

## Government Can't Make the Market Fair

By Lester C. Thurow  
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Anyone who thinks the current round of corporate scandal could have been prevented with new rules and regulations simply does not understand American capitalism. The Enrons, WorldComs and Tycos are not abnormalities in a "basically sound system." Scandals are endemic to capitalism. The best any government can do is contain the damage, and the best any individual investor can do is get out of harm's way.

Yesterday's wide fluctuations in the market, when the Dow Jones industrial average veered from loss to gain and back again, closing down 235 points, are the latest evidence of investor distrust of corporate accounting procedures. It also shows that investors are worried about the market's ability to recover from, or respond to, scandal.

We did not arrive at this point by accident. At the end of a boom, the pressures to keep the good times going just a little bit longer are enormous. All companies want to "hit their numbers" (that is, ensure that their revenues and profits match those predicted by Wall Street analysts). This imperative cascades up and down the corporate pyramid — and it infects not just the organization itself but the individuals within it. Sales representatives, for instance, can get fired if they don't hit their numbers. They don't want to get fired. So they make adjustments. Sooner or later, small adjustments become large adjustments. And then no one wants to look too closely at the numbers and be the one who announces that the good times are over.

In this way whole companies, even entire industries, convince themselves that good times are about to return. It is just a temporary dip, they tell themselves. Altering the numbers now will not matter when the good times do return; in fact, the good times will make the false numbers into true numbers. Some of the booming revenues and profits of next quarter can be backdated into this quarter to make this quarter's reported numbers true.

It is naïve to think that changing the rules governing the accounting profession is going to alter this culture. Politicians calling for new sets of rules to prevent financial scandals from recurring are like generals fighting the last war: by the time they demand change, it's already too late. New laws and regulations adopted in the aftermath of scandal are almost always useless in preventing future wrongdoing, especially in financial matters. The last great wave of regulatory lawmaking, designed to prevent systemic fraud and abuse among savings and loans in the 1980's, proved largely irrelevant to preventing systemic fraud and abuse among accounting firms today.

So what can be done about the inevitable scandals of capitalism? The first and best solution is to warn all small investors that the game is rigged. No individual investor, no matter how well informed, can play on the same level as the major institutional investors, Wall Street firms and corporate executives, who receive more accurate information more quickly than the average viewer of CNBC. The major players talk all the time, and very little of what they learn becomes known to the general public; that is what the investment banker Herbert Allen's annual summer get-together of media

moguls in Idaho is all about. Of course, such meetings are not illegal. But neither do they inspire confidence in the openness and honesty of the system.

None of this is to say that the government cannot, and should not, penalize executives, bankers, analysts or others when their behavior gets out of control. That is, in fact, what we mean by a basically sound system: one in which actions are rapidly taken to restore order and punish those who have transgressed the rules.

But no government can ever guarantee that the small investor has an equal chance of winning. It is beyond dishonest to pretend that rules can be written to prevent future financial scandals; it is fraudulent. No set of regulations can ensure fairness and transparency in the markets. To pretend otherwise is to set up the government as the system's ultimate liar.

*Lester C. Thurow is a professor at the Sloan School of Management at the Massachusetts Institute of Technology.*