

When Fragile becomes Friable: Endemic Control Fraud as a Cause of Economic Stagnation and Collapse

William K. Black
Executive Director, Institute for Fraud Prevention

IDEAS Workshop: Delhi, India
Financial Crime and Fragility under Financial Globalization
December 19-20, 2005

Abstract

Individual “control frauds” cause greater losses than all other forms of property crime combined. They are financial super-predators. Control frauds are crimes led by the head of state or CEO that use the nation or company as a fraud vehicle. Waves of “control fraud” can cause economic collapses, damage and discredit key institutions vital to good political governance, and erode trust. The defining element of fraud is deceit – the criminal creates and then betrays trust. Fraud, therefore, is the strongest acid to eat away at trust. Endemic control fraud causes institutions and trust to become friable – to crumble – and produce economic stagnation.

White-collar criminology emphasizes incentive structures. A criminogenic environment is one that has strong positive incentives to engage in crime. While economists stress incentive structures, economics ignores criminogenic environments. The weakness comes from three sources. Economic theory about fraud is underdeveloped, core neo-classical theories imply that major frauds are trivial, economists are not taught about fraud and fraud mechanisms, and neo-classical economists minimize the incidence and importance of fraud for reasons of self-interest, class and ideology.

Neo-classical economics’ understanding of fraud is so weak that its policy prescriptions, if adopted wholly, produce strongly criminogenic environments that cause waves of control fraud. Neo-classical policies simultaneously make control fraud easier and more lucrative, dramatically reduce the risk of detection and prosecution by maximizing “systems capacity” problems, and encourage crime by making it easier for fraudsters to “neutralize” the social and psychological constraints against deceit and fraud. Thus the paradox: neo-classical economic triumphs produce tragedy. Perverse policies led to four recent crises: the deregulation and desupervision of the savings & loan (S&L) industry produced the 1980s crisis, “shock therapy” caused the collapse of the Russian economy, the “Washington consensus” produced a wave of control fraud in Latin America, and the desupervision of the U.S. economy in the 1980s and 1990s led to an epic wave of control fraud that contributed materially to the \$9 trillion loss in U.S. stock market capitalization.” With globalization, these crises can transmit to other nations through “contagion” or by causing key international investors to fail.

These recurrent disasters have discredited neo-classical policy nostrums through most of the world. In Latin America, for example, the perverse policies have led to the election of a series of explicitly anti-U.S. and anti-free market leaders. In Russia, the perverse policies discredited neo-classical economics and nascent democratic institutions. Yet, neo-classical economists learn nothing and proceed from failure to failure.

It is vital that criminological findings and theories about fraud become part of the economics canon. If it is bad criminology it is bad economics. If neo-classical economics predicts something (e.g., that control frauds cannot fool creditors and shareholders) that criminologists have shown to be false, then the economic theory is incorrect. Criminologists have found that neo-classical economic policies, taken to the extreme, erode the institutions that constrain control fraud and make markets more efficient. Neo-classical policies damage markets and aid the financial super-predators whose predations discredit markets and democracy and bring Hugo Chavez to power. The intriguing issue is whether these results are unintended consequences or deliberate.

Introduction

White-collar criminology has a set of empirical findings and theories that are useful to understanding when markets will act perversely. This paper addresses three, interrelated theories economists should know about. “Control fraud” theory explains why the most damaging forms of fraud are situations in which those that control the company or the nation use it as a fraud vehicle. The CEO, or the head of state, poses the greatest fraud risk. A single large control fraud can cause greater financial losses than all other forms of property crime combined – they are the “super-predators” of the financial world. Control frauds can also occur in waves that can cause systemic economic injury and discredit other institutions essential to good government and society. Control frauds are commonly able to defeat for several years market mechanisms that neo-classical economists predict will prevent such frauds.

“Systems capacity” theory examines why under deterrence is so common. It shows that, particularly with respect to elite crimes, anti-fraud resources and willpower are commonly so limited that “crime pays.” When systems capacity limitations are severe a “criminogenic environment” arises and crime increases. When a criminogenic environment for control fraud occurs it can produce a wave of control fraud.

“Neutralization” theory explores how criminals neutralize moral and social barriers that reduce crime by constraining our decision-making to honest enterprises. The easier individuals are able to neutralize such social restraints, the greater the incidence of crime.

