Two, Three, Many?

By PAUL KRUGMAN

Here's a scary question: How many more Enrons are out there?

Even now the conventional wisdom is that Enron was uniquely crooked. O.K., other companies have engaged in "aggressive accounting," the art form formerly known as fraud. But how likely is it that other major companies will turn out, behind their imposing facades, to be little more than pyramid schemes?

Alas, it's all too likely. I can't tell you which corporate icons will turn out to be made of papier-mâché, but I'd be very surprised if we don't have two, three, even many Enrons in our future.

Why do I say this? Like any crime, a pyramid scheme requires means, motive and opportunity. Lately all three have been there in abundance.

Means: We now know how easily a company that earns a modest profit, or even loses money, can dress itself up to create the appearance of high profitability. Just the simple trick of paying employees not with straight salary, which counts as an expense, but with stock options, which don't, can have a startling effect on a company's reported profits. According to the British economist Andrew Smithers, in 1998 Cisco reported a profit of $1.35 billion; if it had counted the market value of the stock options it issued as an expense, it would have reported a loss of $4.9 billion. And stock options are only one of a panoply of techniques available to make the bottom line look artificially good.

Motive: The purpose of inflating earnings is, of course, to drive up the price of the stock. But why do companies want to do that?

One answer is that a high stock price helps a company grow; it makes it easier to raise money, to acquire other companies, to attract employees and so on. And no doubt most managers have puffed up their stock out of a genuine desire to make their companies grow. But as we watch top executives walk away rich while the companies they ran collapse (there are cases worse than Enron; the founder of Global Crossing has apparently walked away from bankruptcy with $750 million), it's clear that we should also think about the incentives of the managers themselves. Ask not what a high stock price can do for your company; ask what it can do for your personal bottom line.

Not incidentally, a high stock price facilitates the very accounting tricks that companies use to create phantom profits, further driving up the stock price. It's Ponzi time!

But what about opportunity? A confluence of three factors in the late 1990's opened the door for financial scams on a scale unseen for generations.

First was the rise of the "new economy." New technologies have, without question, created new opportunities and shaken up the industrial order. But that creates the kind of confusion in which scams flourish. How do you know whether a company has really found a highly profitable new-economy niche or is just faking it?

Second was the stock market bubble. As Robert Shiller pointed out in his book "Irrational Exuberance," a rising market is like a natural Ponzi scheme, in which each successive wave of investors generates gains for the last wave, making everything look great until you run out of suckers. What he didn't point out, but now seems obvious, is that in such an environment it's also easy to run deliberate pyramid schemes. When the public believes in magic, it's springtime for charlatans.

And finally, there was (and is) a permissive legal environment. Once upon a time, the threat of lawsuits hung over companies and auditors that engaged in sharp accounting practices. But in 1995 Congress, overriding a veto by Bill Clinton, passed the Private Securities Litigation Reform Act, which made such suits far more difficult. Soon accounting firms, the companies they audited and the investment banks that sold their stock got very cozy indeed.

And here too one must look not only at the motives of corporations, but at the personal motives of executives. We now know that Enron managers gave their investment bankers — not their investment banks but the individual bankers — an opportunity to invest in the shell companies they used to hide debt and siphon off money. Wanna bet that similar deals didn't take place at many other firms?

I hope that Enron turns out to be unique. But I'll be very surprised.