CATO HANDBOOK FOR CONGRESS

POLICY RECOMMENDATIONS FOR THE 108TH CONGRESS

CATO INSTITUTE
Washington, D.C.

22. Enron, WorldCom, and Other Disasters

Congress should

- clarify that the criminal penalties in the Sarbanes-Oxley Act require proof of malign intent and personal responsibility for some illegal act,
- repeal the Williams Act of 1968,
- approve the deduction of *one-half* of dividend payments from the earnings subject to the corporate income tax, and
- eliminate the limit on salaries that may be deducted from the earnings subject to the corporate income tax.

The collapse of the Enron Corporation in late 2001 led to two broad concerns:

- There may be more ''Enrons'' out there, because many other firms share the characteristics that led to the Enron collapse. This concern was reenforced by the subsequent collapse of Global Crossing, WorldCom, and some other large corporations and was reflected by the general weakness of the stock markets and the dollar, even though most of the subsequent economic news was better than expected.
- The revelation of gross accounting violations by these and other firms and the continued weakness of the financial markets have undermined both popular and political support for free-market policies. This effect has already led to the increased regulation of accounting and auditing authorized by the Sarbanes-Oxley Act, proposals for even more regulation, and increased criticism of any proposal for privatization. Any number of critics have been quick to blame many of the problems of the modern world on the corporate culture, with a potential effect similar to that of the muckrakers in shaping and promoting the early progressive legislation.

While these issues deserve further study, some lessons can be drawn now.

Enron Is a Symbol of a Broader Problem

Enron filed for bankruptcy protection on December 2, 2001, a consequence of the combination of too much debt and some unusually risky major investments. Such conditions are characteristic of firms that declare bankruptcy and, by themselves, are not sufficient evidence of a broader problem. The optimal number of bankruptcies is not zero because our broader interests are served by corporations using some amount of debt finance and taking some risks. Moreover, Enron did not collapse because it broke the accounting rules, although it apparently broke some rules to cover up its financial weakness. The collapse of Enron led to huge losses to Enron investors, creditors, and employees but, by itself, had little effect on other parties. The conditions specific to Enron will be adequately sorted out by the market and the courts.

As expressed by one blunt-speaking investment manager, however, ''Enron ain't the problem. . . . The unremarked gut issue today is that over the past decade there was a landslide transfer of wealth from public shareholders to corporate managers. Enron was just the tip of the iceberg ready to happen.'' For the larger community, the important issue is not the specific reasons why Enron collapsed but whether the general rules affecting all corporations lead managers to use too much debt and to incur too many risks. Another important issue raised by the Enron collapse is why these conditions either escaped notice or were not acted upon by any link in the audit chain.

The broader pattern of financial developments since the mid-1990s is clearly more consistent with a description of Enron as ''the tip of the iceberg'' than with a view that the collapse of Enron was merely a random observation from a stable distribution of potential corporate failures. Something is seriously wrong in corporate America. General shareholders, now a majority of Americans, have a financial interest in correcting the conditions that led to these problems. Those of us who are concerned about maintaining the necessary popular and political support for a market economy have a special political stake in correcting these conditions.

Some Corrective Actions Have Been Taken

The collapse of Enron proved to be a valuable wake-up call to a number of affected groups. The following actions have already been taken by private organizations:

- The Business Roundtable, composed of the chief executives of about 150 large firms, urged corporations to adopt a number of voluntary changes in corporate governance rules, including that a ''substantial majority'' of corporate boards be independent ''both in fact and appearance.''
- The New York Stock Exchange and the National Association of Securities Dealers approved major additions and changes in the rules for accounting, auditing, and corporate governance as necessary conditions for listing of a corporation's stock for trade on the exchange. The major continuing uncertainty is how the exchanges will monitor and enforce these rules.
- The International Corporate Governance Network, institutional investors that control about $10 trillion in assets, has approved a set of international standards for corporate governance that its members would use their voting power to promote.
- Merrill Lynch, the nation's largest retail broker, signed an agreement with the New York State attorney general that its stock market analysts ''will be compensated for only those activities and services intended to benefit Merrill Lynch investor clients,'' as determined by their superiors in the research department. This agreement was designed to reduce any conflict of interest between the market analysis and investment banking activities of Merrill Lynch and is expected to be adopted by other major brokerage firms.
- Standard and Poor's, one of the three major credit-rating agencies, has developed a new concept of ''core earnings'' as a measure of earnings from a company's primary lines of business. Compared with earnings as defined by the generally accepted accounting principles (GAAP), for example, the S&P measure will exclude gains and losses from a variety of financial transactions. S&P plans to report this measure of earnings for all publicly held U.S. companies.

