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A Skeptical View of Financialized Corporate Governance

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The vast bulk of economic activity today involves business corporations. Corporations are abstract legal entities that combine legal rights and obligations with a significant degree of flexibility. The legal separation between corporations and their stakeholders, including shareholders, has been important to the success of the corporate form in organizing long-term, large-scale production, while limited liability and the tradability of shares help corporations acquire funds from a broad set of investors.

However, this legal separation exacerbates conflicts of interest between those who control corporations and others, including shareholders, creditors, employees, suppliers, customers, public authorities, and the general public. In large corporations, stakeholders vary enormously in the information and degree of control they have on corporate actions. Contracts and markets do not generally create efficient outcomes if markets are not competitive, contracts are incomplete or costly to enforce, or if corporate actions create negative externalities for those with little information or control. Laws and regulations can help alleviate these frictions, but their design and enforcement are also costly and subject to information and control frictions.

In recent decades, much emphasis has been placed on aligning the interests of managers and shareholders. Managerial compensation typically relies on financial yardsticks such as profits, stock prices, and return on equity to achieve

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such alignment. This development has been part of a broader trend referred to as "financialization," whereby the financial sector and financial activities grow in prominence within the economy, and financial markets and measures increasingly guide economic activity.

Financialized governance may not actually work well for most shareholders. Even when financialized governance benefits shareholders, significant tradeoffs and inefficiencies can arise from the conflict between maximizing financialized measures and society's broader interests. For example, financialized governance provides incentives for slanted presentations of accounting data and even in some cases outright accounting fraud. Misconduct, law evasion, or fraud directed at other stakeholders such as customers and governments may benefit shareholders, but they may ultimately have to bear legal expenses, large fines, and loss of reputation. Financialized incentives can also lead to misallocation through "short-termism" or mismanagement of risk, with the upside benefiting those controlling corporations and the downside harming others, including shareholders and the broader economy.

Effective governance requires that those in control are accountable for actions they take. However, those who control and benefit most from corporations' success are often able to avoid accountability. In cases such as corporate fraud or excessive endangerment in which the public is insufficiently aware of the potential conflicts, governments may fail to design and enforce the best rules because of the incentives of individuals within governments and their own lack of accountability.

The important real-world issues around corporate governance do not fit neatly into most common economic frameworks and models. The history of corporate governance includes a parade of scandals and crises that have caused significant harm. Although each episode has its unique elements, after each scandal or crisis, the narratives of most key individuals tend to minimize their own culpability or the possibility that they could have done more to prevent the problem. Common claims from executives, boards of directors, auditors, rating agencies, politicians, and regulators include "we just didn't know," "we couldn't have predicted," or "it was just a few bad apples." A recent report commissioned by the board of directors of Wells Fargo Bank regarding the scandal in which bank employees misled customers and fraudulently opened accounts for years referred to executives and the board as having a "disinclination ... to see the problem as systemic" despite numerous flags and opportunities to act (Independent Directors 2017, p. 6).

Economists, as well, may react to corporate scandals and crises with their own version of "we just didn't know," as their models had ruled out certain possibilities. They may interpret events as benign, arising from exogenous forces out of anybody's control, or try to fit the observations into alternative models. However, many economic models still ignore highly relevant issues of incentives, governance conflicts, enforcement, and accountability. Economists may presume that observed reality is unchangeable or efficient under one set of frictions, while leaving out other frictions and ways to address them through changes in governance practices or policy.

Effective governance of institutions in the private and public sectors should make it much more difficult for individuals in these institutions to get away with claiming that harm was out of their control when in reality they had encouraged or enabled harmful misconduct and, moreover, when they could have and should have taken action to prevent it. Better practices and policy would follow.

Financialization and Shareholder Governance

The last few decades have seen an expansion of financial activity and financial markets driven by a number of factors: increased volatility of exchange rates and interest rates, globalization, changes in financial regulations, and financial innovations such as securitization and derivatives (Davis 2011; Krippner 2011). The expansion of financial activity has offered greater risk-sharing opportunities and enabled innovations, large-scale investments, and economic growth. However, it has also allowed risk to become hidden and magnified in an opaque and complex system that is rife with conflicts of interest (Partnoy 2009; Zingales 2015). Whereas economists usually presume that the size of a sector is efficient if it is determined in markets, recent empirical work argues that "too much finance" may harm growth, create distortions, and contribute to income inequality (Cecchetti and Kharroubi 2015; Cournède and Denk 2015; de Haan and Sturm 2016).

My focus here is on the interaction of financialization and corporate governance. Financialized corporate governance starts with the view, especially dominant in the United States and the United Kingdom, that corporations should focus on benefiting shareholders (Hansmann and Kraakman 2001). The economics and finance literatures have focused almost exclusively on potential conflicts of interest between shareholders and managers (Bebchuk and Weisbach 2010). In recent decades, the main approach to resolve that conflict has been to incentivize a maximization of "shareholder value" by tying compensation to financial measures such as reported earnings per share, revenues, stock prices, and return on equity.

