

90-20



**U. S. Securities and Exchange Commission**  
Washington, D. C. 20549 (202) 272-2650

**News  
Release**

**COMPETITION IN THE 1990's**

**REMARKS OF**

**RICHARD C. BREEDEN, CHAIRMAN  
U.S. SECURITIES AND EXCHANGE COMMISSION**

**THE COMMONWEALTH CLUB OF CALIFORNIA  
SAN FRANCISCO, CALIFORNIA**

**SEPTEMBER 28, 1990**

## **COMPETITION IN THE 1990'S**

**Remarks of**

**Richard C. Breeden, Chairman  
U.S. Securities and Exchange Commission**

**The Commonwealth Club of California  
San Francisco, California**

**September 28, 1990**

**Ladies and gentlemen, it is certainly a very great pleasure for me to be here with you in San Francisco. My years at Stanford University, as well as living here in San Francisco for a time gave me a great appreciation for the beauty and vitality of the Bay Area. Of course, the quality of life has declined somewhat since I lived here -- then we had two consecutive Rose Bowl championship teams down at Stanford.**

**Stanford has not been the only part of the Bay Area to produce champions in recent years. In Silicon Valley and elsewhere on the Peninsula, as well as throughout the Bay Area, new companies have emerged and prospered. Often built on a foundation of the world's most advanced technology, Bay Area companies in many different**

**industries have proven the strengths of the U.S. in global economic competition. California's strong position in Pacific Rim trade is certainly enhanced by the economic and technological vitality of so many such companies.**

**Maintaining U.S. global economic competitiveness is certainly one of the crucial challenges of our era. In facing world competition, the U.S. has many important economic strengths.**

### **Our Competitive Position**

**We still have the largest economy in the world, both in absolute terms and per person. In terms of GDP per worker (including both agricultural and service sectors), the United States is more productive, on average, than Germany or Japan. German productivity (measured as GDP per worker) is only 78%, and Japanese productivity only 73%, of that of the United States. Adjusting for differences in hours worked, the average U.S. worker can produce in only 49 minutes what it takes his German counterpart one hour to produce, and in only 32 minutes what takes an hour in**

**Japan.**

**- Our universities are among the finest in the world, and each year thousands of foreign students come to the United States to attend them.**

**- Our innovativeness and creativity is the source of new technologies and new products.**

**- Our political system cannot seem to produce a federal budget, but we otherwise have a strong and dependable system of laws and government.**

**- We have a very large domestic market, with strong ties as well to both Canada and Mexico.**

**- Throughout the 1980's the U.S. had a very strong economy, with GNP growth from 1982 to 1989 of over 30% (compared with only 32.8% in Japan).**

**- The U.S. has consistently produced vast numbers of new jobs, particularly concentrated in small firms. Throughout the 1980's**

**U.S. job growth was higher than that of many of the other industrial nations combined.**

**While the U.S. is a leader in many areas, other countries are catching and even surpassing us in some respects. For example:**

**- During the 1980's, the rate of increase of productivity of U.S. workers was only about half of that in Europe, and only about one-third of that in Japan.**

**- From 1980-1988, the number of patents issued to foreign inventors rose by more than 50%, while the number of patents issued to U.S. inventors increased only slightly. Indeed, though its population is only half as large as ours, Japan, has more engineering graduates each year than the U.S.**

**- Though we spend more per capita on our educational system, U.S. primary and secondary schools produce among the lowest-skilled students -- especially in science and math -- of the major industrial countries.**

**The key question is not, however, where we stand today. The vital question is how to ensure that we will remain successful and prosperous in the 1990's and beyond.**

**One area that will have an important impact on future U.S. economic health is that of our policies toward competition and concentration. It is instructive to note that many of the strongest Japanese companies have intense domestic competition. There are nine major automobile makers in Japan, and thirty-four companies making semiconductors. Numerous Japanese consumer electronics firms engage in intense competition among themselves.**

**Similarly, the strongest U.S. companies are often found in those industries where there is the most active domestic competition. Frequently these industries, such as computer software, lead the world. By contrast, U.S. industries like auto manufacturing that have a highly concentrated domestic market often fare poorly in international competition.**

**Thus, although some advocate relaxation of U.S. antitrust controls in the name of international competitiveness, a strong antitrust policy is an asset and not a liability in international**

**competition. Competition, not government planning, is certainly the best way to foster efficient companies. Laws or policies that inhibit competition should always be subject to the greatest scrutiny - and suspicion. It is competition, not concentration, that is the path to global competitiveness.**

