

# The Enron collapse and the crisis of the profit system

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The collapse of the energy trader Enron on December 2—the largest bankruptcy in US corporate history—has resulted in a series of increasingly critical comments both in the American and international press.

While detailing the extent of the collapse and the corrupt and possibly criminal activity that played such a crucial role in the functioning of Enron, sometimes in quite strident terms, all of this commentary serves an essential political purpose. It seeks to stop investigation at the very point where it must go deeper.

The decisive question which is not raised, let alone answered, is what are the driving forces within the economy that have led to the situation where corruption and even criminal activity have come to play such a central role. Enron was not only the seventh largest US corporation, it was regarded as a “market leader”.

The rightwing *Washington Post* commentator George Will, in an article published in the January 22 edition of the *Australian Financial Review*, claims that problems revealed by Enron’s collapse are “rooted in recent changes in US legal, financial and accounting professions,” which had their origins in an “epidemic of aggressiveness in the 1980s, when all three professions began to think of themselves as ‘can do’ people—‘problem solvers’ who ‘think outside the box.’”

The result of this mentality and the increasing use of stock options, he maintains, was a “hyper-aggressive management cadre continually trying to impress analysts with ambitious targets for growth in stock values. When the targets were met, the analysts raised the bar, and sometimes the ever-higher expectations could not be met without financial and accounting practices that were the equivalent of steroids.”

Will concludes that the primary cause of Enron’s “risky behaviour” was the “growing arrogance of executives who became confident that no-one was looking over their shoulders, watching—and understanding—what they were doing.”

But all the essential questions remain unanswered. For instance, what is to account for the changes in accounting and financial practices in the 1980s and how did they come to dominate? Why the concentration on share valuations and ever-increasing expectations? And why the abandonment of regulatory procedures that had been established over decades? None of these questions is even touched on.

In a comment published on January 15, *New York Times* columnist Paul Krugman dubbed the Enron affair “crony capitalism, US style” and pointed out that the “real story is much bigger” than one company. Three days later, in a comment titled “A System Corrupted”, he further elaborated.

“The Enron debacle,” he wrote, “is not just the story of a company that failed; it is the story of a system that failed. And the system didn’t fail through carelessness or laziness; it was corrupted.”

According to Krugman, the Enron affair has revealed that the institutions governing the capitalist economy, including modern accounting rules, independent auditors, securities and financial market regulation, and the prohibitions against insider trading have been

corrupted.

“The truth is that key institutions that underpin our economic system have been corrupted. The only question that remains is how far and how high the corruption extends.”

But for all his denunciations of “the system,” Krugman leaves the analysis at the point where it should really begin. His articles amount to a series of descriptions which, in the end, explain nothing. The corruption of Enron is explained by the corruption of the system which was supposed to regulate and control it. So in the end, the existence of corruption is explained by ... corruption, the source of which is never probed.

The significance and implications of the Enron collapse can only be grasped by examining it within the context of the historical development of the capitalist economy, in particular the post-World War II period.

Taken as a whole this epoch falls broadly into two parts. Expanding accumulation of capital, the growth of profits, and a general increase in living standards in the major capitalist countries marks the period from 1945 to 1973. In the last 25 years, starting with the global recession of 1974-75, profit rates are estimated to be around half what they were in the earlier period, living standards have remained stagnant or even declined and unemployment has been higher.

While the business cycle—boom, downswing, recession and upswing—has operated in both periods, its characteristics have been markedly different. As Leon Trotsky explained, the business cycle is to capitalism what breathing is to a living human being. Breathing continues from the moment of birth until death, but its character changes and these changes provide an indication of the health of the body.

Likewise, the business cycle has accompanied capitalism from its birth and will continue for as long as the system exists. Like breathing, it provides an indication of general economic health.

Viewed from this standpoint, the past decade of economic expansion in the US—the period which saw the rise of Enron and other so-called “new economy” companies—forms a marked contrast with earlier cycles. The 1990s upswing and boom constitute the longest period of growth in the history of American capitalism. But overall the average annual growth rate in the US economy in this period was only 3.1 percent. This fell short of the rate in the 1970s, was only marginally above the growth in the 1980s—acknowledged as a decade of considerable economic problems—and was well below the growth rates of 4 percent plus for the US economy in the 1950s and 1960s.

The contrast becomes even more apparent if we consider the character of economic life in the 1990s with that of the 1950s and 1960s. The past period, especially the last decade, has been characterised by vast changes in the processes of production, associated with the computer chip, whereas the earlier period is characterised by relative stability in production processes. Yet the growth rate of the earlier period far exceeds that of the past decade. In other words, a great deal more economic activity is required to produce the same results as previously. That is, the “breathing” of the capitalist system has become rather laboured.

This points to changes at the very heart of the process of capitalist production. Under this system, production is not carried out to increase social wealth or meet social needs, but to expand capital through the accumulation of profit. This process takes place from capitalism's birth until its death. The crucial issue, which determines its state of health in any period, is the rate at which this accumulation occurs. That is, in the final analysis, the "breathing" of the capitalist economy, the business cycle, expresses the rate at which this accumulation, indicated by the rate of profit, is taking place.

