The Corrupt Corporation:
A Galbraith Inspired Analysis

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1. Introduction

This paper presents an analysis of corrupt corporations that builds on theoretical principles developed by JK Galbraith. The inspiration for the paper is threefold. First, is the obvious presence of corrupt companies in modern economies, particularly since the 1980s. Secondly, limitations and inadequacies of the usual explanation of such corruption based on regulatory failure; an argument has been propounded by, for example, Stiglitz (2003). A simple indicator of the inadequacy of the regulatory failure account of corruption is that millions of firms exist in the same regulatory environment, but a relatively small proportion appears corrupt. Hence, at a basic level, a complete analysis of corruption requires regulatory failure plus an analysis of the motivation of corrupt firms.

This analysis of motivation leads to the third inspiration for the paper: use and development of the framework presented by JK Galbraith to analyse the modern corporation. Corruption is a subject that can be studied from several different perspectives. We choose a Galbraith inspired framework to make the discussion meaningful within the context of firms (especially corporate entities). This framework can be used to provide the necessary analysis of corrupt motivation in a corporate setting, involving in particular the importance of a company's 'technostructure'. But the Galbraith framework requires reinterpretation to incorporate corruption. This development and reinterpretation is arguably necessary as witnessed by the opinion expressed by Galbraith, in a recent interview conducted by one of the authors (Dietrich, 2003), that modern firms are fundamentally well run. Corrupt corporations can be viewed either as an exception to this opinion, or what is meant by 'well run' requires examination. Either possibility would seem to be an important part of a Galbraith inspired analysis.

The rest of the discussion is organised as follows. In the next section basic definitions are presented. In section 3 the discussion turns to Galbraith's (1967) idea of a corporate technostructure and its significance for corrupt activity. The final substantive section presents a number of case studies that are used to provide empirical content to the essentially conceptual discussion. Finally brief conclusions are drawn.

2. Corrupt Corporations: basic definitions

This first main section of the paper presents basic definitions and terminology that are necessary for the discussion to be undertaken. An overwhelmingly large number of studies on corruption involve a study of the government sector, state bureaucracies and public sector procurement policies; see Rose-Ackerman (1975) for a seminal analysis of this type of analysis. Several other studies relate corruption to growth, poverty or governance aspects, especially for the case of developing countries; see, for instance, Bhagwati (1982) and Krueger (1974). In this paper a different approach is adopted that concentrates on corrupt practices within the private firm sector.

Following Galbraith (1967) a distinction is drawn between the sphere of the economy inhabited by competitive (neoclassical-type) firms and the sphere of the economy inhabited by large corporations. This distinction between competitive and corporate spheres is important for the analysis of corruption. As will be argued below corruption in the two spheres is understood in terms of two different frameworks. Competitive sector corruption is explicable using traditional economic categories whereas corporate corruption requires recognition of organisational complexities; and in particular those suggested by Galbraith. The difference of framework illustrates a fundamental difference between competitive and corporate sectors. Hence it is important to highlight the general differences involved.

Using casual empiricism we can suggest the competitive sector is inhabited by small and medium sized firms and the corporate sphere by large and giant firms. This is useful as an introductory statement but is inadequate for current purposes, for which a more analytical approach is required. We can understand the differences involved as being based on two factors: institutional and informational. The institutional difference between market and corporate sectors involves the definition of ownership. We must recognise that economic conceptions of ownership as used in, for example Hart's (1995) analysis of the firm and more general traditional principal-agent approaches, are not necessarily consistent with legal conceptions. The latter define the institutional basis of the firm in reality and so are important for current discussion. The legal conception of ownership reveals a difference between market and corporate firms.

Kay (1997) points out that, according to legal principles, ownership is defined in terms of eleven characteristics: a right of possession; a right of use; a right to manage; a right to income from ownership; a right to the capital value; a right to security from expropriation; a power of sale or disposal; no time limit on ownership rights; a right of residual control; property can be used to obtain satisfaction of legal judgement against the owner; a duty to refrain from harmful use. Two important implications follow from this legal definition. First, it is clear that individual shareholders do not own companies instead they own shares. So, for example, shareholders have a right to use, manage, derive income from and dispose of shares. But no individual shareholder has the right to use, manage, derive income from and dispose of the assets of a company. The second implication is that we cannot even argue that companies are collectively owned by shareholders. This follows because shareholders, collectively or individually, have no duty to refrain from harmful use of company assets. In our context harmful use covers corrupt practices. Managers have a duty to refrain from harmful use of a company’s assets, but equally this does not imply that managers own companies. In short, we can follow Kay (1997) and suggest that the ownership of publicly quoted companies is inevitably ambiguous. In terms of the distinction between markets and corporate spheres, one criterion is therefore the ambiguity of ownership. With unambiguous ownership, corrupt practices are either result of strategic intent or the result of inefficiently managed ownership rights. With ambiguous ownership the analysis is less straightforward.

In narrow economic terms, with unambiguous ownership it is possible to define the principal(s) and agents in any relationship. With ambiguous ownership the definition of principal(s) and agents is not a priori clear. This lack of clarity implies that the actual functioning of principal-agent relationships is ex-post institutionalised in actual economic processes rather than being an ex-ante determinant or guide to the structure of these processes. This complexity is recognised in formal economic theory by Douglas and Whinston (1986) when they suggest that ‘common agency’ may be significant. Examples of common agency fall into one of two categories: delegated or intrinsic. Delegated common agency arises when several parties voluntarily bestow the right to make certain decisions upon a single (common) agent. Intrinsic common agency arises when an individual is “naturally” endowed with the right to make a particular decision affecting other parties, who may in turn attempt to influence that decision. Both possibilities involve a number of principals who simultaneously announce incentive schemes for a common agent. In the presence of collusion institutional remedies for the resulting inefficiency are needed. In addition the distribution of net rewards among the principals is, in general, indeterminate when we have common agency.

