2-1-2004

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The Imperium Strikes Back:  
The Need to Teach Socioeconomics  
to Law Students

WILLIAM K. BLACK*

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I. AN OVERVIEW OF TEACHING SOCIOECONOMICS

George Stigler’s memoir referred to economics as the “Imperial Science” because economists had colonized so many of the social sciences and, in his view, done by far the best work in a wide range of fields.\(^1\) Indeed, he felt that economics was the only social science worthy of the name “science.”\(^2\) Stigler’s Imperium was unremittingly hostile to government intervention in the markets.

Socioeconomics takes the opposite perspective. It sees economics as a coequal branch of the social sciences and believes that other social sciences can make substantial contributions to economic theory. Socioeconomics emphasizes that some forms of governmental involvement are essential to the creation of the institutions that permit the effective and fair functioning of most commercial transactions. Socioeconomics also recognizes, however, that the governmental involvement can be harmful.

Stigler wrote at a time that the Imperium was in its ascendancy. Now, it is in crisis because neoclassical economic predictions have failed in so many critical applications. Simultaneously, socioeconomics is surging. Recent Nobel Prizes in economics have gone to behavioral and institutional economists that demonstrated that socioeconomic approaches are essential to understand and predict economic relationships.\(^3\)

Unfortunately, most law and economics texts were written, and many law and economics scholars were educated, at a time when the Imperial Science was conquering the world and continue to teach propositions that have been falsified—sometimes decades ago. The Imperium continues to strike back. Socioeconomic scholars in law schools face the challenge of how to teach the new findings that have revolutionized the study of economics and led to dramatically different recommendations for law and public policy.

I make three points in this Article. First, it is valuable for law students

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2. See id. at 87 (“[C]riticism of economics is the chief bond joining the other social sciences. How much sweeter is envy than pity.”); id. at 115 (“Of all the social scientists, only economists possess a theoretical system to explain social behavior . . . .”).
3. See infra note 6.
to learn about economics. Second, done properly, socioeconomics is good, indeed superior, economics. This is a mainstream economics view. For example, behavioral and institutional economics are not heterodox among professional economists. I illustrate this point by explaining how I teach about the inadequacy of the prevailing law and economics theory of corporate governance. Third, socioeconomics is superior economics because it has superior predictive power. With these propositions in mind, I discuss teaching strategies I employ in the setting of a public policy school that may be of interest to law professors.

**A. Economics Is Useful to Law Students**

Public policy schools uniformly recognize that it is essential that their graduates be economically literate. As teachers of students who may one day represent clients and influence public policies, we hope first to give them “a seat at the table.” If they are excluded from the key meetings at which policy is made their ability to influence policy will be limited. As a former regulator and lawyer, I know that one of the most common reasons that government lawyers get excluded from policy meetings is that the topics are perceived of as primarily economic and outside the ken of the lawyer’s expertise.

The next step for us as educators is to help prepare the student to provide useful input at such meetings. Most of this Article focuses on why a background in socioeconomics is an important part of that preparation. Legal training should equip lawyers to evaluate the economic reasoning that animates most discussions of policy, to recognize the most common flaws, and to generate alternatives capable of advancing the client’s broader objectives. Training in socioeconomics is critical to that preparation because it focuses on the weaknesses in traditional economics and provides a rich source of alternatives. I found my economics background of extraordinary benefit to my career as a lawyer and savings and loan (S&L) regulator during the heart of the debacle, in my eventual return to school to study criminology, and as an academic.

**B. Socioeconomics Is Useful Because, Done Properly, It Is Good Economics**

Law and economics should be taught because it is useful to practitioners. A student who knows only about neoclassical economic principles that were outdated decades ago by findings in institutional or
behavioral economics (two subsets of socioeconomics)\(^4\) is a poorly educated student. We can make graduates more effective lawyers by improving the quality of the economics taught in law school.

Neoclassical economics is in crisis. To its credit, it has been hoisted on its own elaborately constructed petard. Neoclassical economic theory’s claim to legitimacy rests on predictive accuracy.\(^5\) That is exactly where it has failed. Behavioral and institutional economics scholars have shown that their insights have improved predictive power in a wide range of microeconomic topics. The improved explanatory power of behavioral and institutional economics is so well accepted today that they have been engrafted onto the neoclassical models, and the leaders in both of the most powerful currents of socioeconomics have received most of the Nobel Prizes in economics.\(^6\) Today, institutional and behavioral economics are not heterodox. Instead, they are conventional.

The absorption of socioeconomics into the conventional economics canon has helped obscure the predictive failures of neoclassical economics in a host of applications. Today, however, the “exceptions” to neoclassical precepts that must be taught in a sophisticated economics class are so common and so important that the underlying neoclassical paradigm bears little relationship to modern economics.

\(^4\) Institutional economics draws primarily on anthropology, sociology, criminology, information and organization theory, and political science. Behavioral economics draws primarily on psychology. Both are quintessential “socio” economics in the sense that they draw on social science findings to inform our understanding of economics.

\(^5\) See generally MILTON FRIEDMAN, ESSAYS IN POSITIVE ECONOMICS (1953). Friedman used “positive” in the title of this book to emphasize his view that economics should not be “normative.” He argued that positive economics was scientific because it relied on predictive ability and testable hypotheses, not value judgments. Id. at 3–7.

