Financial crises, corporate scandals and blind spots: who is responsible?

According to the U.S. Financial Crisis Inquiry Commission, the main causes of the financial crisis of 2007-2009 were failures of corporate governance and policy, including widespread failures in financial regulation and supervision, lack of transparency, poor preparation by the government, and systemic breakdown in accountability. The Commission concluded that the crisis was avoidable.

In their book *This Time is Different: Eight Centuries of Financial Folly,* Reinhart and Rogoff show that financial crises over many years and jurisdictions have similar characteristics. The authors suggest in conclusion that crises are preventable but that, since governments are themselves part of the problem, the challenge of prevention is political: “Encouragingly, history does point to warning signs that policy makers can look at to assess risk—if only they do not become too drunk with their credit bubble-fuelled success.”

Policymakers’ failures to act on lessons of financial crises persist. Today’s financial system remains excessively fragile, inefficient, and dangerous. Many rules are still poorly designed and unnecessarily complex. Regulation is often inadequate and sometimes counterproductive. Hundreds of billions paid by financial firms in fines for fraud and other violations of rules do not seem to deter bad conduct. The individuals in private and government institutions whose actions and inaction cause harms suffer minor if any consequences.

In a recent essay, I argue that the problems in the nexus of corporate governance and political economy are deep and go well beyond the financial sector. Corporations cause preventable distortions and harm through deception and recklessness largely because governments fail to set and enforce proper rules. These important issues are often ignored in economics.

Corporate finance textbooks and much of the corporate governance literature argue that managers should create “shareholder value,” which in practice translates to a focus on financialised measures such as stock price and accounting earnings. Milton Friedman famously claimed in 1970 that the social responsibility of managers is to “make as much money as possible while conforming to the basic rules of society.” This approach presumes that individuals and firms abide by the rules and that, through contracts and laws, the rules provide protection to stakeholders and enable trust in markets and society that is essential for corporations to operate efficiently.

These conditions, however, are often violated in key ways. Differences in information and control powers enable those with better information and control to benefit while harming others. Contracts and laws are imprecise and costly to enforce. Reputation concerns cannot fully neutralise differences in information and control if responsibility is diffuse and the gains from misconduct are large. Auditors or rating agencies are unlikely to uncover fraud or provide reliable information unless contracts, laws and effective enforcement provide proper incentives. It can be difficult even for governments to obtain sufficient information to enforce rules on large and opaque corporations. Political economy frictions determine how well governments perform in their role of setting and implementing effective rules that enable markets and address frictions that cause distortions.

Current governance practices encourage managers to lobby to obtain and maintain monopoly rents and excessive subsidies and to shape the language and enforcement of rules. Beyond fraud, managers and others may also benefit from creating or perpetuating confusion in policy debates. The results can harm most shareholders, who may also suffer as citizens, employees or customers. In my essay I discuss how regulatory capture, enforcement frictions, and cross-jurisdictional competition can cause policy failures.

These and related problems arise in many sectors, including energy, cars, food, pharmaceuticals, and technology. Some of the issues can also be seen in the case of Carillion, a UK construction giant that collapsed recently. Harmful conduct is often hidden and may go undetected for extensive periods of time. Those who are aware of such conduct may either benefit from it or remain silent because speaking up is personally costly or they feel powerless to effect change. When corporate scandals or policy failures come to light, people in positions or responsibility tend to deny harm, divert attention from their own culpability, and shift blame to others or to exogenous factors out of anyone's control. In reality, these individuals have often enabled or at least implicitly encouraged harm through their actions or inaction, and they could have and should have done more to prevent it.

The status quo, in which governments — even in well-developed democracies — tolerate or exacerbate corporate governance failures and in which false and misleading narratives obscure reality, is alarming and dangerous. Beyond inefficiencies and injustice, it causes distrust in institutions and contributes to the vulnerability of public discourse to manipulation by demagogues exploiting and diverting anger and fears. The main issue is not the oft-debated size of government, but rather the quality, integrity, and effectiveness of all institutions, especially those that design and enforce the rules for all.

Economists usually seem blind to these issues and overlook them in their analyses. For example, the vast majority of papers in macroeconomics and banking either take the extreme fragility of the financial system as given, or suggest on the basis of inadequate assumptions that fragility is essential or even beneficial. They ignore key conflicts of interests, regulatory failures, fraud, and political economy forces that are critical for understanding the issues being analysed, including the behaviour of banks, the growth of the so-called shadow banking system, and the contagion mechanisms that create systemic risk.

Related policy discussions reflect these blind spots. They focus primarily on what to do once sudden exogenous "shocks" have caused a crisis. The possibility that better policies can address the underlying causes of fragility in banking, reduce the likelihood of financial crises, and improve the financial system's ability to serve the economy rarely receives serious attention. In another recent essay entitled "It Takes a Village to Maintain a Dangerous Financial System," I discuss the many enablers of policy failures in the financial sector, including economists and academics. Paul Pfleiderer's essay on the misuse of models in finance and economics offers many relevant insights.

Blindness to reality can harm, and recognising problems is necessary for addressing them. To improve corporate governance and policy, we must identify instances where markets and institutions cause harm and suggest approaches to reduce the scope for abuses of power in all institutions. We must also challenge false or misleading claims and demand that policy decisions are made on the basis of sound analysis and in the public interest.

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Notes:

- *This blog post is based on the author's paper A Skeptical View of Financialized Corporate Governance, Journal of Economic Perspectives—Volume 31, Number 3—Summer 2017—Pages 131-150*
- *The post gives the views of its authors, not the position of LSE Business Review or the London School of Economics.*

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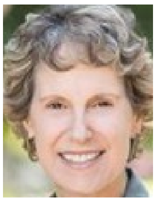

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