Prior to the 1970s, only 16 percent of the chief executive officers in S&P 500 companies had performance-based compensation, but this proportion grew to 26 percent in the 1980s and 47 percent in the 1990s (Bank, Cheffins, and Wells 2017). The vast majority of large corporations today use earnings per share in incentive plans, and most use stock prices and shareholder returns in their compensation plans (Reda, Schmidt, and Glass 2016). Compensation for managers (as well for as boards) typically includes restricted stocks and options. In this way, corporations are effectively "managed" by markets and by accounting-based metrics (Davis 2011).[1]

[1] An alternative approach to motivating managers to focus on shareholder value relies on the market for corporate control (Manne 1965). The idea is that firms whose managers do not maximize shareholder value as measured by the stock price will be targets of hostile takeovers and the underperforming managers will be replaced. However, boards and managers can find ways to raise the costs of hostile takeovers such as poison pill provisions, and governments may block takeover transactions because of political pressures. Most corporate mergers today are "friendly."

The prevalence of stock-based compensation affects the efficacy of corporate governance arrangements, but understanding the issues around corporate governance more fully requires a broader context. First, the shareholders of most public corporations today are not individuals, but rather institutional investors such as mutual funds, pension funds, hedge funds, or endowments, which are usually corporations themselves with their own governance challenges. Second, corporations may set up and invest in corporate subsidiaries, creating complex corporate structures. In this environment, stock prices do not measure properly whether managers actually benefit the majority of their ultimate shareholders. Third, some of the tradeoffs associated with financialized corporate governance are relevant even in the absence of shareholder–manager conflict and arise in the context of private corporations as well.

Consider the layered ownership structure of public corporations. Institutional investors accounted for only 6.1 percent of corporate ownership in the 1950s, and, by 2009, this fraction grew to 73 percent for the top 1,000 largest US corporations (Gilson and Gordon 2013). Mutual funds are usually subsidiaries of "management companies," which are separate corporations with their own objectives (Bogle 2005). This ownership system creates new agency problems between corporate managers in the firms along the ownership chains and the investors at the ends of the chains. Moreover, those who control institutional investors have their own objectives that may conflict with their clients. The managers of institutional investors often have little incentive to engage in the governance of portfolio firms even if it would benefit ultimate investors (Taub 2009). Gilson and Gordon (2013) refer to the conflicts between the interests of funds' managers and investors as the "agency costs of agency capitalism."

Even if individuals held corporate shares directly, it is unclear that maximizing "shareholder value" as currently practiced captures the preferences of most or all shareholders. First, high-powered financialized incentives may be counterproductive when managers have multiple tasks (Holmstrom and Milgrom 1991). Second, modern portfolio theory suggests that investors should diversify their holdings, which means that shareholders often own shares in multiple firms in the same industry. As shareholders, they may benefit if firms collude, but lack of competition harms them as customers or employees and distorts the economy. Indeed, shareholder unanimity is not assured except under unrealistic assumptions such as complete markets and perfect competition. Third, the ability to engage in short selling and trade derivatives can decouple the economic interests of some shareholders from their voting rights (Barry, Hatfield, and Kominers 2013).

An interesting phenomenon in a broader corporate governance context is the proliferation of opaque shell corporations with no employees or publicly traded shares (Story and Soul 2015). Individuals and corporations often create them to limit liability, hide activities, or avoid taxes or other laws. Many jurisdictions, including Delaware (the most popular US state for incorporation) do not require any information about the shareholders—the so-called "beneficial owners"—of corporations they register. One office building in Delaware is the legal address of 285,000 separate businesses; Delaware uses revenues from taxes and fees by absentee corporations to fund a significant part of its budget, and it has fought against federal legislation that would increase the transparency of corporate ownership (Wayne 2012).

Tradeoffs from Financialized Corporate Governance

Financialized, shareholder-focused governance is appealing in its logic. However, in addition to the issues already raised above, it introduces tradeoffs and potential distortions that can have significant effects on the economy. Corporations interact with most of their stakeholders, other than shareholders, through contracts and markets. Counterparties will be more willing to engage with corporations, make investments, and produce economic efficiencies if they trust that corporations would not harm them subsequent to their investments (Mayer 2013). For example, if lenders cannot trust the legal system to collect loans in a timely manner or prevent borrowers from exposing them to additional risk once the loan is made, they will refuse to make loans or charge a high rate of interest. Creating trust requires being able to make credible commitments, but making commitments may be impossible, difficult, or costly. Dealing with externalities may require government action.

The cost of making and enforcing commitments is ultimately borne by the corporations' residual claimants and by society as a whole through the government that creates and enforces the rules. For corporations and their governance to support the economy best, it is important that contract enforcement be efficient, markets be competitive, and appropriate rules correct market failures and externalities. Financialized governance aims to focus corporate managers on benefitting shareholders, but it can result in gaps between what is good for executives, directors, and some shareholders and what is good for society as a whole.