The second criterion referred to above is an informational difference between the market and corporate sectors. Assuming unambiguous ownership, with perfect information we can use standard principal-agent theory to specify optimal contracts. It follows that any corruption is the result of principal objectives rather than inefficiently managed ownership rights. But the possibility of such optimal contracting requires two key information inputs.[1] The principal must have ex-ante full knowledge of (1) the production/transformation processes being managed and (2) agents' preferences. If we follow a Galbraith (1967) logic, ex-ante knowledge of production/ transformation processes is not possible because such knowledge is embodied in the functioning of an organisation's technostructure, a matter discussed in more detail in the next section. Knowledge of agent preferences would seem to be impossible in all circumstances except where regular day-to-day contact allows inferences to drawn based on observed behaviour. In short, in large companies optimal contracting seems infeasible because of principal ignorance.

This latter point, about shareholder ignorance, is not of course fundamentally original. Instead it invokes a traditional argument based on a divorce of ownership from control in large joint stock companies (Berle & Means, 1932). More recently, however, the rise of institutional firm ownership has somewhat undermined a traditional shareholder ignorance argument (Nyman and Silberson, 1978; Baldwin, 1964). In terms of corporate corruption we will see below that financial institutions seem to have been party to the corrupt practices of business firms. It follows that for current purposes, i.e. an analysis of corporate corruption, their existence must be

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1 The theory of optimal contracting is discussed in any reasonable advanced microeconomics text, for example Gravelle and Rees (2004) and Kreps (1990).

recognised. The complexities this introduces are presented, schematically, in figure 1. The competitive sector is characterised be unambiguous ownership and owner information that is (effectively) complete. Traditional divorce of ownership from control is based on owner ignorance, but the ownership is considered unproblematic. If financial institutions have (effectively) perfect ex-ante knowledge of firm affairs the modern joint-stock company would not be part of the corporate sector. Instead it would be subject to effective financial control. But if we recognise the centrality of a firm's technostructure such knowledge is ex-ante not available. Hence, the corporate sector is defined here as involving (inevitably) un-informed ownership that is ambiguously defined. The emphasis on ownership ambiguity is not an explicit part of a Galbraith framework. But for an analysis of corruption it would seem to be necessary, because it its absence corruption can be viewed as ineffective corporate control i.e. a regulatory failure. With ambiguous ownership perfect corporate control of corrupt practices is not even, in principle, possible. Hence analysis can be more firm, rather than regulatory system, focussed.

Figure 1: Information, ownership and the corporate sector

			Owner Information	
		Informed		**Ignorant**
	Unambiguous	Competitive sector		Divorce of ownership from control
Ownership characteristic				
	Ambiguous	Financial control		Corporate sector

Competitive market firms are largely ignored in the later discussion of corporate corruption. This is not to suggest that corruption does not exist in the competitive market sector. Such market sector corruption does, of course, exist and a brief discussion is warranted here as an introduction to the main topic of corporate corruption. The nature of market sector corruption is somewhat easier to analyse than for the corporate sector because of unambiguous ownership and that the firms involved are controlled by individuals rather than technocracies.

Competitive sector corruption is based on information asymmetries between buyers and sellers, to a seller’s advantage, with resulting hidden information and hidden action problems. These problems are a reflection of the personal and in particular profit maximising objectives of those who control market sector firms. Arguably the standard analysis of hidden information and hidden action can be used to analyse such corruption. It follows that contracting failures are an adequate framework for such an analysis, i.e. a standard analysis of corruption based on regulatory failure is relevant. In this context the minority of firms in the market sector that are corrupt can be analysed in terms of high degrees of risk loving behaviour given the probability of less than perfect legal sanction. From a neoclassical economic perspective, risk loving behaviour is a common attribute of entrepreneurial activity. From an Austrian economic perspective (for example Hayek, 1945; Kirzner, 1973) corrupt exploitation of information advantages is simply an example of the commercial use of subjective knowledge that underlies all entrepreneurial activity. It follows that firm corruption in the market sector can be seen as a form of entrepreneurial activity that takes on anti-social significance.

Two implications follow from this brief discussion of corruption in the competitive sector. First, the distinction between social and anti-social entrepreneurship and behaviour is of critical importance. As seen above, ownership is defined in terms of a duty not to do harm. Hence, corrupt practices by entrepreneurially owned firms imply abuse of ownership rights. But it is clear that the definition of anti-social behaviour is not geographically or historically neutral. For example, the making and taking of bribes may be acceptable in one economy but evidence of corrupt activity in another. Perhaps more importantly the conception of anti-social activity can change over time. Such a change clearly occurred in Anglo-Saxon and some other Western economies from the 1970s onwards, and perhaps more dramatically in the old Soviet dominated economies. Based on earlier discussion we might suggest that such change will stimulate anti-social entrepreneurial behaviour as it affects not only the profit opportunities involved but also the probability of legal sanction for any particular anti-social act. Hence the apparent rise in corrupt corporate activity from the 1980s onwards in perhaps not surprising, given the rise of market liberalism and attendant socio-political changes.

The second implication that follows from the brief discussion of corruption in the market sector involves recognising that because of the transaction costs involved in the policing of legal sanctions (Williamson, 1985) strict optimal contracting is not possible because of the costs of search, negotiation and policing of agreements; i.e. less than complete contracting is rational. From a policy perspective, an appropriate response might therefore rely on ‘market’, non-state or ex-post private litigation solutions. Market and non-state solutions involve greater provision of information that undermines the basis of corrupt activity. For instance, the media can play an important role in information provision as can market testing and state agencies. Any such policies will not, of course, eliminate corruption but will remove its long-run rationale. Given the relatively small size of any one corrupt market sector firm the social costs involved might appear small and a necessary cost of market functioning.

