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"CAPITAL FORMATION, THE MARKET ECONOMY AND THE SEC"

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CAPITAL FORMATION, THE MARKET ECONOMY
AND THE SEC

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I am delighted to be here with you to discuss this important subject. The issues commonly lumped together under the rubric of capital formation are at the center of virtually every debate about our economy. They concern the stuff of economic life in a free society: jobs, income levels, distribution of wealth and inflation. Our ability to generate growth with increasing productivity and efficiency will determine much about our political life and our social stability in the coming decade. These questions will occupy the attention of every administration and every agency concerned with our financial system.

In spite of, or perhaps because of, the complexity of this set of problems, there is too little appreciation of their difficulty and the extent to which many different policy tools must be used at the same time. This area typifies H. L. Mencken's famous dictum that for every complex problem there is a solution that is short, simple -- and wrong.

Fiscal policy, the structure of the tax system, monetary policy, government credit allocation, amelioration of the effect of economic adjustments on individuals, and preserving the efficiency of the capital markets all play an important part.

In the case of the SEC, our primary mandate is generally bounded by the parameters of the public securities markets.

Within those limits, we have great responsibility for the efficiency, stability, and fairness of those markets. In a mixed economy, the SEC is tied firmly to the market system, and its effectiveness for the capital-raising process must be our lodestone.

Before pursuing our role, however, I would like to spend a few minutes sorting out some of the separate pieces of the capital formation puzzle, for it is important to keep the responsibility of the Commission in perspective.

All of the following problems -- and more -- are commonly raised in discussions of capital formation:

- -- the level of aggregate savings
- -- the level of aggregate investment
- -- the disturbing shift in corporate debt-equity ratios
- -- the aged and inefficient physical plant in certain industries
- -- an apparent decline in the level of innovation
- -- the special problem of the availability of long-term capital for small business and new industries
- -- structural unemployment
- -- regulatory burdens on investment.

Savings

It is absolutely essential that the rate of private savings be increased. Our rate of personal savings has fallen from more than 7.5% in the first half of the 1970's to 4.3% in 1979 -- a huge drop. Moreover, the comparable rates for other countries are vastly higher:

Japan	25%
France	17.2%
Britain	17%
Federal Republic of Germany	13.7%

This is a difficult problem. In fact, it is only recently that economists have begun to agree that the level of personal savings is responsive to changes in interest rates and other returns on capital. Nevertheless, solving the problem is not easy.

First, our tax system exhibits a sharp preference for consumption over investment. The deductibility of interest on consumer debt and the taxation of interest income at ordinary income rates tells the whole story. That bias is a fundamental part of the tax structure. Its remedy is not found in quick fixes like a limited exclusion for interest income. Most proposals of that character would have the effect of merely exempting from taxation small savings already accumulated or, at most, simply shifting investors' preferences from one financial instrument to another. In France, for example, this shift in preferences may have been the result of the special tax credit made available for qualifying investments. A parallel shift here would drain funds from home mortgage credit, intensifying problems in that sector which have already assumed major proportions.

More fundamental changes, like switching to a VAT tax, would have the effect of favoring investment over consumption -- since only money spent on consumption would be taxed.

Yet changes of this order must proceed through a political thicket that has, in the past, proved the master of most tax reform proposals.

Second, in recent years inflation has been an even more powerful deterrent to the accumulation of savings. The erosion of financial assets when the CPI ranges from 10% to 20% is frighteningly fast, and those with the good sense to see what is happening quickly move from savings to consumption and its investment analogue, residential real estate.

Finally, there is a political aspect of this problem that is worth mentioning. For those who feel there should be larger income transfers, a dollar of tax reduction is a dollar not devoted to a compelling social need. On the other hand, almost all sectors of the population would prefer lower taxes. Thus, when a tax reduction proposal is considered, there are always competing legitimate claims for tax relief and, more broadly conceived, for the use of those tax dollars.

