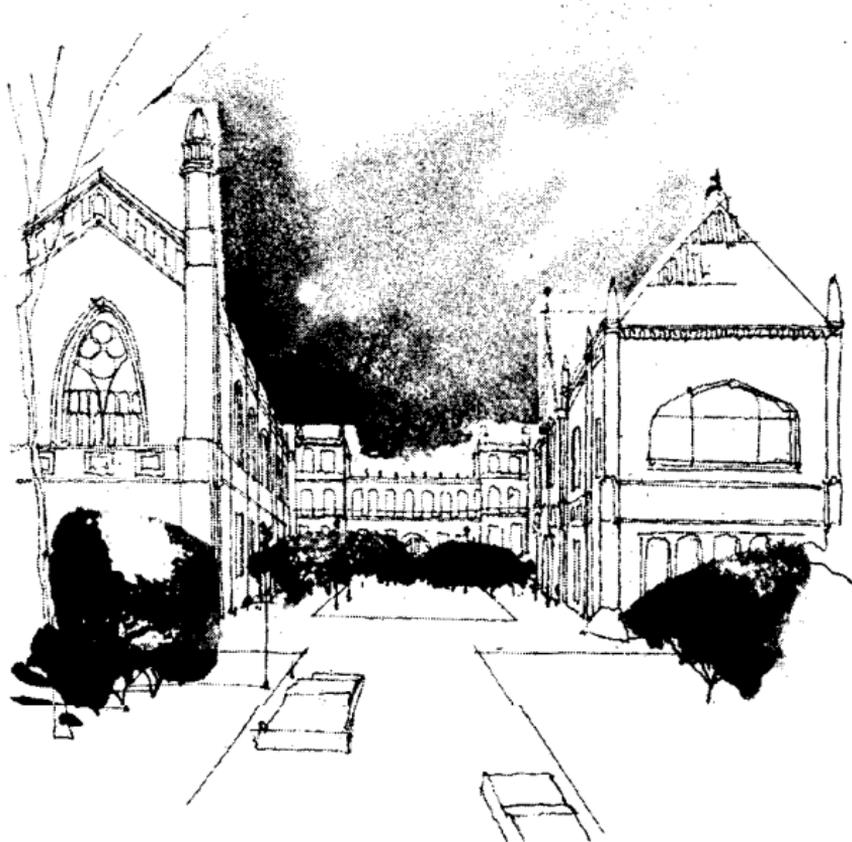


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The New Federalism at Work

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The New Federalism at Work

I WOULD LIKE to begin with a bit of anecdotal history. It concerns Theodore Roosevelt and J. P. Morgan, the leading tycoon of T.R.'s day. Morgan had made a contribution of \$150,000 to Theodore Roosevelt's election. But the former Rough Rider apparently did not feel that the contribution put him under any lasting obligation. Promptly after his election T.R. labelled businessmen as "malefactors of great wealth." Then he left on an African hunting expedition. J. P. Morgan was understandably offended. Learning that the President was going on safari, Morgan said: "I hope that the first lion he meets will do its duty."

I tell this story because it in turn relates to my topic tonight. Morgan was not just indulging in a carnivorous fantasy. He was really passing a politico-economic judgment—a judgment that illustrates the inseparability of politics and economics. To talk economics as though it were a world apart is really to talk in unreal terms. Economics and politics and the markets make the real world, and that is the one I want to talk to you about tonight.

Most of the economic news that you have been reading on the front pages recently seems to be depressing. You've read that the value of the dollar is down, the trade deficit is higher, and the price of steak is out of sight. The person who skims the headlines and half-listens to the nightly television news must carry away the impression that the U.S. economy is going from bad to worse.

As a matter of fact we do have a number of serious economic problems. But the reality un-

derlying the dark clouds of doom and gloom is quite a bit brighter than many people realize. Indeed, ladies and gentlemen, I shall share a well-kept secret with you this evening: we are in the midst of a boom.

The economy is in the third year of a broad expansion. Last year our nation's output of goods and services grew at a real rate of 6.5 percent, the best advance in a half dozen years. The forecast for 1973 indicates another good year is in prospect. Real wages and corporate profits are increasing. And our rate of inflation, despite those horrendous increases in food prices, is still lower than that of any other major industrialized nation. The economists at Lionel D. Edie & Co., Merrill Lynch's subsidiary, are even venturing the guess that the price of steak may be lower by next fall.

Nevertheless, even those of us who are optimistic by nature are affected by the atmosphere in which we live, work and make our daily decisions. And the short-term perspective on the economy, on politics, on the course of our society-is reflected in today's stock market, even though the market is supposed to be a long-term indicator. Things appear bleak and pessimistic, for no apparent reason except that people seem afraid to feel good. A pessimist, according to an old definition, is a person who feels bad when he feels good for fear he'll feel worse when he feels better.

