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Only Government Intervention Can Stop Corrupt Capitalism

By: Ben W. Heineman Jr.

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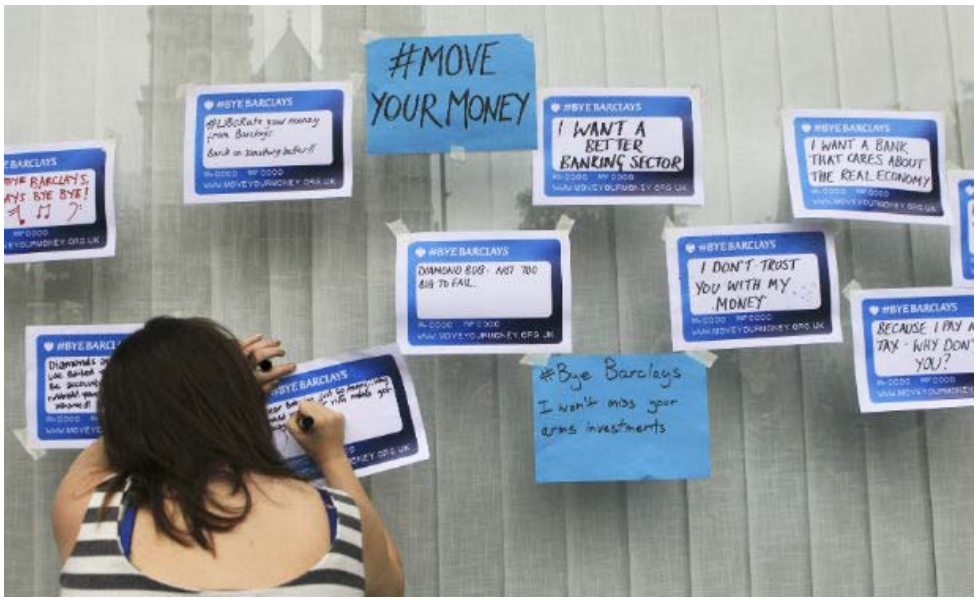
After scandals at Barclays and GlaxoSmithKline, it's clear that a no-regulation approach to markets won't work.



At a branch of Barclays Bank in London, a protestor from the group Move Your Money hangs up posters. (Reuters)

At the core of capitalism are powerful forces that, if unconstrained, cause corporate corruption, as reflected in two recent corporate scandals, one involving Barclays and a second involving GlaxoSmithKline.

These cases raise starkly, yet again, the issue of how to realize the benefits of market capitalism while restraining the powerful impulses to cut corners, cheat, and commit fraud. This ageless question is of special moment in this polarized political season, in which the role of government is central. The cases rebut the assertions of the

Republicans, Tea Partyers, libertarians, and corporate leaders who wish to reduce the reach of law and government and who believe that markets will always self-regulate -- people from Ayn Rand and Russell Kirk, to Ron Paul and Grover Norquist, to Tea-Party Republican majorities in the House who want to "starve government," to individual and corporate donors to super PACs, all of whom are today shaping the Republican message

The cases support people who believe in a mixed economy that gives a central role to economic freedom and free markets -- but a system that also places important legal and regulatory limits in order to prevent corruption and protect social goods.

Barclays agreed to pay $453 million to settle U.S. and British allegations that it manipulated the London interbank offered rate, or Libor, which is the benchmark for interest rates (the cost of money) on an estimated $500 trillion in mortgages, credit cards, and other loans and derivatives affecting individuals and businesses around the world. Libor is based on submissions from major banks which report on their own borrowing costs -- and Barclays falsified those reports, often in collusion with others, in order to hide a weakened financial position during the melt-down or fraudulently to improve profitability. The chairman, the CEO, and the COO of Barclays were all forced to resign, with the CEO calling his bank's actions "reprehensible." The governmental investigation has targeted 18 financial institutions, and a dozen firms have fired or suspended traders for manipulation of the rate. The far-reaching scandal has just begun to reveal its dirty secrets.