### **Lowering the Cost of Capital**

**Perhaps the most important problem that we face in keeping America competitive is the extremely unfavorable cost of capital in the U.S. The Federal Reserve Bank of New York has estimated that the real, after-tax cost of capital during the 1980's in the United States was between two and four times as high as the cost of capital in Japan and Germany.**

**These numbers are not very encouraging in the aggregate, or in specific applications. For example, as of 1988, the cost of funding a ten-year research and development program in the U.S. was over 20%, while in Japan it was about 9% and in Germany about 15%.**

**What do these numbers mean? Well, assume that a U.S. company and a Japanese company each are considering developing a new way of manufacturing computer disk drives that will decrease**

**production costs and improve product quality. Both companies anticipate that the initial cost of developing the technology will be \$50 million, and that the resulting technology will increase cash flow by \$10 million a year for 10 years. Solely because of the higher capital cost, on a net present value basis, the U.S. company would lose about \$9 million on the investment, but the Japanese company would make a \$15 million profit. Despite the potential for improved productivity, the U.S. company will almost certainly not make the investment for a sound economic reason - its cost exceeds its expected return. However, based on essentially the same economic analysis, the Japanese company will make this investment in future productivity because it will return more value to the company than it will cost. Thus, based solely on its lower cost of capital, the Japanese company will make money from this investment in R&D while improving its technological position against its U.S. competitors.**

**The high cost of capital in the United States is also severely disadvantageous for longer-term projects. As of 1988, total expense of financing the construction of a new \$100 million factory in the U.S. was about \$10.2 million per year. At the same time, in Japan financing construction of such a factory would only cost \$5 million per annum. Thus, even if the product to be built was invented in a**

**U.S. lab, for every new plant built by a U.S. company, its Japanese competitors can either build an identical facility at half the annual cost – or simply build two new plants for every one in the U.S.**

**As these simple examples show, the cost of capital can powerfully discourage U.S. corporate investment in research and development, new plant and equipment, and other desirable productivity improvements. Our high cost of capital, for example, may explain why during the 1980's aggregate U.S. spending for non-defense research and development was only about 1.9% of our gross domestic product. In Japan, the comparable figure was about 2.6% of GDP.**

**The higher cost of capital also helps to explain why less new plant and equipment is brought on line in the United States than in some of our major competitors. Indeed, during the 1980's, U.S. investment in fixed assets, excluding residential housing, was lower as a percent of GDP than in Italy, West Germany, France and Canada. Combined together, the disincentives for R&D and new plant and equipment help explain the very ominous fact that U.S. productivity growth in the 1980's was only 1/3 that of Japan, and 1/2 that of Europe.**

**If we do nothing about reducing the cost of capital, U.S. firms will not do the research, and not make the investments, necessary to reverse this trend. Over time, the United States will become less and less competitive in more and more industries, and we will lose both jobs and income to our foreign competitors. Therefore, we do not really have any alternative to directing our energy and creativity to reducing the cost of capital in this country. What would this effort entail?**

**The cost of capital is a reflection of many factors, including the forces of supply and demand. Demand for funds in the United States is rather high, and our supply of savings is unfortunately low. The best opportunity to reduce demand would be to reduce the federal budget deficit, which voraciously consumes our pool of domestic savings. This is why it is so important for Congress and the Administration to agree now on substantial and sustained reductions in the federal deficit.**

**Another way to reduce demand for investment capital would be to reduce significantly the volume of bank loan losses. Indeed, provisions for loan losses by FDIC insured banks have averaged**

**about \$30 billion per year over the last 3 years. At this level, provisions for bank loan losses represent almost 40% of total annual U.S. expenditures on non-defense R&D.**

**In addition to steps to reduce non-productive use of capital, we must also increase the supply of capital by increasing personal savings. The U.S. savings rate is about one-third that of Japan and about one-half that of Germany. One obvious way to encourage savings and investment would be to reduce the tax on successful investments, the capital gains tax. Many foreign countries, including Germany, Italy, and the Netherlands, encourage investment with a zero capital gains tax rate. Other countries, including Japan, Canada, France and Sweden, have a capital gains rate that is about half of that in the United States.**

**As you all know, the question of reducing the capital gains tax is a major political issue between Congress and the Administration. Hopefully, the final budget agreement will reduce in some manner the serious disadvantage of the U.S. in the cost of equity capital. Beyond capital gains, we should be focusing our attention on finding other policies to encourage innovation, improvement, and investment.**