I will focus on two types of tradeoffs that derive from frictions such as asymmetric information and the difficulty and cost of effective commitments. First, financialized governance may lead managers to manipulate disclosures and engage in deception, fraud, or other misconduct. Second, financialized governance may cause inefficiencies through misallocation of resources and risk. The culprit in many of the examples appears to be a focus on financial metrics. The inefficiencies ultimately link to the weak or lacking incentives of those who are in a position to put in place mechanisms to prevent harmful conduct.

Corporate Opacity, Fraud, and Deception

Enforceable contracts and effective governance require reliable and verifiable information. Extreme information asymmetries can cause markets, contracts, laws, and the potential discipline of reputation concerns to break down. Thus, providing information that enables markets and contracts to function well, and which allows effective control and accountability, is a key governance issue.

Managers whose compensation depends on financial targets have incentives to divert time and energy to actions that improve the appearance of meeting or exceeding short-term financial targets. For example, managers may engage in "managing" earnings within allowable accounting standards (Teoh, Welch, and Wong 1998; Graham, Harvey, and Rajgopal 2005). These activities may become deceptive or fraudulent, as happened at Tyco, Enron, WorldCom, and numerous other institutions. Complex transactions in opaque derivatives markets and the creation of off-balance-sheet subsidiaries make it difficult to detect or distinguish financial fraud from other misleading disclosures, as illustrated by Lehman Brothers' use of "repo 105" transactions (Eisinger 2017). The complexities of securitization and derivatives allow banks to manipulate valuations and hide losses (Piskorski, Seru, and Witkin 2015). Opaque off-balance-sheet subsidiaries can make large banking institutions appear as "black boxes" to investors (Partnoy and Eisinger 2013).

Corporate fraud or misrepresentation can remain hidden for extended periods or even indefinitely (Zingales 2015), which prevents effective accountability. It is often hard to pin the responsibility and intent to specific and appropriate individuals. There are also insufficient incentives or willingness within corporations to uncover fraud or deception, particularly if executives are able to benefit from such practices. Whistleblowers face hardships, lose jobs and opportunities, and may be unable to prevail if authorities are not inclined to pursue their claims (Sawyer, Johnson, and Holub 2010; Ben-Artzi 2016). Even if it is possible to trace misconduct to specific individuals, markets may do little to correct the problem. Financial advisors with records of misconduct continue to find employment (Egan, Matvos, and Seru 2017).

The problem extends to auditors, which are supposed to be independent watchdogs, but in fact have weak incentives to uncover fraud and do not opine on the absence of fraud. Despite accounting scandals in the early 2000s that led to attempts to improve the quality of audits in the United States, Ronen (2010, in this journal) describes auditors as "lapdogs" and the *Economist* (2014b) calls them "dozy watchdogs." Four large, for-profit corporations with little accountability to the public dominate the auditing industry. These companies are opaque themselves, and some, such as KPMG, have been accused of fraud and obstruction of justice repeatedly in recent years (Eisinger 2017).

Consumer fraud or deception, and other law evasion or misconduct, may actually benefit shareholders, particularly if the misconduct remains hidden. Of course, if and when problems come to light, the legal costs, fines, and loss of reputation affect the corporation's success and are borne by shareholders, employees, and possibly others. Recent examples include Volkswagen's evasion of environmental regulations and the case of Wells Fargo Bank "cross selling" and improperly opening accounts. New information on corporate prosecutions and misconduct keeps coming to the surface.[2]

[2] A new Corporate Prosecution Registry (Garrett and Ashley 2017) at the University of Virginia Law School collects data on corporate prosecutions (at http://lib.law.virginia.edu/Garrett/corporate-prosecution-registry/index.html). The nonprofit Corporate Research Project collects information with the purpose of increasing corporate accountability, including "corporate rap sheets" (at http://www.corp-research.org/).

The costs to society of corporate opacity, fraud, and deception are high. Lack of trust by shareholders and other investors can increase the funding costs of corporations. Lenders who fail to recognize loan losses may avoid restructuring loans and continue to lend to insolvent borrowers rather than making new loans. Lingering debt overhang for households and lenders can contribute to long-term recessions that harm entire economies, as happened in Japan in the 1980s, in the United States during the housing crisis, and European nations today (Admati and Hellwig 2013; Mian and Sufi 2015). Ownership chains involving shell corporations can also enable fraud and make contract enforcement and beneficial renegotiation more difficult, all of which were evident in the recent mortgage crisis (Dayen 2016).

More subtle and harder to address are corporate strategies involving systematic and harmful deception that may cause significant social harm to shareholders and consumers. Consider, for example, tobacco companies that denied the addictiveness and harm from cigarettes for decades even as they had information inconsistent with the claims they made, or the campaign by the sugar industry to distort nutrition research and dietary guidelines by diverting attention away from the harm of sugar consumption. Akerlof and Shiller (2016) discuss these and other cases where manipulation and deception by profit-maximizing corporations have caused distortions and harm. The main weapon against such strategies is public education and awareness of how conflicts of interests can corrupt information sources, including even supposedly neutral academic research.

