Financialization and the Political Economy of Corporations

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The political economy of corporations is key to economic outcomes and social welfare in our global economy. Those who control corporations and government institutions often collude to benefit themselves at the expense of others while distorting the economy and deceiving the public. Governments can set and enforce rules to correct market failures and address negative externalities, yet even in well-functioning democracies, they tolerate and sometimes promote excessive rent extraction and fraud by corporations. Political bargains between policymakers and financial institutions are particularly pervasive and contribute to the distortions and inefficiencies associated with financialization and failed corporate governance. Many economic analyses assume that markets are competitive and free of fraud and that corporations serve society by maximizing "shareholder value." Political economy realities, however, often make these assumptions false. Economists must help hold governments accountable by recognizing these realities and exposing situations where policies based on inappropriate assumptions distort markets and cause harm.

1. Introduction

The vast majority of economic activity in developed economies involves some kind of corporation. Corporations are abstract entities that owe their existence to governments; they have legal rights and obligations but significant flexibility. The legal separation between corporations and their shareholders has been important to the success of the corporate form in organizing large-scale production with long-lived assets, while limited liability and the tradability of shares help corporations acquire funds from a broad set of investors. This legal separation, however, can create conflicts of interest between those who control corporations and others, including shareholders, creditors, employees, suppliers, and public authorities. These conflicts can rise to the level of the society as a whole.

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Many believe that corporations should be managed to maximize shareholder value.[1] 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 the society, both those embodied in law and those embodied in ethical custom." The underlying and often implicit assumption behind this statement, made in much of the corporate governance, finance, and banking literature, is that the rules that govern markets and contracts for everyone, including corporations, promote competition, address negative externalities, and prevent excessive rent extraction, fraud, and deception. Under this assumption, the "invisible hand" logic suggests that whatever is privately optimal for the corporations' shareholders is also optimal for society as a whole.

In this essay, I will argue that this model is based on illusory assumptions. Corporations often get away with rent extraction, fraud, deception and law evasion. In the name of maximizing shareholder value, profit-maximizing corporations gain economic and political power that they often use successfully to benefit at the expense of society. Those who control corporations and who benefit most from their success, often managers and executives, are not held accountable for any harm corporations cause as they find ways to evade the rules, change the rules to their advantage, or otherwise benefit from their relations with governments. Those who make decisions within governments, sometimes trying to compete with governments in other jurisdictions, may collude with corporations to advance their own objectives, and may tolerate and sometimes exacerbate distortions and harm.

Corporate control depends on the relevant laws, on corporate charters and bylaws, and on the ownership of the corporations' shares. Governments operate under political systems that determine who controls laws and public institutions. Individuals within corporations and governments, whose actions affect other people's money and well-being, have incentives to benefit themselves even at the expense of others. Effective governance requires that those in control are held properly accountable for actions they take, particularly if they cause harm.

The corporate governance literature in economics and finance has focused almost exclusively on the potential conflict between managers and shareholders under the false assumption that if this problem is solved, corporations will serve society's interest and that the only policy issues involve the obligations and structure of boards of directors, shareholder voting, etc. This narrow focus ignores the possibility that shareholder-controlled corporations can harm society in the political economy. Dispersed shareholders and poor shareholder control exacerbate and compound the issues; managers may harm most shareholders and benefit mainly themselves as they interact on behalf of corporations with governments and others.

In recent decades, trying to align the interests of managers and shareholders and thus solve the agency conflict between shareholders and managers has increasingly taken the form of using financial yardsticks such as profits, stock prices, and return on equity to compensate managers. This development has been part of a broader trend sometimes referred to as the "financialization" of the economy, whereby economic activity is increasingly guided by

[1] I will focus on business corporations; municipalities, nonprofit, and other corporations have different objectives and rules.

financial measures and markets. Significant increases in trading of financial assets, the size and complexity of financial markets, and the importance and relative size of the financial sector within the economy are among the other trends considered part of financialization.

I will frame both financialization and the role of corporations in society in the broad context of political economy. The financial industry provides an extreme example of the issues. The excessive growth in size, complexity and power, both economic and political, of the financial sector, and the unwillingness of governments to protect the public from the distortions and harm brought about by the inefficient, opaque and fragile financial system are rooted in the political economy of the financial sector. Effective governance is broken also because of the layers of corporations, including financial intermediaries, through which the public invests.

Economists usually start their analyses by making assumptions about the rules and about agents and firms. Sometimes they use theoretical or empirical analyses to make policy recommendations. Policy recommendations that depend critically on invalid assumptions, however, may distort policy and cause harm. Policymakers may also justify harmful actions by referring to flawed economic models if doing so serves their own narrow interests.

Economic thinkers such as James Buchanan, Ronald Coase, George Stigler, Mancur Olson, and Elinor Ostrom emphasized the importance of institutions, politics and collective action issues for economic outcomes, yet most economic analyses related to corporations proceed as if the rules are exogenous. They also tend to reflect an implicit bias towards the view that what we see is efficient. In fact, political economy forces point towards inefficiencies when policymakers interact with corporations.

