Drawing the lessons of WorldCom

Nick Beams
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A somewhat desperate campaign has been launched involving the Bush administration, financial analysts and media commentators to try and present the American financial crisis simply as a case of wrongdoing and fraud by greedy corporate executives and accountants.

In the wake of the WorldCom revelations and the news that Xerox, long suspected of "creative accounting", had to reclassify more than $6.4 billion in revenue, US President George W. Bush promised that executives who were guilty of wrongdoing would face fines and jail terms and that "no violation of the public's trust will be tolerated." Bush is set to make a speech on July 9 to announce harsher penalties for corporate malfeasance.

Last Friday WorldCom chief executive John Sidgmore declared in a letter to Bush that the current management team were "equally surprised and outraged". This was why they had immediately brought the false accounting of almost $4 billion of expenses to the attention of the Securities and Exchange Commission (SEC) and the public, he explained.

Around the world similar pronouncements are being made—all aimed at presenting the crisis as merely the product of corrupt individuals and not of problems deep within the capitalist economy itself.

The underlying motivation for this campaign was clearly revealed in an article by George Trefgarne, the economics editor of the London newspaper, the *Telegraph*, published in the July 1 edition of the *Sydney Morning Herald*.

After noting that one of the "greatest speculative manias of all time" is now in an advanced stage of collapse, with consequences to follow for several years to come, he pointed to the political sea change that the Enron and now WorldCom debacles presage.

"No doubt," he wrote, "some academic pundits and left-wing rabble rousers, playing on fears that the system doesn't work, will take advantage of the situation and question the very values and institutions upon which the world economic system rests."

Trefgarne insisted that "those of us who believe in the markets must not be cowed" but must recognise that "like anything else dependent on human nature, they can fall victim to humours and passions, such as greed and fear." Moreover, he continued, the markets are not failing, they are working. Collapsing markets are in fact part of the process of "creative destruction" in which capital that has been misallocated is wiped out and the way cleared for renewed expansion.

Having offered this reassurance, Trefgarne continued: "So if the system isn't the problem what is? The answer is that just about every one of the recent problems to hit financial markets has been caused by individuals acting incompetently, fraudulently or dishonestly."

But this type of reasoning, which has more to do with religious mysticism and doctrines about inherent flaws in human nature than an objective examination of the workings of the economy, collapses as soon as a few basic questions are asked. If "one of the greatest speculative manias of all time" can be set off and then collapsed by the "evil-doings" of a few individuals, then is there not some inherent weakness in the structure itself? And if corruption and fraud are the problems, why have they only emerged at this point in time and not some other?

If we are not to put forward some kind of "bad Hitler" theory of economics, it is clear that the emergence of the type of accounting practices seen in the recent period must be related to overall economic conditions, which must themselves be investigated. But Trefgarne and other pundits have no desire to venture down that path because even a brief analysis will show that the crisis in the financial markets is the outward expression of deep-rooted problems intrinsic to capitalism.

In order to grasp the significance of the market turbulence it is necessary consider a few basic issues. The driving force of the capitalist economy is the accumulation of profit, not the production of material wealth as such. The source of this profit is the surplus value extracted from the working class (white collar or blue collar) engaged in the production of goods and services.

While the extraction of surplus value forms the foundation of the capitalist economy, there arises upon it a vast financial superstructure, including the share market, which itself becomes an arena for the accumulation of profit. The share market consists of ownership titles to capital. In the final analysis the value of each share is related to the future stream of profits it will receive.

But this does not mean that the relationship between the real base of the capitalist economy—the extraction of surplus value—and the financial superstructure is a direct one. On the contrary, it often takes an inverted form. That is, in historical periods when the average rate of profit is relatively high, activity in the share market tends to be subdued, while falling or stagnant profits often leads to increased emphasis on the accumulation of profit by means of financial transactions.

The economic history of post-war America demonstrates this process. In the 1950s and 1960s, when the average rate of profit was high, the stock market moved up relatively slowly. It began its rapid rise in the early 1980s, receiving a check in the 1987 stock market crash, only to resume its upward course in the 1990s, and then accelerating rapidly after 1995.

However, growth in the US economy—a reflection of the average rate of profit—followed a different trajectory. In the first half of the 1990s the growth rate was lower than for any other five-year period in the entire post-war epoch.

It began to revive somewhat by the middle of the decade but even with a US upturn, the growth rates for the major capitalist economies during the 1990s failed to reach the levels of the 1970s and 1980s, let alone those of the postwar boom of the 1950s and 1960s.

The origins of the "creative accounting" methods of the past period lie in these objective processes.

In his analysis of the formation of the general or average rate of profit, Marx explained that the competitive struggle between different sections of capital was the way in which the total mass of surplus value that had been extracted from the working class was shared out among them in the form of profit.

So long as things were going well, he noted, competition "effects an operating fraternity of the capital class ... so that each shares in the common loot in proportion to the size of his respective investment. But as soon as it no longer is a question of sharing profits, but of sharing losses, everyone tries to reduce his own share to a minimum and to shove it off upon another. The class, as such, must inevitably lose. How much the individual capitalist must bear of the loss, i.e., to what extent he must share in it at all, is decided by strength and cunning, and competition then becomes a fight among hostile brothers" [Marx, *Capital Volume III*, p. 248].

Price is only one of the forms through which competition takes place. Another is mergers and takeovers whereby one section of capital tries to wipe out another, or seize control of its assets and bring down costs through economies of scale, or attempt to gain access to a particularly lucrative cash flow that can be used to finance another takeover.

This war of each against all is financed through share transactions, or by means of loans from banks and other financial institutions. In both instances it is necessary to maintain a high share value—in line with "market expectations". Failure to do so means that a particular corporation, instead of initiating a takeover or merger, can itself become the target for other firms.

But there was a major problem for US corporations engaged in this battle in the 1990s. The flood of money into the stock market—fuelled in major part by the policies of the Federal Reserve and the inflow of capital from the rest of the world—pushed share values to new heights. This meant that companies had to report profits in excess of 10 percent simply to maintain their share price. However, the economy as a whole was growing by nowhere near 10 percent per annum.

In these conditions, the only way to increase profits faster than underlying growth was to engage in a process known as "backing in". In this procedure, instead of the profit figure emerging as the end result of accounting procedures, it becomes the starting point. Beginning with a level of profit necessary to meet "market expectations" and maintain or increase the share price, companies worked backwards to manipulate the balance sheet to attain that goal.

In the case of Enron, transactions that could have depressed the profit rate were shifted off balance sheet, or expenses were designated as investments as in the case of WorldCom, or revenues were recognised before they had actually been received, in the case of Xerox. And if these practices were not brought to light—if the would-be regulators failed to see the large elephant with spots, as one description put it—it was because they were so widespread.

The assertion that individual fraud and corruption are to blame, rather than a crisis in the profit system itself, is aimed at trying to prevent ordinary working people, whose jobs, pension funds, savings and retirement benefits have been destroyed, from drawing the political lessons of this experience.

The past quarter of a century has witnessed an unprecedented assault on living standards and social conditions, accompanied by an unending campaign preaching the virtues of the capitalist market and the profit system.

Like no period ever before in history, the market has been able to run its course without restraint. The corruption that now oozes from every pore, the theft and deception which has characterised its highest operations and the damage this is inflicting on the lives of millions of people cannot be put down to the actions of "bad" individuals. To be sure, individuals made and implemented decisions. But their actions were the personification of objective tendencies lodged in the system itself—a demonstration in the clearest possible way that its replacement with a social order based on human need, not profit, is historically well overdue.