But the social significance of corporate corruption cannot be viewed as a necessary, but undesirable cost of market functioning. As Galbraith (1967) has emphasised, the corporate sector is based not only on standard monopoly power of the firms involved but also on the management and commercial use of scientific information. Given these bases to large firm corporate activity it is by no means obvious how simple information provision can remove the information asymmetry upon which corruption relies. In addition, given the legal and other resources that the corporate sector can exploit, but are not available to many private individuals, it is by no means obvious how ex-post private litigation can be expected to work anything other than highly imperfectly. In short, corporate corruption can be expected to have a profound impact on economic activity rather than being an undesirable but necessary adjunct of market functioning. Hence an understanding of the topic in its own right would seem to be important.

Given this brief consideration of competitive sector corruption the discussion can now turn to the more involved topic of corporate corruption. For current purposes a distinction is drawn between three 'types' of corporations: (a) non-corrupt corporations; (b) non-corrupt companies with corrupt individuals; and (c) corrupt corporations. Type (a) companies are those emphasised in much of Galbraith's writing. In general terms such companies can be described in terms of high degrees of organisational effectiveness. A precise definition of 'organisational effectiveness' is presented in the next section using an explicitly Galbraith inspired framework. For the moment it is sufficient to define effectiveness in terms of two general characteristics: organisational coherence and organisational objectives. The links between effectiveness, coherence and objectives are well illustrated using traditional strategic management theory (for example, Johnson and Scholes, 1997). Here, organisational objectives are derived from the position and power of various organisational stakeholders. It is the responsibility of senior organisational strategists to reconcile these stakeholder aspirations and to map this organisationally viable set of objectives into concrete organisational activity, i.e. coherent strategies and operations acceptable to all organisational actors. In short, therefore, organisational effectiveness requires this senior organisational arbitration role.[2]

If type (a) corporations are conceptualised in terms of this effective organisational arbitration, type (b) and type (c) companies are conceptualised in terms of a breaking down of this effective arbitration. An example of a type (b) non-corrupt company that has corrupt individual(s) is Barings Bank in which a Far East trader was allowed to extract significant personal financial advantage from unrecorded trades that eventually precipitated the collapse of the company. In Barings the key problem was that organisational coherence was limited because control systems were clearly undermined by individual aspirations i.e. there was not an effective mapping from objectives into coherent operations.

Examples of type (c) corrupt companies are given below. Their general characteristic is that while organisational coherence is high, i.e. the company can run itself effectively, there is a corruption of organisational objectives. This corruption can be viewed as a failure of the traditional strategic management framework outlined above. In this framework senior strategists are viewed as essentially arbiters of organisational stakeholders. What is not considered is that the senior strategists can be stakeholders themselves, and in particular powerful and significant stakeholders because of the organisational position involved. When senior strategists shift from

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[2] This senior arbitration role is similar to that suggested by behavioural theorists, for example Cyert and March (1963) and March and Simon (1958), a tradition that Galbraith (1967) uses. But for reasons briefly set out in Dietrich (1994) this behavioural basis to the firm is not used here to analyse corrupt corporations because it lacks a strategic dimension.

being arbitrators to being dominant stakeholders organisational objectives become skewed. Corruption results when this skewing takes on anti-social significance. It may, of course, be argued that over-riding socially accepted stakeholders is itself anti-social, in which case all skewing of objectives involves corruption.

In practice it would appear that a skewing of objectives requires a formal or informal alliance between senior management and other powerful stakeholders, e.g. financial institutions and auditors. Two comments would seem to be pertinent in this regard. First, such alliances take on greater significance when financial and auditing services are provided by organisations that are themselves in the corporate sector. In these circumstances financial and accounting companies may skew objectives. That this has been indeed the case is indicated in the case studies reported later. The second comment concerns the earlier discussion of stakeholder, and in particular shareholder, ignorance. In Anglo-Saxon type economies auditing is a core way in which ex-post information provision is institutionalised. It follows that corruption of the auditing process is a necessary basis for wider corporate corruption; hence the significance of accounting companies being in the corporate sector. In Japanese and European based economies the auditing function is complemented by a greater direct but private managerial, rather than arms-length, role for the banking system. In principle this would seem to increase the possibility of corrupt practices emerging, if the objectives of the banking system are skewed, because of the tighter and longer term alliances between companies and financial institutions.

Figure 2: A simple taxonomy of corporate effectiveness

		Organisational objectives	
		Effective	**Skewed**
Organisational coherence	**High**	Type (a) Galbraith corporations	Type (c) corrupt corporations
	Low	Type (b) corrupt individuals	non-viable corporation

The simple taxonomy of organisational types suggested here is presented in table 2. The only addition to earlier discussion in this table is the ‘non-viable’ category. This can be thought of as either a transitional category during periods of radical organisational and technological change or alternatively as the space inhabited by market sector firms that are small scale and dominated by individuals. It might be argued that the definition of corruption offered here is rather extreme, in which case it is appropriate to identify two types of corrupt corporations. First are those companies in which corruption is endemic or core to organisational activity and secondly are those companies in which corruption is marginal or non-core to organisational activity. These sub-types can be called fundamentally corrupt and anti-social corporations respectively. With fundamentally corrupt companies, removal of the corrupt activity, by reorienting objectives to reflect non-senior strategist stakeholders, implies that the organisation would become effectively non-viable. This would seem to be the case with companies such as Enron and Parmalat. With anti-social corporations, reorientation of the objectives results in reduced profitability but organisational viability is not fundamentally undermined. This would be the case with successful anti-monopoly or cartel activity. Perhaps more topically we can also cite the recent case of Shell that overestimated oil stocks because of the financial advantages that were derived. This paper is primarily interested in fundamentally corrupt corporations, although other organisational types may be introduced for illustrative purposes.