The possibility of governments collaborating with selected individuals and private institutions to harm citizens are obvious in non-democratic or poorly-functioning regimes. Acemoglu and Robinson (2012) show that extractive regimes are associated with the failure of nations to promote growth and prosperity. Bargains between governments and corporations at the expense of many people occur, however, albeit more subtly, in well-functioning democracies as well, and globalization has made the issues more complex as many governments and many corporations interact. This political economy nexus, and the harm from economic models that ignore the issues by making inappropriate assumptions to guide policy, are not sufficiently appreciated.

The essay is organized as follows. Section 2 will describe briefly observations referred to as financialization and then focus on the impact of financialization on corporate governance. This discussion leads naturally to political economy considerations, which I discuss in detail in Section 3. Section 4 offers concluding remarks suggesting a rich research agenda for economists and urging care to examine assumptions when applying economic analyses.

2. Financialization and Corporate Governance

Starting in the 1970s and especially since late 1980s, corporations have increasingly used financial measures, especially stock prices, to compensate managers (Davis 2011, Hellwig

2000, 2005, and Mayer 2013). Over the same period, we have witnessed an increase in the size and complexity of financial markets and excessive use of private debt to fund housing and consumption (Greenwood and Scharfstein 2013, Cournède and Denk 2015, Denk and Cournède. 2015. Jorda et al. 2016). Related 'financialization' trends that will not be discussed directly in this essay include the impact of derivatives trading on markets in physical commodities (Tang and Xiong 2012, Singleton 2014, Buyuksahin and Robe 2014, Basak and Pavlova 2015), and a larger share of profits that manufacturing firms derive from financial activities such as lending to consumers or trading (Krippner, 2011).

The trend towards financialization was related to developments such as increased volatility of interest rates and exchange rates, globalization, changes in accounting rules and financial regulations, and financial innovations (e.g., derivatives and securitization) that allowed better risk-sharing but that also enabled those in the financial system to magnify risk and hide its sources in an opaque system (Partnoy 2009). The view that private firms and "free" markets produce better outcomes than government-run bureaucracies has led to privatizations that involved large public offerings (Megginson and Netter 2001). Globalization allowed corporations to engage in international acquisitions.

The deepening of financial activity was generally viewed as having positive impact on growth (Levine 1997). More recently, however, some have become concerned that "too much finance" may create distortions, harm growth, and contribute to income inequality (Davis 2011, Cecchetti and Kharroubi 2015, Cournède, Denk and Hoeller 2015, Denk and Cournède 2015, Denk and Cazenave-Lacroutz 2015, Haan and Sturm 2016, Foroohar 2016).

Financialized corporate governance starts with the dominant view, especially in the UK and US, that shareholders own corporations and corporations should focus on benefitting shareholders (Hansmann and Kraakman 2001). The division of control between boards, managers and shareholders has been a subject of debate in the corporate law literature (Blair and Stout 1999, Bainbridge 2003, Bebchuk 2005). However, after the influential work of Jensen and Meckling (1976), Berle and Means (1932), Grossman and Hart (1980), Jensen (1986) and Holmstrom and Tirole (1993), the economics and finance literatures have focused almost exclusively on the conflicts of interest between shareholders and managers (Bebchuk and Weisbach 2010).

I note in passing that shareholders may not all agree that "shareholder value" is the preferred corporate objective. Shareholder unanimity can only be assured under unrealistic conditions such as complete markets and perfect competition (Grossman and Stiglitz 1980, Milne 1981). For example, the shareholders of some of the early US corporations, which focused on building turnpikes, tunnels and bridges, were mainly customers who needed the infrastructure for their businesses (Hansmann and Pargendler 2014). As customers, they would not necessarily support the corporation charging them monopoly prices, even though monopoly rents would increase their shareholder value. In today's markets, the ability to engage in short-selling and trade in derivatives market can also decouple the economic interests of some shareholders from their voting rights (Martin and Partnoy 2005, Hu and Black 2006, Barry et al. 2013).

The main approach since the 1980s to ensuring that corporations maximize shareholder value has been to tie managerial compensation to financial measures meant to capture shareholders preferences such as reported profits, stock price, return on equity, or profits attributable to individuals or groups of employees (Frydman and Saks, 2010, Das 2010).[2] Despite the purported purpose of these compensation structures, however, they can distort managerial decisions in ways that harm shareholders.

Compensation that depends on reported profits lead managers to manipulate accounting disclosures, as happened in Tyco and Enron (Healy and Palepu 2003). The short-term focus associated with the use of such measures may also lead managers to pass up worthy investments that would lower reported profits in the short term even if they would benefit shareholders and the corporations in the long term (Graham et al 2005).

Stock-based compensation structures suffer fewer pitfalls than profit-based incentives (Holmstrom and Tirole 1993), but they too can harm shareholders. Managers benefit from high stock prices that they often had little to do with, while their compensation is often adjusted upwards through new shares or in ways that are opaque to shareholders, such as backdating terms of executive options, if stock prices decline (Heron and Lie 2009, Collins et al. 2009, Daines et al. 2016). Stock-based compensation may also lead to inefficient decisions even in the absence of managers-shareholders conflict if managers have better information than shareholders (Stein 1988, 1989).