Most important, the long bear market has changed the attitude of many corporate managers and directors. In good times, no one manages the store in firms that make an adequate rate of return, even though other firms may have a significantly higher rate of return. Over the past two years, however, corporate managers have been quicker to reduce employment and close plants in response to weak demand, productivity growth has continued to be high as a consequence, and corporate boards appear to have been more cautious about approving new investments and increased executive compensation. The important test is whether the costly lessons of this period will survive a recovery of demand and another long bull market.

In the meantime, after much sound and fury, Congress approved the Sarbanes-Oxley Act by an overwhelming margin. As is too often the case, Congress responded to a new problem that it does not understand by creating a new bureau, in this case a Public Company Accounting Oversight Board to oversee public accountants. The act also authorized a 64 percent increase in the budget of the Securities and Exchange Commission, a strange reward for the failure of the SEC to uncover any of the major recent accounting violations. The act also makes some minor changes in audit rules and authorizes a substantial increase in criminal penalties for a broader array of white-collar crimes.

The Sarbanes-Oxley Act is a result of a political demand to ''do something'' about a problem of shared concern. The act was unnecessary, in that the SEC had the authority and had already implemented most of the prescribed actions. The act is expensive, in that the huge increase in the SEC budget is not likely to improve accounting and auditing very much. More disturbing, the major potential problem is an awesome threat that senior corporate managers may be held liable for an illegal action by some subordinate that the senior manager did not direct, condone, or even know about. Congress has wisely refrained from applying this standard to government managers, even though the General Accounting Office reported in 1998 that ''significant financial systems weaknesses . . . prevent the government from accurately reporting a large portion of its assets, liabilities, and costs.'' On first hearing of the Enron breakup, my reaction was that someone ought to go to jail as a consequence; that is an understandable but not very nuanced reaction. Unfortunately, Congress does not seem to have thought much beyond that first reaction. At a minimum, Congress should clarify that the criminal penalties in the Sarbanes-Oxley Act require proof of malign intent and personal responsibility for some illegal act.

Unfinished Business

Most important, the corrective actions taken to date will not be sufficient to reduce the frequency and magnitude of corporate bankruptcies. Enron and other large corporations failed by making unusually bad business decisions, *not* by violating the accounting standards. A blatant violation of accounting rules and auditing procedures clearly offends the general public and the political community, but the losses to a corporation's shareholders, creditors, employees, and local communities are more directly related to the failure of the corporation than to the measures its managers may have taken to delay recognition of its financial weakness. Without changes in the policy-related conditions that contribute to corporate failure, improved accounting and auditing procedures would accelerate bankruptcies with little effect on their frequency or magnitude. Almost all of the public and press attention, however, has focused on reducing the accounting violations, not on those policies that contribute to business failure.

The major lesson from the collapse of Enron and other large corporations is that the rules of corporate governance do not adequately protect the interests of the general shareholders against the increasingly divergent interests of corporate managers. In other words, ''the agency problems'' that result from the separation of ownership and control posed by Berle and Means in 1932 have not yet been fully solved and may have recently increased. The rules of corporate governance—in effect the ''constitution'' of a corporation—are a complex combination of federal securities law, the conditions for listing on some stock exchange or for access to credit, the corporate regulations and court decisions of the state in which the firm is incorporated, and company-specific rules.