Thus, the tax reform effect is complicated by its implications for the distribution of wealth. Private noncontractual savings -- excluding insurance policies and pension contributions -- represent personal income not spent on consumption. It is not surprising, therefore, that the lower-earning sectors of the population have a low or negative savings rate, and significant savings do not appear until earnings become substantial. If taxes on savings are reduced and expenditures are not reduced, then taxes on consumption must be raised -- at least in the short run. Thus tax relief intended to increase the savings rate is often criticized for helping the wealthy get wealthier and increasing the strains on everyone else.

The desire to avoid that dilemma has provided the passion in current debates about the Laffer Curve and the effect of tax cuts on GNP. Wherever the truth lies, the notion that reducing taxes on savings will benefit the wealthy has a hard core of truth that is ineluctable. Yet, unless the government is to do the investing, I see no other way to create the base for a sharply increased level of investment.

Investment

It is investment in plant and equipment that is our primary concern. So long as the economy has unused capacity, the problem is not to increase savings, but to increase investment by business in fixed plant and equipment. When we are operating at capacity, increased savings are necessary to power new investment. Here, too, we lag significantly behind other countries, with only 10.8% of our real GNP represented by investment in plant and equipment; the major Western European industrial nations invest half again as much, and Japan more than twice as much.

This rate of investment has been too low to keep our physical plant as current as it should be, and that fact has been translated into lower productivity. The rate of growth in productivity in this country has dipped from almost 3% in the 1962-1967 period to zero in 1977-1980, with declines in 1979 and 1980.

As in the case of policies addressed to the savings rate, the remedial tools are fiscal and monetary policy and, in a broader sense, deregulation.

Debt-Equity Ratios

The shift of American business to reliance on debt is a related and disturbing trend. A recent analysis by Henry Kaufman and others noted that in the 1970's liabilities grew twice as fast as equity. And while debt comprised 44% of the capital of manufacturing companies in 1970, it has risen to 50% today -- even higher if the equity-rich oil and gas sector is excluded. The tax system and inflation have conspired to make debt more attractive than equity. Dividend payments are subject to double taxation; interest payments are not. Inflationary times make equity very expensive, and cheapen the dollars with which fixed obligations will be repaid.

Allocation of Capital

None of these fundamental economic problems are within the purview of the Commission. Our concern is not with the level of financial capital but with the method of its allocation. Allocation issues are concerned with capital flows in the economy. Is capital employed efficiently? Is the efficient result consistent with other values? Here again, a host of problems are commonly lumped together in the capital formation basket -- the mortgage credit cycle, the noncompetitiveness of certain industries, the decline in investment in R&D, the shift of jobs to the Sun Belt from the Northeast, and the like.

The adjustment stresses posed by these problems have raised challenges to the market system that are unprecedented in the post-World War II period. Claims for government aid to distressed sectors of the economy and distressed areas of the country abound. And this neo-mercantilism is given added impetus by the success of the Japanese economy, which is subject to considerably more government direction and protection than is ours.

Recently, many steps have been taken to ameliorate the impact of the free market system: agricultural price supports, cushioning of the effects of foreign competition, and, in the financial markets, Federal aid to housing finance, small businesses, railroads and, most recently, the Lockheed and Chrysler corporations, to name just a few.

The SEC

In this age of antiregulation, there is something of a tendency to throw out the baby with the bath water. Regulation can serve an important purpose in promoting the market system. We do not impose significant barriers to entry, either to the securities business or to the public markets. There is little or no administered pricing. I believe that, granted our share of the excesses to which human beings are prone, the securities markets are better for our presence. I would like to spend a few minutes summarizing this view.

