POLITICAL PHYSICS-ACCOUNTABILITY VACUUMS AND SOCIAL DYNAMICS

by

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I am honored to appear before you today as the 1980 David R. Calhoun, Jr memorial lecturer. My topic this afternoon, corporate accountability and the balance between the public and private sectors in fostering it, was a subject to which David Calhoun was especially sensitive. He was influential in the establishment of independent audit committees long before their importance was as widely recognized as it is today. Similarly, he perceived clearly the unique role of the outside director and brought the same seriousness of purpose, care, and thoroughness which marked his other activities to his own board responsibilities. As the chairman of one of the boards on which Dave Calhoun served put it, "He was looking after the interest of shareholders long before there were any Ralph Naders."

The opportunity to speak from this podium on the role of government in the American economy is especially stimulating. Washington University is widely recognized as one of the focal points for analysis and debate concerning regulatory reform, and Murray Weidenbaum, the guiding force behind the Center for the Study of American Business, as one of that movement's most thoughtful and provocative contributors. As a former business executive, former management school dean, and current chairman of a major federal regulatory agency, the work which is being done here is of special interest to me. Regulation is a big business. While it is the subject of intense public concern, it has received inadequate academic scrutiny. Indeed, there is no organized body of research, theory, and knowledge from which those who chose to engage in the field can learn and build on the experience of others. That condition underscores the importance of this University's, and specifically the Center's, commitment to the field.

I have chosen as my title today "Political Physics -- Accountability Vacuums and Social Dynamics." As that phrase suggests, the interplay between government and business is dynamic -- pressure applied at a given point in the system will have consequences, often unforeseen, at many others. At the same time, the relationship between government regulation and private economic decision-making is, I suspect, subject to discernible principles, much as the movements of natural bodies are subject to the laws of physics. "Political Physics" has not yet, however, encountered an Issac Newton. Its principles are poorly understood, and the social consequences of alterations in political or economic structures defy accurate prediction

For this reason, my theme today is not that we need more regulation to ensure a more just society -- or less to guarantee a more productive one. Rather, it is a warning that we lack a well-developed philosophy within which to evaluate the interaction between a free market economic system and the increasing governmental and political involvement in that system. Whether under the banner of regulatory reform or some other, we need to develop a coherent set of principles aimed at creating an equilibrium between the energies of a free, private economy and the meliorating effects of regulation. That equilibrium must not fetter the private sector and prevent it from continuing to provide us with the wealth necessary to attain our national aspirations. Similarly, however, we must take care not to denigrate government's role in satisfying the deep-rooted belief that private economic power must be accountable to the public good. Reforms -- regulatory or otherwise -- which fail to strike a reasoned balance between these precepts will, in my judgment, prove inherently unstable.

In examining that challenge, it is useful to bear in mind the larger context in which the regulatory reform debate is occurring. The subject of the government's role in constraining the business community is obviously one of practical significance to our Nation as we struggle with rising inflation, declining productivity, high interest, low rates of savings, and other phenomena which influence our daily well-being. The debate in this country today concerning regulatory reform is, however, only a small component in a larger contest between the advocates of individualism and statism. Since the Renaissance, Western societies have placed their emphasis on the individual and on the benefits which flow from his unrestricted ability to utilize his creativity, ingenuity, and energy for personal and societal gain. Historically, those cultures which have operated on this premise have flourished Nonetheless, in this century, as advances in science and technology have propelled us into societies more complex, more interrelated, and more heavily dominated by institutions which seem to dwarf the individual, questions have arisen concerning whether personal freedom, in its traditional sense, has become obsolete or dysfunctional. As we proceed, unconsciously for the most part, to grope for a new political, economic, and social order in this country, we are therefore confronting a very basic question. In the final analysis, our task is to balance the benefits of individual freedom against the need for social cohesion and consensus in a fashion which creates a society both humane and effective.