Misallocation of Resources and Risk

A related but somewhat different set of tradeoffs from financialized corporate governance involve inefficiencies from misallocation of resources and risk. First, managers may display "short-termism" in response to short-term accounting metrics and pass up worthy long-term investments (Graham, Harvey, and Rajgopal 2005). Second, financialized governance can encourage managers to endanger stakeholders—for example, by compromising product quality, the health and safety of customers or employees, or even the solvency of the corporation—particularly if such actions remain hidden and still allow the manager to be rewarded upfront, before risks materialize. Shareholders may be harmed by being exposed to excessive risks without compensation or even knowledge of the risk, but sometimes they benefit from endangering or harming other stakeholders.

Because stock prices reflect assessments of future cash flows, stock-based compensation is less prone to causing distortions than compensation based on short-term accounting measures. In theory, if all investors have the same information as managers, their holding periods or investment horizons do not matter, and neither does the timing of dividends. In that special case, the stock price reflects the consequences of all corporate action for shareholders. If managers of public corporations reinvest profits in worthy projects, shareholders who need immediate cash can sell shares at prices that reflect the investments.

Accordingly, in the standard teaching of basic finance, shareholders agree that managers should invest in projects that create value for the corporation, and increases in firm value raise the share price. The conclusions change if managers have different information than investors. In such cases, managers may make inefficient decisions that harm shareholders (and possibly others) while inflating stock price even in the absence of an underlying managers–shareholders conflict (Narayanan 1985; Stein 1989).

Compensation based on earnings or return on equity targets without accounting for risk creates significant distortions that can harm shareholders (Admati and Hellwig 2013). For example, it encourages managers to magnify risk by using debt even if doing so harms shareholders and others. The incentives are particularly strong if managers can reduce taxes for the corporation or take on risk in ways that magnify the upside for shareholders while sharing downside risk with others.

Managers can also "front load" the upside and reap large bonuses, because return measures are high at first while potential losses, realized later, fall mainly on shareholders and others (Bhagat 2017). Those who manage institutional investors such as asset management companies, pension funds, mutual funds, and endowments may also be judged by short-term return measures and expose the ultimate investors to excessive risk (Bogle 2005; Partnoy 2009). In some cases like public pension funds, banks with insured deposits, or institutions whose creditors are likely to receive support from governments or central banks, a share of the downside risk ultimately falls on taxpayers.

Risk taking in innovation, where those who take the risk bear the downside, is useful and beneficial if taken properly and responsibly. Indeed, managers, fearing for their jobs, may be excessively risk averse and take too little such risk. The problem of excessive risk taking arises when executives can shift downside risk and endanger others inefficiently. Cases such as Volkswagen, British Petroleum, or the nuclear industry in Japan illustrate the problem and the potential harm that can result. Dispersed consumers or the public do not have sufficient information or ability to bring about safer practices or to prompt action to eliminate products that turn out to be unsafe (Fletcher 2001).

Another example of the harmful consequences of financialized corporate governance that may lead to lower firm value and collateral harm is excessive use of debt funding by corporations. Managers acting on behalf of shareholders of indebted corporations make investment and funding decisions that may not maximize the total value of the corporation. In particular, they may make excessively risky investments and increase indebtedness inefficiently because shareholders benefit fully from the upside of risk while sharing an increased downside risk with creditors (or others). At the same time, indebted corporations avoid taking actions that benefit creditors and the corporation as a whole at shareholders' expense, such as beneficial reductions of indebtedness and some worthy investments that do not have sufficient "upside" potential for shareholders (Admati, DeMarzo, Hellwig, and Pfleiderer forthcoming).

Heavy borrowing thus leads to distorted investments and to an increased risk of defaults and bankruptcies that entail deadweight cost and, for large corporations, can cause collateral harm to employees, customers, and the community. The problem of excessive and reckless use of debt is particularly harmful in banking, where passive depositors and short-term creditors do not provide market discipline, and explicit and implicit guarantees exacerbate the distortions, essentially feeding a "debt addiction" that characterizes heavy borrowing. Unless regulations counter the harmful incentives, the result is distorted credit markets; financial instability, including periodic financial crises; and further governance problems, recklessness, and distorted competition when institutions are considered "too big to fail."

Some Policy Proposals

The key to improving corporate governance is to increase transparency, create better internal and external control and accountability, and address distortions and inefficiencies through effective laws and regulations. With financialized governance, executives will obviously seek to maintain market power and prevent entry, and antitrust laws should attempt to promote competition and entry. I will focus on addressing the potential inefficiencies from opacity, fraud, and excessive endangerment discussed above.

One place to start reducing corporate opacity would be to require shell corporations to reveal the identity of their beneficial owners, and any limits to their liability, so that authorities and the public can better track chains of ownership. Such laws exist in many jurisdictions but, surprisingly, not in the United States (Caldwell 2016). It also makes sense to consider whether the privilege of incorporation should be available as easily as it is now. One idea is that incorporations would require a disclosure of purpose, at least in general terms, which would be revised and examined periodically with possible termination if the corporation is primarily set for the purpose of increasing opacity and evading laws. Such examinations could also lead to charges of tax evasion or fraud.