The SEC's mandate is not to ameliorate the effects of the operation of the markets. It is to increase their efficiency, stability and fairness. Although the protection of investors is the hallmark of our regulatory system, I do not view the securities laws as consumer legislation. Much of what we do has a separate public purpose -- preserving the critical role of the public markets in raising and allocating capital. The protection of investors is an essential element in maintaining the broad, liquid secondary markets that make effective primary markets possible. Liquid secondary markets will not exist if investors fear misinformation, fraud, manipulation or unstable intermediaries.

If I were to summarize our principal goals, as I understand them, they would be:

-- to protect investors against fraud and deception

-- to require the timely dissemination of material information in the marketplace

-- to protect the stability of the market structure

-- to impose as few regulatory impediments to the free flow of capital as possible

In a broader sense, it is our job to see to it that the public securities markets work properly. Let me give you some examples of the ways in which our mandate extends beyond consumer protection.

Consider, for example, the disclosure system. Many see those rules as designed only to protect investors against deception. Yet, in this area, the Commission's most important actions in recent years have been focused upon

-- seeking more meaningful information, and

-- reducing the regulatory burden where the informational needs of the market do not require additional disclosure.

In my judgment, the steps the Commission has taken to encourage forward-looking information and financial disclosure to take account of the effects of inflation represent the most important changes in the disclosure system in recent times. Financial reporting is the heart of any investment appraisal. And the hard fact is that in a time of high inflation, an accounting system rooted firmly in historical costs is defective. Of course, the shift from a system based only on historical costs is not easy -- and like all changes of this magnitude, it requires much refining.

These steps were not taken in response to some narrow concept of our responsibility for financial disclosure in documents filed with the Commission -- or even a concern that inflation had converted past accounting and disclosure practices into a deceptive practice. Indeed, it was a concern for the ability of investors to evaluate management projections that retarded this development. Rather, these steps are directed at protecting the market system itself, which rests upon the availability of meaningful, as well as accurate, information.

As it attempts to improve quality of information disseminated to the trading markets, the Commission has also sought to reduce regulatory burdens by giving increasing recognition to the efficient market hypothesis. For securities that are widely traded and followed by analysts, the Commission recognizes that it is appropriate to give primary attention to promoting continuous disclosure of information by means of annual, quarterly and current reports filed under the Securities Exchange Act. For less actively followed securities, there is some concern that the markets do not process information as quickly or efficiently, and that market participants do not seek out information on a continuous basis; in this area we continue our traditional emphasis on communication directly to shareholders and potential buyers and sellers.

Small businesses have been given substantial relief in the private placement area and the Commission has supported legislation to amend the Investment Company and the Investment Advisers Acts to make it easier to attract public investors to venture capital. We are also considering requiring different amounts and types of disclosure from smaller companies.

It is plain that these deregulatory efforts involve some risk of increased abuse. Indeed, all regulation-deregulation decisions involve a trade-off between the abuse-prevention of a prophylactic rule and that rule's interference with the activities of non-abusers. That balance is -- and ought to be -- a part of the consideration of every regulatory agency. Although I like to think that we have been better than some others in facing up to these responsibilities, it is evident that we could improve.

In the market structure area, institutional changes, coupled with the powerful momentum of technological development, are leading to a restructured system for trading equity securities and to new regulatory responses.

Now, what is the impact of our actions on the raising of capital? Those who emphasize the burdens of our regulation misconceive, I think, the positive contribution of securities regulation to capital-raising.

By preserving the confidence of individual investors we contribute to liquidity in the markets. Regulation of broker-dealers contributes to stability in the markets. Insuring a current flow of information improves the efficiency of the pricing mechanism. And technological developments reduce transaction costs, and improve the quality of execution of trades.

In short, we think of ourselves as helping the markets' allocative mechanism work smoothly and efficiently. We are trying hard to look with fresh eyes at our work and to take advantage of our expanded economic analytical resources. Nevertheless, as I said at the beginning of this speech, because of the complexity of problems confronting the capital market system today, the SEC often moves forward slowly. But, in my view, this is the responsible approach and one I basically support.

Thank you.