

Pork for the *Vaterland*

Reviewed by George C. Leef

HOMELAND SECURITY SCAMS

by James T. Bennett

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Politicians are known for their proclivity to overreact. They often react excessively to imaginary or highly doubtful problems (think of the Alar scare, for example) and, when faced with an unquestionably real problem of great importance, their overreaction is usually of gargantuan proportions. In *Homeland Security Scams*, George Mason University economics professor James T. Bennett argues that the latter is the case in the United States' efforts to guard against terrorism.

In the wake of the September 11, 2001, terrorist attacks, the stream of statutes, regulations, and spending that has issued from Washington, D.C., has been prodigious and expensive. That response has significantly undermined our constitutional liberties, yet has done little or nothing to make Americans safer from future terrorist attacks.

While our elected officials constantly reassure us that they are doing a magnificent job of protecting our "homeland" (a term that our author finds bothersome, since Americans never before used such terminology, unlike the Germans who refer to the *Vaterland*), the truth, Bennett writes, is that "homeland security is developing into the largest boondoggle in the history of the U.S. government." Politicians, of course, bear no cost for being extravagant with taxpayer dollars and the most feared attack from political challengers is that the incumbent "did not do enough." Thus, we have gotten into a bidding war between Republicans and Democrats to

see who can gain the greatest political advantage from the supposed promotion of "security." Bennett finds it all to be stupendous folly.

The first part of the book is devoted to the creation of the Department of Homeland Security (DHS) and the outlandish pork barrel spending that is taking place under its control. Bennett begins with a long-forgotten fact — that a proposal from the bipartisan Commission on National Security/21st Century for the establishment of an agency to protect against terrorism had been made months prior to the 9/11 attacks, but had gained no political traction. Following 9/11, Congress rushed frantically to do something to make Americans think that the politicians were leaving no stone unturned in the effort to protect the country. Although President Bush was not initially in favor of the legislation to establish a new cabinet-level department (he believed the Office of Homeland Security that he had established was adequate), he readily acquiesced to the political imperative of maximum visible action. Bennett writes:

There was no political downside to the creation of a Department of Homeland Security. The limited-government Republicans, to the extent that any such grouping exists anymore, had largely lost their voice after 9/11. So President Bush proposed his own DHS — which promptly came under attack by Democrats for being too small and niggardly!

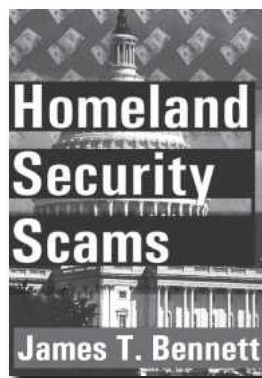
So the spending war was on. Bennett covers the sprawling domain of DHS, which as of March 1, 2003, had 180,000 employees and a budget of \$31.2 billion — the third largest cabinet department.

Since then, its budget has grown rapidly, reaching \$40 billion in fiscal year 2005.

CORNUCOPIA OF PORK Is that money well spent? Is it going into programs and equipment that are necessary to prevent terrorist attacks or deal with them if they should occur? Bennett leaves no doubt that the answer is in the negative. Much of the DHS spending is pure pork. Politicians immediately realized that the mushrooming DHS budget was a cornucopia and soon projects having only the most tenuous connection with terrorism defense were showered in federal money. Unsurprisingly, there have even been conferences devoted to the art of wheedling funds from the generous folks in Washington for just about anything that might be called a "homeland security need."

Here are just a few of the ways our tax dollars have been spent under the homeland security rubric:

- The Village of Little Chute, in rural Wisconsin, received \$38,000 to purchase new air tanks for its fire department. The department probably has use for the tanks, but the spending is hardly a response to terrorism risk.
- Just down the road from Little Chute is the town of Combined Locks, which used homeland security funding to install bulletproof glass in its police headquarters. There has not been much shooting in Combined Locks, much less any terrorism, but I suppose the all-purpose political justification applies — "better safe than sorry."
- Bennington, N.H., is probably not considered a high-value target by Islamo-fascists. Yet it received a 2003 homeland security grant of \$6,500 to buy chemical weapons suits for its "first responders." You never know — those suits might



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come in handy some day.