\(^6\) In 2002, the Nobel Prize went to Daniel Kahneman and Vernon L. Smith, a psychologist and an economist respectively, for their work in behavioral economics. In 2001, the prize went to three institutional economists, George Akerlof, A. Michael Spence, and Joseph Stiglitz. In 1998, Amartya Sen, one of the world leaders in socioeconomics, received the prize. In 1996, the prize was split between two institutional economists, James A. Mirrlees and William Vickrey. Three game theorists, John C. Harsanyi, John F. Nash, and Reinhard Selten, shared the prize in 1994. Two law and history theorists, Robert W. Fogel and Douglass C. North, shared the prize in 1993. Gary S. Becker, the most prolific of those interested in institutional economics, won the prize in 1992. The leading “new” institutional theorist, Ronald H. Coase, won the prize in 1991. James M. Buchanan won the prize in 1986 for his work in institutional economics, particularly public choice theory. In 1982, George J. Stigler, a leading institutional theorist, won the prize. In 1978, Herbert A. Simon won the prize for his work in institutional economics. In 1974, as in 2002, the prize was split between scholars from polar ideological perspectives who had done noteworthy work in the related fields. Gunnar Myrdal and Friedrich August von Hayek were the “odd couple.” In 1972, Sir John R. Hicks and Kenneth J. Arrow, who shared an interest in the rationales for and efficacy of governmental program, split the prize. The prize in economics was first awarded in 1969. See The Official Web Site of the Nobel Foundation, List of All Laureates, at http://www.nobel.se/search/all_laureates_c.html (last modified Dec. 3, 2003).
In this Article, I discuss how I bring socioeconomics into my teaching about corporate governance, white-collar crime, and regulation. I have chosen as my illustrative example my socioeconomic critique of the predictive strength of the leading law and economics model of corporate governance in the S&L debacle and the current financial scandals. I show that its predictions failed uniformly and that its proponents did not acknowledge these failures or adjust the model to remedy the flaws. I explain that its proponents are sanguine about the danger of fraud by controlling persons (“control fraud”) without any consideration of the white-collar criminology literature that takes the opposite view. I note that the policy advice flowing from the model helped cause the ongoing financial scandals.

I provide a sketch of the intellectual history of the field that I present to my students when I teach classes in microeconomics, public financial management, and regulation. I find that students appreciate a map that explains the general outlines of the relationship between neoclassical and socioeconomics. My sketch ends with another thing I explain when I teach microeconomics: the current crisis in microeconomic and finance theory brought on by its predictive failures exemplified by the twin Japanese bubbles, the U.S. high-tech bubble, and the ongoing wave of enormous control frauds.

I also explain to students how the standard neoclassical model “proves” that employment discrimination could produce segregated workplaces but not discriminatory wages.\(^7\) I find this example particularly useful in starting class discussions. The students realize that the claim is false and could lead to perverse policies, but they also come to see that neoclassical economics does support the conclusion. They find that they have to consider other social sciences—sociology and political science, for example—to understand why what Becker termed a “taste” for discrimination could persist for over a century despite the fact that it was “inefficient” and why that “taste” could produce dramatically lower wages for black Americans.\(^8\)

\(^7\) See Gary S. Becker, The Economics of Discrimination 14 (2d ed. 1971). Becker applied microeconomic theory to explain employment discrimination. His central argument was that discrimination could produce employment segregation if workers had a taste for discrimination, but it could not cause lower wages for blacks absent extraordinarily pervasive bigotry because firms that did not discriminate against blacks would gain a competitive advantage over firms that did.

\(^8\) See id. at 101–34.
1. The Overall Difficulties with Conventional Law and Economics

The central problem in teaching economics to law students is that, overwhelmingly, law and economics scholars tend not to know much about, or be sympathetic toward, socioeconomics. My view is that socioeconomics, done properly, is good economics. As such, it should be central to any law and economics class. This is not because it is more “moral” than neoclassical microeconomics, or a better description of the real world, but because it has better predictive strength. In a better world, the members of this section would be centrists within the law and economics section and this section would not exist.

The reason this section does exist is that scholars who have a polar ideology (libertarian) to most socioeconomics scholars are seen as dominating law and economics. This schism was not inevitable, and it is generally overstated. Many of the earliest law and economics scholars were not, for example, hostile to regulation. Now, however, business interests that are intensely hostile to regulation fund most law and economics endowments in academia and in foundations and actively seek to drive law and economics into a libertarian mode. (These business interests had generally become enraged with the government after it found that they had violated laws or regulations, so their vitriol was rational.)

The scholars who edit journals devoted to law and

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9. For example, Washington Post staff writer Robert G. Kaiser reported, on May 3, 1999, about the leading funder of hard right causes, Richard Mellon Scaife. Scaife had one last serious fling with electoral politics in 1972, when he gave 330 $3,000 checks—$990,000—to 330 different dummy organizations, all of them fronting for the Nixon campaign. The Washington Post disclosed these contributions a fortnight before the election, and Scaife readily acknowledged them. He wrote so many checks to avoid the federal gift tax then in force.


The Olin Corporation is a chemical company that has run afoul of CERCLA and a host of environmental laws. It was an important producer of DDT at the Redstone Arsenal (poisoning local waters and humans). Olin sought to have CERCLA declared unconstitutional to escape liability for severe pollution. The United States Court of Appeals reversed the lower court in *United States v. Olin Corp.*, 107 F.3d 1506 (11th Cir. 1997), noting the following:

Olin has operated a chemical manufacturing facility in McIntosh, Alabama since 1951. Until 1982, the plant produced mercury- and chlorine-based commercial chemicals that contaminated significant segments of Olin’s property. This appeal involves one such portion of the site, called Operable Unit #1 (“OU-1”). Groundwater and soil pollution at OU-1 make it unfit for future residential use.

Id. at 1508.

economics often share this hostility.

One of the consequences of this hostility is that too few law and economics scholars emphasize the three major theoretical economic developments of the last two decades. Those developments are the increasing maturity of institutional economics, the rise of behavioral economics, and the predictive failures of neoclassical economics.

2. Why Many Law and Economics Scholars Devalue Socioeconomics

I believe that the explanation for the lack of emphasis by law and economics scholars about the failures of the libertarian neoclassical economic models and developments in institutional and behavioral economics has three parts. First, most law and economics scholars are, like me, not professional economists. They know less about the flaws in the neoclassical model than professional economists. Second, they focus on other matters, and life is too short for noneconomists to try to keep up on all the advances in behavioral and institutional economics. Third, much of what economists are discovering is contrary to libertarian law and economics scholars’ ideological interests, and, as behavioral economics teaches, cognitive dissonance is powerful. Socioeconomics is most commonly associated with communitarians—the antithesis of libertarian thought.

3. The Centrality of Institutional Economics

Institutional economics has a long pedigree. Indeed, it was part of the classical and neoclassical models before it was ever given a name. The classical theorists, Adam Smith and Hobbes, worried about institutions and recognized that a rule of law, a police power, and an effective tort and contract system were essential to a well-functioning economy. They recognized that the unseen hand needed a backbone to function, and that a legal system, police, and courts were all essential institutions to effective markets. Smith warned that other institutions, for example, trade associations, were important and could lead to cartels. Smith’s passion

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was pointing out the pernicious effects of anticompetitive institutions created by government to aid the rich and politically powerful.  