For large corporations, it may be useful to find more unconflicted sources of information outside the corporations by providing incentives to independent analysts to expose misconduct, given the difficulty of relying on whistleblowers and the conflicts of interest of auditors and rating agencies paid by the corporations. Since producing reliable information is so critical for effective governance, it may be desirable to delegate some of these functions to government agencies or to not-for-profit organizations with committed and unconflicted experts.[3] Unless rating agencies are more accountable to the public, regulations and institutional investors should avoid relying on their scores (Partnoy 2016).

As abstract entities, corporations cannot go to jail. Extracting fines from corporations does not prevent corporate fraud and misconduct if shareholder governance is weak. The individuals who are involved in, encourage, or tolerate

[3] Shifting the responsibility for choosing auditors to private insurance companies (Ronen 2010) may be helpful, but it does not address the distorted incentives of individuals in response to their own compensation and the lack of personal accountability when responsibility is diffused.

corporate misconduct or law evasion often benefit from effective personal impunity because their personal culpability or intent cannot be established with sufficient confidence to meet a legal standard. Unless shareholder governance is effective, corporate misconduct rarely leads to significant negative personal consequences for executives and board members.

The ability to deter large corporations from bad behavior is limited by the fact that imposing the most severe punishments—huge fines, or worse, the revocation of license to conduct business—would cause significant collateral harm to innocent employees and others (Garrett 2016). Such issues do not arise if we increase accountability for individual executives and board members. Doing so may require re-examination of the laws and rules defining liability that would give authorities sufficient tools to pursue individuals in civil and criminal courts, and to claw-back pay. Devoting sufficient resources to investigations of individuals, which tend to be complex and risky, may also be necessary (Eisinger 2017).

There have been attempts to improve corporate governance and prevent accounting fraud through laws. However, the Sarbanes–Oxley Act of 2002 that came as a response to the Enron bankruptcy and the numerous accounting scandals around that time did not prevent the massive fraud and deception by many financial firms that contributed to the housing crisis and to the near implosion of the financial system in 2008 (Coates and Srinivasan 2014). There is also no evidence that independent directors have prevented fraud (Avci, Schipani, and Seyhun 2017). The 2010 Dodd–Frank Act has done little to address corporate fraud except for attempting to encourage whistleblowers.

Many deceptive practices fall in a gray area where it is difficult to identify or establish that they are fraudulent with intent to deceive as defined under law. To prevent corporations from hiding safety problems of which they are aware, laws are needed to force corporations to take strong action to inform consumers about safety issues and to prohibit settlements that specifically obscure safety violations. Consumer protection laws are useful when it is difficult for consumers to evaluate products—for example, in the context of financial services (Campbell 2016). Educating the public to be more aware of potential conflicts of interest, thus creating savvier consumers of products and information, including from experts and media, would also help.

To address the problem of corporations transferring risk inefficiently to others and misallocating resources, it is important that incentives offered to managers create a long-term focus. Corporations should also have processes to ensure that relevant information about safety issues is not diffused or lost and reaches executives in positions of control. Measures that prevent or reduce harm are obviously better for all, including shareholders who would otherwise deal with fines and the company's loss of reputation.

Effective laws and regulations are essential when competitive markets and contracts do not work to create effective commitments or there are externalities. In creating laws and regulations, the key should be first on prevention of harm if it can be achieved at a reasonable cost, rather than focusing on how to deal with the conduct after the fact. For example, preventing traffic accidents through appropriate traffic laws such as speed limits and proper infrastructure is better than relying solely on insurance, fines, prisons, civil litigations, and ambulances. Similarly, it may be significantly more cost efficient and prevent collateral harm to try to detect and address misconduct, fraud, and endangerment early than to deal with consequences such as nuclear disasters, oil spills, car explosions, or financial crises once they happen. In the case of children's products in the United States, for example, safety standards are lax and corporations often obscure information about unsafe products (Felcher 2001).

Of course, it is important that policymakers choose the least costly ways to achieve prudent conduct. Yet, some laws are counterproductive and interfere with efficient corporate governance. For example, tax laws in many jurisdictions favor debt over equity funding. Such laws are distortive by creating incentives for inefficient indebtedness (Hirshleifer and Teoh 2009; Admati et al. forthcoming). This feature of tax codes is particularly perverse for banks, which already have incentives to choose dangerous debt levels. The *Economist* (2015) called tax-free debt "a vast distortion in the world economy [that] is wholly man-made." Bankruptcy codes that favor commitments in derivatives and short-term debt (so-called repos) over other corporate liabilities, and which also exacerbate the conflict of interest between managers with financialized compensation and society, should be changed (Skeel and Jackson 2012).