- Colchester, Vt., received \$58,000 to purchase a search-and-rescue vehicle capable of boring through concrete to find victims buried in collapsed buildings. Of course, it is extremely unlikely that the vehicle will ever be used, but as long as there is some chance that it might be useful, that is enough.
- The Steamship Authority of Massachusetts, which runs ferries that shuttle tourists from the mainland to Martha's Vineyard and back, received \$900,000 from DHS to upgrade security. The harbor-master told a local newspaper reporter, "Quite honestly, I don't know what we're going to do, but you don't turn down grant money."
- Homeland security pork sometimes doubles as corporate welfare. Several of the nation's largest oil companies have received DHS money for fencing, cameras, and gates around their refineries. Why should firms like Citgo and Shell pay for their own security needs if the government will?
- Former Washington, D.C., mayor Sharon Pratt managed to obtain a contract for "bioterrorism consulting" worth \$236,000. Her qualifications in this field? "It requires someone who appreciates how to pull the players together," she explains.
- Among other howlers, \$100,000 was spent on a group of 40 young people in a summer employment program. Their connection to homeland security was that they wrote and performed a dance and rap number about emergency preparedness.

To make matters worse, homeland security grants seem to be following the usual political course: they are becoming annual entitlements. As for accountability, the General Accounting Office has found "a history of poor systems and inadequate financial management" in DHS.

CRISIS AND LIBERTY Foolish expenditures, however, are not Bennett's only

objection. In the latter part of the book, he argues that Americans' civil liberties have taken as much of a hit as our wallets.

For example, DHS's Office of Intelligence is busy compiling a prodigious database of information on every American citizen. This project, originally called Total Information Awareness, continues despite the fact that Congress officially terminated it in 2003. Research is ongoing on "methods by which the police and military can identify persons by their walk, their talk, their irises, their facial features, and even, incredibly, their usual smell," Bennett writes. Will that make us any safer from terrorism? The likelihood is infinitesimally small. Will the information ever be used for purposes having nothing to do with security from terrorists? Informational firewalls have often been breached in Washington.

Then there is the USA-Patriot Act, a huge piece of legislation that scarcely any member of Congress had completely read, much less thoroughly analyzed, prior to voting on it. (The lopsided votes of 356 to 66 in the House and 98 to 1 in the Senate are a testament to the frantic political atmosphere in the fall of 2001.) Bennett quotes Sen. Russ Feingold's lone dissenting voice:

If we lived in a country that allowed the police to search your home at any time for any reason; if we lived in a country that allowed the government to open your mail, eavesdrop on your phone conversations, or intercept your e-mail communications; if we lived in a country that allowed the government to hold people in jail indefinitely based on what they write or think, or based on mere suspicion that they are up to no good, then the government would no doubt discover and arrest more terrorists. But that probably would not be a country in which we would want to live.

Bennett briefly discusses each crucial section of this law and then observes that, as historian Robert Higgs has shown to be the case in previous emergencies, liberties that are lost to "crisis" legislation are

seldom later regained. The power of the government ratchets up, but hardly ever ratchets back down.

H.L. Mencken once wrote that the aim of practical politics is to keep people clamoring for government protection from "an endless series of hobgoblins." The prospect of terrorism has been cleverly used by politicians to make Americans believe that the politicians are diligently guarding us — and they should therefore remain in office. It has also been used by those who feed at the public trough to fatten up. Bennett's book shows us exactly how politics works these days, and that is what should truly frighten us.

And there is no relief in sight. The book does not end with one of those optimistic "Here's what we can do!" chapters, apparently because the author believes that America is so thoroughly politicized that we should accept the bungling of any big issue as inevitable.

A FEW ERRORS *Homeland Security Scams* is not without flaws. For one, there is so much frothy writing that it gets somewhat tiresome. For example, mentioning how John Kerry constantly used firefighters as props during his 2004 campaign (he had pledged to support legislation desired by the International Association of Fire Fighters that would benefit the union by dragooning non-union firefighters into its ranks), Bennett writes, "A Bic couldn't be flicked within a mile of the Kerry campaign before whole departments of fire fighters aimed their hoses at the little flame." There is just too much of that sort of thing, detracting from the seriousness of the book.

There are also some errors that a more careful editing job would have corrected, like referring to "Fort Dietrick, Maryland" (it's "Detrick") and spelling the same person's name two different ways on the same page.