The Private Sector and Public Values

In exploring the balance between government regulators and private decision-makers in our economy, it is perhaps useful to consider at the outset what in the private enterprise system spawns demands for the regulation of business. Proposals to reform or repeal regulation which fail to come to grips with the factors which motivate government intervention are likely doomed to failure.

The American economic system has propelled us, in less than a hundred years, from an under-developed, primarily agricultural, society, to one of mass wealth and mass consumption. In the process, we have raised the standard of living in much of the rest of the world along with our own. And, most importantly, we have created a society which respects fundamental human values and affords the economic freedom for large numbers of our citizens to spend a significant share of their energies pursuing those values.

While the United States has developed a free-enterprise system typified by de-centralization of power and diversity in addressing national needs, other societies have, of course, made other choices. In the Soviet Union, for example, the state is explicitly intended as a tool to reshape society according to predetermined contours, and the individual's role is derivative of the needs of the state. Correspondingly, in the economic sphere, the Soviet government exercises rigid control over virtually every aspect of production and consumption.

Theoretically, one could establish a socio-economic continuum along which each nation could be placed. At one extreme would be the totally unregulated economy, in which government, at most, is assigned a role in promoting business interests. In the middle, in the area of mixed government-private sector cooperation, which includes some level of regulation, would be clustered the world's democracies -- some, like Japan, placing greater emphasis on governmental direction; others, like the United States, traditionally allowing greater private sector initiative. State controlled economies would fall at the other end of the spectrum. The direction in which this Nation, wittingly or unwittingly, is moving, or should move, along this continuum may be the most significant political question of our time.

In any event, the key point to bear in mind is that the unprecedented strength of our economic system is, in large measure, the direct result of private economic decision-making -- a fact which is all too easy for the regulator to forget. The source of the private sector's great power is, however, also the source of society's tendency to seek curbs on that strength. The free market system is value neutral. As a result, it is an efficient allocator and prolific well-spring of goods and services. Unless hampered by external forces, the market, in its purest form, responds equally to buying power or talent or creative genius regardless of the ancestry, social philosophy, race, or religion of market participants. At the same time, however, the free play of market forces is oblivious to any concepts of what might be called "social justice." If the market does not value what one has to offer, one receives nothing in return; and if, as a result, one succumbs to starvation or is driven to championing government overthrow, that is a consequence of no direct relevance to the interplay of the impersonal forces of demand and supply.

Unlike those forces, however, society and its members do have non-economic values -- values which may well be offended by the cost and wealth allocations of the free market. For this reason, in a democratic society, the consequence of the workings of a value-neutral free enterprise system -- no matter how successful in economic terms -- is increasing government regulation of private business. Much of the work of the political system during the last 90 years has been directed toward using government to temper the power and efficiency of the free marketplace with notions of fairness, justice, and some measure of economic equality. Government is the medium for implementing political determinations, and the type of democratic process which our political system embodies tends to be egalitarian, consumption-oriented, and concerned with the common man and equal distribution of income and benefits. Business, on the other hand, functions by incentive and reward, is hierarchical, rewards risk-taking, and fosters uneven distribution. Democracy is concerned with values -- the free market is essentially value-neutral. Free enterprise encourages self-interest, while democracy focuses on common purpose. Democracy inclines towards compromise and conciliation. In its purest form, the phenomenon we call the "free market" is intolerant and uncompromising. The consequence of these differences is that government's power is invoked to impose society's values on the marketplace.

The Limits of Regulation

There are, however, two sides to this coin. We are today beginning to realize that, as more and more of these "extra-economic" demands are placed on the market, there is a corresponding loss of efficiency and effectiveness in business's ability to meet its traditional economic goals, such as providing employment and a source of livelihood for our workforce; supporting the innovation, reasearch, and investment necessary to keep the economy going; and producing the goods and services which define our standard of living. The impact of that realization is visible in the current demands for deregulation and regulatory reform.