CLEARLY the emotional upheaval of the past decade has left its mark. So many things went sour and wrong in the cruelly disappointing 1960s that we almost refuse to dare hope that things might go right in the 1970s. In the recent past change meant violence and the rule of irrationality. We find it hard to believe the evidence of our eyes that change can occur peacefully and according to the rule of reason. In short, after having heard so much about

the breakdown of the system, we are slow to recognize that it is working, after all.

One of the prime and perennial worries feeding pessimism is the citizen's worry about the government, and what it will do to his financial life. By excessive deficit spending such as we witnessed in the late 1960s by fiscal and monetary policies badly adapted to the economy's and the nation's true needs, the federal government can upset everybody's applecart. Inflation comes upon us swiftly, but is very hard to push back.

Now we are told that a major battle is shaping up between President Nixon and the Congress over the federal budget for the fiscal year beginning next July 1st. The rhetoric on both sides of the argument is heated, to say the least. The President has accused the Democratic-controlled Congress of wishing to spend the country into ruin; and the Democrats have accused the President of being a tyrant for refusing to spend all the money the Congress has voted. Senator Mondale has predicted that the Congress will wage "jungle warfare" against the President. We are told that we are on the brink of a "constitutional crisis."

All this steam has fogged our vision. In fact, there is a little understood, very significant and sweeping movement taking place in this country. The movement is a compound of philosophy, politics, economics, and a bit of exigency, and it is impossible to assign precise percentages to each component. Indeed, each component is imbued with the other: the philosophy embraces both the politics and the economics. There is no way to undo this particular merger.

After I've tried to explain that sweeping movement, I'll turn to some "pure" economic results, in terms of federal revenues, the budget, the deficit, and other related macro-topics. When I come to them, I'll try neither to bore you nor to lose you in the midst of billions.

These huge figures relate closely to the individual's role in the marketplace, and the climate for investment.

THE MOVEMENT I am speaking of is called the new federalism. Businessmen and students of business who find some comfort in the notion that politics doesn't concern them had better pay the new federalism particular heed. It promises to have great impact on our country and society for years to come. It has substantial historical provenance and long roots. The new federalism is worth some close study.

It seems incredible to us today that Thomas Jefferson feared the accretion of excessive authority in the federal government of 1800. But he did, and he declared what was later to become a first principle of the modern Republican party. The principle was that the centralization of authority in Washington would deprive citizens of some of their personal liberties, would not be responsive to their true needs and desires, would be excessively costly, and would run counter to the true American spirit. He agreed with a homily of James Madison, who said that "the truth is that all men having power ought to be mistrusted."

Every politician likes to hark back to Jefferson while he is delivering his favorite stem-winding speech. Still, in this case that hark-back to a founding father has some justification. For the essence of the philosophy of new federalism is Jeffersonian decentralization. This is the sweeping change in all our futures to which President Nixon is deeply and seriously committed. He has dedicated his second administration to its accomplishment. He has some dedicated people working toward its accomplishment. Many are unknown young lieutenants scattered throughout federal agencies to carry out the President's will.

We live in a time much less elegant in phrase and style than Jefferson's. So the new

federalism remains a crucially important concept in search of a label to match. The President has of course explained in a fairly level tone of voice what his objectives are. But no brilliant forger of words has put this idea into some brightly shining phrase that would catch everybody's imagination and linger on everyone's tongue. The phrase itself, the new federalism, is hardly sexy. It doesn't hold a candle to the New Deal, the New Frontier, or the Great Society. Instead, it has acquired a clumsy synonym. The new federalism has been dubbed "disfunctioning." Don't knock it because of that-it is in fact going to function very effectively indeed.

Disfunctioning means nothing less than this. The authority now concentrated in Washington and in the various bureaucratic conglomerations there is being broken up. That authority is being parcelled out to state and local communities. Out with it goes the dynamic power to make decisions about huge sums of money. Money, power, people-all are being dispersed and regrouped on local levels.

How much money is already involved in this shift of power? Well, it is a sum worthy of our macro-economic age. Some \$30 billion in subsidies over five years will be moving out of Washington. This \$30 billion will continue to be spent, but the federal government will not be managing the expenditures. The disfunctioning takes these huge federal programs, transforms them, and puts them in the hands of local politicians, especially governors and mayors. It is to those local officials that power and its essential concomitant, money, will be flowing. If the flow is great enough, local officials should become the Administration's allies.

