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# DEMOCRACY AND THE PLANNED ECONOMY -- FRIENDS OR FOES?

An Address By

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In the past year, deregulation, re-regulation, and regulatory reform have become the slogans of practically everyone. Yet, at the same time, we are plowing inexorably ahead with laws, regulations and rulings that materially increase government regulation of the economy. There is even now an effort in Congress to secure laws providing for an all-encompassing federal, master, long-range economic plan.

There is an apparent contradiction between what we seem to be saying and what seems to be happening. We must ask -- do economic planning and democracy go together -- are they friends or foes?

But my primary focus tonight is not on regulatory reform -- rather, it will be an effort to take something of a Bicentennial view of capitalism and particularly to comment upon how government regulation of capital formation and allocation may be affecting both capitalism and our traditional form of government.

Let me offer my thoughts -- as they have been affected by one year in government service, nine months spent in an effort to deal with the problem of government economic planning, and three months spent as part of the problem.

The premises for these remarks are borrowed in part from a recent book by Professor Daniel Bell:

First, we have witnessed a rapidly-rising standard of desires since World War II. Today the level of property to which people believe they are entitled to is higher than it was 25 years ago. We live in biggger -- not necessarily better -- houses. We drive bigger -- not necessarily better -- cars.

For good or for bad, our appetites as a society are increasing faster than our resources. Frankly, we have too often ignored the fact that we are motivated as much by our drive to consume conspicuously as we are by our desire for economic well-being, and so no given level of economic well-being will ever suffice. We have, says Bell, gone through a revolution of rising entitlements.

Second, we have developed a large number of incompatable wants -- of diverse values. Once we perceived only single truths; one problem, one answer. Something was either desirable or undesirable -- right or wrong. Social and economic problems are subject to rational solution in such a framework. But now we recognize relative values, liberty vs. equality, efficiency vs. spontaneity, knowledge vs. happiness.

These are not absolutes. To resolve such problems, we must chose beween different "rights", not necessarily between right and wrong.

Put another way, we do not have sufficient resources to meet all the desirable goals that we have set for ourselves.

Third, our grand economic growth has had serious spillover effects. Agricultural gains brought chemical pollution, smog came from cars. These spillover problems are similarly incompatible. No one has a formula to decide how many jobs or how much food justifies how much pollution.

Fourth, increasing demand, lagging capacity, and the rising cost of resources has brought us something close to permanent inflation, a factor complicating all the others.

Because these factors have grown in relative importance, we have, as a nation, become less willing to allow free competition to make the necessary economic choices. Because of our unwillingness to wait for the verdicts of the market place, we now tend to make more of these decisions in the political arena.

We have changed our approach, not because some new ideology has manipulated a political conversion, but rather because of the increasing distrust by the Congress and voters of the free markets. People do not believe in our competitive free-enterprise, capitalistic system; because they don't believe its competitive, they do not believe its free, and the word "capitalist" sounds like another one of those fellows who won't tell the truth.

So, we have moved ever closer to "state capitalism," to state-directed economics.

Today, where government expenditures are about forty percent of our gross national product, the chief political issues, whether we notice them or not, deal with the allocation of capital.

Our banks are the focus of such an issue now. Headlines list "problem" banks, public figures accuse the banks of poor management, and government agencies of too lenient regulation. There is an overtone to Congressional criticism that says the Controller of the Currency and the Federal Reserve Board should have kept those banks from making such bad loans.

Such pressures can clearly cause a redirection of capital, and could, if they persist, drastically curtail capital availability to smaller growth businesses that present greater risks.

When such decision-making is subjected more to political processes and less to market forces, a fundamental change can occur in the nature of our government as various segments of our society organize specially to influence capital allocation.

No longer is it management versus labor. More likely, it is the Northeast versus the Midwest, or urban interest versus rural interest. Such combinations, coupled with "social litigation", often produce paralysis, sometimes seem to procure social victories, but almost always distort capital allocation.

The unfortunate fact is that we have no reliable mechanism to deal with such controversies, and so democracy, in the form we would like it to be, suffers from new forms of organizational pressure.

It is instructive to observe Europe. To look back at their experiments with national planning.

Raymond Vernon, in his introduction to "Big Business and the State", characterizes these European experiments with state capitalism this way:

> "Public authority had been parcelled out among committees, organizations, and enterprises throughout the society . . . . and the result had not been encouraging.

His conclusion is grim.

> "In brief, there has been a growing tendency to use large national enterprises in an effort to solve specific problems as if they were agencies of the state. And, there has been a a related tendency to develop methods of government that have reduced the role of the parliamentary process and elevated the role of specialized groups."