Finally, compensation based on measures of return on equity (ROE) encourages managers to take excessive risk and expose shareholders to risk for which they are not properly compensated (Admati and Hellwig 2013a, chapter 8). Managers can "front load" the upside and reap large bonuses because returns measures are high at first while potential losses, realized later, fall on shareholders and others but entail little downside risk to managers (Bebchuk et al. 2010, Bhagat 2016). Managers of asset management companies, pension funds and endowments, may also be judged by short-term return measures and expose the ultimate investors to excessive risk (Bogle 2005, Das 2010, Partnoy 2009).

There have been dramatic increases in executive compensation levels, both in absolute terms and relative to employees' average pay, during the period in which financialized compensation became popular. The aggregate compensation paid by public firms to their top-five executives in the U.S. grew from 5% of the firms' aggregate earnings during 1993-1995 to 9.8% during 2001-2003 (Bebchuck and Grinstein 2005). CEOs compensation in large U.S. firms was around 40 times that of average workers in 1980 and has grown to between 140 and 335 (depending on how calculations are done, Economist 2016b). Weak board governance (Bebchuk and Fried 2004, Bogle 2004) and changes in social norms (Bank et al. 2017) are

[2] Another approach to motivating shareholder value focus relies on the market for corporate control (Manne, 1965, Jensen 1993). The notion is that firms whose managers do not maximize shareholder value will be targets of hostile takeovers and their managers will lose their jobs. Many large conglomerates created in the 1960s in the US broke up after hostile takeovers in the 1980s (Davis 2011). Boards and managers, however, can often find ways to resist hostile takeovers using staggered boards and poison pills, and governments may stop takeovers because of political pressures (Hellwig 2000, 2005). Hostile takeovers have become rare after the 1980s; most corporate mergers are "friendly."

plausible contributors to this situation. The increases in compensation have given corporate executives more economic and political power.

Financialized shareholder governance thus appears to serve more as a rhetoric used by executives rather than a successful device to align managers' preferences with shareholders' interests. Consistent with this assessment, Bogle (2004), written by the founder and former CEO of Vanguard mutual funds, provides a scathing account of the failure of the financialized corporate governance for shareholders in the U.S. in the 1990s and early 2000s. He discusses many harmful practices, including in addition to excessive compensation, excessive mutual fund fees, and the use of stale prices to value mutual fund (Boudoukh et al. 2002), and concludes that corporations serve primarily the interests of their executives and not those of shareholders from "the investing public."

More recently, Jack Welch, the chief executive officer of General Electric from 1981 to 2001 and often considered the first leader of the "shareholder value" movement, said in an interview that executives' focus on quarterly profits and share price gains is "a dumb idea" (Guerrera 2009). An opinion piece by a CEO and vice chair of the U.S. Chamber of Commerce (Wilson 2016) argues that the focus on profits has "widened the trust gap between corporations and society" and "is in danger of diminishing the very capitalist system Friedman [1970] promoted." In arguing that corporations should become a force for good and take on societal problems, Wilson (2016) suggests that governments and charities are incapable of tackling these problems alone, and argues that a long-term broader view is in shareholders' true interest.

For corporations to be efficient, those who control them must find ways to commit that they would not harm others who need to make investments in the corporation once those investments are made (Burkart et al. 1997, Shleifer and Summers 1998, Tirole 2001, Blair 2003, Mayer 2013, Admati et al 2017). An implicit assumption behind the notion that corporations that focus on shareholder value are efficient is that contracts and market competition protect other stakeholders. Distortions and inefficiencies arise, however, if markets are not competitive and if contracts are ineffective in resolving conflicts between shareholders and other stakeholders.

To be *socially* efficient, in addition, third parties must also be protected from harm by corporations by effective laws and regulations. If corporations that maximize shareholder value can do so at the expense of, or while harming the public, and if they are able to affect the rules so the harm is tolerated by governments, then models of corporations where the rules are assume to be exogenous and socially efficient become invalid.

One example of potential inefficiencies is corporate borrowing, which creates conflicts between shareholders and creditors regarding corporate actions once debt is in place. Decisions made on behalf of shareholders may not only harm creditors but also reduce the total value of the corporation. For example, indebted corporations may take excessive risk and increase their indebtedness inefficiently because shareholders benefit fully from the upside of risk while sharing the downside with creditors; at the same time, indebted corporations may pass up some worthwhile investments and avoid beneficial reduction of indebtedness (for example by making payouts to their shareholders through share buybacks or dividend and avoiding issuance of new equity) because such actions benefit creditors at shareholders' expense (Berk and Demarzo, 2016, Admati et al. 2017).

Shareholders' inability to commit credibly to act in the interest of the corporation as a whole is costly to the corporation as it leads to value-reducing decisions and causes creditors to increase the interest they charge and place costly restrictions in the contract that may lead to a loss of flexibility, for example by requiring that creditors approve certain decisions.

