Waving Goodbye to the Invisible Hand

What Enron teaches us about economic system design

BY MARJORIE KELLY

Sometimes it's the little things that say it all. With Enron what lingers is the story of the company's creation, when the original plan was to call it Enteron—until somebody figured out this was the Greek word for "intestines." There you have it. In the end, the story of Enron's implosion is not about one diabolical company. It's about the guts of our economy.

It's about many gut-level issues confronting us: corporate control of politics, executives getting rich while their company sinks, employees laid off by the thousands, 401(k) plans tanking, messes left by deregulation, a corporate board asleep at the switch. All are themes in the Enron soap opera, yet not one is unique to Enron. The problems the scandal reveals are systemic. The individuals involved may have been uniquely greedy and unethical, but they were empowered by a system that exalted greed as it diminished ethics and accountability.

The most basic issues of Enron are system issues. These come down to two, not unrelated truths:

1) The ideal of the unregulated free market is flawed, and it's time we said goodbye to the invisible hand.

2) Managing a company solely for maximum share price can destroy both share price and the entire company.

These are foundational flaws in economic theory, flaws in how we conceive of markets and how we define business success. They are system design flaws. For beyond the juicy tales of villainy at Enron, the deeper issue is why the system lent so much power to villainy, and why there were so few checks and balances to stop it.

A key reason is that we are told—and, more incredibly, believe—that checks and balances are bad, because free markets are good. Unregulated markets are ideal. Left free to work its magic, self-interest (i.e., greed) ostensibly leads things to work out to the benefit of all, as though guided by an invisible hand. This myth is taught in Economics 101 as gospel truth, trumpeted routinely in the business press, and sold abroad as the cure for what ails all economies.

The lie of it has been exposed many times. Think of the Great Depression, the savings and loan crisis, or the collapse of Asian economies in 1997–98. Unregulated free markets often lead to disaster. Self-interest is an insufficient regulator for a complex economy. Yet we seem to have to learn this lesson again and again.

Enron is the latest case in point. Consider California's experiment with electricity deregulation, which as Sen. Barbara Boxer said, left the state "bled dry by price gouging." As CEO of Enron, Jeffrey Skilling had predicted deregulation would save California $9 billion a year. But as Boxer noted at a Senate hearing, the state's total energy costs soared from $7 billion to $27 billion in a single year. Prices rose a gut-wrenching 266 percent.

Not coincidentally, Enron's stock shot up. Total return to shareholders in 1998 was a remarkable 40 percent. The next year, a miraculous 58 percent. And in 2000, a jaw-dropping 89 percent. Deregulation did indeed work the magic it was designed to work, by turning Skilling's stock options into a gold mine. Just before the company was turned into rubble.

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California wasn't the only one duped by the magical thinking of deregulation. Enron helped convince Massachusetts, New York, and Pennsylvania to deregulate energy markets. And it did the same with Washington.

In 1993 Enron persuaded the SEC to grant it an exemption from the Public Utility Holding Company Act (PUHCA), a Depression-era law that prevented utilities from diversifying into unrelated risky businesses. Enron pursued this diversification, to its disaster. As Rep. Ed Markey (D-Mass.) put it, "If Enron had been regulated under PUHCA, I seriously doubt that the types of transactions that brought this company down would have occurred."

Strike two against the myth of deregulation came in 1997, when the company won exemption from the Investment Company Act of 1940, allowing it to leave debt from foreign power plants off its books. This led to dubious offshore partnerships, which contributed to the firm's undoing.

Strike three came in 1999, when Congress killed the Glass-Steagall Act of 1933, which had separated commercial from investment banking. This allowed J.P. Morgan, to use one example, to entangle itself with Enron in conflicts of interest. It underwrote bonds for Enron, traded derivatives contracts with the company, bought stock in the firm, and had a research analyst covering the company (recommending it as a buy until last fall), even as the bank risked billions in loans to Enron. Lured by millions in investment banking fees,

J.P. Morgan was left holding the bag on $2.6 billion in Enron debt. Glass-Steagall would have prevented that.

One could go on. Enron successfully opposed regulation for derivatives trading, then used such trades to mask debt. Arthur Andersen helped defeat a proposal to separate auditing and consulting practices, which left it reluctant to challenge a client. Businesses opposed truthful accounting for stock options, which led executives to deliberately inflate stock prices.

Piece by piece, protections that might have prevented the debacle were defeated. Layer by layer, existing protections were removed. The result was the train wreck of Enron.

