try to obtain higher pay.

So maybe the explanation for the surge in executive pay is lowering taxes? "No doubt taxes affect the level of executive pay and its structure," says Murphy, "but I have not seen evidence in the US for the link Piketty described." A change in pay structure and benefits is noticeable, though. In the fifties and sixties, for example, when the top marginal tax rate in the U.S. was higher than 90%, executive compensation was grossed up through hunting cabins, company's aircraft and luxury office, compensation which can't be taxed as income. In fact, the surge in the popularity of options in the fifties was caused largely by the fact that capital gains tax (25%) was lower than regular income tax (91%)".

An increase in income levels is expected

Furthermore, Murphy does not hesitate to attack the arguments underlying the study of Piketty et al. "Non- equality originated by corruption, theft, or discriminatory laws is clearly a bad thing. But non-equality that emanates from better skills or hard working is not a bad thing by definition".

Murphy says the trend of Executive pay in Israel, reminds the US in the nineties. In the last decade "CEO pay in the US market has not recorded a double-digit yearly growth as in the past". "Looking at the data on Israel", says Murphy, there is one major change: the significant increase in the share component in executive pay that occurred in 2007-2008. Once understanding the significance of this change, he argues, the rise in executive pay in the country over the last decade is not as dramatic as it first appears.

"It is a well understood and acceptable tradeoff - if one ties payment to performance, one can expect that the pay level will rise". The same applies in the opposite direction as well – average executive pay of listed companies traded in the TA100 list decreased in 2010 perhaps because the share of stock compensation in total pay decreased.

"If you grant a manager 100K NIS in shares, and tell him that he can't sell the stock for five years, then this amount is not worth 100K NIS to him."

Because shares imply some risk?

"It's more than risk. There is also time cost. Assuming a CEO has a million dollars pay, and now the company says to him: ' We will give you one million dollars in stock instead, however you can't sell them for five years. I would say it's a bad deal. The CEO would then say: ' Not only that there is a risk, you also prevent me from consuming any of it for quite a while. You have to pay me two million dollars to convince me to accept such a transaction. Therefore, what is often missing in the public debate is the recognition that CEOs pay is different from all others' pay. People look at statistics that claim a CEO earns 4 million NIS, and for most people it looks like 4 million in cash. This is, however, not the case".