Unfortunately, white-collar criminology has had no influence on neo-classical economics. This is largely due to mutual mono-disciplinary blinders – neither field reads the other field’s work. Some white-collar criminologists do now read the relevant economic literature. We have found that our core theories and recommended praxis are contradictory. White-collar criminologists (unlike many of our blue-collar counterparts) emphasize incentive structures and generally proceed from the *starting* assumption of

rational, self-interested behavior and stress that the key attribute of a good model is predictive power – not descriptiveness. This is consistent with neo-classical economics, so the question becomes why our disciplines produce contradictory results.

White-collar criminologists believe that their empirical work established over 60 years ago that elite U.S. corporations frequently acted unlawfully. Sutherland's (who coined the term "white-collar crime") classic work reached this conclusion by relying on a study of adjudicated findings of violations of the law. There are inherent empirical limitations in studying such elite crimes that cause the findings to be substantially understated. Unlike typical blue-collar crimes, the victim of an elite white-collar crime generally does not know that they have been victimized. Most such crimes are secret and create indirect, generalized injuries, e.g., a cartel. Frauds, by definition, are hidden and elite frauds, e.g., the CEO that loots a firm by using abusive accounting to create fictional profits that make his stock options valuable, may never be discovered. Governments such as the U.S. keep detailed records of non-elite property crimes – but not elite property crimes. Even if a regulator or prosecutor believes that an elite fraud caused the injury no case may be brought. When regulators bring enforcement actions they typically settle through a consent decree that has no adjudication of guilt. Sutherland's findings are more powerful given these limitations.

Several neo-classical economic and finance theories, however, predict that control frauds will be trivial. These theories are logical extensions of the core theories underlying modern neo-classical economic and finance theory. These extensions rest on predictions about the behavior of other economic actors, e.g., external auditors, which assert that these actors will virtually never act abusively. White-collar criminologists' theories predict the opposite and have demonstrated superior predictive power. Top audit firms routinely provide "clean" opinions to deeply insolvent, pervasively fraudulent companies.

I argue that if it is bad criminology, it is bad economics and if it is good criminology it is good economics. Where economics, on the basis of an economic theory, makes a prediction about crime that criminologists prove to be empirically false the economic theory is false. Where criminology accurately predicts and explains perverse market behavior it should become part of the economics canon.

White-collar criminology findings falsify several neo-classical economic theories. This paper discusses the predictive failures of the efficient markets hypothesis, the efficient contracts hypothesis and the law & economics theory of corporate law. The paper argues that neo-classical economists' reliance on these flawed models leads them to recommend policies that optimize a criminogenic environment for control fraud. Fortunately, these policies are not routinely adopted in full. When they are, they produce recurrent crises because they eviscerate the institutions and mores vital to make markets and governments more efficient in preventing waves of control fraud. Criminological theories have demonstrated superior predictive and explanatory behavior with regard to perverse economic behavior. This paper discusses two realms of perverse behavior – the role of waves of control fraud in producing economic crises and the role that endemic control fraud plays in producing economic stagnation.

Typologies of private sector control frauds

Control fraud theory explains why these frauds cause such disproportionate losses. In the private sector, the individual that controls the company (in practice) is typically the CEO. When the nation is used as a fraud vehicle (“kleptocracy”) the head of state typically controls the nation. One can classify private sector control frauds by the nature of the primary intended victim of the fraud. In “looting” control frauds the CEO loots the company’s creditors (which include the workers) and shareholders. Accounting fraud is the looter’s “weapon of choice.” The CEO uses it to overstate the company’s profits and net worth in order to convert company assets to his personal use through seemingly normal and legitimate corporate mechanisms (e.g., salary, bonuses and stock options).

In anti-customer control frauds the CEO can use the company as a weapon in three distinct manners. He can join with other firms in a cartel. Not all cartels are unlawful – the ultimate success in control fraud is for the government to make one’s action lawful. Most cartels, however, are unlawful and have to be kept hidden through deceit – fraud. Another way to use the company as a weapon against consumers is the “scam.” The seller defrauds the consumer about the quality, existence, or delivery of the good or service. These are classic “lemons” market frauds. Scams against suppliers typically involve not paying the supplier for the goods. The other means of defrauding the consumer is procurement fraud. Such frauds rely on bribery the customer’s agent in order to defraud. Procurement fraud can be used against both buyers and sellers.

