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The Spreading Scourge of Corporate Corruption

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Perhaps the most surprising aspect of the Libor scandal is how familiar it seems. Sure, for some of the world's leading banks to try to manipulate one of the most important interest rates in contemporary finance is clearly egregious. But is that worse than packaging billions of dollars worth of dubious mortgages into a bond and having it stamped with a Triple-A rating to sell to some dupe down the road while betting against it? Or how about forging documents on an industrial scale to foreclose fraudulently on countless homeowners?

The misconduct of the financial industry no longer surprises most Americans. Only about one in five has much trust in banks, according to Gallup polls, about half the level in 2007. And it's not just banks that are frowned upon. Trust in big business overall is declining. Sixty-two percent of Americans believe corruption is widespread across corporate America. According to Transparency International, an anticorruption watchdog, nearly three in four Americans believe that corruption has increased over the last three years.

We should be alarmed that corporate wrongdoing has come to be seen as such a routine occurrence. Capitalism cannot function without trust. As the Nobel laureate Kenneth Arrow observed, "Virtually every commercial transaction has within itself an element of trust."

The parade of financiers accused of misdeeds, booted from the executive suite and even occasionally jailed, is undermining this essential element. Have corporations lost whatever ethical compass they once had? Or does it just look that way because we are paying more attention than we used to?

This is hard to answer because fraud and corruption are impossible to measure precisely. Perpetrators understandably do their best to hide the dirty deeds from public view. And public perceptions of fraud and corruption are often colored by people's sense of dissatisfaction with their lives.

Last year, the economists Justin Wolfers and Betsey Stevenson from the University of Pennsylvania published a study suggesting that trust in government and business falls when unemployment rises. “Much of the recent decline in confidence — particularly in the financial sector — may simply be a standard response to a cyclical downturn,” they wrote.

And waves of mistrust can spread broadly. After years of dismal employment prospects, Americans are losing trust in a broad range of institutions, including Congress, the Supreme Court, the presidency, public schools, labor unions and the church.

Corporate wrongdoing may be cyclical, too. Fraud is probably more lucrative, as well as easier to hide, amid the general prosperity of economic booms. And the temptation to bend the rules is probably highest toward the end of an economic upswing, when executives must be the most creative to keep the stream of profits rolling in.

The most toxic, no-doc, reverse amortization, liar loans flourished toward the end of the housing bubble. And we typically discover fraud only after the booms have turned to bust. As Warren Buffett famously said, “You only find out who is swimming naked when the tide goes out.”

Company executives are paid to maximize profits, not to behave ethically. Evidence suggests that they behave as corruptly as they can, within whatever constraints are imposed by law and reputation. In 1977, the United States Congress passed the Foreign Corrupt Practices Act, to stop the rampant practice of bribing foreign officials. Business by American multinationals in the most corrupt countries dropped. But they didn’t stop bribing. And American companies have been lobbying against the law ever since.

Extrapolating from frauds that were uncovered during and after the dot-com bubble, the economists Luigi Zingales and Adair Morse of the University of Chicago and Alexander Dyck of the University of Toronto estimated conservatively that in any given year a fraud was being committed by 11 to 13 percent of the large companies in the country.

Yet it may be wrong to shrug off the latest boomlet of corporate crimes and misdemeanors as a mere reflection of the business cycle. Americans appear to believe that corruption has become more prevalent over the years. And some indicators suggest they may be right.

In 2001, Transparency International’s Corruption Perceptions Index ranked the United States as the 16th least-corrupt country. By last year, the nation had fallen to 24th place. The World Bank also reports a weakening of corruption controls in the United States since the late 1990s, so that it is falling behind most other developed nations.

The most pointed evidence that breaking the rules has become standard behavior in the corporate world is how routine the wrongdoing seems to its participants. “Dude. I owe you big time!... I'm opening a bottle of Bollinger," e-mailed one Barclays trader to a colleague for fiddling with the rate and improving the apparent profit of his derivatives book.

It's difficult to know why corruption may be spreading. But there are a few plausible explanations. From globalization to rising income inequality to the growing role of corporate money in political campaigns, political and economic dynamics may have increased both the scope of corporate wrongdoing and the incentives for business executives to bend, or break, the rules.

Just consider the scale of recent wrongdoing. Libor is one of the most important rates in the economy. It determines the return on the savings of millions of people, as well as the rate they pay on their mortgage and car loans. It is the benchmark for hundreds of trillions of dollars worth of financial contracts.

Bigger markets allow bigger frauds. Bigger companies, with more complex balance sheets, have more places to hide them. And banks, when they get big enough that no government will let them fail, have the biggest incentive of all. A 20-year-old study by the economists Paul Romer and George Akerloff pointed out that the most lucrative strategy for executives at too-big-to-fail banks would be to loot them to pay themselves vast rewards — knowing full well that the government would save them from bankruptcy.

Globalization can encourage corruption, as companies compete tooth and claw for new markets. And the furious rush of corporate cash into the political process — which differs from bribery in that companies pay politicians to change laws rather than bureaucrats to ignore them — is unlikely to foment ethical behavior.

The inexorable rise of income inequality is also likely to encourage fraud, fostering resentment and undermining trust in capitalism's institutions and rules. Economic research shows that participants in contests in which the winner takes all are much more likely to cheat. And the United States is becoming a winner-takes-all economy.

It's hard to fathom the broader social implications of corporate wrongdoing. But its most long-lasting impact may be on Americans' trust in the institutions that underpin the nation's liberal market democracy.

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