In his analysis of the capitalist economy, Marx demonstrated that there was an inherent tendency for this rate of capital accumulation, measured by the rate of profit, to decline. This tendency arises from the very structure of the capitalist economy itself. While the sole source of profit is the surplus value extracted from living labour in the processes of production, the outlay on this labour power forms an ever-smaller proportion of the total capital laid out in the production process.

In other words, a relatively smaller amount of living labour has to expand an ever-larger mass of capital. When the rate of increase in the surplus value extracted from this labour fails to keep pace with the expansion of capital, the rate of profit begins to fall. This decline in the rate of profit sets in motion other processes within the capitalist economy aimed at trying to overcome it—processes which have been increasingly apparent over the past two decades.

"If the rate of profit falls," Marx wrote, "there follows, on the one hand, an exertion of capital in order that the individual capitalists, through improved methods, etc., may depress the value of their individual commodity below the social average value and thereby realise an extra profit at the prevailing market-price. On the other hand, there appears swindling and a general promotion of swindling by recourse to frenzied ventures with new methods of production, new investments of capital, new adventures, all for the sake of securing a shred of extra profit which is independent of the general average and rises above it" [*Capital, Volume III*, Marx, pp. 253-254].

Throughout its history, capitalism has continually developed the productivity of labour through new methods of production, based on new technologies. However, this increase in the productivity of labour has a contradictory impact on the rate of profit. To the extent that increased labour productivity drives labour out of the process of production it tends to lessen the mass of surplus value and depress the profit rate. However, to the extent that increased labour productivity enables increased extraction of surplus value from those workers remaining in the production process, it tends to increase the mass of surplus value, leading to expanded capital accumulation.

This means that a development of labour productivity throughout the economy will tend to provide an expansion in the rate of profit to the extent that the latter tendency predominates over the former. If this takes place the capitalist economy will undergo an expansion and the "breathing" becomes easier.

That was certainly the case for the three decades following World War II. The vast increases in labour productivity resulting from the extension of assembly-line methods of production throughout the major capitalist countries brought about increases in the rate of profit and a general expansion of accumulation. However, from the mid-1970s onwards, profits began to turn down.

Over the past quarter century, capital has responded in the manner indicated by Marx. On the one hand there has been a frantic drive to increase the productivity of labour, while on the other there has been a growth of speculative attempts to overcome falling profits through financial means.

There is no denying that technological changes have brought about vast increases in the productivity of labour. For example, US Steel employed 120,000 people in 1980. A decade later its workforce had dropped to

20,000 yet output was only slightly lower. During the 1980s, the steelmaking area of Sheffield saw the destruction of tens of thousands of jobs. Yet steel output from that region is as high as any time in the past. In the same decade the General Electric Company cut its workforce by over 40 percent, yet its sales tripled.

Many examples from other industries could be produced which make clear that there have been significant increases in labour productivity. But what is also clear is that this rise in productivity has resulted in little, if any, increase in the average rate of profit.

According to the US economist Fred Moseley, the rate of profit fell from 22 percent in the late 1940s to 12 percent in the mid-1970s—a decline of almost 50 percent. Vast changes in the US economy over the next two decades—including the driving down of real wage levels—have brought about an increase. But despite these efforts, the rate of profit in the mid-1990s had only increased from 12 to 16 percent. That is, it had only recovered about 40 percent of its earlier decline and was still 30 percent below its previous peak.

Many economic processes testify to the continuous downward pressure on profit rates in all sections of industry including: the existence of overcapacity in many key industries, the intense competition in all sectors of the economy and the billion dollar mergers of the recent period as corporations seek to cut costs and eliminate competition.

The failure to overcome the downward pressure on the rate of profit in the process of production has led to increased attempts to circumvent it by financial means. According to British economist Harry Shutt, since the start of the 1980s an increasing proportion of the return on investments has resulted from capital gains (an appreciation in the market value of the financial asset) rather than from earnings. He has estimated that some 75 percent of total returns in Britain and the US came from this source in the period from 1979 as compared with a rate of well under 50 percent in the period 1900-79.

"This clearly suggests," he concluded, "that the rise in value has been driven more by the increasing flow of funds into the market and speculation that prices will continue to be pushed upwards ... than by the actual income stream produced by the securities" [*The Trouble with Capitalism*, Harry Shutt, p. 124].

This points to a crucial feature of the political economy of the recent period. Under conditions where profits increasingly take the form of gains from financial transactions, the markets require an ever-greater inflow of funds—a veritable "wall of money"—to sustain them. Those who purchase financial assets (for example shares) at prices which would have previously been dismissed as "irrational" are able to do so provided more money comes into the market to push prices still higher and bring them a capital gain.

This need for increased inflows of money is one of the reasons why the past decade has seen the dismantling of previous systems of regulation—the scrapping of the Glass-Steagall Act in 1999 in the US which prevented banks from engaging in investment and commercial activities is a case in point—and the hostility to the establishment of new regimes of control. The opposition to regulation stems from the fact that ultimately it represents a constriction on the flow of money needed to sustain the addiction of financial markets.