Our society as a whole, and business as a part of society, is being compressed between competing claims and goals, each of which could be achieved individually, but not all of which can be attained at once, without adversely impacting the health of both the society and the market system. What our priorities should be, where our scarce resources should be applied, and what systems impacts we can accept are questions which are seldom explicitly addressed. The result is often the adoption of regulatory solutions to perceived social problems which reflect political expediency and compromise rather than reasoned judgments about society's overall needs and capacities. Only recently has there been any significant degree of public recognition that we cannot afford everything we might want and that the burdens of regulation are felt in every pocketbook. Traditionally, the American political system has lacked the ability to set limits on popular expectations of what government can accomplish -- to say "no" as well as "yes" to demands for public solutions to private sector problems Our brand of democracy encourages coalitions of single interest constituencies and affords them tremendous leverage over governmental decision-making.

The result is a tendency to try to create a remedy for every wrong. Thus, Americans have implicitly assumed that government's role is to create a risk free society. Today, however, we are beginning more frequently to ask whether every risk, every accident, and every loss really require, as a matter of societal philosophy, a statutory redress -- or a rush to legislate against the possibility of a repetition. And, even those who are tempted to answer that question affirmatively, may not be prepared to live in a society burdened with the magnitude of the governmental role which that choice would entail. As Justice Brandeis put it many years ago·

> "Experience should teach us to be most on guard to protect liberty when the government's purposes are beneficient. * * * The greatest dangers to liberty lurk in insidious encroachments by men of zeal, well-meaning but without understanding."

At the same time, however, an underlying American political axiom is that anyone who exercises power must be accountable to someone else for his or her stewardship -- or, in other words, that there be no vaccuum in accountability. The logic of this precept is that a person who is not subject to an accountability process will tend to exercise authority in an autocratic, arbitrary, or anti-social manner. We are reluctant to allow powers which can influence society as a whole to be exercised by any institution unless it is subject to an accountability system. An obvious example is the Constitutional system of checks-and-balances with which all secondary school civics students are familiar.

The same rationale extends to the economic arena. If the national mood seems to have turned against government intervention, consider the demands for strict restraints on nuclear power – hardly an unregulated activity -- following the Three Mile Island incident; the calls for special taxation of the oil companies as a result of the rapid rise of oil prices; or the enactment of the Foreign Corrupt Practices Act following revelations of questionable overseas corporate payments. In short, given a struggle between government's interests, as defined by a public consensus, and business's interests, as defined by the interplay of market forces, government will inevitably prevail.

Toward a Regulatory Philosophy

Let me summarize the dilemma which I believe must be confronted by every regulator and every advocate of deregulation On the one hand, despite -- indeed because of -- the strength and power of a market economy, some measure of inequity is an unavoidable by-product of the generation of wealth in a free enterprise system. Although that unfairness is part of the force which drives the system, certain of its consequences will be unacceptable in a society which places a premium on human worth. Accordingly, the power of government is invoked to regulate business.

Yet, it is not government that creates the economic wealth we have come to expect -- although it is also not the marketplace which creates the political equality, equity, and egalitarism which we demand. The two forces together have fashioned the uniqueness of this society. Both are valid; both must be healthy; and both must be mutually supportive and yet mutually independent in order to thrive. Thus, if we are to move from being a political economy to being an economic polity, that judgment must be made consciously and with great care and deliberation.

Many, however, view the contemporary federal regulatory structure as moving us inexorably along the scale toward a stullified, state-run economy. Our federal regulatory machinery is the legacy of a generation which proliferated well-intended, but not always effective, regulatory efforts to deal with noneconomic issues in a setting of unprecedented economic prosperity. That machinery has not worked uniformly well, and the economic growth that spawned so much social legislation and regulatory initiative has waned. Thus, the process needs to be reassessed and the machinery reshaped to reflect the economic and social challenges which we now face. For that reason, I support the broadly-based movement in favor of regulatory reform.