Smith identified what we would now term “agency” problems because of the separation between ownership and control in stock companies. In short, institutional economics was present from the beginning of classical economics.

The development of institutional economics, of course, continues. The neoclassical microeconomics model is constantly modified in the journals to take into account institutional characteristics. Neoclassical scholars have done much of the best work in institutional economics. The unsophisticated neoclassical response to why cartels are (purportedly) unimportant—they are doomed to fail because they encourage cheating by cartel members—relies on institutional and behavioral economic principles. The more sophisticated neoclassical response is that a cartel is a “repeated game” with no predictable Nash equilibrium because cartel punishment and social bonds can produce stable cartels. Thus neoclassical debates often center on institutional considerations.

Much of what is considered central to modern neoclassical economics is institutional economics. Coase’s theory of the firm was a seminal work in institutional economics. He presented the paradox of why an organization (the firm) so central to modern market economies existed at all and why it generally rejected relying on internal markets. The answer, implicitly, rested on behavioral and institutional economics. The Coase Theorem requires a focus on transactional costs and the enforceability of rights. Both of these factors depend on institutions. Stigler’s economic theory of regulation (“regulatory capture”) became a staple of institutional economics, and Buchanan’s public choice theory applied institutional economics to the government more broadly.

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12. See Smith, supra note 11, at 420–65 (discussing protectionist trade restraint).
13. Smith also opined that humans consistently overstate their chances of winning a lottery—which means he also embraced at least part of what we now call behavioral economics.
14. Criminologists have used principles arising from psychology, anthropology, and sociology to explain why some cartels are extremely stable. See generally Gilbert Geis, White Collar Crime: The Heavy Electrical Equipment Antitrust Cases of 1961, in CRIMINAL BEHAVIOR SYSTEMS: A TYPOLOGY 139 (Marshall B. Clinard & Richard Quinney eds., 1967) (demonstrating how the electrical generator manufacturers developed internal cultures that produced a stable price-fixing cartel).
16. See id. at 114–49 (discussing why assignment of legal rights through the judicial system is necessitated by the existence of transactional costs).
17. See George J. Stigler, The Citizen and the State: Essays on Regulation 114–44 (1975) (arguing that “as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit”).
18. See James M. Buchanan & Gordon Tullock, The Calculus of Consent:
Becker’s classic articles on the family assume widespread altruism and discuss a broad range of behavioral characteristics and institutional arrangements. Hernando de Soto’s work on property rights and economic development states that the institutions societies use to define, allocate, and transfer rights to property are vitally important.

In short, I teach that sophisticated classical and neoclassical economists have long stressed that effective governmental institutions are essential for a market economy to perform well. Classical economists did not see economics as an isolated field. They often used the phrase “political economy” to describe their work. They saw the field we now call economics as deeply intertwined with politics and philosophy.

4. The Rise of Behavioral Economics

Behavioral economics poses a more central challenge to the neoclassical model. It strikes at the core assumption that, in the economic sphere, individuals will act rationally. Rationality is an enormously useful assumption because it makes many economic models determinative. Behavioral economics, however, can also offer clues as to how markets may work despite some kinds of irrationality. Whether individuals are risk averse, risk neutral, or risk lovers is a matter of preference, not rationality. Behavioral economics teaches that these preferences are not always stable. Individuals may change their preferences as they age. They are frequently risk averse when the issue involves a large portion of their wealth but risk lovers when small amounts are involved (which helps explain the success of numbers, the lottery, and Las Vegas). A subtle changing of the way a question is phrased, which does not change the distribution of risk and payoffs, can lead to very different risk preference results in studies.


Despite all these limitations, however, I teach students that these risk preferences are sufficiently stable that trillions of dollars of financial derivatives and trillions of dollars of instruments with embedded options (for example, the typical American home mortgage) trade every year. They trade on the basis of incredibly complex “option adjusted spread” (OAS) models that use Monte Carlo simulations to estimate values. The most sophisticated market participants use supercomputers to produce these simulations, a daily mark-to-market, and a “value at risk” (VAR) study of risk exposure of the investment portfolio. Behavioral economics is embedded in the Black-Scholes model used to estimate option values.22
In sum, what we call neoclassical economics subsumes an enormous range of findings from institutional and behavioral economics.

When derivative traders talk frankly about risk, they discuss institutional and behavioral characteristics. Indeed, the failure of Long Term Capital Management (LTCM) (despite Robert Merton and Myron Scholes’s presence with the firm) is a testament to both of these characteristics. Institutional factors were critical to Russia’s default, and behavioral economics best explains the resultant “flight to quality” that meant that LTCM’s diversified portfolio was exposed to systemic risk. LTCM essentially made the same bet a thousand times: that spreads would narrow. In a flight to quality, spreads widen. Behavioral economics also best explains the hubris that left LTCM undercapitalized, grossly leveraged, and overly sanguine about its risk exposure. LTCM’s failure made the award of the Nobel Prize for economics to scholars who have expertise in behavioral economics certain. If the two economists who received the 1997 Nobel Prize for economics for their work on the Black-Scholes model23 helped lead their company to disaster through a series of irrational decisions, then the behavioral economists had to be on to something very important.

5. The False Dichotomy Between Descriptive Accuracy and Predictive Strength

I believe (and teach) that one of the most ill-conceived debates concerns the descriptive accuracy versus predictive strength debate. Predictive strength is rightly prized in a model. Models must and should be reductionist to be usable. A quantitative model with strong, robust predictive strength is a wonderful thing.

There is, however, no logical basis for believing that assumptions that

23. I tell students that the Nobel Prize winners exemplify a new psychiatric category—“savant-idiots.”
are strongly contrary to fact will predict more accurately than accurate assumptions. Take the example that one of the economists who trained me used—the ideal gas laws that we all studied in chemistry or physics. The ideal gas laws make simplifying assumptions that are broadly, but not invariably, accurate. My professor concluded that this analogy showed that descriptive accuracy was irrelevant. I reached the opposite conclusion. The ideal gas laws provide highly accurate results as long as the very unusual cases assumed away are not present. The ideal gas laws provide inaccurate estimates in situations (extraordinarily high or low pressures) that are contrary to the simplifying assumption.