A few mistakes in a book hurried into print will not do any harm, however. The enormous political mistakes involved in the mania for "homeland security," will. Bennett deserves congratulations for a book that exposes the high price we are paying for allowing the political process to run wild. **R**

A Wonderful Opportunity

Reviewed by George C. Leef

THE SARBANES-OXLEY DEBACLE

By Henry N. Butler and Larry E. Ribstein

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I judge high school debates. Those debates often go something like this: The affirmative side presents a case for changing the status quo that is based on weak evidence, emotional appeals, and faulty logic. The negative side then demolishes the affirmative case by demonstrating that the alleged problem is not nearly as awful as claimed, that the status quo can deal with it, and that the affirmative's plan for improving matters will actually make them much worse. Barring some stupendous blunder later on, the negative side wins easily.

I was reminded of that while reading *The Sarbanes-Oxley Debacle* by professors Henry Butler and Larry Ribstein. The weak affirmative team was played by the politicians and "reformers" who pushed through the Sarbanes-Oxley Act in 2002 as a response to the highly publicized collapses of Enron and WorldCom. Unfortunately, in the political environment of that time, there was no negative team. The hasty, far-reaching regulatory changes in SOX (as the authors refer to it) were enacted into law without much opposition or even discussion.

This book is Butler and Ribstein's negative case against SOX, and they do exactly what an adept negative team does. They tear the affirmative side to shreds.

WONDERFUL OPPORTUNITY After the implosion of Enron, Washington was gripped in what the authors call a regulatory panic. With headlines blaring and pundits opining that Congress had to do something to prevent business fraud and

restore confidence in the market, the politicians went wild. Even though very few people were actually affected by those business failures, the climate of opinion dictated that a law be passed and most politicians were only too happy to oblige. In the great theater of Washington, Enron's collapse was a wonderful opportunity to grab media attention with bills, and speeches, and press releases, and hearings showing the senator or representative at his most concerned.

It is easy to understand why Democrats would jump on the issue of corporate fraud, but Republicans were also eager. An important reason why, Butler and Ribstein point out, was that in July 2002, a story emerged in the press about President Bush's failure to file appropriate notice about a sale of stock in a company of which he was a director back in 1990. Shortly thereafter, "looking like he had been caught with his hand in a cookie jar," the president announced his support for a set of corporate governance reforms.

The press was already in a feeding frenzy over a string of business corruption cases and President Bush's trouble created the perfect storm in Washington. The legislation moving in the House and Senate became almost impossible to oppose and the chairmen of the committees holding hearings stacked the proceedings with witnesses who favored additional regulation. Opponents could only land a few op-ed pieces.

On July 25, 2002, SOX passed the House by 422 to 3 and the Senate 99 to 0. The authors call it a case of "Sudden Acute Regulatory Syndrome." That syndrome often grips politicians after some market panic — the 1929 stock market crash being a good example.

What Congress did in SOX was to substantially increase federal control of corporate governance, something that had

traditionally been left to the states. Some of the law's main features are as follows:

First, the law requires increased internal monitoring by business executives to prevent fraud by corporate employees. The key provisions here are that the board's audit committee must consist only of independent members, and that top executives must certify the accuracy of statements and reports, with criminal penalties looming over those who certify documents later found to be false.

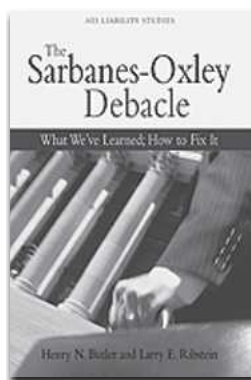
Second, SOX attempts to guarantee that professionals who oversee corporate transactions will do so more diligently. Key provisions include attorney reporting of evidence of fraud and the creation of a new governmental watchdog, the Public Company Accountability Oversight Board.

Third, SOX mandates more disclosure of information pertaining to a firm's internal controls, pro forma earnings, and off-balance sheet transactions.

Fourth, SOX attempts to control insider misconduct by forbidding company loans to executives and requiring the return of incentive-based compensation in the event that earnings are later restated.

DIVERSION AND DISTORTION All of that was done to the chant, "We must stop fraud!" Butler and Ribstein correctly observe, however, that the optimal amount of fraud in business is not zero. Trying to stamp out every possible instance of fraud would cost more than the losses from fraud, and therefore it is not what shareholders would want. The core of their argument against SOX is that whatever marginal benefit it might have in ferreting out and preventing future business fiascos is dwarfed by its costs.

To use an overworked phrase that is truly applicable here, the "bottom line" assessment of SOX by Butler and Ribstein is that it "has diverted attention from the hard work of maximizing shareholder value and distorted executives' incentives and investment decisions." For an estimate on its cost in lost market value, they point to a study by



Professor Ivy Zhang that puts the total at \$1.4 trillion. Political frenzy leads to prodigious mistakes.