A common anti-public control fraud harms the public by increasing pollution. A firm hired to dispose properly of toxic waste can decrease its expenses substantially by dumping the waste in a river and a company that pays an effluent tax can reduce the tax by fraudulently underreporting its emissions. Another common variety of anti-public control fraud is corporate tax evasion.

These forms of control fraud are all similar in several respects. Each is predatory. Each creates and betrays trust (though that is more tenuous in the toxic disposal case). Widespread control fraud operates like a strong acid that erodes trust. In each form of control fraud the gain to the CEO is far smaller than the loss to the victims. Each form of control fraud materially increases economic inefficiency. In each case the losses are far greater because the CEO rather than a more junior official runs the fraud. The CEO has unique ability to optimize the company for control fraud, unique capacity to shape the external environment to aid the fraud, unique apparent legitimacy, and can secure a larger gain in status from the fraud than any junior officer.

The three forms of private sector control fraud do not operate in the same manner. “Looting” control frauds create fictional income and real losses. Indeed, one the reasons they produce extraordinary losses is that they create perverse incentives to enter into the worst transactions because they produce the best accounting “profit.” One optimizes a looting control fraud by rapid growth, e.g., by operating as a “Ponzi” scheme that uses a portion of the new funds brought in through growth to pay off old creditors. The Ponzi

scheme extends the life of the fraud, increasing the “take” and the losses. If a wave of looting control frauds occurs it means that the companies will continue to invest in the asset categories optimal for accounting fraud, e.g., commercial real estate. This causes, and extends, a bubble. The bubble causes further economic inefficiency and the collapse of the bubble can cause systemic economic injury (e.g., the collapse of Japan’s twin bubbles in 1990). Looting control frauds will eventually collapse unless they are protected by public sector control frauds. This is a variety of “crony capitalism.”

The other two forms of private control fraud produce real economic profits, indeed, they are undertaken in order to reap supra normal profits. Anti-consumer and anti-public control frauds frequently endanger public safety. Inferior products are frequently unsafe products because it is more expensive to design and produce a safe product. The process of producing unsafe goods may also be unsafe, so workers may also be victims of lemons markets. The risk to public safety of improper waste disposal or the deceptive emission of additional pollutants is obvious.

Whenever fraud creates real cost savings an additional problem arises. Analogous to Gresham’s law (hyperinflation causes “bad money to drive good money out of circulation”), frauds that produce a competitive advantage must be vigorously prevented by public authorities or they will create an incentive for rivals to emulate the fraud. KPMG (1998), for example, adopted a scheme of selling illegal tax shelters to rich clients on the explicit bases that (1) all of its competitors did so already and that acting unlawfully would put them at a competitive disadvantage, (2) the IRS was overwhelmed and was unlikely to spot the crime, and (3) the penalties for acting unlawfully were far smaller than the fees the firm would earn. The first point is a classic Gresham’s law dynamic that made tax fraud endemic at top tier firms (according to KPMG) and the second two points are classic examples of severe “systems capacity” limitations that criminological theory predicts will lead to criminogenic environments and increased crime.

Cartels operate very differently from looting control frauds. Instead of expanding production and growing rapidly, a cartel optimizes by restraining production.

Looting control frauds and procurement fraud inherently cause damage to other critical institutions because they can only succeed by suborning agents, e.g., outside auditors and law firms or purchasing officers, who are supposed to protect the company and the public. This corrupts these institutions and harms the economy directly and by creating a Gresham’s law-style dynamic in which bad accounting can drive out good accounting (NCFIRRE 1993; Black 2005).

The optimization of looting control frauds

The primary manner in which criminological and neo-classical economic theory contradict arises from looting control frauds.¹ This paper will explain briefly how looting control frauds optimize as an exemplar. Control frauds are the optimal form of looting because the CEO has four unique advantages. First, the CEO can suborn internal and external controls and pervert them into allies. The principal external control against accounting fraud is supposed to be the outside auditor. CEOs control the hiring and firing of internal employees and non-governmental external controls. They, therefore, have the unique ability to “shop” for an auditor that will aid their looting. This does not require any explicit conspiracy. The CEO simply looks for an audit partner that stresses his aggressiveness and sophistication. Control frauds have consistently, world wide, shown the ability to get “clean” opinions for financial statements that purport to show that the company is highly profitable and solvent when the company is in fact deeply insolvent and unprofitable and pervasively corrupt. Moreover, the CEOs that engage in looting control frauds do not merely “defeat” the internal and external controls – they almost invariably choose top tier audit firms and use their reputation and “blessing” of their financial statements as their primary means of deceiving creditors and shareholders.