3. Corruption and the Corporate Technostructure

Central to Galbraith's (1967) analysis of the business corporation is his idea of a technostructure that controls corporate activity. In this section the functioning of the technostructure will be linked to corrupt business practices. In his New Industrial State he argues that

> In the past, leadership in business organization was identified with the entrepreneur... With the rise of the modern corporation, the emergence of the organization required by modern technology and planning, ... the entrepreneur no longer exists as an individual person... [Instead, there] is a collective and imperfectly defined entity ... [that] embraces all who bring specialized knowledge, talent or experience to group decision-making. This, not the narrow management group, is the guiding intelligence – the brain – of the enterprise. I propose we call this organization the Technostructure.
>
> [Galbraith (1967), p85]

The importance of this technostructure has not been undermined by the 'new economy'. For example, Galbraith (2001, p55) claims that although the argument presented above was developed "before the computer revolution... the essence of [the argument], the bearing of technology on modern industrial structure, is still stoutly valid". In more detail he made the same point in a recent interview (Dietrich 2003)

> Now the modern corporation has taken over the basic industrial structure and on the whole it is economically competent. It does the economic task well… On the whole the old fashioned capitalist power had a wide range of damaging features. And the most serious was its inability when it came to technical innovation and productive competence. The modern corporation owes much of its power, much of its authority, and much of its acceptance to the fact that it does its job very well. There is no complaint. On the other hand that gives it a licence to reward its management very wonderfully. In fact it has moved power to the managerial complex and has left the owners in a more or less celebratory role… But power doesn't rest usually with any identifiable individual, although it may. It really rests with the corporate structure… the competence may not be greater but the consolidation of power in the management structure is greater than I then [in the 1950s and 1960s] told or foresaw.

For current purposes, a key implication of the dominance of the technostructure is that within it the nature of individual motivation changes. As argued in his New Industrial State, the importance of compulsion and pecuniary motivation are downplayed, instead identification and power seeking become more significant. In terms of an analysis of corporate corruption the basic argument can be presented as follows. An effectively functioning corporate bureaucracy requires that compulsion and pecuniary motivation become subordinate to identification and power seeking. Effectively functioning here means effectively exploiting specialist technical and human knowledge. But the skewing of corporate objectives that underpins corrupt practices implies that financial objectives and compulsion become dominant compared to identification and power seeking. It follows that corruption implies an undermining of technostructure functioning. For this reason fundamentally corrupt practices are likely to have no long-run viability except in circumstances in which the corruption involves state protection. In this regard, we can recognise the importance of Galbraith's (2004) recent statement that

> The accepted distinction between the public and private sectors has no meaning when seriously viewed. Rhetoric, not reality. A large, vital and expanding part of what is called the public sector is for all practical effect in the private sector. (p48)

Furthermore

> In recent times the intrusion into what is called the public sector by the ostensibly private sector has become a commonplace. Management having full authority in the modern great corporation, it was natural that it would extend its role to politics and to government. (p50)

To develop this argument in more detail we use non-Galbraith writing to understand the importance of power seeking and identification. We can recast Galbraith's analysis and suggest that non-financial motivation is necessary to generate organisational coherence in a context of non-centralised decision making, with such decision making being necessary because of the complexity of organisational tasks. The alternative is that centralised decision making, based on financial motivation, can be used to generate coherence with resulting corrupt business practices that may be 'merely' anti-social or fundamentally corrupt.

Dealing initially with power seeking, the issue here involves Sen's (1970, 1983) paradox, similar to Arrow's (1963) possibility theorem, that no social choice rule can guarantee efficient and coherent decision making for all preferences given three characteristics: (a) unrestricted preferences, (b) Pareto optimality, (c) minimal delegation. Technostructure functioning allows coherent decision making by controlling at least one of (a), (b) or (c).

To facilitate discussion we present a firm-based example of Sen’s paradox, inspired by Miller (1992). A company has three groups of experts: financial specialists, marketing specialists and production managers. Each group has a characteristic time horizon for decisions based on the nature of their specialist task. Financial specialists have a short-term orientation. Marketing managers can be assumed to have an overwhelming objective based on market share development that requires a medium term horizon. Production managers emphasise technical issues and research and development that require a characteristic longer-term horizon. Three mutually exclusive strategies are assumed to exist:

Strategy M: exploitation of existing monopoly power using skimming pricing;

Strategy P: further market share development using penetration pricing;

Strategy N: new product development based on application of research and development.

The priority rankings of the three groups of specialists are as follows:

Finance: M > P > N

Marketing: P > N > M

Production: N > M > P

A simple voting rule produces the following results

M > P (2 votes to 1)

P > N (2 votes to 1)

N > M (2 votes to 1)

We can now derive Sen’s well-known paradox. In any organisation with minimal delegation and unrestricted preferences there is always some combination of individual preferences that lead to either intransitivity or inefficiency in group choice. The intransitivity is clear from the circularity in the above company rankings i.e. consistent and logical organisational decision making is not possible. Inefficiency is given a Pareto interpretation. Decisions can be rendered consistent by assuming some sort of dominance in the decision process. With financial dominance N > M is overridden in which case M is chosen. Marketing dominance involves M > P being overridden, in which case P is adopted. Production dominance involves P > N being vetoed resulting in N as the strategy. But any of these vetoes implies company decision making is not Pareto efficient.

