THEORY AND REALITY IN FINANCIAL ECONOMICS

Essays Toward A New Political Finance

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Foreword

It is quite unusual to see the words "theory" and "reality" together in the title of a book on financial economics. It is even more unusual to see the word "political" in its subtitle. For most finance professors, reality is something you use to test your theories, but the theories themselves are deliberately unrealistic. And if the theories are not consistent with reality, the blame falls on reality and not on the theories. Politics is something that impedes the efficient functioning of markets, which, if left to their own devices, will deliver the greatest good to the greatest number of people.

George Frankfurter is uniquely qualified to challenge these conventional views. His distinguished academic career has given him a thorough background in the theories that form the foundation of financial economics. Unlike most of his professional colleagues, however, he has not hesitated to expose the cracks that would topple large parts of the structure were it not for a quasi-religious faith in the feats that rational economic men are capable of accomplishing when they are given free rein in free markets. He has not been afraid to confront the academic publication and promotion system that ensures no one is allowed to question the real issues too closely.

George is one of the few financial economists who has a sufficiently broad perspective beyond the campus to see how this faith not only props up academic theories, but also sustains a form of elite capitalism that serves its masters and their political allies better than it serves the rest of us. Any number of astonishing deceptions and disturbing inequities are excused as the inevitable consequences of a competitive market.

Since Microsoft has acquired an overwhelming dominance in the market for personal computer operating systems, it must be as a result of superior innovation and performance. Since for-profit universities are successfully making money selling degrees, they must be the best means to create an educated and engaged citizenry. Since Enron's stock price was soaring, it must have represented the future of the nation's energy management. And if we couldn't believe their auditors — the venerable Arthur Andersen — that all was well, then who could we believe?

It seems so obvious, then, that if we want to ensure adequate medical care for everyone, insurance and healthcare companies will take care of it. If we want to enhance the nation's security through energy independence, oil companies will create the alternatives to imported petroleum. If we want to eliminate poverty, there are small businesses desperate to hire the poor at the right wage. Through the magic of free markets, everyone can make money and build a just and equitable society at the same time.

Not content to just expose what has gone wrong, George is able to suggest reforms to both the academic and the political-economic systems that might make markets truly efficient. Fair, not just free, markets are capable of giving us greater wealth and freedom in many ways — not just the freedom to become wealthy by purchasing stock that we hope to sell to someone else for a higher price.

Professor Elton G. McGoun
William H. Dunkak Professor of Finance
Bucknell University

Prologue

> The animals that depend on instinct have an inherent knowledge of the laws of economics and of how to apply them; Man, with his powers of reason, has reduced economics to the level of a farce which is at once funnier and more tragic than Tobacco Road.
>
> — James Thurber[1]

Political finance? As in "political economy"? Who in his right mind would conjure up such a thing? The short, barely six-decade history as an academic discipline of what is called finance that later distinctively changed to "financial economics" or "modern finance" has been ruled by Friedmaninan instrumentalism (Friedman, 1953) and neoclassical economic dogma. Its elite vehemently argue that financial economics is value-neutral, ergo it is not and cannot be influenced by politics that is by definition ideology-laden.

If one subscribes to the notion that nothing that humans do is value-neutral, but rather based on ideology, be it creed, religion, politics or self-promotion, then one must consider financial economics' claim to value-neutrality as a farce at best and disingenuous at worst. Thus, modern finance[2] just might be a ruse with which academic research (what can be thought of the ontology and epistemology of the field) masquerades as an imitation of the natural sciences. Consequently, it is busy developing models and explanations — the more complex, the merrier — that fit compactly within the confines of equations and statistics, instead of dealing with economic realities that are suffused with politics.

This logic is to make sure that the movers and thinkers of academe will debate forever whether one paradigm or another can be supported by empirical evidence without the possibility of ever reaching a definite conclusion. It also ensures that finance academics are not engaged in the

[1] *The Columbia Dictionary of Quotations* is licensed from Columbia University Press. Copyright © 1993, 1995 by Columbia University Press. All rights reserved.

[2] I am using the term modern finance interchangeably with the term financial economics, as many of the practitioners of the latter argue that the two are one and the same.

process of discovery, the ultimate goal of science, because such process might bring an end to the ideology that rules the field.