Economists have always, implicitly, admitted that seriously counterfactual assumptions would produce erroneous predictions. Classical scholars were largely concerned with monopoly. They recognized that the competitive model could not be used to predict outcomes if there were, contrary to the standard assumption, one instead of many providers of a good or service. Similarly, oligopoly and imperfect competition models were found necessary to deal with situations in which there were few providers and differentiated products.

Many of the Nobel Prizes in economics have gone to scholars who asked what would happen to the predictions of the neoclassical model were more accurate assumptions to be made. Stigler became famous for investigating what would happen if the cost of gaining information was considered.24 Akerlof’s prize came from considering the impact of erroneous information and the dynamic process that results when market participants consciously deceive.25 Both of these scholars’ insights are now fixtures of institutional economics, and Akerlof’s work is also central to behavioral economics. Neoclassical economists now consider both of these findings to be part of their canon. The study of barriers to entry spawned the dynamic view of market power. Better assumptions have led to better predictive strength.

C. Teaching the Triumph and Tragedy of Neoclassical Economics

I try to teach students about the triumph of neoclassical economics without foreshadowing the crisis. I find that it makes a compelling story

and keeps students’ attention. I present the narrative as the successful struggle of the neoclassical model to overcome three challenges. The first is the challenge of Marxist economics and the purported rapid growth of the Soviet Union and the expansion of communism. The second challenge is one of universality. The neoclassical model was found to be useful in a broad range of nations and to very different economies ranging from “primitive” to high-tech. Japan’s economic miracle and a rival Japanese model of microeconomics (based on socioeconomics) pose the third challenge.

Neoclassical microeconomics surmounts each of these increasingly difficult challenges with bravura. The irony I am setting up, of course, is the ancient warning that those whom the gods wish to destroy they first make proud. The standard neoclassical models produce their most abject failures at the very time that the models triumph. My teaching emphasizes microeconomics because it is most relevant to the subjects I teach, such as finance, regulation, and white-collar crime. I provide my students with the briefest of overviews of macroeconomics to show that the same irony of snatching defeat from the jaws of victory occurred in neoclassical macroeconomics. I do not discuss the crisis in macroeconomics here because it is tangential to teaching law students.

The proverbial bottom line that I leave students with is that both branches of “traditional” economics are in crisis. I explain to students that while macroeconomics failed first, microeconomics’ crisis has been coming for a long time. Microeconomics’ crisis was only widely recognized recently. Both fields are in crisis because of their predictive failures. I find that providing this background to students both intrigues them and makes them open to considering whether socioeconomics could inform our understanding of economics and public policy in areas as diverse as white-collar crime, discrimination, equality, regulation, finance, and politics. However, I also use the story as a caution about socioeconomics. Japan’s microeconomic model was a form of socioeconomics, and it appears to have failed to overcome the universality challenge—it may have worked exceptionally well in the past, but it works very poorly now. We all know how many embarrassingly poor theories have been developed by social scientists. Socioeconomists will fall prey to similar gaffes.

1. Teaching the Triumph of Neoclassical Economics over Marxism

The ultra-brief version of how I teach the response of neoclassical economics to the three great challenges is as follows. The first challenge, Marxism, posed the least difficulty. Neoclassical economists think that
Marx was wrong on the economics.

The rapid economic development of Communist nations seemed to pose a more serious challenge to neoclassical economics. There was some hand wringing when the USSR was reporting record growth and launching Sputnik, but economists were skeptical about the numbers. Neoclassical economists had a relatively good track record in identifying the stultifying effect of communism on economic development and freedom.

Even before the collapse of the Soviet Union, libertarian economists believed that they had conquered the intellectual landscape and that success proved their unique merit. The passages about the “Imperial Science” by Stigler that I quoted in the introduction capture the spirit of triumphalism in the late 1980s.

2. Neoclassical Economics Establishes Its Universality

Adam Smith developed his theories through the study of specific institutions and practices in Europe in general and England in particular. One of the obvious questions was whether his theories had general applicability to other cultures and to more modern economic forms. Adolf Berle and Gardiner Means, for example, said that the development of the modern corporation as the dominant form of economic activity changed everything. Means’s studies quantified the degree of separation between ownership and control in the typical corporation, and he and Berle opined that the separation led to widespread exploitation of shareholders by managers. Means also argued that prices were “administered” by large corporations, not set by markets.

Much of the twentieth century was grim for neoclassical economics. Nations turned their back on free trade, which helped produce the Great Depression. The Great Depression led to a great expansion of government activity and made leaders like President Roosevelt heroes to many

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26. Ironically, it was neoclassical economists who developed economic theories explaining how an economy in which the state owned the means of production could be economically efficient. The Communist states, however, for reasons that institutional economics could explain, never made effective use of shadow pricing. Similarly, behavioral economists, from Adam Smith on, could have explained why state ownership would lead to a society in which, in the words of the old Soviet-era joke, “They pretend to pay us, and we pretend to work.”

27. See supra notes 2–3.

people. Wars are fought by governments, and the triumph of the Allies increased their legitimacy and helped lead Americans and Europeans to look to their governments for solutions. The success of the Marshall Plan and the fact that the United States did not return to depression after the war reinforced this favorable view of government. The socialist Labor Party defeated Winston Churchill, Great Britain’s war hero.

Libertarian neoclassical economists were in despair. They met in small groups to try to derail the march down the “Road to Serfdom.” Hayek railed that scientific socialism was seen as the wave of the future, and capitalism was considered an archaic, inhumane form of economics rightly discarded by all advanced thinkers. The dictum attributed to Margaret Mead, “Never doubt that a small group of thoughtful, committed citizens can change the world; indeed, it’s the only thing that ever has,” aptly describes the small group of libertarian neoclassical economists at the end of World War II. It took them almost forty years of struggle to attain primacy. The elections of Margaret Thatcher and Ronald Reagan testified to the triumph of the neoclassical model over scientific socialism, state planning, and the welfare state.