We can now see the way in which technostructure functioning facilitates the management of the potential conflict between decentralised decision making and firm activity and why it is necessary for organisational coherence in a context of non-centralised decision making. The technostructure allows manageable decision making by controlling at least one of the factors that generate the Sen paradox i.e. there must be (a) constrained delegation; and/or (b) preference restriction; and/or (c) Pareto inefficient practices. In terms of technostructure activity we can see two general ways in which such coherence can be developed. First, specialists within an organisation can act politically, i.e. undertake power seeking behaviour, with the objective of controlling the ‘corporate agenda’ hence their objectives come to dominate corporate activity, i.e. this controlling group become the central strategists. In the above example N > M, M > P or P > N is over-ridden depending on who controls the agenda. Secondly, central strategists can impose an external coherence not based on the specific tasks of organisational actors, with corrupt consequences. In terms of the above example, and with corruption involving a skewing of objectives towards financial gain, external coherence involves imposing N > M.

The conclusion that organisational coherence can be developed in these two general, but mutually exclusive, ways is consistent with the more formal analysis presented by Itoh (1991). Technostructure functioning can be viewed in terms of team activity because the shared knowledge of specialists produces an interdependent knowledge base unique to each organisation (Dietrich, 1993). In this team situation Itoh examines possible incentive schemes; either interdependent schemes or individual based schemes. The key result, for current purposes is the nonconvexity of the optimal task structure where the principal either wants a specialised structure or substantial teamwork in which agents have full information about each other's actions. A specialised structure is equivalent to an external imposition of team coherence whereas the development of teamwork is equivalent to a more decentralised development of coherence.

The discussion can now move on from power seeking to the importance of identification for motivation within a technostructure. In this regard the work of Dietrich and Roberts (1996, 1999) on the economics of professional behaviour is relevant. In these works it is argued that professional organisation gains a comparative advantage when a principal is ignorant about the transformation processes undertaken by an agent. The relevance of this ignorance for the corporate sector and technostructure functioning is clear from earlier discussion. As discussed above, the result of this ignorance is that arms-length contracting is an ineffective means of controlling economic activity. This comparative effectiveness of professional organisation requires the development of a professional ethic that provides a signal that a principal can trust. But equally professional organisation involves an inevitable institutionalisation of monopoly power to the advantage of the professional.

Using this perspective it is clear why professional identification is necessary for effective technostructure functioning and also why a degrading of such identification can facilitate a skewing of technostructure objectives with corrupt consequences. This identification is important within an organisation, as a means of controlling power seeking and financial motivations. Equally it is important externally as a means of controlling relationships between senior organisational managers and key external stakeholders e.g. auditors and financial institutions. But as discussed above, this internal and external role for identification is basically the same when external stakeholders are themselves part of the corporate sector. The importance of this professional identification is emphasised by Galbraith (2004, p 66):

> The least expected contribution to the adverse and even criminal [corporate] activity was … corrupt accounting… This provided cover for devious actions and extended to outright theft. Individuals of inquiring mind had long regarded accounting as both competent and honest. Over a professional lifetime in economics, … I have read through dozens, perhaps hundreds of corporate financial statement. That some were a disguise for quiet larceny did not cross my mind.

4. Corrupt corporations: Enron, Parmalat and Royal Dutch Shell

In this section the intention is to provide some empirical meat for the conceptual skeleton developed in the previous two sections. This application involves case studies of three famous examples of corporate corruption: Enron, Parmalat and Royal Dutch Shell. The intention here is not to provide detailed corporate histories of these companies but rather to use them as illustrations of the framework developed above. There are several analytical strands which are similar for all three firms. Inadequate adherence to accounting norms, incomplete disclosure of information, serious conflicts of interests, a dilution of accounting rigour due to conflicts generated by lucrative consulting fees and finally, the limited role of independent non-executive directors existed in all these firms. To get an idea of the scale of the problem consider the fact that 250 US public companies restated their profits in 2002, compared with only 92 in 1997 and three in 1981 (The Economist, 2002). In 2002, the venerable Xerox Corporation was fined US $10 million to settle a case brought by the US Securities and Exchange Commission (SEC), the largest such fine ever paid till then. Xerox admitted that it had overstated its profits by US $1.4 billion between 1997 and 2001 (The Economist 2002).

Enron

Enron was a Houston based energy firm founded by Kenneth Lay. It transformed itself over its sixteen year lifespan from an obscure gas-pipeline firm to the world's largest energy trading company (for both offline and online businesses). As a consequence of deregulation, Enron moved to the electricity business to supplement its natural gas business. It also tried to buy into the water business. For a while Enron was viewed as a trailblazer and it became the darling of Wall Street and investors alike. In 2001 Enron's several deceptions began unravelling. Inspite of its best efforts at manipulation, Enron failed to enter the California retail electricity market. As a consequence of a lack of transparency and concealing fraudulent numbers on its balance sheets by October 2001, Enron's credibility, its share prices and credit rating plunged. A rival firm, Dynegy, shied away from a proposed lifeline merger fearing lawsuits over Enron's shoddy and fraudulent accounting. By December 2001, Enron filed for bankruptcy, but by then many of its employees lost their savings and their jobs. Some employees also lost their retirement funds, because their pensions were invested in Enron stock through their company scheme. US Federal prosecutors took senior management to task with ex-CEO Kenneth Lay charged with fraud in July 2004. Michael Kopper, an assistant to Andrew Fastow pleaded guilty to money laundering. The ex-CFO, Andrew Fastow, plea bargained a ten-year prison sentence in January 2004 (The Economist 2004e). As of now, criminal charges have been brought against a total of 30 people involved in Enron's collapse, not counting the charges against Arthur Andersen, and ten guilty pleas have been entered (The Economist 2004f).