There is a sufficient justification for the growing tendency to use national planning.

Of even greater concern is the fact that wide areas of government economic regulation have been implanted in our society without any particular thought.

Take, for example, tax laws which discriminate against equity capital by allowing deductions for interest payments, but not for dividends. There have been substantial shifts from equity to debt in corporate capital structures since 1950 arising, in significant part, from this tax preference. Between 1951 and 1975, the ratio of debt to equity for manufacturing corporations has increased from less than twenty percent to more than forty percent. This preference for debt financing grew up inadvertently.

Preference for debt obviously increases corporate leverage, and builds instability into corporate earnings. Most important, the absence of dividends makes equity capital investments less attractive.

The point simply is that, without plan or thought, our tax policies have allocated unknown amounts of capital away from equity securities with results that we cannot even accurately describe -- but we may suspect that the problems of the late 1960's, the go-go years, and the problems of some failing companies today, can at least partially be traced to this inadvertent policy.

Each time government wittingly or unwittingly affects the allocation of capital or the process of capital formation, the economy is deprived to some degree of the benefits of free competition. It almost necessarily follows that some business enterprise that would otherwise secure capital, or secure it cheaper, is penalized.

Each time we create a disincentive for good management or good ideas, we risk the loss of some real economic growth.

If the sad record of government planning in Europe is not a sufficient warning to those who forge ahead here, surely our efforts to "plan" competition in the airline, railroad, and maritime industry should be enough to damper the ardor of even the strongest devotee of state capitalism.

Much of our railroad system is either in bankruptcy or teetering on the edge; our maritime industry propped up by subsidies cannot compete with anyone; and many airlines faced with bankruptcy seek subsidies or other government aid.

The sum of government planning in the airline industry had diverted attention from good management efforts which could call for different routes, different prices and different equipment, into a struggle for the attention of government planners.

Who can blame the banks who will not loan to the airlines and investors who will not invest in them for distrusting both the willingness and the capacity of the government to fix fares and award routes at an economically correct and predictable level?

Major airlines now wish to have large subsidies from the government, in part because they say that government policies have induced them to do uneconomic things. Who can tell? Who knows what they would have done if their sole concern had been with their need to compete efficiently?

And, if such subsidies are granted, who will explain to profitable competitors, who made it on their own, that they must now compete against state capital?

The real tragedy today, in the larger sense, is that management of many of these airlines, who are admittingly flying routes they would rather not fly, resist legislation that would gradually return the industry to a more competitive status. How can they believe that risk capital refers to the risk of government action rather than the risk of inefficient management?

The real losers are the public who will continue to pay as they watch the spectacle of these huge corporations competing vigorously over the quality of their china service and their wine but <u>never</u> over the level of their fares.

Thirty-eight years of government planning for the airline industry has:

> "Stifled innovation, protected inefficient practices, created distortion . . . and caused a chronic tendency toward excess capacity."

The path of federal interference with market forces is sticky. By guaranteeing the loans of a major airplane manufacturer, the federal government financed the manufacture of large planes which cannot be sold or which have been sold to airlines that cannot afford them.

The bankruptcy of a large employer would certainly have significant repercussions -- but should the federal government step in to prevent the benefits of competition from going to competitors who compete without federal guarantees.

Time and again in so many industries we see management and labor combine with their Congressional representatives to compete for greater government largesse rather than for a better market positions.

There is, in short, every reason to fear that Raymond Vernon's analysis of government economic planning in Europe holds a lesson for America. When private industry is manipulated by government to solve problems of the state, or when private industry pressures the government for capital advantages, the industry tends to be less efficient, and the state tends to be less democratic.

What can be done to reestablish faith in the market place, to ward off the eager efforts of special interest groups, or of government regulators?

The predicate, of course, is the creation of greater confidence in the capacity and the character of our governmental and business institutions. That confidence has taken, and is taking, a pretty good battering these days, but maybe we can begin the process of rehabilitation.

For example, those who dwell on Watergate and complain about the lack of national leaders have missed the fact that this nation survived a major Constitutional crisis, and this this government has managed to guide our distressed economy into a sound recovery far ahead of the other free nations of the world.

If the charge is that this government did nothing, that the economy did it on its own, and strong leaders could do it faster, my point is made. If only our leaders had been strong enough and wise enough to do nothing in 1971 when wage and price controls were imposed to "help" the economy:

Consider what those controls accomplished. Before controls, our real growth rate was three percent, our rate of inflation was five percent, and our unemployment rate was five percent. What we would have given for those same statistics after we got over our craze for controls.

