IDEAS ON LIBERTY
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Enron Lessons

The Enron soap opera continues to unfold. And as it unfolds, lessons are being learned. Some people are learning lessons about the energy business. Some are learning lessons about the securities business. Some are learning lessons about the accounting business.

But some are not content to learn such narrow lessons. They want to look at the big picture. And so when studying Enron, they have learned the lesson that the invisible hand doesn't work. Or it doesn't apply any more. Here is Marjorie Kelly, cofounder and editor of the journal *Business Ethics*, on the Enron affair: "The ideal of the unregulated free market is flawed, and it's time we said goodbye to Adam Smith's 'invisible hand.'"

Numerous other writers have invoked the failure of the invisible hand to protect us from Enron.

When Adam Smith wrote about the invisible hand, he was referring to the effect of investors' putting capital into domestic industries in search of the highest profit. He argued that the desire to find the highest return on their money led to beneficial effects for society as a whole.

But what most critics have in mind when they invoke the invisible hand is something more complex. They are referring to the worldview that says that markets are self-regulating, that there are natural restraints on greed and dishonesty built into the market system.

I agree with that worldview. Let me flesh it out a little further. Those of us who are sympathetic to this view believe that human nature is self-interested. There are greed and even malice along with altruism and kindness. What is the best way to restrain that self-interest from being harmful? In the Smithian worldview, competition and market forces impose costs on dishonesty.

But that does not eliminate greed. It does not eliminate dishonesty. Even in a free-market system, there are con men and scams and products that are poorly made and even sometimes unnecessarily dangerous. The claim of the Smithian worldview is that such behaviors are hard to sustain. The market punishes dishonesty. The market drives out products that are mediocre or unnecessarily dangerous.

If the maker of a first-rate product decides to cut corners and live off its reputation, it may get away with it for a while. Lexus and Southwest Airlines could continue to thrive for a while if they lowered their quality. But they will pay a price as information spreads and consumers acting in their own self-interest choose alternatives. The threat of those alternatives is an incentive for market leaders to try to maintain their high quality.

The critics of the Smithian worldview seem to be arguing that the Enron disaster is, in and of itself, evidence of the failure of the Smithian worldview. On one level, this is a

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little hard to understand. After all, Enron is bankrupt. Its stock price the last time I looked was under a dollar. No one thinks Kenneth Lay is a genius any more. Arthur Andersen's reputation is in tatters. It may go out of business. It has hired Paul Volcker to try to re-establish some piece of its former reputation and has given him significant control to do so.

On this level, the unregulated system seems to have worked fairly well. As soon as it became widely known that Enron had overstated its earnings dramatically, the stock price plummeted. And it plummeted well below what was consistent with the new corrected level of earnings. The new stock price reflected the loss of trust caused by dishonesty. Enron's credibility was shot.

And of course the system is not really unregulated. Numerous state and federal statutes will be brought to bear on the executives of Enron and Arthur Andersen, and some of them may be fined or put in jail.

So why do the critics of the Smithian worldview find the Enron story so decisive? One possibility is that they are upset that some Enron executives appear to have managed to make a great deal of money by selling their shares before the fall in stock prices. Others appear to have gotten fabulously rich using complex partnership structures with debt financing. These techniques may or may not have been illegal. What is clear is that these techniques have become dramatically less attractive.

Broken Hand?

What I think the critics of the Smithian worldview have in mind when they bring up Enron is something simpler: there was wrongdoing, ergo the invisible hand is broken. Why weren't there more "checks and balances to stop it?" asks Marjorie Kelly.

This is a strange standard of evidence. CBS News recently tested the new airport security systems and found that some bags were not inspected correctly. Does this mean that the current system of federalized security is a failure? I happen to be against federalizing airport security systems. But I don't expect a federal system to be perfect. Its imperfection doesn't prove my case.

Sometimes the President of the United States gathers power beyond what the Constitution has in mind. Does that mean the constitutional system of "checks and balances" is a failure?

The government takes our payroll "contributions" and spends them. There is no real Social Security trust fund, only an accounting fiction. I would like to see a purely private retirement system. But does the fact that the government solution has this marketing dishonesty about it prove my case? I wish it did, but it doesn't. The argument has to be made on a fuller set of principles.

Neither private nor public control is perfect. If you are a pure pragmatist, then the issue is simply one of which system works better. But perfection should never be the standard. It is not a standard that any system or solution can meet.

I am sure there are changes that could be made to our current regulatory system which might make the probability of future dishonesty less likely. The interesting question is whether these changes require more or less regulation. What would the world look like without the current state of federal and state laws that regulate financial disclosure? Does the current web of such laws destroy private systems that might work even better?

Those who dislike the decentralized solution of the marketplace would protect us from Enron by increasing such requirements and limiting the freedom companies have to use stock options to provide incentives to employees and management. I hope that in the current hysteria we preserve the freedom of individuals to make these choices voluntarily. □

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F.A. HAYEK (1899–1992), *The Constitution of Liberty*

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