So just what is wrong with the full-court press that SOX demands against the possibility of corporate fraud? Butler and Ribstein count the ways. There are explicit costs of having to produce more reports and implicit costs of compelling management to focus far more attention on regulatory compliance. In the face of the law's vague new standard of "significance" (the old SEC standard of "materiality" was at least fairly well understood), managers are apt to adopt an attitude of caution. The authors write, with reference to the internal controls mandated by Section 404, that "SOX clearly penalizes change and innovation. Any upgrades, new software, or acquisitions would have to be evaluated as 'significant changes in internal controls or in other factors that could significantly affect internal controls.' The safer course, when in doubt, is to do nothing." The problem of induced timidity is greatly exacerbated by the fact that the law imposes severe criminal penalties for violations.

The high cost of compliance will not fall equally on all firms. Smaller companies will bear a disproportionately high cost compared to large ones. Butler and Ribstein argue that SOX is therefore an impediment to entrepreneurial ventures — at least public ones formed in the United States. There is already strong evidence that firms are avoiding SOX by going private (not publicly traded) or "going dark" (firms with fewer than 300 shareholders). Also, initial purchase offerings that used to be so common in the United States are now being done much more often in London or other financial centers. SOX is therefore driving small and startup firms away from the benefit of the U.S. capital market.

Besides the high explicit and implicit costs imposed by the law, it also contains a "litigation time bomb." The authors contend that the new causes of action created by SOX for shareholders who have suffered a loss of value will

lead to a great deal of ruinous litigation the next time there is a major market downturn. Prosecutors and private litigators will have strong incentives to search for managerial failures to spot opportunities for fraud, which will then be blamed for the fall in share price. Such litigation will not protect shareholders, but it will further divert resources from productive uses into legal bills. It is an ideal breeding ground for litigation blackmail.

Butler and Ribstein offer this overall assessment: "These changes are more likely to deter honest people from engaging in risky but productive businesses than they are to prevent dishonest people from circumventing the law."

They also point out the irony that it was earlier federal meddling that removed the strongest impediment to managerial misconduct, namely the prospect of a hostile takeover. The

Many businessmen might prefer to have a federal nanny who tells them what they should do instead of living in a world of dangerous liability if their own decisions turn out badly.

Williams Act, with its strong deterrents to takeover bids, weakened the market for corporate control. When managers do not have to worry that their sloppy or self-serving actions will depress the stock and therefore invite the attention of "raiders," they are more likely to forget that their obligation is to run the business for the shareholders.

REFORM Congress very rarely revisits its regulatory blunders, except to compound them. The defenders of SOX seem to be impervious to evidence of its harmful results, but there is one reason for hope in this instance. In February 2006, a lawsuit was filed by the Free Enterprise Fund. The essence of the suit is that by having the members of the Public Company Accounting Oversight Board appointed by the Securities and Exchange Commission, SOX violates the

Constitution's appointments clause. If the courts agree, the whole law would fall because it lacks a severability clause. Therefore, it is possible that Congress may have to return to this issue.

If that were to happen, the authors would recommend that the whole statute be junked. They do not think that is likely, though, and advocate that if SOX is to be amended, the most important provisions to change would be:

- Defuse the litigation bomb by making violations not subject to private suits.
- Exempt smaller corporations and foreign firms.
- Eliminate the criminal penalties.
- Scale back the liability threshold for internal controls reports to a reasonable business judgment standard that would be assessed at the time of the report, not in light of subsequent events.

If Congress does not kill SOX or at least whittle it down substantially, Butler and Ribstein fear that the next round of regulatory panic will have Congress looking at more draconian ways of trying to restore (or, to be more accurate,

giving the public appearance of restoring) investor confidence. They cite a recent paper in which the author suggests that the government might have "monitors" from the SEC embedded with firms to oversee management.

Would American business not resist that, tooth and nail? Not necessarily. Many businessmen might prefer to have a federal nanny who tells them what they should do instead of living in a world of dangerous liability if their own decisions turn out badly. That is a frightful prospect.

The Sarbanes-Oxley Debacle is clearly written and argued, leaving no doubt that the enactment of SOX was a terrible blunder. If Congress ever does get around to revisiting its handiwork, Americans who care about the vitality of our markets should get copies of the book, read it, and then insist that their political representatives do the same. **R**