

## **WHAT THE SCANDALS REVEAL: A STRONG ECONOMY**

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The corporate misdeeds during 2002 that involved misleading accounting, false information, and unethical behavior by some executives were deeply embarrassing to American business. Europeans delighted in this apparent indication that American-style competition was inferior to their consensus capitalism. These scandals are deplorable, but in an unexpected yet instructive way they demonstrate the underlying strengths of the U.S. economy.

The collapse of Enron, WorldCom, Global Crossing, and other companies had a chilling effect on investments in equities and venture capital--and for a while engulfed the whole U.S. financial sector. Investors quickly avoided guilty companies and sometimes also innocent companies that happened to be in the same line of business. Arthur Andersen LLP, one of the world's largest and most respected auditing companies, has ceased to exist because of the transgressions of a few employees. Most of the executives responsible for the misdeeds had much of their wealth destroyed by sharp declines in shares of the bankrupt companies they so egregiously mismanaged. Criminal charges take longer to work their way to trial, but leaders of Enron Corp. and other companies may eventually serve prison sentences.

Laws already on the books, along with the financial markets' responses, seem to have been adequate to punish corporate fraud and misrepresentation. Many companies have reviewed and tightened when necessary their auditing and oversight procedures because they witnessed how the market pounded the stocks and hurt the borrowing of transgressors.

With hindsight, investors have concluded that corrupt companies are a small fraction of the approximately 16,000 publicly owned companies in the U.S. The vast majority have abided by accepted rules of corporate governance and of accounting, even though some accounting rules are quite arbitrary.

Placed in this context, the Sarbanes-Oxley Act on corporate governance and accounting appears to have been hastily passed by Congress and too enthusiastically greeted by President George W. Bush. This law requires audit committees to be entirely composed of outside directors and chief executives to certify personally that a company's financial reports accurately reflect its financial condition. It also establishes a Public Oversight Accounting board with vast but vague powers. Since Enron satisfied many of the requirements of this law, Sarbanes-Oxley probably would not have prevented the debacle at the company.

Moreover, an overly aggressive oversight board and the threat of criminal prosecution to CEOs are likely to make U.S. business leaders less flexible and more cautious. As a result, the law could have a chilling effect on risk-taking by CEOs and entrepreneurs--and

that would weaken the business foundations that have propelled the U.S. economy so far ahead of Europe's.

A marker of the economy's strength is its impressive performance in the face of so many traumas: the corporate scandals, the sharp decline in the stock market when the tech and telecom bubbles burst, and the terrorist attacks on September 11, 2001. The recession officially began, according to the National Bureau of Economic Research, in March, 2001, months before the World Trade Center attacks and the blowup of Enron, WorldCom, Tyco, and other companies.

Yet the downturn has continued to be mild, with two quarters of actual declines in aggregate output. Indeed, real gross domestic product grew by over 4% during the recently completed third quarter, up from a little over 1% during the second quarter. Other aspects of the economy are sluggish--unemployment recently hit 6% and may go higher--but not long ago, an economy was considered to be at full employment when jobless rates were 6%.

The downturn has been tame largely because of rapid productivity growth since 1995. While productivity usually falls in downturns because of excess capacity, it has continued to expand at an excellent pace, including during the past quarter. Since productivity is measured by the growth in output relative to the growth in labor and the real capital stock, this impressive performance isn't the result of slick accounting, the Internet bubble, or the general overvaluation of stocks.

Europe has not had as many accounting scandals or as much devastating terrorism, yet their economies have suffered more during this period. The U.S. economy has responded better mainly because fewer regulations and lower taxes make it more flexible and productive than Europe's.

The U.S. economy has shown its mettle with a surprisingly good performance in 2002, despite major shocks that would have brought most other economies to their knees. I am optimistic about the future, yet I am concerned that the new legislation on corporate governance and accounting will not help, and may seriously hinder, the efficiency and world leadership of the U.S. business sector.