This is why, for instance, academics in the finance discipline have been pondering close to 40 years the question of whether markets are efficient, and if yes, then to what degree. Informational market efficiency[3] was enshrined in Fama's efficient markets hypothesis (EMH) (Fama, 1965, 1970) as a quasi-religion and later was assigned three distinct forms:

- the weak;
- the semi-strong; and
- the strong.

The consequence of the EMH is the perception that markets are omnipotent (*de facto* the avatar of God), and Pareto optimal. So, anything that would replace them would be a deterrent to the welfare of some and possibly everyone without leaving anyone better off. This notion, lately, found for itself several new euphemisms for the benefit of the common man, the most popular of which are "free markets," "globalization," "new/space age," "the new world order," etc. Accordingly, everyone who sets out to interfere with the market, especially a government, is doing a disservice to any given society, and possibly to humankind as well.

Those who doubt my contention here that modern finance is ideology-laden are advised to read Frankfurter and McGoun (1999). If after doing so the reader is still convinced that financial economics is "pure science," although there is no such thing even in the natural sciences, then this manuscript is to serve as an additional charge to the contrary. I will argue, in the hope to convince the convincible skeptics,[4] that the financial world which financial economics tries to understand, explain, forecast and fashion is infused with politics to the point where the boundaries between economics and politics are totally muddled. Thus, finance as a discipline that is ideologically driven cannot possibly understand, explain, forecast and fashion this world.

[3] There are two other qualifiers of efficiency: liquidity (how fast the market can find a buyer for an asset), and allocational (how well the market allocates capital where it does the best). However, here as almost everywhere else I am dealing with informational efficiency only: how well prices reflect value.

[4] I learned that where beliefs are based on deep ideological convictions, no argument, fact or evidence would change the mind of those who, because of this deep ideological belief, will not accept anything inconsistent with their values.

Not that it ever wanted to, either. Fama (1998) argues that the EMH cannot even be criticized until or unless a better and more complete paradigm is proposed to replace it. This is in complete contradiction of Karl Popper's heeding that "the beginning of science is myths, and the criticism of myths." For how can we come up with a better paradigm than the EMH if one cannot criticize the EMH without offering a better paradigm?

One must also recall that the EMH is there because it was the first to arrive, and not because it unseated an inferior paradigm that preceded it.

To make my point, first, I let others speak for me. An editorial of *The Washington Post* that appeared in late May 2002, titled "After ENRON", has this to say:

> The past decade has been a strange, split-screen kind of period. On your left screen there was America the superpower, which triumphed over communism, created a new realm called cyberspace and outpaced rivals in Europe and Japan. On your right screen there was America the scandal power, plagued by an explosion in political money and insider lobbying and a decline of trust in government. Throughout the 1990s, these two screens seemed separate. But the Enron scandal, starring a firm that symbolized both America's economic dynamism and its political cronyism, brought the screens together. It showed how lobbying and campaign money can damage the economic system.
>
> This is why the Enron scandal is so potent. Its many tentacles are united by a sense that rich insiders are rigging the system at the expense of ordinary Americans. Enron's energy dealers ripped off California's consumers and got away with this behavior because of Enron's clout in Washington. Wall Street's analysts cynically promoted Enron's stock to unsuspecting investors because they coveted fat investment-banking fees — and got away with this conflict of interest because lobbyists and campaign dollars kept the regulators soft. Capitalism rightly rewards people who make life better by providing goods and services. But when rewards are distributed according to insider influence, that is cronyism.
>
> Accounting is where the economic costs of cronyism are potentially highest. Since the 1970s, the accounting lobby has fought off regulation and squashed opposition to its consulting ambitions — despite the fact that those ambitions sometimes turned outside audits into insider shams. As a result, corporate accounts have been distorted — in Enron's case, spectacularly, and investors are hard-pressed to know which companies deserve their money. Capitalism defeated communism partly because the apparatchiks directed savings to the wrong places. When cronyism undermines the information that investors rely upon, it damages capitalism's central nerve.

Then, the column goes on to describe how the Republican Party and the administration leaves the cure for the disease threatening capitalism's "central nerves system" to industry itself, as opposed to a Democrats' sponsored bill. The editorial makes the point that

> . . . the bill crafted by Senator Paul Sarbanes, Democrat of Maryland, is so important. Unlike the sham alternative backed by Senators Phil Gramm, Republican of Texas, and Michael Enzi,[5] Republican of Wyoming, the Sarbanes bill offers most of what is needed to make corporate numbers meaningful. It guarantees the financial independence of the accounting standards board, thus shielding it from moneyed lobbies. It creates a new regulatory board to watch over auditors, one that would be genuinely independent of the profession. It goes part way toward curbing auditors' conflicts of interest by banning some types of consulting.