Heavy indebtedness, accounting manipulation and excessive risk taking lead to investment distortions and increase the risk of costly bankruptcy or financial instability that harm not only creditors but also employees and others, indeed possibly society as a whole. Through various subsidies, governments often provide supports that keep corporations alive even when their business model is weak or nonviable. If banks hide losses on nonperforming loans and attempt to appear stronger than they are, for example, they may avoid and delay restructuring loans or continue to lend to insolvent borrowers rather than making new loans (Mayo 2011, Dayen 2016, Bennet 2016, Veron 2016). Lingering debt overhang lengthens and exacerbates recessions (Reinhart and Rogoff 2009, Mian and Sufi 2015, Taylor 2015).

Laws and regulations can help create commitments and enable corporations to operate more efficiently and cause less collateral harm. For example, governments can enact rules that encourage competition (Council of Economic Advisors 2016a, 2016b) and address negative externalities. In particular, laws generally forbid insolvent corporations from transferring funds to shareholders. Similar restrictions can prevent distressed corporations from harming stakeholders and others when creditors are too passive, as is the case for bank depositors.

In reality, governments often fail to enact beneficial rules. Worse, they may enact counterproductive rules that exacerbate conflicts and inefficiencies, favoring some corporate stakeholders over others or over society as a whole. For example, the tax codes in many jurisdictions provide an advantage to debt over equity funding for corporations, which intensifies conflicts of interest between shareholders and creditors and the resulting inefficiencies associated with heavy corporate borrowing (Admati et al. 2017). This feature of the tax code can widen the gap between the level of debt that is desirable for shareholders and the one that maximizes the overall value of the corporation.

The corporate tax code is particularly perverse in the case of banks, which have unusually passive creditors such as insured deposits and thus strong incentives to become excessively indebted (Admati et al. 2013, Roe and Tröge 2016). Because the distress and default of many banks or any "systemic" institution causes so much harm, governments and central banks often provide them support and bailouts. Although these institutions are persistently weak and inefficient, and often become insolvent, governments tolerate and implicitly support them instead of winding dysfunctional institutions down or making sure that they reduce their indebtedness by retaining profits and issuing more equity (Admati and Hellwig 2013a, Admati 2016b). Such policies cause great harm and increase the likelihood and the cost of financial crises. Bankruptcy codes that exempt certain creditors from the process exacerbate the fragility of the financial system, providing another example of counterproductive laws (Roe 2011, Skeel and Jackson 2012).

These observations lead to important questions. Why would governments in well-functioning democracies put in place counterproductive tax and bankruptcy codes and fail to reduce the excessive, inefficient, and dangerous indebtedness of banks when doing so would bring significant benefit with the only "cost" being to reduce the ability of these institutions to extract distortive subsidies? To answer this question and other harmful distortions, we must consider the political economy of corporations.

3. Corporations, Governments, and "Other People's Money"

Corporations exist and owe their privileges to governments and legal systems. Early corporations operated much like governments; they were monopolies that took on trade and infrastructure projects and sometimes even operated armies (Dari-Mattiarcci et al. 2017). To the extent that these early corporations maximized shareholder wealth, they did so partly by extracting monopoly rents. Thus, corporations were chartered from the beginning in ways that created tensions between maximizing shareholder wealth and maximizing society's welfare. These tensions and interactions between governments and corporations have evolved over the years (Ciepley 2013a, 2013b).

Corporations were successful because governments gave them property rights, shielded them from their stakeholders, and committed to avoid expropriating their assets. Limited liability and the ability to trade shares allowed them to raise funding from many investors, and the ability to retain earnings and to borrow allowed them to grow and undertake large-scale projects. Economists commonly view corporations as bundles of assets or "nexus of contracts," but corporations would not exist and function as they do without the legal framework that creates them and establishes their governance (Bratton 1989, Hansmann and Kraakman 2000, Blair 2003).

Whereas initially incorporation was relatively rare and required special government charters, over time it became easier and available for any legal purpose. Free incorporation can bring about more investment and encourage competition but, depending on the rules of incorporation, the ability to hide behind a corporate veil may cause harm, illustrating the political economy issues and some of the observations regarding financialization such as the complexity and opacity of the financial system.

Numerous corporations created in recent years are shells with no employees or real economic activity, bearing little resemblance to the original rationale for incorporation. Individuals and corporations can "shop jurisdictions" and set up opaque corporations or subsidiaries that allow them to avoid taxes or other laws (OECD 2015, Schjelderup 2016). Shell corporations hide wealth (Story and Soul 2015, Obermaier and Obermayer 2016), and opaque subsidiaries obscure risk in financial disclosures (Partnoy and Eisinger 2013, Herring and Carmassi 2014). Ownership chains involving shell corporations also hide fraud and make contract enforcement and beneficial renegotiation more difficult, as happened recently when securitized mortgage defaulted (Dayen 2016).

