NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 272-2650

Remarks to
Eleventh Congress
European Federation of Financial Analysts Societies

The Hague

October 17, 1980

"TRANSITION TO THE 1980's -- POLITICAL AND ECONOMIC EVOLUTION"

Stephen J. Friedman
Commissioner
United States Securities and Exchange Commission

I should confess at the outset that I come to this task with a strong bias. The Securities and Exchange Commission is responsible for the stability, fairness and efficiency of the public securities markets in the United States, and I believe that the securities markets are better for our presence. Today, the securities industry is healthy and the markets are vigorous. Increased competition has heightened the efficiency of the organized exchanges, with the promise of further improvements as we progress toward a national market system. Over $400 billion in value of stocks were traded on the New York Stock Exchange alone in the first three quarters of this year -- and 11 billion shares are expected to be traded there in 1980.

The over-the-counter markets have made giant strides in enhancing their efficiency. And venture capital investment in young and growing companies is burgeoning.

Would that efficiency, breadth and liquidity were all that is required to make our markets an attractive home for equity investment! An economy plagued in the late 1970's by inflation, skyrocketing energy costs and slow growth has given pause to equity investors; for example, pension funds reduced the share of their assets in equities during that period. Moreover, some observers have raised questions about the ability of the American political system to deal adequately with the resulting economic strains. With that background, and in a world in which economic and political change proceeds at a dizzying pace, predicting the course of equity investments in the 1980's requires peering into a very cloudy glass indeed.

Nevertheless, I am persuaded that the 1970's were a period of political and economic transition in the United States. A review of some of the structural problems that caused so much trouble in the 1970's suggests some encouraging trends:

-- The American political system experienced a number of evolutionary changes in the 1970's concerning the relationship between the executive and legislative branches that made it even more difficult to cope with the challenges posed by energy prices, inflation and slower growth. I believe that the President and the Congress will act with a new unity and sense of purpose in the 1980's.

-- It has taken some time for the magnitude of the danger of inflation to be fully appreciated in the United States. We are a country whose national economic nightmare is the Great Depression and unemployment, not inflation. The lesson has now been learned, however.

-- In the same way, a clear understanding of the impact of inflation, the tax structure and regulatory developments on capital formation has been slow in permeating the American consciousness. Today there is almost no economic issue that occupies more attention.

Evolution in the Political System

The debate on energy issues and national economic problems in the 1970's was complicated by several structural factors in the American political system, and it is important both to understand them and to keep them in perspective. Briefly, they are:

-- the relative roles of the President and the Congress

-- changes in the way the Congress is organized

-- the growth of special interest lobbies

-- the time frame in which public policy issues are considered

The framers of the American Constitution purposely avoided the parliamentary model. They intended the executive and legislative branches to act as checks, each upon the other. Accordingly, the pendulum of power has swung back and forth throughout our history between the President and the Congress. In the aftermath of Vietnam and Watergate, the pendulum moved far to the Congressional side.

Moreover, the Congress has always played a greater role in domestic policy than in foreign policy, and except for the Depression era of the 1930's and time of war, the problems of Presidential leadership in domestic affairs have always been difficult. For most of the 1970's, a major portion of the problems of American public life were domestic -- or at least the domestic implications of international events.

This structure has historically forced our domestic policies to the middle of the road, and that has been a source of great strength in American political life. But the sharing of power and the necessity of compromise slows our response to radical changes in conditions which are perceived as something short of an emergency. Without the party discipline of a parliamentary system, and with a Congress actively involved in domestic issues and reflecting the wide range of interests in American life, the ability of an American President to act quickly is necessarily hindered. As a consequence, the building of a national consensus on coping with inflation and a national energy policy was a far slower process than one would have hoped.

Changes in the way that the Congress organizes itself have exacerbated this trend. The democratization of internal procedures has weakened the power of Congressional leadership in comparison to prior years. The erosion of the seniority system has made it more difficult to negotiate compromises on major legislation. Simultaneously, there has been tremendous growth in the staff of Congressional committees, increasing their ability to develop their own comprehensive legislative proposals -- which often differ from proposals of the executive branch.

In the 1970's there also appeared an increasing awareness throughout American society of the importance of a presence in Washington. There has been a luxuriant growth of new lobbyists and lobbying groups. These groups tend to represent relatively narrow interests -- specific industries or sectors of industries or issues. The concomitant growth of public interest lobbies has tended to produce groups with a narrow focus, such as the environment, consumer safety, and the like. These developments have had very important effects: the ability of some groups to affect the re-election of particular Congressmen has meant the individual members of Congress sometimes find themselves compelled to represent very narrow interests. That makes it difficult for them to reach compromise positions; and, in turn, the overall process of compromise in the national interest is rendered more difficult.

Finally, I think American government has sometimes suffered from dealing with many issues in too short a time frame. Because of the organization of our national political life, the period for dealing with problems is often seen as beginning and ending with the two-year life of a new Congress, or at most the four-year life of a Presidential term. In some areas, the result is a lack of continuity and a tendency to repeat past errors.

In spite of these problems, I am confident about the future. The genius of the American constitutional system has been its ability to evolve and adapt to changed circumstances. Just as it is important not to view economic events in too narrow a time frame, it is foolish to assess the evolution of political institutions without perspective or foresight.

In my judgment, the fact that only the President has a truly national constituency will bring more balance to the relationship between the executive and legislative branches on domestic policy issues. Moreover, the Congress is developing institutions to encourage consideration of issues in a broader context. Recent years have witnessed the growth in importance of Congressional budget committees. They are responsible for the macroeconomic effects of spending. Their primary goal is to place overall limits on Federal spending, leaving the allocation of that amount to the appropriations process. In addition, there is heightened awareness and concern about the implications of single-interest lobbies for the political process.