The need of financial markets for an expanding flow of funds is one of the driving forces behind the changes to the pension system in the US and elsewhere. The basis of these changes has been to tie funds directly into the financial markets, meaning that, as in the case of Enron, workers face the prospect of having their entire savings and future income wiped out overnight.

The extent of these changes is highlighted by figures compiled by the OECD—the 30-member group of the major capitalist economies. It found that the value of financial assets held by investor institutions in the member states (consisting of pension funds and insurance companies) rose

by \$9,800 billion between 1990 and 1995—an annual average increase equivalent to 10 percent of GDP. [See *The Trouble with Capitalism*, Harry Shutt, pp. 110-111.]

It is this increased flow of funds in the 1990s which generated so many of the illusions in the so-called “new economy”—illusions that are sustained by the very functioning of capitalism itself.

One of the sources of mystification within the capitalist system is that, viewed from the standpoint of the market, all sections of capital appear to be the same. It appears that a certain mass of money generates a profit out of its very nature as money.

But there are fundamental differences between the forms of capital. While they generate a return, financial assets are not themselves productive capital engaged in the actual extraction of surplus value from the working class. They are only titles to property, that is, claims upon the income generated by other sections of capital. This means that while it is possible for corporations to overcome the pressure on profit rates through activities in the financial market, there are definite limits to this process, set by the fact that the ultimate source of all forms of revenue to capital is the surplus value extracted from the working class.

The approach towards these limits gives rise to significant changes in the physiognomy of the capitalist economy.

Forced to turn to operations in financial markets to secure profits, all sections of capital become increasingly dependent on their ability to attract new money. Keynes once likened the financial markets to a beauty quest. In such a contest, the participants need to dress themselves up, hide their blemishes and conceal damaging information from the judges.

So it is in financial markets. But unlike the beauty contest, which is a once-for-all event, judgment in the market is a never-ending process. In the struggle for funds, bad news, leading to a fall in share values, can spell disaster. Under conditions where each corporation must not only make a profit but must be seen to do better than “market expectations”, the pressure to cover up the real situation becomes intolerable.

Thus potentially damaging news, such as the increase in debt, as in the case of Enron, must be concealed, accounting must be carried out to inflate sales and profits and shift bad news “off balance sheet”. Employees’ pension and 401(k) funds must be locked in to prevent a fall in share values. Deceit and falsification become endemic.

Speaking to NBC’s “Meet the Press” current affairs program last Sunday, Joseph Berardino, the head of accounting giant Arthur Andersen, the Enron auditors, pointed to the extent of these methods. “To my knowledge,” he said, “there was nothing that we’ve found out that was illegal.” In other words, the financial and accounting practices at Enron were regarded as the norm.

In the coming weeks and months there will be growing calls for controls and regulation, for a tightening of accounting practices so that something like Enron can never happen again ... just as there have been such calls after previous financial disasters.

A comment in the January 28 edition of the *Newsweek* magazine sets the tone. “The key to the Enron mess,” it claims, “is that the company was allowed to give misleading financial information to the world for years. Those fictional figures, showing nicely rising profits, enabled Enron to become the nation’s seventh largest company, with \$100 billion of annual revenues. Once accurate numbers started coming out in October, thanks to pressure from stockholders, lenders and the previously quiescent SEC, Enron was bankrupt in six weeks. The bottom line: we have to change the rules to make companies deathly afraid of producing dishonest numbers, as we have to make accountants mortally afraid of certifying them. Anything else is window dressing.”

Such comments are aimed at trying to assuage public anger on the one hand and blocking an in-depth examination of the underlying causes of the collapse on the other. The Enron debacle was not the product of the failure of accounting methods but was deeply rooted in structural changes in the

capitalist economy itself.

It was not that Kenneth Lay and his fellow Enron executives started out with a plan to establish a corrupt and very possibly criminal enterprise. Rather, it was the entire economic environment in which they operated, conditioned by the deep-going crisis of the profit-system itself, which dictated their resort to ever more dubious practices. Moreover, the changes in accounting procedures, the abandonment of audit standards, the development of conflicts of interest etc., which cleared the way for the Enron management, were themselves the outcome of this environment. The accounting firms responsible for audit and financial oversight are no less subject to the pressures of the market than their clients.

Calls for greater control, which remain within the framework of the capitalist economy and the profit system, miss the essential point. The Enron debacle, which has brought such economic devastation to the lives of many thousands of people, is a symptom, not the disease itself.

It is the outcome of a crisis in the capitalist economy as a whole. The subordination of the production of wealth to the extraction of private profit—the basis of the capitalist economy—has now reached such a state of decay that fraud and deception have become its *modus operandi*.

Real control cannot be established by tightening accounting rules and procedures. This is because accounting firms themselves are major corporate players and the accounting system itself is based on the very system of private ownership and private profit which lies at the heart of the crisis. Real control, in any case, can never be exercised by a caste of administrators and officials. It can only be established when society as a whole and its members, the producers of all wealth, are able to democratically determine how it shall be utilised and developed. Such a social order presupposes the establishment of social ownership of the means of production. This is the central issue raised by the Enron collapse.



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