**As part of this process, other tax code provisions are worthy of attention with respect to their impact on the cost of equity capital. For example, we are the only major industrial nation that provides no relief from the double taxation of corporate profits. This means that corporate income is taxed once at the corporate level and then again at the individual level, with no credit whatever for the taxes already paid at the corporate level.**

**We also have many provisions that channel investment away from industrial facilities and into residential housing. For example, gains from selling a residence can be rolled over without tax into a more expensive home. For someone selling a home with appreciated value in the Bay Area and moving to Oregon or New Mexico, this may mean they will have to build a 20,000 square foot house with 2 dozen tennis courts in order to roll over their entire gain. Under current law it is not possible to roll over any part of such gains into an IRA account, much less to roll over gains from selling common stock of Hewlett-Packard into a purchase of Genentech.**

**I am not advocating change in these specific provisions of the tax code, but rather trying to illustrate how existing policies help to drive up our cost of capital and to make long term investment in our**

own productivity more expensive. Housing is without doubt important, but building a new house produces jobs mainly in the year the house is built, while building a new factory or installing new equipment can produce jobs year after year after year.

### **SEC Initiatives**

Most of these measures to reduce the cost of capital are beyond the control of my agency, the SEC. We have been attempting, however, to do our part to reduce the cost of raising capital. A few months ago, for example, we approved Rule 144A, which simplifies the procedures, and thus reduces the cost, of raising funds in the private placement market. Already more than a dozen companies have used the new rule, and other offerings are underway.

Later this fall we hope to implement a multijurisdictional offering system with Canada. This would permit a U.S. company to go to market in Canada at the same time it goes to market in the United States, using the same prospectus. Canadian companies would be able to do likewise in the United States. We hope that if the system works well with Canada, we will be able to consider utilizing a similar approach with certain other countries. Our goal is to help U.S. companies raise capital around the world at the lowest possible cost.

**Improving U.S. accounting principles may also represent an important opportunity to reduce the cost of capital for well-run firms, by providing more accurate information to investors. Greater attention to fairly presenting a firm's current financial condition can help provide shareholders, creditors and regulators with far more useful information regarding a firm's financial performance than may be provided under current cost accounting standards.**

**Probably the most important element, though, in increasing the supply of equity capital is maintaining and improving public confidence in the U.S. markets. Individual and institutional investors, domestic and foreign, will not invest in the U.S. markets unless they are confident that they can do so without becoming a victim of fraud or other abusive market practices. Without such confidence, people will put their money in bank accounts or treasury bonds or housing: they will not put it into the U.S. equity market.**

**Maintaining and building investor confidence is why the SEC places so much emphasis on enforcing the laws against market manipulation, insider trading, and other forms of securities fraud. Whether it is a broker churning customer accounts, or an investment**

**banker seeking to manipulate prices of an entire market, securities fraud is an attack on the health of our markets and the strength of our economy. We will continue to strive to detect and punish all types of violations of the securities laws.**

**Just yesterday the Senate passed the Securities Law Enforcement Remedies Act of 1990. This statute represents an extremely important milestone for the SEC. Today we have the authority to give a securities firm a reprimand or to put them out of business, but with this legislation we will have the ability to seek a fine to deter serious violations. This will be important in areas where firms are willfully engaging in activities that damage customers or put others at serious risk. This legislation will allow us to remove the economic benefits a firm might otherwise obtain from such actions as violating capital rules or sales practice standards for unsophisticated customers.**

**This week, the Senate and House also passed the Market Reform Act of 1990. That legislation authorizes the SEC to develop a program to oversee the risks that parent firms and other affiliates of broker dealers may be undertaking. The legislation also gives the SEC the authority to obtain information as to very large traders in the**

**market, something that will help us understand sizeable market moves better than we can today. Finally, the bill will encourage development of a uniform set of laws on clearance and settlement. This is an area where enormous risk can and should be eliminated from the market by creating a faster system for completing trades through ultimate payment.**

**Together, Market Reform and Enforcement Remedies, if passed by the House next week and signed by the President, will represent the most far reaching and positive change in our securities laws in decades.**

### **Conclusion**

**From the coast of California to the shores of Maine, from Alaska to the tip of Florida, U.S. firms - and their workers - have repeatedly proven that they can produce some of the world's most innovative technology, finest products and strongest companies. Our job is to help them succeed in a highly competitive world by creating a safe and stable financial market that can deliver the capital necessary to create tomorrow's prosperity. Over the long haul, it is vital for the SEC to help ensure that we have large and thriving capital markets producing low cost capital. We will try to ensure that these markets**

**remain what they have always been, the finest and fairest markets  
anywhere in the world.**