On the other hand, the social expectations on which much of our regulation is premised have not disappeared. While these concepts of social justice cannot be comfortably quantified or reduced to "costs" and "benefits," they are nonetheless very real in political terms. And, to complicate matters further, when the economy's ability to meet the ever-rising expectations of society's members diminishes, the demand intensifies for more government intervention in order to ensure the "fair" distribution of the shrinking pie.

I have no simple answer to this dilemma. I do, however, want to devote the balance of my remarks to outlining factors which I think must figure in the solution. The problem needs to be approached from two perspectives -- that of government and that of business.

A. The Role of Government

Contemporary advocates of regulatory reform tend to view the problem on an agency-specific basis. The Congressional oversight process, for example, assigns responsibility for particular agencies to the Congressional committees with an interest in the subject of the agency's work. As a result, with some notable exceptions, both the over-seer and the over-seen tend generally to have the same general philosophy about the importance of regulation in the area involved. Similarly, while the pending regulatory reform legislative initiatives would change the way that agencies make decisions and the considerations which they bring to bear in the regulatory process, these proposals would not generally enhance their ability to balance considerations outside of the agency's mandate. Both of these approaches to regulation work from the premise that, if particular agencies were more thoughtful or more limited in their power or more closely overseen by Congress, the quality of regulation would improve and the quantity decrease.

While there are serious limitations to this view, agencies can indeed alleviate many regulatory problems within the existing framework. Since 1977, the Securities and Exchange Commission, for example, has undertaken to review the body of its rules in particular substantive areas with a view to eliminating regulation which has outlived its purpose or which impedes some more fundamental objective. The Commission's attitude toward small business capital formation presents an apt example of this latter effort. We have recently created several new avenues by which small and start-up ventures can raise capital without submitting to the full panoply of Securities Act registration requirements.

Another theme which the Commission has sought to inject into its regulatory philosophy is the elimination of complex and stringent regulations which deprive business of the responsibility to manage its own affairs. In the investment company area, for example, the Commission has traditionally prescribed many of the minutiae of day-to-day business activity. The Commission has now shifted its focus to marking out the contours of investor protection and permitting investment company directors to decide, within these contours, how to proceed. Indeed, regulatory revisions of this nature are part of a larger process of stimulating the private sector to assume its own responsibilities and function in a fashion which obviates the need for further regulation. In a broad sense, the Commission's corporate governance proceeding, its emphasis on audit committee and independent directors, and similar Commission initiatives, are examples of this philosophy.

The Commission has also made considerable progress during the last several years in integrating economic analysis into regulatory decision-making. The Commission's Directorate of Economic and Policy Analysis, staffed largely by economists, works closely with the more legally oriented divisions during the formulation and evaluation of both regulatory and deregulatory proposals. The result is a better informed decision-making process and rules which have less of a tendency to ignore economic realities. Similarly, the Directorate and the operating divisions have devised innovative monitoring programs in order to track the impact and operation of selected rules after they are adopted.

Finally, the Commission has sought to further illuminate its decision-making by ensuring useful public participation in its proceedings. For example, the Commission periodically publishes a list of its pending rule-making proposals and is contemplating the publication of a similar list on its deregulatory initiatives. In addition, the Commission has been holding some of its public hearings outside of Washington in order to have the benefit of views it might not otherwise hear. I believe these steps have been useful to both the public and the Commission.

As the Commission's experience illustrates, there is much that agencies can do on their own. In my judgment, however, the regulatory reform legislative proposals currently before Congress do little to encourage this initiative or experimentation -- and much to hamper legitimate government processes. If regulation is to be rationalized with contemporary national objectives, and if patterns of regulation that spring from the requirements of law are to be altered, the President and Congress must amend the substantive laws under which administrative regulations are issued. In some cases, for example, complaints about government regulation can be traced to the philosophy, reflected in the organic acts of many agencies, that remedial legislation should be drawn broadly to give the regulator maximum discretion. In other cases, the opposite is true; the agency may be statutorily prevented from considering important national policies or economic objectives which impinge on its mandate. In both cases, the only cure is to rewrite the underlying law. Amending substantive law, however, is not "regulatory reform;" it is law reform.