I find this part of the tale amazes most students. Few of them are aware that there was a time when conservatives felt like an endangered species. I intend it also as a message that small groups of people can prevail, but they need a coherent theory of change and commitment to the very long haul.

3. The Japanese Challenge to Neoclassical Economics

The “twist” I present that students most appreciate in my sketch of the crisis in microeconomic theory is the case of Japan. I explain that the real challenge to the neoclassical microeconomic model was not the USSR, but Japan. Japan had pervasive government intervention in key markets. Japan had a series of practices that seemed irrational under neoclassical microeconomic principles, such as lifetime employment (for males in larger firms), salary increases based on seniority, not productivity, and a “convoy” system in which the “main banks” organized a welter of cross subsidies and transactions within the keiretsu.

Japan’s economic challenge to the neoclassical model had two related dimensions. First, its performance was superb. “Economic miracle” remains an apt name for Japan’s decades-long expansion.

Second, Japan began to develop a Japanese theory of microeconomics and development. This model rested on behavioral and institutional

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29. FRIEDRICH A. HAYEK, THE ROAD TO SERFDOM (1944).
30. Id. at 10–23, 43–55.
economics. It posited that lifetime employment meant that Japanese workers had no incentive to resist technological advances. Japanese social cohesion and group orientation meant that there was labor involvement as well as labor peace and that cooperation prevailed over competition within the firm and the nation. (Japan was the communitarian state.) A “just in time inventory system” is ideal when there is labor peace, but it gives labor enormous leverage if there is discord. Japanese patience and its long-run perspective were said to allow Japan to accept lower returns on investments, spurring greater economic growth. Japan’s institutions were said to give it enormous advantages.

Japanese institutions other than lifetime employment were also thought to be critical to its success. Its ultra-competitive universities funneled the best and the brightest into jobs as bureaucrats. Business and government were closely intertwined and cooperative. The main banks were said to be far better judges of credit quality because their largest loans went to firms in which they had seats on the boards of directors. Japanese leaders eagerly anticipated surpassing the United States as the world’s largest economy. They wanted the political independence that would come with their new status. A famous book’s title, *The Japan That Can Say No*, captured the sentiment.31

Japan was also proving influential. A host of Asian states emulated its policies—and they produced their own mini miracles. They shared cultures that put less stress on the individual, and they all employed a substantial government role in economic development. Neoclassical economics was at a loss to explain Japan’s success. The standard model implied that Japan’s anticompetitive practices should be disastrous.

In sum, Japan posed a different form of theoretical challenge to the universality of the neoclassical model. Perhaps it only worked best in Western cultures that emphasized individualism. Indeed, perhaps a very different economic model could be far superior to the neoclassical model if a society were arranged along Confucian lines.

Few things were sweeter to neoclassical economists than the piercing of the twin Japanese bubbles, the subsequent crisis throughout the Asian nations that copied its policies, and, most delicious of all, the reaction of Japan’s economists to the rolling recessions that have now stretched over a dozen years. Japanese economists decided that the answer was to

adopt U.S. policies. Imitation is the sincerest form of flattery. The predictive power of the neoclassical microeconomic model seemed to be proved.

I explain to students that the fall of Suharto was the high-water mark for neoclassical microeconomics. The markets deposed a notoriously corrupt (nearly) absolute leader. The markets were doing something that Indonesia desperately needed yet had been unable to achieve for decades. And the markets did it peacefully despite Suharto’s best efforts to lie, cheat, obfuscate, and threaten. The market trumped politics as a reformer.

4. The Rise of the “Hyperpower”

All of this happened as the United States emerged from economic plodding and began to grow faster than virtually any developed nation during much of the 1990s. Meanwhile, U.S. military power became transcendent. The French now refer to the United States as the “hyperpower.” The stock market went into the greatest U.S. bull market of modern times. America was the leader in the “new economy” and the leader in “venture capital.” It seemed poised to widen its lead. The United States was the supercharged engine that pulled the world economy forward during the 1990s—with no help from Japan, little help from Germany and France, and little help from the former Asian tigers. U.S. inflation was minimal, employment reached record levels, poverty declined, and the federal budget reached unprecedented surpluses. Delegations from all over the world visited the United States to learn how to manage.

5. The One-Two Punch KOs the Neoclassical Model at Its Moment of Triumph

Students appreciate the irony that while Soviet economics never posed a serious challenge to the neoclassical microeconomic model, the fall of the Soviet system did. Hundreds of Western economists became consultants to the former Soviet states. The results were humbling and revealing. Things went very badly, and institutional and behavioral factors became all the rage in discussing the problems of post-Soviet development. A drive for “transparency” and “accountable” institutions was now perceived of as the prerequisite for economic development. Scholars from a broad range of fields began to stress “trust” as central to economic, political, and social development.

The collapse of the Soviet system dealt out an even more embarrassing lesson in the dangers of hubris to economists. The August 17, 1998 Russian debt default brought down LTCM and humbled the Nobel Prize
winners who shaped modern finance. They did not know how to fix Russia’s economy, and they did not understand its weaknesses. (The latter helps explain the former.)

The final irony is that the boom of the 1990s that seemed to represent the triumph of neoclassical economics transformed into its greatest failure when the boom was revealed to be a bubble. The bursting of the high-tech bubble in U.S. stocks in early 2000 and the wave of scandals caused by the failure-of-control frauds like Enron in late 2001 followed quickly on the heels of the late 1998 failure of LTCM. The central principle of modern finance theory (which is applied microeconomics) is the “efficient markets” hypothesis, which predicts that markets lack any systematic bias and move toward prices that reflect real economic values. The NASDAQ and the NIKKEI have both lost roughly seventy-five percent of their market value from their highs during their respective bubbles. This suggests that markets can be massively inefficient and move steadily away from prices that reflect real economic values for many years. Microeconomics is often defined as the study of the price system, so a massive flaw in pricing goes to the heart of the neoclassical model. I will explain why this has particular relevance for teaching corporate governance, white-collar crime, and control fraud theory.