Many jurisdictions, including Delaware, the most popular state for incorporation in the U.S. in the last century, do not require any information about the shareholders, so-called beneficial owners, of the corporations they register. One office building in Delaware is the legal address of 285,000 separate businesses. Delaware uses revenues from taxes and fees paid 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, Caldwell 2016). Panama, Liberia and Bermuda are popular havens for many corporations and wealthy individuals (Davis 2011), but the U.S. and some other developed nations are among the easiest places to hide wealth (Economist 2016a, Hutchins 2016).

The ease of incorporation and the complicated corporate structures in the financial system are among the reasons corporations have become opaque and shareholder governance works so poorly for ultimate shareholders. Individual savers increasingly invest in corporations through mutual funds, which themselves are corporations with their own directors but no employees. The mutual funds in turn are subsidiaries of so-called management companies, which are again separate corporations with their own objectives (Bogle 2004). This situation creates layers of agency problems where intermediaries' interests are conflicted with the interests of their customers, who are the ultimate shareholders of portfolio companies (Taub 2009, Gilson and Gordon 2013).

The political economy of corporations involves, among other things, competition among jurisdictions. Governments in corporate havens such as Delaware may benefit while harming taxpayers and citizens in other jurisdictions such as the US federal government. In another example, the German government has supported and protected Volkswagen, which deceived authorities deliberately about emission from its diesel engines to evade regulations (Gude et al. 2015). Powerful corporations play off governments to blunt rules and regulations anywhere and to enable them to extract rents.

Those who control corporations, whether shareholders or managers claiming to create shareholder value, obviously seek to benefit themselves when interacting with governments. Acemoglu (2003) advances a theory of social conflict based on the difficulty of those with economic and political power to commit to not using their power to benefit themselves even if their decisions harm many others. Commitment difficulty and self-interest on the part of decision makers can result in significant inefficiencies.

Laws and regulations may not work as intended when those charged of setting and implementing them become "captured" by industry or narrow interest because of repeated interactions and revolving doors (Stigler 1971, Dal Bó 2006, Connaughton 2012, Carpenter and Moss 2013). Sometimes the issues are complex and government resources are limited, thus staffers and policymakers may rely on corporations and their lobbyists to draft rules (Lipton, and Portes 2013, Drutman 2015). Complicated and distortive tax codes and regulations that may be ineffective and poorly designed create bloated systems of experts who find revolving opportunities in government and the private sector based on knowing the details (McCarty 2013, Lucca et al 2014). Narrow interests may have outsized influence because they are better organized and better motivated than the diffuse public (Olson 1971, Gilens and Page 2014).

The dynamics of policy capture are often subtle. Corporations employ lobbyists, consultants, lawyers, public relation firms, and influential, connected individuals to shape rules. Such activities have expanded in recent years (Drutman 2015, Transparency International 2015). Money in politics can corrupt politicians and their decisions (Lessig 2012, Teachout 2016). Like marketing and public relations, lobbying can cause subtle forms of capture by influencing decision makers' preferences. Large corporations that control significant economic activities and may have significant market power gain political power that make them especially successful in affecting the rules, thus further exacerbating distortions.

Those involved in policy may choose to believe convenient narratives, rationalize them and willfully ignore others by believing experts who themselves want to conform to the views of powerful individuals and avoid challenging them. Some of the terms used in this context are cognitive, intellectual or social capture (Johnson and Kwak 2010, Kwak 2013), groupthink (O'Connor 2003, Fligstein et al 2014), deep capture (Hanson and Yosifon 2003), and willful blindness (Heffernann 2012, Admati 2017). "Thin political markets" can result in biased rules that obscure information if most experts on esoteric but critically important issues such as accounting standards are conflicted (Ramanna 2015). Various capture mechanisms can also distort the views and recommendations of scientists or others considered experts even when they come from non-profit or public institutions (Zingales 2013, Flitter et al. 2016, O'Connor 2016, Lipton and Williams 2016, Admati 2017).

In the political economy, corporations may harm society even in the absence of the manager-shareholder conflicts. If executives can benefit at shareholders' expense as well, the problems are exacerbated, as executives can use their increased economic and political power as well as their control over corporate resources with little regard to shareholders' interests.

The list below describes many interactions between governments and corporations that can lead to harmful bargains. These interactions involve governments as effective stakeholders in corporations (such as customers or investors) and interactions related to the creation and implementation of laws.

- **Outsourcing and governments as customers**. Governments rely on corporations to control important economic activities and frequently buy products or services from corporations. In the U.S., corporations provide healthcare, prisons, emergency and security services, higher education and even elementary school education. Student loans are used to pay tuition to private colleges that may exploit market power to charge excessively (Kargar and Mann 2016). Occupancy guarantees to private prisons and lack of monitoring create abuse and inefficiency (Newkirk and Selway 2013, In the Public Interest 2013, Mukherjee 2016). In another example, the U.S. governments agreed to avoid negotiating drug prices or constrain the list of medicines available to those it insures under Medicare, allowing pharmaceutical corporations to extract significant rent from the government and patients (Friedman 2009, Special Committee on Aging, United States Senate 2016).