Enron removed big liabilities from its balance sheet and put them into so called 'special-purpose entities' (SPEs) (with names like Raptor and Chewco), which were financial structures apparently designed to remove unpleasant information from the sight of investors. When this deception could not be continued any longer, Enron had to restate its profits for the years from 1997 to 2000, knocking off more than US $1.2 billion from its book value (The Economist 2002). Enron (much like another discredited firm, WorldCom) set out to revolutionise its industry on the back of deregulation which let it enter new markets and the Internet which changed the economics of entry. In the ensuing fallout accompanying its collapse, investor confidence has diminished significantly and chief executives of firms and accountants have come to be perceived as particularly untrustworthy. Most of these issues fall under the rubric of corporate governance. In all three cases discussed here, the role of auditors as guardians of managers' accounting probity has been increasingly questioned. The auditors of Enron, Arthur Andersen faced an unresolved conflict between its auditing and its faster growing, higher margin, consulting business. In 2000, it earned US $25 million from auditing Enron's books and another US $27 million from providing consulting services which had been aggressively promoted. Andersen ultimately went out of business on Aug 31, 2002. It was revealed that its executives had shredded incriminating documents about Enron, even after US Federal investigators started looking into the auditor's activities. The US Department of Justice decided to bring criminal indictments against Andersen, hastening its demise.

Another factor that fuelled these excesses was the practice of awarding extravagant rewards to top corporate executives with the company boards condoning such rewards. This was largely possible through share options. Share options were given generously in the 1990s in the hope that they would align managers' interests with those of shareholders, but in many cases share options motivated the unscrupulous to massage their company's figures and to persuade their auditors to go along with them. In the case of Enron, Andersen did not need much persuading. Partners who objected were moved to other clients. Finally, insiders exercised their share options before accounting deceits were revealed and before share prices collapsed, often netting large windfall gains in the process. Deficiencies in financial statement disclosure and corporate corruption were serious problems long before the Enron debacle. In most countries surveyed, the lack of disclosure of information by companies was a bigger issue than either corrupt business practices or a lack of effective accounting guidelines. Only for the case of the UK, more CFOs (chief financial officers) considered the lack of effective accounting guidelines to be an issue of more concern than lack of disclosure. In developing countries, as could be expected, CFOs regarded corruption to be the more important problem, as compared to disclosure issues and issues relating to accounting guidelines. Barth et al (2003) also contend that the lines between law and accounting are becoming very blurred. In their view, inadequate training in accounting theory and practices on the part of lawyers resulted in a diminishing competence on the part of lawyers to understand and effectively monitor the firms whose operations were being analysed.

In the United States, the Enron case led to the enactment of the Sarbanes-Oxley Act of 2002, which attempts to increase the transparency of corporate financial statements, reform the oversight of accounting and aims at helping to restore investor confidence. Barth et al (2003) cite a remarkable quote from the US Senate's Permanent Subcommitte on Investigations (2002):

> Citigroup and [JP Morgan] Chase each deliberately misused structured finance techniques to help Enron engage in deceptive accounting or tax strategies, and were rewarded with millions of dollars and favorable consideration in other business dealings.

Parmalat

Parmalat is a well known Italian food and milk products company, especially well-known for its innovative brand advertising. Parmalat was viewed as an apparently healthy firm, the product of decades of entrepreneurial endeavour that had turned a tiny ham merchant in Parma into a global giant. Fifty-one percent of its shares were owned by the family of the founder, Calisto Tanzi. In December 2003, Parmalat caused panic among investors by almost defaulting on a small bond issue. Parmalat was a regular heavy user of the bond markets, and it had often been criticised for its habit of carrying large debts that were supposedly offset by big cash holdings. Suddenly in December 2003, Parmalat struggled to redeem a euro 150 million (US $180 million) Eurobond, despite having already bought back much of the issue. Financial markets wondered why the redemption was a problem for a group with more than euro 4 billion of reported cash and short-term assets. Investors panicked when Parmalat admitted that it had been unable to secure the release of almost 500 million euros trapped in a mutual fund in the Cayman Islands. Within days, Parmalat's banks forced out Calisto Tanzi who was the group's chairman and chief executive, and appointed Enrico Bondi in his place, effectively as a troubleshooter. Enrico Bondi quickly discovered a huge and long-running deception, which became the subject of a full scale judicial inquiry. There were two main allegations: first, that the family-owned group falsified its accounts to conceal its losses and secondly, that up to euros 800 million were embezzled, chiefly by Calisto Tanzi. Faced with implosion at Parmalat, the Italian government passed an emergency law introducing American Chapter 11 style bankruptcy protection in order to salvage parts of the Parmalat group's business which were still viable going concerns. This case did not prove to be a uniquely Italian affair. The investigation has spread to the Netherlands, America and Brazil, and it encompasses questionable behaviour on the part of international investors, credit-rating agencies, banks and auditors, prompting the media to dub the Parmalat case as being Europe's Enron. Quite like Enron, Parmalat had a corrupt management and a complacent board of directors, as well as complicated financial deals in offshore tax havens via big banks, which seem to have been only too willing to underwrite deals that kept a massive fraud alive for years. As at Enron, accounting and auditing deceptions enabled the fraud to continue.