II. TEACHING SOCIOECONOMICS IN THE CORPORATE CONTEXT

Several of the classes I teach discuss the necessity of using socioeconomic principles to make sense of the $7 trillion loss in U.S. stock market capitalization. I have chosen two aspects of what I teach to illustrate the approach I use.

The first is the S&L debacle of the 1980s that dealt painful lessons that could have helped us avoid the current scandals. I explain why the conventional economic wisdom about the debacle was almost entirely in error and led to poor public policy choices that left us condemned to repeat the misfortune. The second is a discussion of how I use socioeconomics to explain one facet of the current scandals—the failure of corporate governance and market mechanisms to prevent control frauds.

A. Misinterpreted Warnings: The Savings and Loan Debacle

There was a major warning sign that the libertarian wing of neoclassical microeconomics was exposing the United States to severe problems well before the recent worldwide collapse of the high-tech
bubbles. The S&L debacle cost the taxpayers $150 billion (present valued in 1993). The debacle had two stages. The interest rate risk phase ran from 1979 to 1982. The fraud and credit risk phase occurred from 1983 to 1989. The first phase was, in great part, the result of very bad regulation, and economists (and regulators, and the industry, and key members of Congress) warned in advance that the rules were exposing the industry to systemic risk. There is broad agreement on the first phase of the debacle, so I use it primarily to explain the concept of interest rate risk and to discuss why public choice and regulatory capture theory are (inadequate) explanations for why the known risk was not addressed.

I teach that the second phase of the debacle was the result of even worse deregulation and desupervision. Economists designed and implemented the policies despite the fact that economic theory unambiguously predicted that they would be disastrous. They did not warn anyone that the policies were dangerous. They led the fight to retain the policies even as the policies proved calamitous. After the debacle, they created a conventional economic wisdom that is false and absolves deregulation and desupervision of blame. They then recommended policies that set the stage for the ongoing financial scandals.

In very brief form, here is what I present. President Reagan appointed Dick Pratt, an academic expert in finance, chairman of the S&L regulatory agency (the Bank Board). Pratt, together with economists at the Office of Management and Budget (OMB) and the Treasury Department, drafted the Garn-St Germain Act of 1982 that (moderately) deregulated federally chartered S&Ls. The model for the bill was Texas’s earlier S&L deregulation.

Economic theory predicted that such a move would cause state legislators and regulators to deregulate even more. This was known as the “competition in laxity.” Despite its revealing, pejorative name, economists favored this competitive dynamic because it led to ever-weaker regulation. Regulation was, of course, bad. Laxity, therefore, was good. California immediately “saw” the federal deregulatory bet and “raised” it by totally deregulating permissible investments.

Pratt, Reagan, and the OMB then added three elements to the mix. They desupervised, cutting the number of examiners and gutting key prudential standards. They tortured regulatory accounting principles to create what the financial world aptly referred to as creative regulatory accounting principles. This was designed to cover up the mass insolvency of the industry and avoid recognizing that the budget deficit was $150

billion larger than reported. They also removed limitations that prevented a single owner from dominating a S&L and encouraged new entries, even by real estate developers with clear conflicts of interest.

To sum it up, at a time of mass insolvency (which maximizes moral hazard), in an industry with deposit insurance (which eviscerates private market discipline), Pratt took a series of actions that were certain to maximize the perverse incentives for fraud by controlling persons (control fraud). Economic theory, and experience, has long taught that this combination will produce a disaster.

Pratt and the administration economists, nevertheless, followed this recipe for catastrophe and did not warn Congress of the risks. No economist warned contemporaneously of the risk. As the economist Larry White admitted ruefully years later, there were “no Cassandras.”

Pratt’s successor, Ed Gray, was a Reaganite with little understanding of economics. He had a “road to Damascus” experience after he realized from a series of briefings that the worst S&L failures overwhelmingly followed the same pattern: They were control frauds dominated by former real estate developers. Gray became the great “reregulator.” This made him anathema within the administration. It first tried to force him to resign. When that effort failed, the administration tried to give Charles Keating majority control of the Bank Board by appointing two members of his choosing to the Bank Board. Eventually, in a cynical deal with then-Speaker of the House Jim Wright (who was shilling for Texas control frauds), the administration promised that Gray would not be reappointed in return for Wright’s support for a bill. I use Gray’s experience to challenge the regulatory capture and public choice explanations for bureaucratic behavior and to explain why public choice theory is inadequate even to explain the intervention by politicians.

Keating led the effort to block Gray’s reregulation. His principal weapon against Gray was the work of his economists, including Alan Greenspan. Keating used Greenspan to help recruit the five U.S. Senators who became known as the “Keating Five” after they pressured Gray to go easy on Keating’s S&L’s massive violation of a Bank Board rule. No prominent economist supported reregulation, even though it proved crucial to containing the debacle and saved the taxpayers hundreds of billions of dollars.

After the debacle, the conventional economic wisdom became that the debacle was utterly predictable under economic theory. It was all a matter of moral hazard. Moral hazard notes that perverse incentives are created when gains and losses are asymmetrical. If, for example, I am permitted to insure my commercial building and its contents in excess of market value, and if my policy has no deductible, I will gain from a fire while my insurance company will lose. I have an incentive to either burn the building down (fraud) or avoid taking any steps that would reduce fire danger if they imposed any cost on me (excessive risk).

Economists, with the exception of Akerlof and Romer and James Pierce, have decreed that control fraud was trivial during the debacle and that it should not be studied because it “distracts” from determining proper public policies. I teach students that this is curious on three levels. First, moral hazard theory predicts fraud as well as excessive risk taking and provides no basis for assuming that either one will be more common. Second, there were over one thousand felony convictions of S&L insiders, and convicting powerful white-collar defendants is extremely difficult and incredibly resource-intensive. Fraud was “invariably present” at the worst failures. Control fraud was clearly one of the largest contributors, perhaps the largest, to the debacle, so its study should not be distracting. The number of S&L insider convictions would have been considerably greater with adequate law enforcement resources and priorities; Attorney General Meese, for example, transferred a substantial number of white-collar financial prosecutors and FBI agents to pursue pornographers. Third, the failures that economists assume to be due to excessive risk followed policies that are wholly irrational if they were honest “gamblers for resurrection,” but wholly rational if they were control frauds. Economists, in this instance, ignore the internal inconsistency of their “rational actor” assumption.