Second, only the CEO can optimize the company for fraud. He optimizes the company by having it invest primarily in assets that have no readily ascertainable market value. Professionals must value such assets – this allows the CEO to hire an appraiser or accountant that will provide a grossly inflated asset value. Because the asset has no obvious market value it makes it extremely difficult for the regulator (much less prosecutor) to contest the valuation. Such assets are also optimal for extending the life of the fraud. I have explained that rapid growth extends the life of the fraud, and increases the “take”, by allowing a Ponzi scheme. The CEO has the unique ability to cause the firm to follow such a scheme. The CEO can also extend the fraud by arranging false “sales” of the troubled assets to “straws” or related parties – at grossly inflated prices that produce additional profits.

The combination of the first two factors means that the only real check on control frauds is often limited audacity. Audacious control frauds invariably get clean opinions for financial statements purporting to show *record profitability*. Indeed, the false profits claimed by audacious looters are far greater than the real profits produced by control frauds that target consumers or the public.

Third, CEOs have the unique ability to convert company assets into personal funds through seemingly legitimate corporate mechanisms. Accounting fraud is the key to this conversion. The record, albeit fictional, profits blessed by the top tier audit firm cause the stock to appreciate. The (U.S.) CEO will typically have a large percentage of his wealth invested in “his” company’s stock. The CEO can then sell a large block of shares and profit. The CEO will also be rewarded with a raise (very large in the U.S.), a bonus, additional perks and new stock options. The CEO will also gain in status and reputation.

¹ The theories also contradict with respect to cartels. Modern neo-classical economists argue that cartels are inherently unstable because they create an incentive for participants to defect. This destroys cartel discipline. Criminology has documented how illegal cartels can be extremely stable and cause severe injury (Black 2004).

Fourth, the CEO has the unique ability to influence the external environment to aid his fraud. Thus, Enron boasted of creating the “regulatory black hole” that left energy derivatives unregulated. Enron exploited this systems capacity limitation to form a cartel and produce the California energy crisis by taking production plants off line. During the S&L debacle the most audacious control frauds used their political contributions to fend off the regulators by influencing key members of the Reagan/Bush administration and Congress (Black 2005; NCFIRRE 1993; Calavita, Pontell & Tillman 1997). CEOs use the company’s assets to burnish its apparent legitimacy by making charitable contributions. The political and charitable contributions also enhance the CEO’s status and reputation.

Economic theories relevant to looting control frauds

Prior to Akerlof & Romer (1993), economics had no theory or model of fraud. As noted above, it assumed that cartels posed no significant problems because it predicted that they could not maintain discipline. Akerlof (1970) provided a theory of markets for lemons – and all of the examples that Akerlof presented were examples of consumer control frauds – but Akerlof does not describe them as frauds. Indeed, in their 1993 article, Akerlof & Romer explicitly assumed that looting control frauds could not exist but for special circumstances, such as deposit insurance, that removed the normal incentive of private creditors to prevent such frauds. Akerlof & Romer assumed that efficient contracts theory and the efficient markets hypothesis demonstrated the efficacy of creditors of risk in preventing fraud (1993: 5-6). This assumption is somewhat remarkable. If efficient contracts prevent fraud then lemons markets should not exist. Akerlof (1970) argued that lemons markets arose because of information asymmetry – the seller knew far more about the true quality of the goods than the buyer. Reading the article also makes clear that, though he does not stress this point, Akerlof knew that the seller in his examples was intentionally misrepresenting the quality of the goods in order to deceive (defraud) the buyer. So, it is curious that Akerlof & Romer did not explore whether the borrowers/stock issuers know more about their true financial value than creditors/shareholders and whether the optimal strategy (under lemons theory) was to optimize the extent of the asymmetry through deception.