Most important, however, is that the 1970's were a time of building agreement for the 1980's. I think there is a clearly evolving national consensus on the principal issues:

- -- inflation as a major source of national concern
- -- the need to bring fiscal and monetary policy into better balance over time
- -- the need for higher levels of savings and investment
- -- a distrust of economic regulation
- -- a new appreciation of the economic burdens imposed by detailed regulation in areas of social concern, and a willingness to experiment with less detailed and coercive methods
- -- adjustment to high energy prices.

The Evolving Economic Consensus

Inflation

There is little doubt that, as a nation, we were relatively insensitive to the problem of inflation in the post-World War II period. The 1950's and 1960's were a period of vigorous growth and only modest price increases. During the past ten years, the shock of successive oil price increases coupled with a reluctance to accept the implications of the transfer of real wealth that is necessarily involved, growing transfer payments, an accommodative monetary policy and other factors have produced successive waves of inflation. Inflationary expections have become embedded. Nevertheless, there is now full recognition of the importance of controlling inflation as a national goal. Of course, the debate continues about where the sacrifices should be made, the necessity of recession or slow growth as a precondition to the cure, and the usefulness of direct controls. But it is very clear that the debate is about means, not ends. The broad range of the middle class in America has seen the toll inflation takes from its financial assets -- and it does not want to see it again.

There is also greater recognition that monetary policy alone cannot do the job. While the problem of balancing the Federal budget in time of recession has posed formidable obstacles, both sides of the political mainstream seem committed to that goal for fiscal policy. Only substantial progress in that direction will reduce the pressure on monetary policy that is created when it is required to bear the whole anti-inflation burden.

Savings, Investment and Productivity

Similarly, never in my memory has there been such widespread concern about our slipping productivity and the need to increase levels of savings and investment. Particular attention has been focused on the capital needs of new and emerging industries. The goal of increasing the flow of venture capital has become a talisman for Congressional activity. I sense that the tendency to view entrepreneurial rewards as somehow immoral or distasteful has faded.

There is no better illustration of this trend than the reduction of the capital gains tax rates in 1978 over the initial objection of the Administration -- which preferred a different approach to the problem -- or the emphasis in our current tax reduction debate on incentives for capital investment.

In addition to the boost that will be given to investment by higher returns on capital, resulting from lower taxes, United States productivity will improve in the 1980's because of the maturing of the post-war baby boom generation. That large group in the labor market will move into the 30 to 40-year age bracket, where their greater maturity will have an important impact, especially in service industries where the training and experience of the work force means so much.

Regulation

The United States has also entered a period of disenchantment with direct regulation and a new commitment to the market system. In particular, the last few years have seen a dismantling of much economic regulation -- by which I mean barriers to entry, administered pricing and artificial division of markets. It has occurred in an impressive way in transportation and communications, and is proceeding apace in the financial markets.

The 1970's saw the growth of new kinds of regulation designed to address actions by American business -- such as environmental pollution -- that create social costs that are external to the market system. No one is terribly pleased with the results. The supporters of laws designed to protect the environment and to promote safety in the workplace and the home do not think enough has been accomplished. Others point to the rigid web of rules that were constructed to achieve these ends and the resulting economic burdens. There are presently pending in the Congress more than 20 bills designed to make the regulatory system work better, and to encourage it to weigh economic burdens in the regulatory balance. Moreover, there is great willingness to experiment with new forms of regulation, such as disclosure and the use of tax incentives.

I do not by any means intend to suggest that the basic social concerns that gave rise to this legislation have lessened. Not at all. But there is a clear desire to seek alternative methods of enforcement that impose lower costs.

Tax Policy

If America is to be an attractive home for equity investment, then we must also face the question of the adequacy of our tax policies. Lower capital gains taxes address only part of the effect of the income tax on equity investment patterns. That step favors venture capital and growth companies in which the investor's return is largely measured by the increase in securities values. Many large companies, like utilities, have huge capital needs and depend on current returns to attract investors. For such companies, only integration of the taxation of dividends and interest would end the current discrimination against equity in favor of debt -- a system under which corporate funds paid out as interest are deductible, and thus are paid with pre-tax dollars, while dividends are not deductible, and must be paid out of after-tax earnings. More broadly, our tax system tends to favor consumption over investment. Interest paid on consumer debt is deductible, while income received from savings is taxed at ordinary income rates. Indeed, capital income other than capital gains is taxed at potentially higher marginal rates than salary or wages.

These general biases can be attacked only through comprehensive tax reform. But that is an endeavor so loaded with political minefields and special interests that its achievement is doubtful. On the other hand, it seems to me that specific measures to increase the attractiveness of capital income are quite likely. And I would expect the tax environment for equity investment in the 1980's to be quite hospitable.

Energy Costs and Availability

I have not discussed the likelihood or impact of future shifts in energy prices and availability, and I do not intend to do so today. That is a question so fraught with uncertainty that forecasting the course of future events is a task I am grateful to avoid. I think we have finally taken substantial steps to put a coherent energy policy in place. Petroleum conservation has been very impressive. Our automobile industry has undergone a major shift in product strategy. And American habits are changing. We have enormous coal resources, and I think that development of nuclear power will resume. The United States will be well-positioned to cope with the energy transition of the next 15-25 years.

* * *

In short, I come to you as an American who is optimistic -- about our financial markets, our political system and our economy.