34. See George A. Akerlof & Paul M. Romer, Looting: The Economic Underworld of Bankruptcy for Profit, 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 1, 23–36 (1993) (arguing that the S&L scandal was caused in large part by fraud and “looting”). James Pierce was the Executive Director of the National Commission on Financial Institution Reform, Recovery and Enforcement and authored its report on the causes of the debacle. See NAT’L COMM’N ON FIN. INST. REFORM, RECOVERY AND ENFORCEMENT, ORIGINS AND CAUSES OF THE S&L DEBACLE: A BLUEPRINT FOR REFORM 101 (1993) [hereinafter S&L DEBACLE].

35. WHITE, supra note 33, at 117.

36. Id. at 40–41.

37. S&L DEBACLE, supra note 34, at 4.


The moral hazard model is particularly interesting because it employs a rational actor assumption but then recognizes that the results as to any particular actor are indeterminate because moral restraints may prevent the actor from maximizing her financial self-interest. Similarly, neoclassical microeconomic models about crime often have embedded in them a term that corresponds to moral restraints. This is yet another example of economists finding that predictive strength improves when more accurate assumptions are made. Economic models that do not incorporate moral and social constraints greatly overpredict crime and traffic incivility (and underpredict tipping, voting, and courtesy to strangers).

B. Corporate Governance and Law and Economics

As bad as these errors about the S&L debacle were, they pale next to the failure to learn the lessons of the debacle for corporate governance. I use Professor Fischel’s law and economics approach to corporate governance to demonstrate to my students the importance of socioeconomics for an understanding of corporate governance, control fraud, and regulation. Professor Fischel’s theories serve as a bridge between the S&L debacle and the more general topics of corporate governance, fraud, and regulation. He was in a unique position to learn the lessons of the S&L debacle. He was already a leading law and economics scholar during the debacle and had, with Judge Easterbrook, revolutionized the field by overturning the Berle and Means paradigm emphasizing the separation of ownership from control in large corporations.

The Easterbrook and Fischel paradigm is radically different. Economists writing about the debacle have tended to remove the “moral” aspect of moral hazard. A large part of the problem is the recasting of the moral hazard theory into option theory. The controlling owner of an insolvent S&L with deposit insurance, for example, can be conceived of as having a “put” option. If the fraud or gamble produces new losses instead of the firm’s “resurrection,” the combination of limited liability and deposit insurance means that the CEO or owner can “put” the losses to the taxpayers. When conceived of as an option, however, the moral aspect disappears and economists assume that the issue is the normal question of maximizing the value of the option. It follows that someone who acts abusively displays “cleverness,” see Edward J. Kane, The S & L Insurance Mess: How Did It Happen? 6 (1989), while someone who fails to engage in perverse behavior in response to moral hazard is no longer “moral.” He is, instead, “stupid,” “irrational,” or both. See Martin Lowy, High Rollers: Inside the Savings and Loan Debacle 54 (1991).

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that corporations are guided by an “invisible hand” to act in the interest of shareholders.\textsuperscript{42} The invisible hand is virtually inerrant; it has produced governance structures that are “optimal for society.”\textsuperscript{43} This view, in turn, was premised in large part on the assumption that financial markets are highly efficient.

Professor Fischel had the opportunity to apply his new theory during the S&L debacle. He was a leading consultant to Charles Keating of Lincoln Savings, Michael Milken of Drexel Burnham Lambert, and David Paul of CenTrust Savings. Fischel used his theories to predict the risk of failure of Lincoln Savings and CenTrust. These calculations were presented as accurate to the ten-thousandth place.\textsuperscript{44} He concluded that both S&Ls were highly profitable, financially strong, well-run, and posed no meaningful risk of failure. He also concluded that their junk bond portfolios were particularly strong.\textsuperscript{45}

Keating, Milken, and Paul are all convicted felons, and Lincoln Savings, CenTrust, and Drexel are all failed firms. The two S&L failures cost the taxpayers roughly $5 billion.

After these predictive failures, Easterbrook and Fischel published \textit{The Economic Structure of Corporate Law} in 1991.\textsuperscript{46} The book is the definitive law and economics work on corporate governance. It does not mention Fischel’s failed efforts to use the theory to predict results. It does not mention the S&L debacle.

The book has the following policy prescriptions that helped leave us so vulnerable to the current scandals:

\begin{enumerate}
\item Control fraud is not a serious problem because the markets find it easy to spot fraud.\textsuperscript{47}
\item Honest firms differentiate themselves from fraudulent firms through three devices:
  \begin{enumerate}
  \item by hiring a top tier audit firm;\textsuperscript{48}
  \item by having their CEOs invest substantial portions of their assets in the company;\textsuperscript{49}
  \end{enumerate}
\end{enumerate}

\begin{flushright}
\textsuperscript{42} \textit{Id.} at 4.
\textsuperscript{43} \textit{Id.} at 7.
\textsuperscript{45} Fischel was retained by Keating and Paul because of his work for Drexel. Both S&Ls were Drexel “captives.” They found out at the end of the day in a telex from Drexel what junk bonds they now owned. Drexel used this absolute control over the portfolios to churn the accounts and dump its junkiest junk on the captives.
\textsuperscript{46} \textit{EASTERBROOK \\& FISCHEL, supra} note 41.
\textsuperscript{47} \textit{Id.} at 21, 116.
\textsuperscript{48} \textit{Id.} at 280–83.
\textsuperscript{49} \textit{Id.} at 282.
\end{flushright}
(c) by being highly leveraged.\textsuperscript{50}

(3) Legal prohibitions against fraud are neither essential nor particularly important.\textsuperscript{51}

(4) White-collar fraud is a “one off” proposition that cannot be repeated.\textsuperscript{52}

(5) Regulation is at best ineffective and is likely to cause harm.