At the heart of the Parmalat scandal lies a letter, purportedly from the Bank of America, in which the bank confirmed that Bonlat, a Parmalat subsidiary based in the Cayman islands, had deposits close to euro 4 billion (US $5.5 billion) with the bank. Parmalat's auditor, Grant Thornton claimed that the forged Bank of America letter was good enough to fool them into approving accounts that were fraudulent. Grant Thornton used Parmalat's internal mail to request financial information, rather than dealing with the banks concerned or other parties directly. Many observers content that either Grant Thornton was too close to Parmalat's affairs to maintain objective, professional standards or that they were incompetent. Grant Thornton expelled its Italian member from the network for deviant and unethical behaviour, no doubt mindful of the fate of Arthur Andersen. The size of the hole in Parmalat's accounts is estimated to be between euros 12 billion to 14 billion (The Economist 2003b). According to Giulio Tremonti, Italy's finance minister, this may well end up being underwritten by taxpayer money (The Economist 2004b). Fausto Tonna, Parlamat's former CFO was one of ten people (including his wife) who were arrested over the affair, and he has confessed to prosecutors that he benefited personally from funds held by Parmalat subsidiaries (The Economist 2004a). Like Enron, Parmalat was overly fond of using elaborate bond and derivates deals, often using complex offshore structures that involved some of its many subsidiaries.[3] For example, Parmalat employed the so-called 'self-references credit linked notes (CLNs)' which were effectively an insurance policy written on itself. Investors and bankers alike struggled to understand its balance sheet or to gauge the true extent of its liabilities. Parmalat became well known for a lack of transparency. In 2002, Merrill Lynch advised investors to sell Parmalat shares on the grounds that they could not understand the need for such opaque financing (The Economist 2003a). Further, respected global banks such as Citigroup, JP Morgan and Deutsche Bank were only too willing to construct the derivative deals by which Parmalat transferred funds offshore and speculated with them. These banks are, of course, not answerable to shareholders, but

3 One particular financial structure has prompted outrage from institutional investors and small shareholders alike. A Citigroup entity registered in Delaware (USA) was called *Buconero*, which is Italian for "black hole", which was allegedly used by Parmalat to conceal borrowings and to conduct a massive fraud (The Economist 2004h). Citigroup has issued an apology for the choice of this name and it has denied any wrongdoing.

they do earn lucrative fees. Credit rating agencies like Standard and Poor's also kept issuing investment grade ratings to Parmalat bonds, without adequate monitoring.

The US SEC widened its probe to include the $1.5 billion worth of bond sold by Parmalat in the US. The SEC is investigating whether American banks, which helped to place the bonds with investors, were wilfully ignorant of the firm's problems. The Parmalat case demonstrates the jurisdictional risks associated with solving problems in a highly complex and uncertain regulatory and legal environment. This problem is exacerbated by the fact that there has been an increasing globalisation of the world's capital markets, as foreign firms increasingly raise money in the US. More significantly, the Parmalat case and similar cases of fraud such as Cirio and Finmatica in Italy have increased calls for an Italy risk premium, to cover opaque financial reporting, poor governance, weak regulation and toleration of corruption, with potential adverse consequences for foreign investments. But on the whole, it is clear that Parmalat is not simply an Italian affair – it reflects a general malaise and deficiencies in corporate governance.

Royal Dutch Shell

Royal Dutch Shell is one of the world's largest oil companies. Till recently it was one of the world's most admired companies and it used to like to boast about its technocratic and managerial excellence. The company is a 60:40 amalgam of Royal Dutch petroleum and Shell Transport and Trading, which together own the many Shell operating companies around the world. Admirers say that this structure generates a need for consensus decision making, which is well suited to a firm with a 50-year planning horizon, and that while decisions may take longer to reach, broad agreement usually results in quicker and better execution. But many critics argue that the firm's governance structure is antiquated and badly designed. It has two separate boards of directors, and at group level, the group head is a chairman of a managing committee of six managing directors and he is not a command and control boss. The firm also does not have a consistent global process for measuring and categorising reserves with each business using its own approach. At rivals like British Petroleum, global processes have been the norm for the last 15 years.

In January 2004, Shell was force to reclassify a fifth of its 'proven' reserves. Such a large reclassification is unprecedented in the history of the oil industry. Some Shell managers attribute this denouement to 'technocratic hubris', while other analysts put it down simply to fraudulent accounting. It is argued that the former chairman of Shell, Philip Watts, deliberately inflated the reserves figures, ignoring the increasingly strict rules of the US SEC about booking reserves, taking full advantage of Shell's own, loose guideline to conceal disappointing exploration results so as to obtain the top job himself (The Economist 2004d). Shell's internal report into this fiasco paints a picture of deception and backbiting at the top, which could end up encouraging shareholder lawsuits and possibly criminal prosecutions.

In the mid-1990s, Shell was finding it very hard to replace the oil and gas reserves that it was pumping out of the ground. During 1997-2001, when Phillip Watts was the head of Shell's Exploration and Production (E&P) division, the firm inflated the reserves that it reported to the SEC as 'proven'. The SEC defines proven reserves as reserves that the company has firm plans to get to the market quickly. Shell now has only 14.5 billion barrels of proved oil and gas, which represents about ten years' worth of production. In contrast, British Petroleum has 18.3 billion barrels (enough for 14 years of production), while Exxon Mobil has over 21 billion which could keep it going for a bit longer than BP. For years, Shell has been falling behind its peers in reserve replacement and reporting fraudulent numbers to hide this fact. The awkward bi-national structure, with two weak boards and a committee of managing directors leads to an inward looking bureaucracy that breeds arrogance and creates conditions where few questions are asked, making deception easier. Walter van de Vijver (recent head of Shell's E&P) wrote an extraordinary email to Phillip Watts (ex-chairman) in November 2003 saying: 'I am becoming sick and tired about lying', fuming that he was tired of covering up for shortfalls in the group's reserves, that resulted from "far too aggressive/ optimistic bookings", mostly made by Phillip Watts who preceded him as head of E&P (The Economist 2004d).[4]

These oversights have led to lawsuits in the US suing Shell on the grounds that this massive deception harmed shareholders and severely overstated the firm's market value. Other class action suits are being prepared for purported malfeasance and the US Sec is also likely to investigate the matter. Phillip Watts, long seen as arrogant and aloof, brushed of allegations of wrongdoing or incompetence, but he was sacked and replaced by Jeroen van der Veer in 2004. Shell memos (dated 2002) leaked to the SEC contend that Watts knew about the deception, but more seriously for Shell they also suggest that van der Veer may also have known about the miscategorisation (The Economist 2004c).