Moreover, if there is to be fundamental change, a different tack is also necessary. The problems of regulation cannot be fully cured on the individual agency level -- no matter how sensitive and progressive the agency or how enlightened the statutory scheme within which it operates. The balance between regulatory constraints and business latitude needs to be addressed from a much broader perspective. A framework is necessary within which the overall costs and burdens of regulation can be assessed and trade-offs made between competing regulatory and economic goals.

The budget process -- another complex trade-off in national priorities -- affords a model which could be adapted to bring discipline and a broader perspective to regulation. I have previously proposed that the President be required to submit during the first session of each Congress a "state of regulation" report. In it, he would provide his assessment of the efficacy of existing regulatory programs and discuss those regulatory schemes -- or entire agencies -- which needed to be strengthened, and those which should be cut back, reorganized, or abolished. This report would also harmonize the regulatory activities of government with the President's overall objectives for the Nation and with the budget, and reconcile any conflicts.

This document would reflect the considered -- and detailed -- judgment of the executive branch as to what our national priorities should be, what we can afford at any point in time, and the choices necessary to most productively use our resources to meet those goals. The present regulatory structure is heavily laced with implicit choices of this nature. For example, our desire for energy independence and our mandate to protect and improve the environment frequently conflict. Yet, there is no formal, intra-governmental process to resolve those conflicts; and a result, they either go unresolved or are forced, on a case-by-case basis, into the courts. Similarly, the important and unquestionably necessary national commitment to worker safety can conflict with the national objective of improving productivity and curbing inflation. There is, however, today no mechanism to balance these goals.

A presidential "state of regulation" report of the kind I have suggested would serve as a fulcrum for striking that balance. My proposal would continue the budget analogy by requiring the Congress to agree -- or disagree

-- with the President's approach through the passage of a series of resolutions addressed to the various areas of regulation. These resolutions, which would then be submitted to the President for approval or veto, would not enunciate specific regulatory changes, but rather, would state principles of regulatory direction. Once consensus was reached, Congress and the President would then proceed to implement the resulting philosophy. Congressional committees having jurisdiction over particular regulatory programs would be directed to conform their oversight to the spirit of the applicable resolutions. Similarly, with respect to the executive departments and agencies under his control, the President would ensure that the Congressional regulatory consensus was translated into regulatory policy. Finally, Congress and the President would integrate their regulatory goals with the federal budget so that programs would be funded -- or not funded -- in accordance with the larger regulatory plan.

B. Private Accountability

I want now to shift the focus from the role of government in rationalizing regulation to a corollary subject which is much less frequently discussed -- the private sector's role in avoiding regulatory encroachment. The natural appeal of proposals to deregulate and return important areas of existing federal regulation to the hands of the private sector make it convenient to ignore the fact that a loosening of regulation will not mean a decline in the public's concern over the accountability of corporate power. But it is necessary only to recognize the media attention which can be mustered for a phenomenon like "big business day" to realize the suspicion which many important segments of the public harbor toward private economic decisionmakers.

Unfortunately, the private sector's approach to the expansion of regulation has generally been reactive. Business often takes a stance of absolute opposition to regulation -- a position seldom successful in a political arena which places a high premium on compromise. Seldom, however, does business try to come to grips with the underlying problem -- or perceived problem -- which is fueling the demand for regulation

The private sector cannot afford the luxury of this approach much longer. Some business critics have already proposed that corporate accountability be obtained by legislating -- not additional regulation of specific business conduct -- but the structure of the corporate decision-making process itself. These critics have advocated such measures as standards prescribing the composition of the board of directors, including the particular constituencies whose interests specific directors must advocate, the nature and role of board committees, the process by which decisions with social impacts are to be made, and similar matters.