Confidence in our business community and its capacity to compete fairly has been badly shaken, perhaps destroyed at least temporarily, by recent evidence of corporate bribery. We must, as a government and a society, condemn bribery anywhere. If bribery will get a contract for a manager in a foreign country, and if he is permitted to try it: Who will be convinced that the same company that bribes abroad will compete fairly at home.

But while we deplore these revelations, we should not believe, and I do not, that bribery is a material factor in the success of American business. Neither should we overlook the determination and the capacity of most business leaders to rid their companies of such practices.

That private industry spurred by the SEC can right the wrong is dramatically evidenced by the remarkable report on the activities of Gulf Oil made to the board of Gulf by a committee chaired by the distinguished Wall Street lawyer, John J. McCloy, who states:

> "The reality is that the long practices of illegal corporate contributions by Gulf is effectively at an end."

President Ford's strong condemnation last week of any American company that makes unlawful payments to officials of foreign governments and his decision to appoint a cabinet-level committee to deal with the subject is further evidence that confidence can be restored.

Similarly, if recent headlines about problem banks have shaken confidence in the banking system, consider the pledge by the Bank of America last month:

> "To develop a model code of voluntary disclosure to assume full and fair and adequate and honest reporting of material events"

I suggest to you that the ethical standard sought by the President, by the Special Committee on the Gulf Oil, and by the Bank of America can become the standard of American business.

I might add that the staff of the SEC can be justly proud of their efforts which spurred this major corporate reassessment. Major American companies with total sales of over 138 billions of dollars have already taken effective steps with the knowledge of the SEC to stop these illegal payments.

Disclosure alone cannot restore confidence in our institutions. Indeed, disclosures carried to an irrelevant degree would only obscure its true value, but the discipline of disclosure will be a power catharsis for much of our present cynicism.

Nor will the election of decent and strong political leaders be sufficient to restore confidence in government. Our laws must be fair and appear to be fair. In this respect, we can no longer suffer a set of tax laws which, to borrow the words of Secretary Simon:

> "Has caused bewilderment and distrust among taxpayers with its myriad of so-called loopholes."

Faith in the fairness of the tax system, and indeed in all of government could be restored by the adoption of Secretary Simon's bold proposal to:

> "Wipe the slate clean of personal tax preferences, special deductions and credits, exclusion from income and the like, imposing instead a single, progressive tax on all individuals.

No temporary disruption in the flow of tax revenues would offset the immense benefit that such a step would have for the self-respect of the nation.

Fair and understandable taxation, full disclosure of corporate activities, and a new faith in the free competitive market will not eliminate the need for government economic regulation; nor will it eliminate the special groups and industries that seek to influence such regulations.

At this juncture, the need for a rationalization of the regulatory process becomes critical. Regulators must be chosen who appreciate the therapeutic value of competition and who are willing to temper lawyer's logic that relentlessly regulates with economic data that can test the need for regulation.

I have no miracles to suggest, but allow me to close by describing an approach we are initiating at the SEC.

We will soon announce a new appointment of a distinguished economist to head our newly formed office of economic research and policy planning. Together with our existing staff, he and four highly qualified economists in our new fellows program will establish day to day economic analysis in each of our Divisions. In the embroyonic stages of newly proposed regulation, a careful empirical and theoretical analysis will be made of the purposes of all proposed regulations.

If the regulatory urge survives this obstacle, the regulatory objective will be carefully articulated and an econometric monitoring program will be instituted so that the Commission must decide within six months or a year later whether its purposes have been met. If they have not, there will be a self-destruct mechanism in the regulation.

Also, we began two weeks ago a major overhaul, guided by outside experts, of our entire disclosure program for the purpose of creating a new disclosure policy tailored for today's economic realities and today's investors.

The purpose of all this is simply to seek more data to find out what is happening before we rush in with new laws or regulations. As the Wall Street Journal put it:

"Lawyers have passed over 35 million laws to enforce the Ten Commandments"

One of my more skeptical associates warns me to be wary of this new reliance on economists. He says the only thing they can be relied upon for sure is to tell you in the Spring precisely why their predictions of the prior fall failed to materialize.

But he reassures me that the experiment will be well worth it, if only the influence of the Lawyers and that of the Economists cancel each other out.

I am pleased to be with you, to return to my home and pleased to participate in this testamonial to a splended educational institution.

I am pleased particularly to report to so many friends that the instincts of decent and capable goverment have survived, that our finest people are still attracted to Government service and that the spirit of innovation in Politics, Government, and Business still has this capacity to provide dynamic leadership.

With the willingness to be bold encouraged by people like yourselves, we will continue to be a proud and democratic Nation.

Thank you so very much for coming.