The column concludes by making it clear what constitutes a better-informed market, and, consequently, better-informed investors, *vis-à-vis* the *laisseze faire* claims, and who sides with which:

> Now, precisely because Sarbanes has proposed tough legislation, the accounting lobby is pounding him. This week Thomas Donohue, president of the US Chamber of Commerce, sent out a letter accusing Sarbanes of a "knee-jerk, politically charged reaction" to the Enron scandal. But strong accounting reforms are not, as Donohue alleges, a threat to "informed market decision-making." On the contrary, they are a prerequisite for functioning markets. It is precisely because public policy ought to be pro-market that it must not be pro-business — not if pro-business means allowing companies to distort the accounting information upon which healthy capitalism depends. Lobbies such as the Chamber of Commerce appear to have lost sight of this, promoting cronyism in place

[5] NPR's Scott Simon, in an interview broadcast on July 13, 2002, asked Senator Enzi, who is the only accountant by profession in the Senate, whether he thought that the crisis in corporate America is endemic, or just a "few bad apples." Mr. Enzi replied that he thought it was the latter. He also indicated that shareholders were shirking their responsibilities. Quoting his father's wisdom, the Senator remarked, "If it looks too good to be true, it probably isn't." This is, of course, the well-known *caveat emptor* principle, which in this context and coming from an accountant sounds strange. How can the shareholder do his/her research when the data coming after certification by an independent accountant are fraudulent or other relevant information is dated? But one must know that Senator Enzi is coming from those politicians who, after 99 percent of the wealth of the nation is securely at the hands of the top 1 percent, would still ask for tax cuts to fix all our woes.

> of capitalism. Those who care about the public interest have a duty to fight back.

For five decades, untold generations of business undergraduates and MBAs were raised on the religious belief that markets see all, know all and do all, and therefore one must keep the dirty hands of government away from them. Of course, it has been nothing less than a carefully nurtured myth, bolstered by corporate America and its support of research that "found" evidence to this "market efficiency" (see Soley, 1995), all the while making the rich richer, the big humongous, and the powerful mightier.

There is no research in existence that would deal with the fact that markets cannot be "efficient" because they are manipulated on a grand scale. This objective would be quite different if addressed seriously than the proof or rejection of the EMH. Depending on how one is slicing, dredging, sifting and otherwise manipulating data, one can prove either one of the two contentions. The untold numbers of papers in the milieu of "anomalies," work that show the existence of real or conjured effects, are no chinks in the EMH's armor. They are called no more than anomalies and treated as such. One can make notice of these without worrying too much, or God forbid, considering the replacement of the paradigm.

Indeed, the history of the "anomalies literature" is over 30 years now. It is still going strong, yet has not changed a thing as far as the paradigm goes.[6] As early as 1978, Ball (1978) allayed the doubts of the would-be-bothered by anomalies:

> There is nothing that necessarily should be done because as argued by Kuhn (1969 *sic*),[7] no area of normal science can justify chasing all anomaly at the expense of more fruitful research. The one proviso is that, if the anomaly is judged to be sufficiently large to hinder normal research, then it must be resolved (*ibid.*, p. 117).

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[6] This is in spite of the rumors floating around about how people actually made a bundle by exploiting these anomalies. If the rumors were true, then these alone should call into question market efficiency. For if one can take advantage of the anomalies, how come many others do not? Taking advantage of market imperfections is the driving force behind the arbitrage mechanism, the *deus ex machina* of modern finance that is always there when needed, yet never proven to exist.

[7] The reference is to Kuhn's *The Structure of Scientific Revolutions*. The first edition was published in 1962. The second edition that is usually quoted was published in 1970. In either case, Ball's reference is incorrect.

Without going into questioning what is "normal science" and "normal research" (as opposed to what? crazy science or crazy research?), it is sufficient to say that up to this very day no anomaly was "judged sufficiently large."