(6) Regulators will perform far worse than the market.\textsuperscript{53}

(7) Stock analysts provide reliable advice.\textsuperscript{54}

(8) The ideal form of management is the controlling shareholder or CEO.\textsuperscript{55}

(9) The best board of directors shares the preferences of the CEO.\textsuperscript{56}

(10) Fiduciary duties of officers and directors are interpreted too stringently.\textsuperscript{57}

(11) Restraints on conflicts of interest are excessive.\textsuperscript{58}

At this juncture, this policy advice requires only explanation to my students, not refutation. The advice has proved to be the worst possible. The advice is wrong because of predictive failures. Those failures come from a lack of understanding of behavioral and institutional economics and criminology. The worst errors flow from two predictions of Easterbrook and Fischel’s model. They are that it is easy for legitimate firms to distinguish themselves from control frauds and that managers whose rewards depend on the company’s profitability will act to maximize shareholder value.

I explain to students why criminology offers superior explanations of the scope and nature of major corporate frauds and why most treatments of “governance” are irrelevant when the CEO is the lead criminal. The law and economics scholars have failed to understand that not only are control frauds able to camouflage themselves by emulating the three means of “differentiation,” but that the three means assist such frauds.

\textsuperscript{50} Id. at 114, 175–77, 282.

\textsuperscript{51} Id. at 283.

\textsuperscript{52} Id. at 103.

\textsuperscript{53} Id. at 20, 31, 303.

\textsuperscript{54} Id. at 18, 31.

\textsuperscript{55} Id. at 133.

\textsuperscript{56} Id. at 70, 73.

\textsuperscript{57} Id. at 107.

\textsuperscript{58} Id. at 115, 140–42.
Easterbrook and Fischel assert that a top audit firm will not provide a clean audit opinion to a control fraud because the gain from taking on a fraudulent client is far smaller than the loss in the value of the auditor’s reputation. But the S&L debacle had just shown that hundreds of control frauds were able to get clean audit opinions, and that they invariably got them from “Big 8” firms. As Keating said, his accountants made him money. A prestigious outside auditor is the greatest ally of control frauds.

Having the CEO own stock in the company also aids control fraud. Control frauds function by creating fictional profits through fraudulent accounting practices. This inflates the value of the CEO’s stock and provides a seemingly legitimate means (along with dividends and stock bonuses) of converting company assets to the CEO’s ownership. Easterbrook and Fischel assert that if the CEO owns stock, the CEO cannot benefit unless the company does. That was not true during the S&L debacle, as Fischel knew when he wrote the book, and it is not true now.

Easterbrook and Fischel claim that only honest companies are highly leveraged because the high interest expenses permit only two choices: the company must be profitable so that it can pay, or it is forced into bankruptcy. Again, Fischel knew from the S&L debacle that there was a third choice for control frauds. Control frauds grow. They are typically ponzi schemes. The high “profits” generated by accounting fraud make it possible to grow by borrowing additional money (or selling more stock). To a control fraud, leverage is simply an opportunity to defraud creditors in addition to shareholders.

I have explained how the CEO’s stock ownership in the company can provide a means of converting firm assets to personal use. Easterbrook and Fischel assume that the stock ownership will align the CEO’s interests with those of the shareholders. This assumption is wrong whenever the company is weak. Agency cost theory posits that the CEO should have superior information about the true condition of the firm. If the CEO knows that the firm has poor long-term prospects, his financial interests are antagonistic to shareholders’ interests. The CEO determines how the stock options will be structured. Unsurprisingly, they are almost always structured to reward short-term results. The CEO can easily manipulate short-term results. Stock ownership by the CEO misaligns his interests with the shareholders when the company is troubled.

The S&L debacle and the ongoing financial scandals are only two examples of how unsophisticated misuse of the neoclassical microeconomic model is bad economics and can lead to harmful policies. Other
participants in this session with diverse backgrounds are presenting their own examples. The S&L debacle, the ongoing financial scandals in the United States, and the twin bubbles in Japan do allow limited generalization. There are many competing statements of the efficient markets hypothesis. Some of them are far more limited in their claims of efficiency. These three events, however, challenge even the weakest formulation. The broadest financial markets can move away from efficiency for years, and the extent of their departure can reach trillions of dollars.

III. CAN WE DO BETTER?

Critique is valuable. Knowing that the efficient markets hypothesis can fail badly is important. Warning students about the predictive failures of neoclassical economics and modern finance warrants teaching socioeconomics. But socioeconomics can be far more useful, and it can be more persuasive in the classroom, if it can provide a model with improved predictive power. Improved predictive power is important because it can lead to better policy advice. For example, efficient markets are desirable. If we could predict what institutional changes would improve their efficiency, we could give better policy advice and teach students something that would be quite useful in practice.

One of the reasons that fraud is bad is that it moves prices away from efficient outcomes. Control fraud has far more potential to inflict this harm because the CEO can use the entire resources of the firm to sustain the fraud. He can derail all the normal external and internal controls and turn them into contributors to the fraud. He can move the operations of the firm into areas with the most abusive accounting practices. He can cause the firm to grow massively. The result is that massively insolvent companies have been able to present themselves as financial juggernauts. This causes extreme inefficiency.

But control fraud does far more damage than inefficiency. It cheats people and it erodes trust. When control fraud becomes common, trust is crippled. We are now beginning to understand how critical trust is to society. In financial terms, a loss of trust translates into an increase in risk. This rise in risk is gratuitous from society’s standpoint. It acts as a deadweight drag on prosperity by increasing the cost of raising capital. In human terms, it can impair cooperation and spread cynicism.

CEOs also set the tone for the organization. Control frauds select the top managers. The standard rule in a control fraud is to pick “yes” men and women without strong moral restraints in the business realm.
Corrupt CEOs create corrupt organizations. Indeed, one of the perils of control fraud is that the “help” often steal from the organization. The government claims that Mr. Fastow did so at Enron. Keating’s director of regulatory compliance (which meant he was in charge of the opposite) embezzled money from Lincoln Savings and his church.

The ongoing wave of control fraud has caused a major loss of trust and efficiency and cheated scores of millions of people. My research goal is to help specify the institutional characteristics that produce waves of control fraud, propose institutional changes that discourage nonsystemic control frauds, and develop better means of detecting and stopping control frauds before they cause catastrophic losses. My research, of course, informs my teaching. I emphasize to my students that they can tackle these issues only with the robust, real world understandings that socioeconomics provides. How can you orient your research agenda to best improve the quality of the economics taught to law students?