In 1993, the U.S. economics profession was focused on the S&L debacle and their *universal* assumption was that deposit insurance was the *sine qua non* for the enormous losses. While the conventional economic wisdom asserted that fraud was trivial during the debacle, even the three economists (Akerlof, Pierce and Romer) that realized that fraud was a major contributor to the debacle asserted that the looting was only possible because deposit insurance unhinged private market discipline. (Pierce’s views can be found in NCFIRRE 1993: 2-6.) This conventional wisdom can still be found in many contemporaneous economic articles. This is an example of bad criminology making for bad economics. Criminologists’ empirical work found over 1000 felony convictions of senior S&L insiders (in an industry of 3,000 S&Ls) (Calavita, Pontell and Tillman 1997; NCFIRRE 1993). Criminologists have also shown that the pattern of the worst failures and the business practices of the worst failures are inconsistent with the “honest gambler”

hypothesis and consistent with the control fraud hypothesis (Black, Calavita & Pontell 1995; NCFIRRe 1993; Akerlof & Romer 1993: 4).

(Subsequently, Akerlof and Romer have modified their views and believe that looting is possible even when there is a financial incentive for creditors and shareholders to engage in private market discipline. As of 2003, Pierce maintained his 1993 position.)

Neo-classical economics had one additional theory about looting – but overwhelmingly interpreted it to exclude fraud. The theory was “moral hazard.” Moral hazard theory relies on asymmetry of outcomes. Limited corporate liability is a common source of moral hazard. When a corporation is impaired the shareholders have a strong incentive for the firm to engage in control fraud and/or take high risks. The logic is that because of limited liability the creditors – not the shareholders – will bear the resultant losses should the fraud or excessive risks fail. Conversely, should the fraud or gamble succeed the shareholders will capture the great bulk of the financial gain. In 1993, however, virtually every economist assumed (typically, implicitly without any explanation) that S&Ls would engage only in ultra high-risk investments – not fraud. There was no basis for this assumption, as Akerlof & Romer note, fraud was a “sure thing” (1993: 5).

There was one area of neo-classical economics with explicit predictions about fraud – but those predictions were that fraud could not exist. The neo-classical theory of law & economics predicted that looting control fraud could not exist for two reasons.

First, they argued that markets were easily able to spot control frauds (Easterbrook & Fischel 1991: 20-21). Second, they argued that even if the markets could not spot control frauds they would effectively exclude such frauds because the markets could identify *honest* firms. While acknowledging that control frauds had an incentive to “mimic” honest firms, the authors asserted that honest firms had both a financial incentive and *unique* ability to signal that they were honest. Honest firms could send three signals: they could retain top tier auditors, they could have the CEO invest the bulk of his wealth in “his” company and they could be extremely leveraged (1991: 282). The logic for these three points was as follows:

- (1) a top tier audit firm has such a valuable financial interest in maintaining its reputation that it would never provide a clean opinion to a fraudulent company,
- (2) a CEO that invests heavily in “his” company “bonds” his faithful performance – he cannot gain unless the shareholders do, and
- (3) a company that is highly leveraged has only two choices – it can be well-run and produce profits to meet the debt expenses or it can fail – promptly. In either event it is not a major fraud risk.

The authors reach these propositions through logical extensions of the efficient markets and efficient contracts hypotheses. They recognize that these models *implicitly* exclude control fraud, because fraud would falsify both hypotheses. The minimum requirement of the efficient markets hypothesis is that the markets have no systematic pricing bias. But looting control fraud creates a systematic bias because it is used to overvalue

(massively) assets and understate liabilities. If control fraud is material, then neither the contract nor the capital markets would be efficient. Therefore, Easterbrook & Fischel had to find a way to exclude control fraud.

Moreover, given their strong priors against government and regulation, they had to develop theories under which the markets would reliably exclude fraud – even if fraud were *legal*. They had no empirical support for their proposition that the markets easily spot control frauds or any of their three signaling devices. Indeed, by the time they published in 1991, each of these four propositions had been falsified during the S&L debacle. Moreover, Fischel was a lead consultant to three of the most notorious control frauds in that era – Drexel Burnham Lambert (which the “junk bond king” Michael Milken controlled), Lincoln Savings (which Charles Keating controlled) and CenTrust Savings (which David Paul controlled). Fischel, relying on these same theories that are the core assumptions of modern finance theory, predicted that each of the control frauds was exceptionally well run, profitable and safe. In each case the company was able to get clean opinions from top tier auditors – right up to their collapse. In each case the executives owned substantial equity in the company – and found ways to become rich while looting the creditors and shareholders. In each case the company was highly leveraged – and collapsed many years later after growing massively. In each case their financial statements showing record profitability made massive growth easy – creditors and shareholders want to invest in companies that report record profits and receive clean opinions from top tier audit firms. Once more, the neo-classical economic theory of corporate law is bad economics because it is bad criminology (Black 2003).