This treatise is a collection of 13 essays written in years 1999 through 2006, a prologue (you are reading, momentarily), an epilogue, and afterword. The first five essays are general in nature and deal with issues of the methodology of financial economics and its relation to neoclassical economics, the meaning of "market efficiency," and what other theoretical development in 21st century economics would be relevant for finance, albeit do not seem to purchase a foothold. To close out the somewhat more academic tone of this part of the book, two papers dealing with the academic publication process in finance explain, among other things, how editors and editorial boards control what is to be known, and what in fact more than half a million journal pages of half a century show, or do not show.

The first essay in this monograph deals with the methodology of financial economics/modern finance. It compares the methodology to a ziggurat, built on layers, each layer being solidly anchored to the one below it. In the ancient ziggurat, at the bottom as well as at the top there was a temple, yet the real purpose of the ziggurat is still shrouded in mystery. I argue in this essay that finance research mistakes method for methodology, where by sheer formalism one can forget about the philosophical underpinnings of what one is doing. The methodology and this blurring of the difference between method and methodology also serve as a vehicle to perpetuate the paradigm. The case in point I am discussing in this essay is the CAPM (Lintner, 1965; Sharpe, 1964; Black, 1972; and others), and its relation to the EMH to perpetuate the myth of market efficiency.

The second essay titled "What is All Efficiency?" deals with the concept/theory/hypotheses of market efficiency. With the simple possible storytelling and images, I am trying to clarify that market efficiency, although heavily ideology-laden, is just an imaginary construct that has nothing whatsoever to do with reality.

The third essay titled "Still Autistic Finance" compares and contrasts perhaps the most important development in teaching and research in the field of economics — the emergence of Post-Autistic Economics, or PAE for short. Following the call of a group of French students for a departure from the hegemony of neoclassical economics, students at Cambridge and later in the USA started a worldwide movement to make economic teaching and research more meaningful. Thus, a new movement got its start at the dawn of the third millennium that calls itself Post-Autistic Economics. In this essay I discuss the meaning of this movement for the methodology of finance and how one should hope that it would create a change in thinking of financial economists as it did in the other branches of economics. Or perhaps not?

The fourth and fifth essays in this book, titled "The Young Finance Faculty's Guide to Publishing" and "Prolific Authors in Finance," respectively, are about the publication process in academic finance. Contrary to naïve beliefs that ascribe to academe purity and impartiality, the publication process in the academic finance journals is very much ideology-driven. It is decidedly not designed to further the true mission of academe, which is discovery, but rather to safeguard an elite from any serious challenge as a result of redirecting the research program. The process is also very much influenced by the sociology of the field, where one's economic and reputational capital is almost totally dependent on one's publication record.

The next section is a collection of six papers dealing with the influence of politics on what should be, supposedly, a pure economic process. The first essay is about for-profit higher education. In the paper I discuss the perils of merchandising higher education: its effect on the real knowledge that is imparted on those who seek their degrees through these enterprises, and what it will or could do to academic freedom.

The next article, titled "Weep Not for Microsoft: Monopoly's Fatal Exception," is about the monopoly case the justice department brought against Microsoft, its resolution and what society is losing by supporting an enterprise that is peddling an inferior product by the crudest tactics of a ruthless monopolist.

The last four essays in this section are about the Enron scandal and its aftermath from different points of view. With these four essays I hope to bring to the fore the connections between ideology and reality, and between reality and politics in and of finance. If I were Henry Kissinger (who I am not), I would call it the *realpolitik* of financial economics. Instead, I call it *schlichtfinanzen*, which translates to simple finance, because instead of complex mathematics and sophisticated econometrics it reveals what finance *simply* is.

The belief in market efficiency as a dogma that had not been shaken by the market crash of 1987 that was, the crash of the market in 1998 that wasn't, the techno-bubble burst of Spring 2000, and the finally officially-confirmed economic recession of 2001, as it has been shaken by the Enron debacle, and its many tendrils that are being discovered as time goes by.

The first of the Enron "trilogy" is titled "The Socio-Economics of Scandals." I started thinking about the issue at the encouragement of Professor Manfred Holler of the University of Hamburg. I was sure that Manfred was joking when he asked me to write about the subject. The issue came about with the collapse of @home.com, the fast Internet service provider that turned to dust as it bit the dust. The demise of @home.com was because some of its partners wanted it to fail, so they could pick up the pieces at fire-sale prices. The end result was thousands of people out of their job, while some executives made a bundle. By that time, the Enron debacle was going on full force, with the possibility of tens of thousands of employees from both Enron and Arthur Andersen losing their livelihood and their retirement investment. The paper is about the paradox of not caring about the working man when mega-firm power plays cause thousands to lose their jobs which we call downsizing and mergers and acquisitions, yet trying to save a failing firm whose executives are caught with their hands in the cookie jar.