Political Economy and Corporate Governance

By putting in place laws and regulations and by enforcing contracts and rules, governments play a critical role in affecting corporate governance practices and determining how well corporations serve society. The determination of the rules, and how they affect different stakeholders, in turn depends on policymakers' incentives and on the political process (Pagano and Volpin 2005). Policymakers may help corporations create useful commitments and thus become more efficient, or instead impose excessive and costly rules on some corporations while tolerating or even perversely encouraging reckless conduct in other contexts.

To see some of the issues, it is instructive to compare corporate governance and aviation safety. A key reason for the safety of airplane travel is that lapses in safety are extremely salient to the public. Authorities design rules that anticipate and reduce potential problems, and they investigate problems promptly. In addition, the incentives of those in the private aviation sector, from the airplane manufacturers to the airlines employees to those working in airports to monitor air traffic, do not conflict with the public's interest in safety. Finally, a key underlying reason for aviation safety has to do with accountability. In virtually all plane crashes, it is possible to point to the cause of the crash. Individuals found responsible or negligent stand to lose jobs or reputation from plane crashes, and they might even get into legal trouble. Although it takes much technology and collaboration across jurisdictions, safety prevails in aviation and mistakes rarely recur.

Corporate governance issues are in some cases starkly different. When those in control of corporations can harm others in abstract or invisible ways, through excessive financial risk or other subtle endangerment, governments may lack the *political will* to consider the issues, do a thorough autopsy when problems arise, or invest properly in putting in place effective rules to prevent the problems from repeating. Instead, governments may enact inefficient, excessive, or wasteful rules that create or exacerbate distortions in order to serve other political objectives.

Even when corporate governance failures become clear, for example in scandals or crises, it is often hard to trace the harm to specific individuals or policies. The governance and accountability of government institutions can become a challenge for society. In this section, I discuss several issues that arise at the intersection of political economy and corporate governance: capture, law enforcement, and companies operating across legal jurisdictions. In the next section, I offer the financial industry as an example in which these issues are particularly stark.

Capture

Laws and regulations will not work well when those charged with setting and implementing them collaborate with those in the industry even if these collaborations harm the public (Stigler 1971; Acemoglu 2003). The dynamics of capture are often subtle. Corporations employ lobbyists, consultants, lawyers, public relations firms, and influential, connected individuals to shape rules and their implementation. Such activities have expanded greatly in recent years (Drutman 2015). The realities of revolving doors and campaign finance in the United States have increased the impact of those who can fund politicians (Lessig 2012).

When the issues are complex and government resources are limited, staffers and policymakers sometimes rely on corporations and their lobbyists to draft rules (Lipton and Protess 2013). Complex laws and regulations create a bloated ecosystem of experts who find revolving opportunities in the private and government sector based on knowing the relevant details (McCarty 2013; Lucca, Seru, and Trebbi 2014).

The actual workings of capture and the corrosive impact it can have on the effectiveness of governments are often invisible. If budgets are tight and expertise lies mostly with conflicted individuals, rules are more likely to become distorted and fail to serve the public interest. The "thin political markets" that produce the rules do not balance the interests of different constituents, affecting even basic accounting rules, which are the fundamental building blocks of effective governance (Ramanna 2015). The mix of genuine confusion and distorted incentives compounds the problems and leads to "intellectual capture" (Johnson and Kwak 2010).

Given the critical importance of appropriate and well-crafted rules, reducing the wage disparity between policymakers and the private sector would be desirable. Low salaries encourage the government-to-lobbyist revolving door and may deprive the government of experts who are more likely to stand up to pressure from the industry and protect the public interest through effective rules (Drutman 2015).

Corporations fight against rules and their implementation in courts, where outcomes often depend on the biases and ability of specific judges to understand the complex issues and on the quality of the lawyers making the arguments. The resources of corporations often overwhelm those that governments are able or willing to devote to the issues.

It does not follow from this discussion of capture that governments should impose no rules on corporations or, alternatively, that all regulations are useful. Rather, my point is that the incentives of those who work in government matter and that it is important that they use their power properly and be accountable to the public. Governments can fail by intervening too much or too little, by creating inefficient and excessively complex rules, or by not devoting enough resources to writing and enforcing rules. Rules should be as cost-beneficial as possible to address market failures while avoiding waste of taxpayer or corporate resources. Preventing capture and providing proper incentives for regulators and others involved in policy is itself an important objective (Carpenter and Moss 2013).

Effectiveness of Enforcement

A related issue is that laws and regulations may fail to achieve their goals if governments do not enforce them consistently and effectively. As a representative example, consider the Deutsche Bank whistleblower who contacted the Securities and Exchange Commission (SEC) to report a significant mismarking of derivatives positions; this case only received attention after the media investigated and reported the allegations (Ben-Artzi 2016). The result was a fine of $55 million, effectively paid by current shareholders, with little if any direct consequences for those responsible for the fraud. Revolving doors between Deutsche Bank compliance and SEC enforcement may have played a role in this case.