In the Shell case, there are two important differences as compared to Enron. Shell's shifting of reserves from 'proven' to 'probable' cannot compare with the phantom profits and bogus assets declared by Enron. The oil and gas actually still exists and Shell still owns them as real usable assets. Probable reserves are simply not as close to commercialisation for Shell to consider them as 'proven' under SEC rules,

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[4] Phillip Watts was the head of Shell's operations in Nigeria in the 1990s, when Shell was under fire for its environmental record. At that time it also faced allegations of causing severe pollution there. To make matters worse for Shell, the Nigerian government executed Ken Saro-Wiwa, a political activist who had consistently criticised Shell's Nigerian policies (The Economist 2004g).

but they are likely to get to market with a time delay. Probable reserves are still assets but not as valuable because of the lower certainty. In fact, in Canada and Australia, oil firms routinely book both proven and probable reserves. Share prices in Shell have recovered after an initial sharp drop. Secondly, Shell takes great pains to emphasize that none of its financial statements have been restated, even though it is undeniable that the firm has restated data of great importance to investors. There is no accounting black hole, or misappropriation of funds. The real damage is to Shell's once stellar reputation.

5. Conclusions

This paper provides an analysis of the functioning of the corrupt corporation within a Galbraithian framework. The Galbraithian notion of a corporate technostructure and the forces and processes that can lead to corruption within the technostructure, and eventually the firm itself, are examined in some detail. The Galbraithian framework also provides us bounds within which to consider the larger issue of corruption, and it distinguishes our paper from previous work which is largely confined to corruption in the government sector, state bureaucracies and in public sector procurement. We distinguish between competitive neoclassical-type firms (small and medium enterprises (SMEs)) on the one hand and large and giant corporate entities on the other, and analyse the incidence and motivation for corruption within both these groups. This paper deals mainly with corruption in the corporate sector which is revealed to be greatly more complex than the case of SMEs. These differences are based on institutional and informational factors. We also employ insights from legal theory to assess ownership and the consequent implications for the well-known principal agent framework. Ownership status, the presence of multiple principals and common agency problems are examined in detail. This allows us to set out the conditions and cases where corruption can be seen to be facilitated in the presence of different types of ownership and informational patterns. The specific cases relating to informational asymmetries and the role of transaction costs are examined in detail.

We then proceed to provide a typology of corrupt practices in the corporate sector. We distinguish between three ‘types’ of corporations: (a) non-corrupt corporations; (b) non-corrupt companies with corrupt individuals; and (c) corrupt corporations. Type (a) companies are those emphasised in much of Galbraith’s writing. In general terms such companies can be described in terms of high degrees of organisational effectiveness. We proceed to assess type (b) and type (c) corporations in detail setting out the role of organisational effectiveness, coherence and objectives combined with the creation and prevalence of incentives (including perverse incentives). Such an analysis enables us to present a simple taxonomy of corporate effectiveness based on an examination of a firm’s organisational objectives in relation to its organisational coherence.

We examine links between corporate structure and the corporate technostructure explicitly. A key implication of the dominance of the technostructure is that within it the nature of individual motivation changes as a result of which compulsion and pecuniary motivation are downplayed, instead identification and power seeking become more significant. An effectively functioning corporate bureaucracy requires that compulsion and pecuniary motivation become subordinate to identification and power seeking. Effectively functioning here means effectively exploiting specialist technical and human knowledge. Dysfunctional corporate objectives that underpin corrupt practices mean that financial objectives and compulsion become dominant compared to identification and power seeking. As a result corruption implies an undermining of technostructure functioning. The conclusion is that corrupt practices are likely to have no long-run viability except in circumstances in which the corruption involves state protection.

We look at these issues more formally within the framework of Sen's paradox. It is shown that in any organisation with minimal delegation and unrestricted preferences there are always some combination of individual preferences that can either lead to intransitivity or inefficiency in group choice. These aspects are considered within a more formal setting involving teams and the effectiveness of incentive schemes.

We examine the case of Enron, Parmalat and Royal Dutch Shell corporations as recent examples which have involved a consideration of the many issues that have been developed in the first half of this paper. These well known cases of corporate corruption have been associated with lack of transparency, inadequate disclosure of accounts, withholding of information from shareholders and regulators, collusion between banks, firm management and auditors, and spectacular financial disasters. The role of perverse incentives and the operation of cartels and informal collusive networks have undermined the operation of firm technostructure for each of these three firms, and many of the factors and processes which led to undermining these firms are of global import and international significance.

An examination of these cases reveals to us the complexity of the legal and regulatory reform required to reduce such instances in the future, as well as the crucial role of informational, institutional and strategic factors in engendering corrupt practices and the scale of the task confronting those who are attempting systemic reform. In our future research, we intend to carry out a more formal analysis in a well defined mathematical framework, in order to analyse the role of incentives, teams and problems relating to multiple principals and multiple agents within a framework consistent with that developed here.

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