GlaxoSmithKline (GSK), the huge UK pharmaceutical firm, agreed to plead guilty to federal crimes and pay approximately $1 billion in fines because it promoted two prescription drugs for unapproved uses and failed to report safety data to the FDA about a third. In addition, GSK agreed to pay an additional $2 billion to resolve civil claims brought by both federal and state authorities alleging, among other things, that the company paid kickbacks to physicians to prescribe drugs, made false and misleading statements about drug safety, and committed fraud under a Medicaid drug rebate program. The $3 billion total payment "is the largest health care fraud settlement in U.S. history," said Justice Department, "and the largest payment ever by a drug company," eclipsing other settlements on similar charges with Pfizer ($2.3 billion), Eli Lilly ($1.4 billion) and Johnson & Johnson ($1 billion in process of being completed).

Corporations large and small apply relentless internal pressure on their people to hit basic financial goals for net income, cash flow, and stock price. Other commercial targets, too, may be critically important: achieving specific returns on investment, equity or assets; hitting sales or service goals; meeting product development or product launch schedules; and attaining productivity increases. Companies, especially those in the global economy, also face external pressures such as endemic corruption, weak rule of law, pervasive conflicts of interest, and extortionate demands from government officials.

Personal incentives are driven, in important part, by "making the numbers." There are ubiquitous temptations and pressures to behave badly. Employees at all levels may feel

that their salaries, bonuses, promotions -- and even their job security -- depend on falsifying accounts, cutting corners, colluding with rivals, and generally ignoring law and ethics.

It is obvious, then, that economic self-interest that in the aggregate can produce societal economic benefit can easily turn into avarice and self-aggrandizement. In the cases of Barclays or GSK, these traits led to fraud in setting interest rates or marketing drugs. And, of course, Barclays and GSK are but the latest in an incessant drumbeat of corporate scandals just since the turn of this century, beginning with Enron (conflicts of interest, misleading public statements) and Worldcom (phony accounting) and leading to News Corp (phone hacking) and Wal-Mart (bribery). (For my take on the last two, see here and here).

There are two broad approaches for dealing with unacceptable corporate acts--false public statements, fraudulent accounting, collusion, privacy violations, bribery--and the inherent business pressures that cause them.

One important answer is "private ordering," internal corporate integrity programs. Leaders of corporations need to create a culture, buttressed by systems, processes, and resources built into business operations, that fuses high performance with high integrity. Such a culture values creativity and innovation but also respects deeply the need to achieve business success with integrity -- law, ethics, and values. Some corporations, especially those with strong brands and reputations to protect in the global economy, have sought to create such a culture. But, as the string of scandals demonstrates, many have not.

A second approach is needed: the checks and balances provided by public policy, laws made by legislatures, regulators and courts. All internal corporate integrity programs are built on broader societal rules, and without the threats and sanctions of public law in many areas of the economy, most companies would not seek to create a culture that seeks to constrain wrong-doing by their employees. This is certainly my belief based on 18 years working on these issues inside a major corporation.

The answer to the anti-government position of the Republicans and their ideological and corporate supporters against strong public checks in the economy and on business is found, in a slightly different context, in one of the most famous passages from the Federalist Papers (No.51). James Madison wrote: "If men were angels, no government would be necessary." Because men and women are not angels, checks and balances on governmental action and on corporate action are essential.

The increasing movement of the Republican Party away from a positive role for government, and the strident language of some ideological groups and corporate leaders who shape the party, is oblivious to the reality of business pressures--and to the implications of corporate wrongdoing, including in the two cases noted here. The Barclays case raises large questions about the financial services industry. The GSK case raises significant issues about drug marketing and drug safety. Both raise

profound questions about the proper mix of private ordering and public policy to deal with such acts. A proper government response is necessary, not just to sanction the companies but to deal with these issues going forward.

What is remarkable about this political season, underneath all the bombast, demagoguery, and financial excess, is the fundamental debate about the role of government. The Barclays and GSK cases perfectly illustrate the issues debate. Let those engaged in the current ideological wars who argue for dramatically reducing government's role tell us how the market, not government, would have addressed the egregious behavior of those two major corporations -- and deal in the future with the significant systemic problems the cases raise.

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