What's astonishing is not that this wreck occurred, but that we bought the deregulation myth that led inexorably to it. We swallowed this fairy tale about some invisible hand.

An earlier generation wasn't so credulous. Those who lived through the Depression saw the absurdity of economic faith healing ("only believe in free markets and all ills shall be healed"). Even the editors of *Fortune* magazine acknowledged, in a June 1938 editorial, that what failed in the Depression "was the doctrine of laissez-faire." They wrote, "Every businessman who is not kidding himself knows that, if left to its own devices, business would sooner or later run headlong into another 1930."

Or an S&L crisis. Or Medicare fraud. Or Enron.

As though under mass hypnosis, we deny what we know in our gut: laissez-faire theory is a hoax. Why were there so few checks and balances to stop villainy at Enron? Because economic theory pretended we didn't need them. We believed the hucksters who sold us the elixir of unregulated markets.

Of course, unregulated markets are never really unregulated. Complex economic interactions need rules. The question is who makes those rules: elected representatives serving the public good, or a financial elite serving itself.

With Enron, the rules were made by folks like CEOs Skilling and Kenneth Lay, chief financial officer Andrew Fastow, and other financial elite. Like all elites, they preferred to run things without public oversight. This is why the invisible hand keeps rising out of the grave. Free market mythology is a smokescreen that disguises the real nature of elite power—like the divine right of kings. It allows elites to run our economy with a veneer of legitimacy.

Which brings us to our second question about Enron: Why did the system design lend so much power to greed? Because doing so was in the interest of the financial elite, including executives and Wall Street. Lay and Skilling both were "laser-focused" on shareholder gain, which led to their own option gains. They succeeded at this so well, few asked any questions. Sherron Watkins wrote Lay but was brushed aside. Why disturb the goose laying the golden eggs?

In the wake of Enron, some have called for closer alignment between executive and stockholder interests. But this close alignment was itself the problem. When we define business success as maximum share price, a soaring price makes it impossible to see problems. What could be wrong? The business is succeeding beyond anyone's dreams.

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But managing a corporation with the single measure of share price is like flying a 747 for maximum speed. You can shake the thing apart in the process. It's like a farmer forcing more and more of a crop to grow, until the soil is depleted and nothing will grow. Or like an athlete using steroids to develop muscle mass, until the body's health is damaged.

Enron's problem was not a lack of focus on shareholder value. The problem was a lack of accountability to anything except share value. This contributed to a mania, a detachment from reality. And it led to a culture of getting the numbers by any means necessary.

If maximum share price is an irresponsible management theory, and deregulation a flawed economic theory, there are better theories already at hand. It's intriguing that the movie "A Beautiful Mind" won an Academy Award during the Enron scandal—because its protagonist John Nash won a Nobel Prize for proving Adam Smith's theory was incomplete. Self-interest alone can lead to disaster for all, Nash demonstrated. Self-interest coupled with concern for the good of the group is most likely to lead to the benefit of all.

Nash's mathematics revolutionized "game theory" and is now central to "evolutionary economics," which emphasizes that cooperation is as vital as competition. It's a more evolved theory than the invisible hand, more appropriate for an economy that has become more humane than the aristocratic world of Smith.

Viewed through the lens of Nash's theory, the Enron scandal can lead us to question our fundamental assumptions. Do we believe corporations are *only* about making money? Or do we care *how* they make their money? Do we care about ethics?

If we do, then we need real accountability. We need actual sanctions for ethical infractions, not a flimsy ethics code that the Enron board could waive without penalty, as it did in allowing Fastow to earn millions from off-balance sheet partnerships.

We need checks and balances not only on the side of shareholders, but on the side of public accountability. That means changing the system design. The best way to do so is to introduce graduated penalties for unethical conduct. Firms caught cooking the books might lose all government contracts. A federal contractor responsibility rule could prohibit the government from contracting with egregious corporate lawbreakers. Such a rule was put in place by President Clinton as he left office, but was overturned by President Bush. It should be made permanent through legislation.

If Enron had faced the prospect of losing millions in revenues, it wouldn't have waived its ethics rules so blithely. Watkins might have been empowered to approach the board, and the board might have been inclined to listen—since financial consequences were at stake.

A more serious penalty was suggested by a state attorney general, who recommended pulling the license of Arthur Andersen to do business in Connecticut. If all corporations knew they faced this ultimate sanction, they would be less inclined to push the limits. We would start to see ethics with real teeth.

The ultimate lesson of Enron is that system design requires our conscious choice. It cannot be left to some invisible hand. It's time we sent that creepy appendage back to the grave where it belongs.