I, for one, am very skeptical that this kind of "regulation" is appropriate to the extraordinarily complex and diverse decisions that are encompassed by the corporate decision-making process -- or that such regulation would, in the long run, leave our personal and political freedoms unaffected. Nonetheless, corporate decision-making mechanisms clearly need an infusion of accountability and, over the past several years, I have advocated a variety of nongovernmental steps to that end, including boards composed wholly of independent directors, except for the corporate chief executive; assignment of the post of board chairman to an independent director; independent audit, nominating, and compensation committees; and other steps. The most important point is not the merit of these proposals -- although I continue to believe that they have considerable merit. Rather, the central point is that business itself has the primary responsibility for ensuring the accountability of corporate power. Whenever business, as perceived by society through the political process, fails to take that responsibility, government will step in.

In order to meet this challenge, the private sector needs to foster the self-discipline and initiative within the business community which will make legislative proposals, at most, a prod to the recalcitrant few rather than a source of potential upheaval for the majority. In order to accomplish this, however, the business community needs to develop more formal, more sensitive, and more effective organs for anticipating the sources of public concern over corporate behavior and addressing them before the momentum to legislate becomes unstoppable.

Business today lacks effective leadership on most questions of social policy. There is no mechanism for consensus building or for dealing with other groups and government. The consequence is that business typically forfeits any leadership role to the politician, and the political process, in turn, constantly chips away at business's freedom. We cannot, of course, expect business groups to become blind advocates of the public interest -- whatever that may be. But it is not unreasonable to expect business to adjust with more sophistication to the large and unavoidable role government now plays in many previously private decisions. And, it is not unreasonable to expect major industries, in their own self-interest, to fashion proposals for public policy solutions which balance corporate objectives and national goals.

This kind of private sector initiative is important, not only to preserve the business community, but also because private enterprise, operating under a profit discipline, creates a climate which sustains the democratic process as we know it. The reverse is also true. Political liberty is essential to flourishing economic opportunity, and the economic system itself stimulates the individualism essential to political independence. Business has shown itself to be the most flexible and dynamic mechanism for digesting economic and social change without disintegrating or losing its identity. Yet, if business waits for the Thalidomide case to occur with respect to corporate accountability, I am concerned that the legislative consequences may well mark the beginning of the end of that resilency and flexibility.

If business fails to take responsibility, there is little hope of reversing the current, almost blind, acceptance of the concept that government must become increasingly dominant in the economic sphere if society is to be tempered with fairness. However, as we elect to ignore the balance which must be preserved and accept increased government domination over business, we will eventually erode, not only the vitality of the free market, but also our political and our economic strenghts along with it.

Conclusion

I want to conclude by reiterating the point with which I began. Despite the pervasive role of government in contemporary society, regulatory science is a discipline that is still in its most nascent stages. As a result, the political system operates without the benefit of any comprehensive weighing of the effects of governmental regulation on society and relies on a principle borrowed from the laws physics -- power vacuums are inherently unstable phenomena into which an outside force will reflexively rush.

Quite clearly, a more subtle analytical framework is necessary, and all of us have a stake in its creation. A strong and viable economic system is a vital component of our society. But without some provisions for harmonizing the discipline of the marketplace with our social goals, our economic achievements lack purpose. Without economic achievement, on the other hand, our social and human goals would not be possible; personal freedom and dignity can exist only so far as the fabric of the society is strong enough to provide and protect them. The principles which should guide our efforts to balance these considerations are not well-defined. It is, however, clear that in the final analysis, our economic health and the social aspirations which our governmental structure implements are not contradictory. They are mutually supportive, interdependent traits, and without either, the richness, character, and humanity of our society could not survive.

Thank you.