- **Conflicted corporate watchdogs.** Investors and governments use accounting disclosures and credit ratings extensively to monitor institutions and assess risk. Those providing these inputs, however, are private profit-seeking audit and credit rating companies with no accountability to the public. Auditing firms and credit rating agencies have a problematic business model from society's perspective, especially if they also engage in consulting (Shah 2015, Partnoy 2016). Governments allow private organizations to set accounting standards, but these bodies may rely on conflicted experts (Ramanna 2015).

- **Governments as investors and providers of subsidies.** Governments may collaborate with corporations, invest in corporate securities through sovereign wealth or pension funds, or provide direct subsidies or guarantees. Subsidies may be provided to attract the corporation, whether a manufacturer or a sports team, to a jurisdiction, but they may provide a windfall for those who control the corporation (Cohen et al., 2011, Story, 2012, Raghunandan, 2016, Brown et al. 2016). Implicit guarantees subsidies to financial institutions that are effectively government sponsored perversely encourage and reward recklessness but they are invisible on budget and thus convenient for politicians (Admati 2014, 2017).

- **Governments as financial market participants and regulators.** Governments borrow extensively from financial institutions and investors. In that way, they compete with corporations and other businesses for funding, and use investment banks as intermediaries for bond offerings. In banking regulations, governments can create biases that make government lending more attractive for banks than lending to small businesses, for example by treating government debt as safer than it actually is. In one such case, banking regulators throughout Europe treat loans to any government in the zone as perfectly safe, allowing banks to fund loans to governments entirely by debt such as bank deposits. This treatment has encouraged banks, including particularly in France and Germany, to lend excessively and recklessly to the Greek government after Greece joined the Eurozone. Eventually, taxpayers through European bailout funds, the European Central Bank and IMF have assumed these troubled loans, and Greek citizens are paying dearly for their governments' failures and actions by other governments. Citizens in Germany, France and elsewhere in Europe, however, are unaware of the failure of governments to control the reckless lending to Greece that allowed the problem to emerge and build up thus causing harm to so many (Admati and Hellwig 2013a, Steil and Walker 2015).

- **Central banks and their interactions with governments and financial markets**. Central banks are supposedly independent but authorized by and connected to governments (Conti-Brown 2016), and they affect the cost of funding for everyone in the economy. Central banks also provide valuable supports to private banking corporations and to governments by being a lender of last resort and through programs such as quantitative easing by which they purchase large amounts of government bonds and other securities (Nyborg 2017). Central banks also have incentives to use their power to obscure banks' weakness and the flaws and failures of regulations (Economist 2014b, Admati 2017).

- **Corporations fighting for legal rights**. Corporations often use courts to expand their rights. Corporations have increasingly gained political speech rights in the U.S., allowing them to spend unlimited funds to try to impact elections and support political causes that those who control them favor (Ciepley 2013b, Winkler 2014, Pollman 2016). Corporations also fight in court to reduce governments' power to regulate them even when regulations are in the public interest (Rose and Walker 2013).

- **Governments set and enforce corporate laws.** Laws specific to corporations, typically set in the jurisdiction of incorporation, define the rights and responsibilities of boards, managers and investors. Laws can differ, sometimes substantially, across jurisdictions. For example, German corporations have two boards, one including employee representatives (Pistor 1999), whereas U.K. law states that corporations should focus on benefitting their shareholders (Mayer 2013). The impact of legal origins on financialization and governance has been intensely debated (LaPorta et al. 2008), but laws evolve through a political process, and political economy considerations matter to how laws are set (O'Sullivan 2003, Roe 2006, Pagano and Volpin 2001, 2005, Perotti and von Thadden 2006).

- **Governments set and enforce *all* laws and regulations.** Numerous laws set by many governments at local and national levels, including tax and bankruptcy codes, labor and tort laws, antitrust, health, safety, environmental and financial regulations. affect corporations. The narrow interests of those who control powerful corporations may have significant impact that can, and often do, distort the rules and their implementation (Connaughton 2012, Drutman 2015).

- **Too abstract (or important) to jail.** Even if laws and regulations are in place, governments often fail to hold corporations properly accountable. Whistleblowers face hardships and may experience authorities unwilling to follow up (Sawyer et al 2010, Taibbi 2011, Cohan 2013). Given auditors' flawed incentives, corporate fraud and misconduct may remain hidden for extended periods (Dyck et al. 2010, Economist 2014c, Shah 2015). Corporations cannot go to prison for committing crimes. Those who are responsible within corporation often claim unawareness even if they set up incentives to encourage misconduct. Personal responsibility is diffused in large organizations, and fines paid effectively by shareholders are largely ineffective in correcting the underlying problems (Eisinger 2014, Garrett, 2016, Matthews 2016). Too-big-to-fail institutions are essentially above the law.