The US Department of Justice and other regulatory agencies have changed how they handle corporate crime, particularly fraud, since the late 1990s. The main tool has become settlements with deferred prosecutions and fines, while indictments of individuals, particularly executives, have become extremely rare since the cases of Enron and others in the early 2000s. Among the reasons for the shift is the length and complexity of investigations and trials of individuals, lack of investigative resources, and the loss of some legal tools to pursue individuals (Eisinger 2017). However, large fines do not appear to change corporate culture or act as a deterrent (Garrett 2016).

If lack of resources undermines enforcement, misconduct is even less likely to surface, and thus it can become more prevalent. For example, the 2010 Dodd–Frank Act expanded the scope of the Commodities and Futures Trading Commission (CFTC)'s jurisdiction dramatically, beyond the $34 trillion US futures market to the much larger market in derivatives traded outside established exchanges estimated to be as large as $400 trillion in so-called "notional value." Yet the agency is severely underfunded relative to other agencies and given the enormous size of the markets it oversees. One person at the CFTC oversees the $117 billion US market where wholesale prices for gasoline and heating oil are set (Leising 2017). The departing head of compliance of CFTC said in March 2017 that the agency is unable to investigate the "massive amount of misconduct" in derivatives markets (Freifeld 2017). The effectiveness of banking regulations also depends significantly on the resources and incentives of regulators (Agrawal, Lucca, Seru, and Trebbi 2014).

Regulation across Jurisdictions

The political economy of corporations involves competition among jurisdictions. This competition can happen within countries: as noted, state-level corporate havens such as Delaware may benefit while harming taxpayers and citizens in other jurisdictions such as the US federal government. Holding corporations responsible can be even harder in the context of a global economy. At the international level, Panama, Liberia, and Bermuda are popular havens for many corporations and wealthy individuals (Davis 2011), but the United States and some other developed nations are among the easiest places to hide wealth (*Economist* 2016).

Corporations can "shop jurisdictions" and set up opaque corporations or subsidiaries that allow them to avoid taxes or other laws (OECD 2015). The process of negotiating and coordinating international regulation often results in a race to the bottom that lessens the effectiveness of the regulations that would have otherwise been adopted in at least some countries. Politicians tend to side with "their" corporations, because corporate voice is more salient to them than the broader and more passive public whose voice might be missing (Admati and Hellwig 2013, chap. 12).

Corporations have also used international trade agreements to challenge actions of governments. Opaque tribunals of private lawyers, where corporations can sue but governments cannot sue or appeal on behalf of their citizens, adjudicate disputes between corporations and national governments (*Economist* 2014a).

Corporate Governance in the Financial Sector

Banks and the financial industry provide an extreme illustration of the distortions created by financialized corporate governance and the shortcomings of laws and regulations. History shows that in the context of banking, governments often lack the political will needed to address market failures, and the difficulty of commitments, by means of effective rules. Sovereign default and other government actions have often caused banking crises (Reinhart and Rogoff 2009).

Today, and even after the crisis of 2007–2009, the result of the combined failure of corporate governance and policy is a set of overly fragile financial institutions and a highly interconnected and fragile system that endangers the economy unnecessarily. In extreme contrast with aviation, where many individuals and institutions collaborate to maintain safety, most of those within the private and public institutions involved in the financial sector benefit personally from practices that create excessive endangerment and that conceal this reality from the public (Admati and Hellwig 2013; Admati 2017).

Economists treat banks as special because of their role in the payment system and their intermediation function, although loans can be—and are—made by other types of institutions. Because banking has always been fragile and has repeatedly produced cycles of booms, busts, and crises, a common view is that fragility is inherent to banking and fundamentally unavoidable.

It is true that banks are prone to liquidity problems: that is, circumstances can arise in which they have trouble converting illiquid assets to cash quickly at a reasonable price to satisfy creditors' demands. These problems can result in panics and runs if depositors and short-term creditors withdraw their funding. Banks can reduce the likelihood of such problems by reducing their opacity and indebtedness (for example by using their profits as a source of funding or issuing more shares and having better disclosures). However, banks have been able to remain dangerously and inefficiently indebted and to obscure the true exposure to risk of their shareholders, creditors, and taxpayers through opaque disclosures.

When banks were run as partnerships in 19th century England, they commonly funded half of their loans with equity, and their owners or shareholders had unlimited liability, exposing their personal wealth to the risk that their bank's assets would not be sufficient to pay deposits. A century ago in the United States, bank equity levels were around 20 percent or more and shareholders often had increased liability. Over the years, banks became limited liability corporations, and some operate within large holding companies engaging in extensive trading and other activities beyond making loans to individuals and businesses. To prevent disruptions from liquidity problems and runs, governments have created safety nets such as deposit insurance and central bank lending. These safety nets weaken and can even lead to the breakdown of corporate governance.

