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The Case for Sanctions

by Robert H. Frank

From his approach to pollution abatement as Texas governor to his approach to corporate malfeasance as President, George W. Bush's watchword has been voluntary compliance. Explaining his initial opposition to the strict criminal sanctions in the recently passed corporate fraud statute, for example, he conceded that although tougher laws might help, "ultimately, the ethics of American business depend on the conscience of America's business leaders."

There are indeed limits to the law's ability to regulate human behavior. And it is surely a positive step for public officials to try to nurture our inclination to do the right thing. But there is also a downside to emphasis on voluntary compliance, which overlooks the critical role of enforcement measures in society's efforts to curb narrow self-interest for the common good. Without such measures, we must ask those who comply voluntarily to shoulder an unfair burden.

The difficulty is illustrated by the forces confronting honest executives as they weigh how to report their company's earnings. They know that many entries in the company's financial statements necessarily entail subjective judgments. Some, for instance, hinge on estimates and assumptions about the future, others on imperfect models for imputing monetary values to non-market assets. For any firm, there is thus a broad range of earnings estimates that could be defended as reasonable.

Therein lies the problem, because a company's ability to finance its future growth depends strongly on how its current reported earnings compare with those of rival firms. After all, it is on this basis that capital markets infer which firms are most likely to succeed. Stock prices often fall sharply in the short run for those reporting relatively low current earnings, increasing their risk of failure in the long run. Under the circumstances, it is difficult to see how even the most scrupulous executives could justify calculating their company's earnings on the basis of strictly neutral, let alone pessimistic, assumptions. On the plausible forecast that most other companies will report earnings near the optimistic end of the reasonable range, failure to do likewise would be to understate the company's true prospects.

Worse still, this situation is unstable, because the standards that define acceptable accounting judgments are inherently dependent on context. When almost all companies issue optimistic earnings reports, such reports come to be viewed as normal. Even the most cautious executives then feel pressure to report their earnings more aggressively, creating room for their more aggressive counterparts to push the envelope still further.

Given this dynamic and the enormous sums at stake in the battle for corporate survival, careful monitoring and stiff sanctions against violators are essential. It is one thing to ask people to forgo ill-gotten gains but quite another to ask them to commit economic suicide. Many of WorldCom's competitors were injured, some even driven into bankruptcy, by their failure to match WorldCom's aggressive accounting practices (and WorldCom itself would still be flying high except for sudden the collapse of revenue in the telecommunications industry).

A similar logic applies to all other forms of malfeasance in the marketplace. If athletes can gain ground at the expense of their rivals by taking steroids without penalty, many will do so. And if people can claim questionable tax exemptions without penalty, many will do so. These actions pressure others to respond in kind, which in turn shifts the standards that define acceptable conduct.

If we want people to restrain themselves for the common good, the sacrifices we demand must be equitable. To ask athletes not to use steroids in the absence of effective sanctions, however, is to penalize those who comply while rewarding those who don't. To ask people to be scrupulous in their tax filings in an audit-free environment is to reduce the effective tax rate for dishonest taxpayers while increasing it for honest ones.

Congress was wise to include criminal sanctions in its recent corporate fraud legislation. Major League Baseball would be wise to include frequent random testing and stiff penalties against violators in the steroid ban it is currently considering. And President Bush might want to rethink the wisdom of the sharp IRS staff and budget cuts that have reduced the tax audit rate by more than half since 1996.

As Adam Smith himself was well aware, the invisible hand of the marketplace does not always produce the greatest good for all. When individual and social interests conflict, calls for voluntary compliance must be supplemented by sanctions that are potent enough to matter. As President Reagan aptly put it, "Trust, but verify."

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