- **Corporations vs. stakeholders in courts.** In disputes pitting corporations against individuals, the latter lack the resources often lose even in cases of corporate fraud (Silver-Greenberg 2012). Corporations have also sought to force stakeholders to give up their rights to use courts altogether, and to commit instead to privatized arbitration systems where corporations are repeat clients (Silver-Greenberg and Gebloff 2015). In a recent case, Wells

Fargo Bank encouraged employees for years to open fake accounts and mislead customers (Cowley 2016), then employed mandatory arbitration clause to avoid courts (Hiltzik 2016).

- **Cross-border resolution of systemic institutions.** When large, global complex, and highly connected financial institutions with enormous short-term debt obligations and numerous subsidaries in many jurisdictions become insolvent, the ripple effects can disrupt markets and cause government to step in and prevent the failure (Admati and Hellwig 2013a, chapter 5). Despite claims that next time will be different, there is no prospect of cross-border coordination to enable the largest financial institutions to fail without causing significant collateral harm. Collaboration will require changes in national laws, which appears unlikely (Financial Stability Board 2014, Wilmarth 2015).

- **Corporations in trade agreements and jurisdictional battles.** Corporations find many ways to avoid taxes through subsidiaries across jurisdiction (OECD 2015) and challenge governments through international trade agreements. In the name of "investor protection" and using perverse logic that views corporations as deserving government guarantees for downside risk on their investment (e.g., if their products turn out to cause significant harm) the agreements allow corporations to sue governments for lost profits. Opaque tribunals of private lawyers, where corporations can sue but governments cannot sue or appeal on behalf of citizen, adjudicate disputes between corporations and national governments. Under such agreements, tobacco companies sued Australia and Uruguay for lost profits after effective anti-cigarette campaigns (Economist 2014a).[3] The agreements can also be useful for corporations to expand and extend monopoly protections through patents, with little public debate about the merit of such monopolies (Sell 2017).

- **National champions and the regulatory race to the bottom.** Governments often protect and collaborate with corporations in their own jurisdiction when these corporations interact with other governments or other corporations. Governments use the flawed narrative of the need for "level playing field" in global competition to justify promoting the interests of "their" corporations even when doing so may harm their citizens or others; some ecnomists seem to fall for this logic as well (Admati and Hellwig 2013a, chapter 12). Coordination of international regulation often results in a race to the bottom that lessens the effectiveness of regulations (Mattli and Woods 2009). Battles between states and the US federal government are evident in the context of shell corporation's opacity noted earlier and elsewhere (e.g., Agrawal et at. 2014).

- **Media, marketing and image**. Corporate success often depends on the ability to convince customers to buy products, which may involve trying to manipulate their preferences (Akerlof and Shiller 2016). Corporations seek to obscure the harm that their products (e.g., tobacco, sugar and soda) may cause (Nestle 2015). All institutions and individuals in the private and public sector seek favorable media coverage, and may use their control over

[3] The agreements now exclude tobacco, but other regulations can be challenged.

access to news to try to mold coverage with the help of paid media relation companies, consultant and experts, including in think tanks and academia. Media companies themselves are typically for-profit corporations with financial objectives and biases. Using the power of their information over customers, social media corporations have recently earned profits by serving fake news and misinformation to some customers.

The financial sector illustrates all the issues mentioned above. Banking has repeatedly produced intense cycles of boom, bust, crises, and extended recessions (Reinhart and Rogoff 2009, Taylor 2015). Governments fail to correct distorted incentives in banking and, worse, they often enact rules that create additional distortions. Lobbyists threaten that regulations would harm credit and growth even as strong evidence suggests that for developed economies, too much credit, distortions in credit markets, and "extend and pretend" policies that maintain insolvent borrowers are most costly and harmful (Akerlof and Romer 1993, Cournède and Denk 2015, Jorda et al. 2015). Politicians view banks and financial firms as a source of funding for favored projects, and often choose to make bargains that compromise the efficiency and stability of the system (Calomiris and Haber 2014, Admati and Hellwig, 2013a, Admati 2017). Even after the devastating financial crisis of 2007-2009 and the recession that has followed, key lessons have not been learned (Hoenig 2013, 2016, Wolf 2014, King 2016, Admati and Hellwig 2013a, Admati 2015, 2016a, 2016b, 2017).

Maximizing shareholder value in banking involves taking advantage of privileged funding from depositors and others, competing with other institutions to be able to endanger by shifting risks and costs to others, and lobbying against regulations. Financial crises alert citizens to the recklessness and flaws of the system and the failure of policymakers, but many in the industry and policy want to portray crises as natural disasters, suggesting that they are unpreventable. In fact, financial crises and much of the harm they cause are largely preventable with effective regulation. Moreover and importantly, ineffective regulations allows an inefficient financial system to distort the economy by misallocating resources and extracting excessive rents every day (Cournède and Denk 2015, Denk 2015, Denk and Cournède 2015, Haan and Strum 2016).