Why neo-classical economics produces policies that cause economic crisis

Because neo-classical theory is virulently hostile towards government and has no explicit theory of fraud and implicitly assumes that control fraud cannot be material, it repeatedly produces recommended praxis that, if adopted, would optimize the criminogenic environment for control fraud. When neo-classical thought triumphs societies adopt simultaneously many elements of this anti-governmental agenda. This produces waves of control fraud and crisis.

The central problem is that neo-classical praxis simultaneously increases the gains from control fraud, maximizes system capacity limitations and enhances neutralization. This trifecta optimizes the environment for control fraud. Neo-classical nostrums increase the gains from private sector control fraud by permitting private interests to gain control of companies (which are vastly more deadly “weapons” of fraud than are individuals) and by greatly increasing the scope of the assets that these companies can invest in – which aids accounting fraud.

Neo-classical policies maximize system capacity problems in a host of ways that vary by country and context. However, it typically harms capacity in four characteristic ways. First, the policies limit the number and quality of regulators. Second, the policies limit the power of regulators. It is common for the profits of control fraud to greatly exceed the maximum allowable penalties. Third, it is common to choose lead regulators that do

not believe in regulation (Harvey Pitt as Chairman of the SEC and, more generally, President Reagan's assertion that "government is the problem"). Fourth, it is common to choose, or retain, corrupt regulatory leaders. Privatization, for example, creates ample opportunities, resources, and incentive to corrupt regulators.

Neo-classical economic policy further aggravates systems capacity problems by advising that the deregulation, desupervision and privatization take place very rapidly and be radical. These recommendations guarantee that even honest, competent regulators will be overwhelmed. Overall, the invariable result is a self-fulfilling policy – regulation will fail. Discrediting regulation may be part of the plan, or the result may be perverse unintended consequences.

Neo-classical policies also act perversely by easing neutralization. Looting control frauds are *guaranteed* to produce large, fictional profits. Neo-classical proponents invariably cite these profits as proof that the "reforms" are working and praise the "entrepreneurs" that produced the profits. Simultaneously, there is a rise in Social Darwinism. The frauds claim that the profits prove their moral superiority and the necessity of not using public funds to keep inefficient workers employed. The frauds become the most famous and envied members of high society and use the company's funds to make political and charitable contributions (and conspicuous consumption) to make them dominant.

In sum, in every way possible, neo-classical policies, when they are adopted wholesale, sow the seeds of their own destruction by bringing about a wave of control fraud. Control frauds are a disaster on many different levels. They produce enormous losses that society (already poor in many instances) must bear. They corrupt the government and discredit it. They inherently distort the market and make it less efficient. When they produce bubbles they drive the market into deep inefficiency and can produce economic stagnation once the bubble collapses. They eat away at trust.

Thus the paradox, neo-classical triumphs produce tragedy. The S&L industry was highly regulated for decades. It was the bane of neo-classical economists. But the sharp rise of interest rates (which rendered the industry, which was exposed to systemic interest rate risk, insolvent) and the election of President Reagan provided an opportunity to radically transform the industry. It was, within one year, suddenly deregulated and desupervised. Within two years, roughly two hundred control frauds had entered the industry. Larry White, a banking specialist, famously noted that there were "no Cassandras" among economists – none warned that the policies would produce a disaster (1991). But White is less well known for also stating that the frauds immediately understand the opportunities. This demonstrates the cost of economic ignorance.

Neo-classical economists learned nothing from this disaster. Instead, they denied that fraud was more than trivial and denied that deregulation and desupervision had anything to deal with producing the crisis. They also suffered no reputational risk. George Benston, for example, opined that 33 S&Ls that had taken advantage of deregulation were much more profitable and safer as a result. Every one of the 33 failed – the great bulk were control frauds (Black 2005). He was given an endowed chair at Emory after

going 0 for 33. I noted Daniel Fischel's record of error – he was made Dean of the University of Chicago's law school. Another economist predicted that Lincoln Savings (the worst S&L control fraud, costing the taxpayers over \$3 billion) “posed no foreseeable risk” to the taxpayers. His name was Alan Greenspan, he was made Chairman of the Fed.