In this essay I also introduce the concept of "fair markets," to replace the myth of efficient markets. Fair markets are markets built on the tenets of Judeo-Christian ethics in which the weak is protected so as not to fall prey to the asymmetry of power that would give a distinctive advantage to the mighty.

The second member of the Enron trilogy is about what I call the "Enron encounters of the third kind." Its title, "Desperately Seeking Toto," reflects on the fact that because of politics and ideology, we are supporting a world not unlike the one created by the Wizard of Oz. Because Enron was a champion of the idea of free markets, all the while rigging the energy markets that turned to be devastating to the State of California, and using both unethical and illegal means to line the pockets of its chief executives, an administration sympathetic to these ideas and the real money that flew into its political coffers not only turned a closed eye on Enron activities, but practically let Enron dictate energy policy for the nation. Nevertheless, I point a finger at a special cabal of operators who enjoyed monetary benefits from furthering Enron's objectives, without taking any real risk of monetary repercussions, loss of reputation, or credibility. This kind of tradeoff, "reward without risk," cannot conceivably exist under the logic of neoclassical economics.

The last essay of the "Enron kind" is about free-marketism turning into a religion with its ceremonies and rituals, not unlike those of the Catholic Church during the period of the inquisition. The title, "And Now for Something Entirely Different," (admittedly borrowed from *Monty Python's Flying Circus*) is to refocus our thinking about globalization, the new world order, the new age, etc., in terms of a religion. This is the case of trying to save Andersen LLP, the CPA firm of Enron, from criminal prosecution on charges of obstruction of justice, with the help of one of Wall Street's "saints," former Federal Reserve Board chairperson Paul Volker. It is not the deeds of Andersen that should or should not be judged, but the purity of the man who is taking the side of a repentant sinner. The moral question of Volker's involvement is also discussed in this essay.

Following the Enron trilogy is what the post-Enron "cat dragged in." Many of the scandals that got their well-deserved limelight were already brewing before the Enron fiasco superseded our war on terrorism. Yet, on the coat-tails of Enron, these scandals — fleecing shareholders; falsifying corporate financial statements; insider trading; investment bankers grossly misleading, indeed, mocking investors — became a major source of devastating loss of nominal capital of the financial markets. It also reflects rather poorly on a president whose attempts, which are long on macho rhetoric but short on substance, are designed to calm investors and markets. This is a president who may be culpable of all the accusations leveled against top corporate executives today, when he was one of them. It rings hollow when he labels these executives today as corporate criminals. No wonder that markets do not take seriously his calls for new morality, and they keep following their downward spiral.

The penultimate essay is the scrutiny of the idea, propagated first by Friedman (1962, 1983) that freedom and democracy is possible only under the social order of capitalism. Because of the gross disparity of allocation of wealth and income pronounced especially during the turn of the century, American society is giving up more individual freedoms, and ultimately a democratic form of government one could have envisaged only under Stalinism.

Finally, one cannot escape the label "bleeding heart" without providing an alternative to the now ruling research program. In the last essay of this anthology I offer a new avenue of research, which perhaps is not a completely defined and focused paradigm, nevertheless represents a start of a journey of new empirical research that, eventually, might cause something of a “paradigm shift.” The title of this paper is “The Theory of Fair Markets (TFM): Toward a New Finance Paradigm.”

The epilogue is my pondering whether a change, even a marginally significant one, could come, especially in the ways and means of academic research. I am very sorry to conclude the collection on a not necessarily encouraging note.

In closing this introduction, a few words of well-deserved gratitude are in order. The first in line is Ms. Yvonne Lewis Day whose magnificent editing work gave true expression to my thoughts. Elton McGoun is by far the person from whom I have learned the most and I hope will keep on teaching me for many years to come. A thousand thanks, Skip.

There are many others to whom I am thankful, but do no want to mention by name, because they might be found guilty by association with a heretic. There is one, however, I am eager to mention by title, if not by name. I am grateful to my former dean at the E.J. Ourso College of Business Administration, Louisiana State University, who was too stupid to understand that progress in science as well as in anything else comes from nonconformists, but smart enough to make my life unbearable as to opt to retire. This gave me all the freedom and time to work on what follows herein.

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