An expanded safety net from central banks and governments supports the financial system and allows those in the financial sector to privatize gains and socialize losses. Those in the financial system who reap the magnified rewards on the upside suffer least on the downside (Barofsky 2012, Fraser 2015, Kay 2015). Fraud, misconduct, excessive risk taking and lack of accountability plague the financial sector (Partnoy 2009, Lewis 2010, Das 2010, Piskorski et al. 2015, Cowley 2016). Misunderstanding and confusion about jargon and risk allow individuals in this system to take advantage of others (Campbell et al. 2011, Egan et al. 2016). The largest financial institutions considered "too big to fail" have outsized economic and political power that distorts the economy, and they are especially inefficient and dangerous (Admati and Hellwig 2013a, Wilmarth 2015).

The failure of financial regulation fails in due in large part to the fact that risk in finance is abstract and diffused and accountability is lacking. This point is evident in the stark contrast between the remarkable safety of aviation. Whereas in aviation harm from safety lapses is salient to the public, economic incentives promote safety, and accountability follows from being able to identify their cause, in the financial system there are strong incentives and ability to endanger recklessly, flawed rules exacerbate the problem, and tracing the recklessness to specific individuals or policy is difficult.

Economists are among the enablers of this situation by providing flawed analyses based on inadequate assumptions that “explain” what we see as efficient, or by remaining silent in the face of harmful policy. Research about financial crises often takes the fragility of the financial system as unchangeable, implicitly accepting a reality that can change if more people become aware of the issues and demand change. Unfortunately, misinformation and misleading claims, including by economists, about the health of the system, the prevalence of fraud, the effectiveness of rules, and the relevant costs and benefits of policy alternatives contribute to the persistence of this distorted and dangerous system (Admati and Hellwig 2013a, 2013b, Admati 2016a, 2016b, 2017, Pfleiderer 2014, Zingales 2015).

4. Conclusion: Economists and the Political Economy of Corporations

> “An economic transaction is a solved political problem. Economics has gained the title of queen of the social sciences by choosing *solved* political problems as its domain.”
>
> Lerner (1972, p. 259)

When predicting economic outcomes or guiding policy, economists generally take the rules that govern what agents and firms can do and how they interact as given. However, rules are the result of collective decisions, and market participants seek to affect them. Some of these participants, especially large corporations, can have significant impact on rules that affect everyone. The political economy of corporations, which is also key to the potential problems in the financialization of the economy, can have a major impact on economic outcomes and can make some of the assumptions used in economic analyses invalid.

Corporations have made enormous contributions to economic growth since they came into existence. Governments, by creating corporations, have unleashed the power of innovation and enabled enterprises to grow to more efficient scale. In today’s financialized global economy, however, governments often appear unwilling to control corporations on behalf of the public, and instead tolerate fraud and excessive rent seeking, collaborating with corporations in ways that harm and endanger.

Friedman (1970) criticizes CEOs who pontificate about corporate social responsibility, warning that such talk will bring “the iron fist of government bureaucrats.” He admonishes them to make as much money as possible while engaging in the “open and free competition without deception and fraud,” presuming that this description captures reality. This presumption is false, however, unless governments actively make it true. Ensuring competition and addressing distortions and fraud requires that policymakers -- indeed brave bureaucrats -- actively counter the incentives of corporate executives to extract rents, endanger, and deceive. If governments tolerate rent extraction and fraud and if ethical considerations do not prevent such pursuits, CEOs who follow Friedman’s admonition are being socially *ir*responsible.

Events in recent decades suggest that something has gone wrong in the political economy of corporations. The public anger and erosion of trust in institutions reflect a troubling reality. Harm from excessive financialization, recklessness, fraud, and rent extraction is real and extensive. Importantly, *getting rid of government interference is not the solution*. Societies live by the rule of law. Our collective task is to shape laws to resolve commitment problems and eliminate or reduce the scope for abuses of power. At issue is also not the *size* of governments, but rather conflicts of interests affecting people in governments and the quality, integrity, and effectiveness of institutions that design, implement and enforce the rules.

Governments can address market distortions and enhance the ability of corporations and the financial system to support the overall economy best. The fact that governments often fail, and the mechanisms that underlie such failures, are critical to economic outcomes. Models with inappropriate assumptions that economists use to provide inappropriate policy advice or that policymakers use to rationalize flawed policy have contributed to governments' failures. In particular, naïvely assuming that corporations that maximize shareholder value act in society's best interest has caused real harm.

Economists have the tools help change this situation, but it is essential first to recognize reality. In most contexts, markets do not become competitive and free of fraud on their own. Credible commitments are difficult to maintain, and inability to commit can lead to great inefficiencies. For-profit watchdogs such as auditors or rating agencies are unlikely to uncover fraud or provide reliable information without proper regulations. The limited liability of corporations has benefits but it creates incentives for recklessness, and lack of individual accountability exacerbates this problem. Relying on conflicted experts to set critical rules for the economy can result in flawed rules. Governments, even in well-functioning democracies, often collude with corporations in ways that distort and harm the economy while benefitting those who control the relevant institutions. The interactions between governments and banking firms have been particularly harmful. The financial system is too opaque, inefficient and fragile because those within the system benefit from this situation and get away with it as those who set and implement policy fail to protect the public.

We must find ways to address these issues and collectively hold governments accountable. Economists can help in this essential task.

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