The next situation in which neo-classical nostrums were adopted wholesale was “shock therapy” in Russia. The effects of privatization in producing the dramatic fall in Russian GDP, sharp rise in corruption, and sharp fall in life expectancy is well documented. This case was particularly striking because a number of the leading neo-classical economists benefited personally from the privatizations. Self-interest is a powerful contributor to the refusal of neo-classical economists to admit that their policies are responsible for the disasters.

The “Washington consensus” represents the third triumph of the neo-classical economic policies. Once again, the early results of looting control frauds led to claims, particularly in Argentina, that the policies were successful and were creating a new wave of entrepreneurs who would lead their nations to modernity. Once more, the result was a wave of control fraud, increased corruption, and budgetary and economic crisis. Another result, which occurred in all four of the cases discussed here, was a sharp increase in economic inequality. Collectively, these results discredited privatization, freer trade, government and the U.S. Virtually every recent election in Latin America, other than Columbia, has brought to power leaders who are explicitly anti-American and virulently opposed to privatization.

The fourth case in which neo-classical economics triumphed was the progressive desupervision of U.S. financial markets in the 1980s and 1990s. Again, this reflected a consensus in which Democrats and Republicans implicitly supported this policy. We tested the Easterbrook & Fischel prediction that neither rules nor regulators were needed to prevent control fraud. The result was the ongoing wave of control fraud in the U.S. Once again, however, no economist has suffered any reputational injury. Alan Greenspan, for example, retained his hero status.

Endemic control fraud can cause the key anti-fraud institutions and mores to crumble and produce economic stagnation and tyranny

Endemic control fraud occurs when corruption becomes pervasive. Corruption is a form of public sector control fraud. The means by which corruption becomes pervasive and the relationship between the public and private sector frauds varies by nation. Mixed systems of cooperating public and private control fraud are common. While the link between corruption and slower growth and a wide range of bad social factors is now well established, there has been little discussion of the role of fraud in corrupt systems. Endemic corruption invariably produces endemic fraud in both the public and private sector. Pervasive corruption simultaneously increases the take from fraud, maximizes system capacity problems, and leads to the most extreme form and breadth of neutralization. In deeply corrupt nations (non) taxpayers do not simply neutralize their

guilt – they perceive themselves as heroes that have risked prosecution to deny the corrupt state additional funds they would steal. Fraud, at least among non-family members, becomes common and desirable. Again, fraud’s defining element is *deceit*. This goes beyond corruption and causes not only economic stagnation, but also a culture that reinforces the deepest skepticism of government and leads to factional tyranny.

References

Akerlof, George A. “The Market for ‘Lemons’: Quality, Uncertainty, and the Market Mechanism. *Quarterly Journal of Economics*. 84 (3): 488-500.

Akerlof, George A. and Paul M. Romer. 1993. “Looting: The Economic Underworld of Bankruptcy for Profit.” *Brookings Papers on Economic Activity*. 2: 1-73.

Black, William K. 2005. *The Best Way to Rob a Bank is to Own One.* Austin, TX: University of Texas at Austin.

2003. “Reexamining the Law and Economics Theory of Corporate Governance. *Challenge*. Vol. 46, No. 2, March/April: 22-40.

2004. “The Dango Tango: Why Corruption Blocks Real Reform in Japan.” *Business Ethics Quarterly*. Vol. 14, No. 4, October: 602-623

Black, William K., Kitty Calavita and Henry N. Pontell. 1995. “The Savings and Loan Debacle of the 1980s: White-collar Crime or Risky Business.” *Law and Policy*. 17: 23-25.

Calavita, Kitty, Henry N. Pontell and Robert H. Tillman. 1997. *Big Money Crime*. Berkeley and Los Angeles: University of California Press.

Easterbrook, Frank H. and Daniel R. Fischel 1991. *The Economic Structure of Corporate Law*. Cambridge, Mass.: Harvard University Press.

KPMG. 1998. Unpublished letter from Gregg W. Ritchie to Jeffrey N. Stein. May 26. <http://www.pbs.org/wgbh/pages/frontline/shows/taxschemes/3.html>

National Commission on Financial Institution Reform, Recovery and Enforcement (NCFIRRE). 1993. *Origins and Causes of the S&L Debacle: A Blueprint for Reform*. A Report to the President and Congress of the United States. Washington, D.C.: Government Printing Office.

White, Lawrence. 1991. *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation*. New York: Oxford University Press.