What actually makes banks and other financial institutions "special" is their unusual ability to shift downside risk and costs to others and the fact that normal market forces do not work to counter the distorted incentives of those who control them. For example, outside banking, bankruptcy courts prevent shareholders of insolvent corporations from benefiting at the expense of creditors, for example, by "looting" the corporation or gambling for resurrection inefficiently. By contrast, hidden insolvencies can persist in so-called "zombie banks" if authorities do not intervene, because depositors and short-term creditors use their ability to withdraw funding, close out their positions, or count on explicit or implict guarantees to protect themselves (Akerlof and Romer 1993; Skeel and Jackson 2012).

Financial innovations such as securitization and derivatives, and the creation of complex structures around the globe, have also allowed financial institutions to take risks and increase their indebtedness while hiding their true financial health from investors and regulators (Partnoy and Eisinger 2013). Corporate structures are particularly complex and opaque in large banking institutions (Carmassi and Herring 2014).

Poor risk governance and the distorted incentives of traders, described in many books about the culture of banking since the 1980s (for example, Partnoy 2009; Das 2010), appear to persist. The US Senate investigation of the JPMorgan

Chase "whale trades" in 2013, which involved taking huge positions in thinly traded markets in London, leading to losses of over $6 billion, showed that risk controls in at least some of the largest institutions remain highly problematic (Norris 2013). But except in such extreme cases, or after bankruptcies or crises, poor risk governance in banking is invisible.

Governments can counter the incentives for endangerment in banking, for example, by insisting that shareholders bear more of the risks they take and by reducing the opacity of the system through better disclosures and tracking of risk. Bank lobbyists often threaten that such steps would "harm credit and growth." In fact, the most costly and harmful outcomes arise from a combination of too much credit in boom times, overly complex and ineffective regulations that exacerbate governance and other distortions, and "extend and pretend" policies that tolerate and support insolvent and dysfunctional banks and other borrowers for too long.

The dynamics of regulatory capture are particularly strong in the financial sector (Connaughton 2012). US Senator Richard Durbin admitted in a 2009 interview that "banks are still the most powerful lobby in Capitol Hill and they frankly own the place."

The regulatory capture problem arises because politicians often view banks and financial firms as a source of funding for favored projects rather than as a source of risk for the public, and thus choose to cut deals that compromise efficiency and stability. Even after the devastating financial crisis of 2007–2009 and the recession that followed, policymakers failed to learn key lessons. Implicit guarantees, which perversely encourage and reward recklessness and are ultimately costly to the public, appear free to politicians. The jargon and technical issues and the abstract nature of the risk muddle the policy debate and create public confusion about the issues and the relevant tradeoffs (Admati and Hellwig 2013; Admati 2016, 2017).

Other misconduct such as fraud and deception plague the financial sector, leading to invisible harm to many and to hundreds of billions in fines in recent years (Zingales 2015). The largest financial institutions, considered "too big to fail," have outsized power that distorts competition and the economy, and they are especially inefficient and dangerous being effectively above the rules. Fragmented regulatory structures, such as in the United States, and the ability to play off governments and regulatory agencies have made financial regulation particularly challenging to design and enforce. The main problem remains the lack of collective *political will* to create a safe and efficient global financial system.

Conclusion

Milton Friedman (1970) famously argued that the social responsibility of corporate managers is to "make as much money as possible while conforming to the basic rules of society, both those embodied in law and those embodied in ethical custom." Friedman presumes that the firms operate in an environment of "open and free competition without deception and fraud," and he warns that chief executive officers who "pontificate" about corporate social responsibility will bring back "the iron fist of government bureaucrats."

However, "free and open" markets will not necessarily become competitive and devoid of deception and fraud on their own. Rules matter. The limited liability and separate legal status of corporations have benefits but also create problems of misaligned incentives, and lack of individual accountability exacerbates these problems. Those who manage firms will respond in predictable ways to financialized incentives. Private sector mechanisms such as auditors or rating agencies are unlikely to uncover fraud, or provide reliable information, without law enforcement and proper regulations and oversight.

The interactions between governments and corporations can promote efficiency, but even in well-functioning democracies, they can also be wasteful and exacerbate distortions that benefit only a few. The issue is not the *size* of governments, but rather conflicts of interests affecting people in all institutions, and particularly the quality, integrity, and effectiveness of the institutions that design, implement, and enforce the rules.

Distortions from inefficient corporate governance are important determinants of economic outcomes. To ensure competition and create accountability, brave and well-informed policymakers—including brave bureaucrats—must erect and implement effective systems that can counter the incentives of corporate managers to extract rents, deceive, and mismanage risk. In a democracy, individuals in government must also be accountable if they fail to act in the public interest. In reality, inefficient governance may persist.

The status quo, in which governments too often tolerate or exacerbate corporate governance distortions rather than alleviate them, is dangerous and harmful. Positive change requires better understanding of the underlying causes. Economists can play an important role by studying these important issues, clarifying the tradeoffs associated with governance mechanisms, identifying instances where markets and institutions cause harm, and suggesting approaches to reduce the scope for abuses of power by individuals in all institutions. Increasing transparency, holding those in control more accountable, and creating and enforcing better laws and regulations to address corporate fraud and endangerment would be highly beneficial.

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