Over time, moreover, there has been some drift from rules that protect shareholders to rules that protect corporate managers. The first major policy change in this direction was the federal Williams Act of 1968, which substantially increased the cost for outsiders to organize a successful tender offer and entirely removed the potential for surprise. More important were decisions by state legislatures and state courts in the 1980s in response to demands by corporate managers. And the superstar CEOs of the 1990s were able to persuade their passive boards to agree to almost any rule. Over this period, in addition, the major outside shareholder in an increasing number of firms was some pension or mutual fund that had interests so diversified that its management had little interest in the performance of any one stock in the fund's portfolio; these funds very rarely use their voting power to place a representative on a corporate board. Very few corporate boards now include a member with a sufficient portion of the total shares to be a credible threat to incumbent management. As a consequence, according to the leading scholar of the market for corporate control, ''it should come as no surprise that, as hostile takeovers declined from 14 percent to 4 percent of all mergers, executive compensation started a steep climb, eventually ending for some companies with bankruptcy and management scandal. . . . Enron is a predictable consequence of rules that inhibit the efficient functioning of the market for corporate control.'' The most important policy lesson from the collapse of Enron is to repeal or reverse those laws, regulations, and court decisions that restrict successful tender offers. The probable results would be a reduction in executive compensation, less pressure to cook the books, an improved allocation of capital, and an increase in the rate of return to general shareholders. Congress should start this process by repealing the Williams Act of 1968.

Another major issue that has been broadly ignored in discussions about the policy lessons from the Enron collapse is that the current U.S. tax code *increases* the conditions that lead to bankruptcy. The corporate earnings subject to tax, for example, exclude interest payments but not dividends; this leads corporations to use more debt finance than would be the case if the tax treatment of interest and dividends were the same. The combined federal and state corporate income tax rate in the United States is now the fourth highest among the industrial nations, so one should expect American corporations to be relatively dependent on debt finance. Second, for most investors, the tax rate on dividend income is much higher than the rate on long-term capital gains; this leads corporations to rely more on retained earnings and capital gains than on dividends as the return to equity. And third, an obscure provision of the 1993 tax law limits to $1 million a year the direct compensation of corporate executives that may be deducted, unless the compensation is ''performance based.'' These biases in the tax code also lead to several other adverse effects—reducing the cash-flow discipline to meet dividend payments, increasing the role of corporate managers relative to investors in the allocation of capital, increasing the use of stock options to compensate corporate executives, and increasing the incentive to inflate the stock price.

Reducing the bias in favor of debt requires reducing the effective tax rate on corporate earnings. Reducing the bias in favor of retained earnings and capital gains requires deducting some amount of dividends from the earnings subject to the corporate income tax *or* reducing the difference between the personal income tax rate on dividends and long-term capital gains. The simplest direct way to reduce both of the first two of these tax-related biases is to allow corporations to deduct *one-half* of their dividend payments from the earnings subject to the corporate income tax. This would make the combined corporate and personal tax rate on capital gains and dividends about the same for most investors without changing any other feature of the corporate or personal income tax code, roughly eliminating those adverse conditions attributable to the current difference in these rates. Over the past several years, in addition, this would have reduced corporate income tax liability by about $60 billion a year, substantially reducing the bias in favor of debt finance. Other tax revenues, of course, would increase due to an improved allocation of capital, increased corporate investment, and higher personal income tax revenues from increased dividend payments. For those who would otherwise be opposed to reducing corporate income tax liability or considering any supply-side benefits of lower tax rates, Cato has long maintained a list of federal corporate welfare spending, the elimination of which would more than offset the reduction of corporate income tax liability. The most important simple change in the federal tax code, thus, would be to authorize corporations to deduct one-half of their dividend payments from the earnings subject to the corporate income tax. The third tax bias in favor of stock-based compensation should be eliminated by the simple repeal of the 1993 limit on the amount of direct compensation that may be deducted. A full elimination of the bias in favor of debt finance would require a more comprehensive tax reform that would either eliminate the corporate income tax *or* any personal taxes on capital gains and dividends.

In summary, Congress should not rest on the faded laurels of the Sarbanes-Oxley Act. More needs to be done to reduce the conditions that lead to corporate failure and to restore American corporations to financial health and integrity. The policy changes recommended in this chapter may be the most important, but other changes are likely to be suggested by completion of Cato's project on the major policy lessons from the collapse of Enron.

Suggested Readings

Gompers, Paul A., Joy Ishii, and Andrew Metrick. ''Corporate Governance and Equity Prices.'' NBER Working Paper no. 8449, August 2001.

Manne, Henry G. ''Bring Back the Hostile Takeover.'' *Wall Street Journal*, June 26, 2002.

Niskanen, William A. ''A Preliminary Perspective on the Major Policy Lessons from the Collapse of Enron.'' Cato Institute white paper, www.cato.org.

Sosnoff, Martin T. ''Enron Ain't the Problem.'' *Directors and Boards*, Spring 2002.

—Prepared by William A. Niskanen