THE PRESIDENT has set about accomplishing the new federalism in several ways. His major legislative program revolves around the theory of shared revenues-the consolidation of over

1,000 categorical grants into large block grants to be used by local leaders as they see fit. The enactment of revenue-sharing legislation last fall started the ball rolling.

The next step is *special* revenue sharing, which adds close to \$10 billion annually to the general revenue sharing funds. This step breaks down into these various legislative proposals for this year.

First, \$2.7 billion for education. Next, \$2.3 billion for the improvement of communities, with no federal strings attached as long as the money is used for community development. That includes eliminating slums in urban areas, providing loans for public works, and improving construction begun in urban areas. Replaced would be the model cities and the urban renewal grants begun during the Johnson administration. Next, \$1.3 billion for manpower training. Next, \$3.65 billion over three years for urban transport, and opening up the hitherto sacrosanct highway trust fund in order to allow cities and states to decide how they will spend their share for mass transit in their own areas. Next, \$680 million for law enforcement to be distributed to state and local governments on the basis of population. And so it goes.

At the same time, and this is the coin's obverse which has attracted just about all the attention, some programs are being killed or allowed to die on the vine. Seven categorical community development programs are ending. Subsidized housing programs and some hospital construction projects are ending. \$8.7 billion in Congressionally appropriated funds have been impounded. Agencies like H.U.D. are being chopped down by those lieutenants I mentioned.

THIS SHIFT threatens the established, entrenched, and potent bases of power in Washington. Power runs like water. When it starts

to rise in one place, you can be sure it is falling somewhere else. The new federalism is draining power from several power pools. It drains power from the Congress, which explains a lot of the screams you have been hearing lately. It also strips power from senior civil servants and bureaucrats in Washington.

That power drain has rather important side effects. It presents an-entirely new set of problems to special interests and lobbyists in Washington. If federally run and federally financed programs move from Washington to municipalities, then it doesn't seem that those high-priced law firms lobbying to impress congressional committees can really do as much as some of their clients might expect. Pork barrel days at the federal level may be at an end.

That accelerates the decline of the Congress as a policy maker. And the whole executive branch will be in for some fundamental reorganization as agencies move around, and as old alliances break up when they do not have the adhesive of money to hold them together. The adhesive instead will be applied to a new surface—the surface that forms a common boundary between the Nixon administration and state and local officialdom. The Congress itself sees very clearly that it must reorganize and streamline the creaky old structure or it will be almost helpless in the face of the onslaught by a determined President.

It is interesting to note the way in which some of the press has missed the underlying thrust of what is going on. A couple of months ago, that daily newspaper that those of us who live in New York are addicted to spoke about “the phasing out of many popular education programs.” The large type told us about “big cuts” that were scheduled for education programs. The whole story about education that morning was couched in terms of ruthless slashing.

Something quite different is really taking

place in the education field. It is not so much a knife-slash as a push in the new direction. The real point is that control will move to local communities. The theory behind that is that those communities know better what the consumers, in this case parents and children, really want on their educational plate. The same principle governs with housing subsidies. The press generally has been missing the underlying and novel philosophy that guides all the changes in specific fields.

THE TOTAL federal budget is the cutting edge of the new federalism. President Nixon's budget for 1974 calls for outlays totalling \$269 billion. In spite of all the shouting and arm-waving it has provoked, this is not an austerity budget by any stretch of the imagination. It represents an increase of more than \$19 billion, or 7.6 percent, over the estimated expenditures for the current fiscal year. That budget also projects a \$12.7 billion deficit—nothing austere about that.

The budget's importance, it seems to me, is two-fold. First, the Nixon budget re-discovers the virtue of in fiscal matters. The President believes that the voters and taxpayers want limits restored: limits on their taxes, limits on government power to interfere in their lives, limits on the claims of the mushrooming public sector against the private sector. When you consider that federal state and local taxes now consume more than one-third of the gross national product, you can see the necessity of setting limits. Thus we have President Nixon's stern warning in this year's State of the Union Message: "If we were to continue to expand the federal government at the rate of the past several decades, it soon would consume us entirely."

The second, closely related, important aspect of the Nixon budget, it seems to me, is the attempt to put the government on a politically

and economically basis. The great society programs were not financed with new taxes—indeed, taxes were cut even as Congress set vast new spending programs in motion. Even if the programs had worked precisely as promised, which they often didn't, they depended on the future willingness of Congress to raise taxes to continue them. And they depended, obviously, on the future support of the voters and taxpayers.

Last year, the money ran out and so did the patience of the taxpayers. According to a widely publicized study by the Brookings Institution, issued a year ago, even if no new programs beyond those proposed were enacted through 1974, and even if the economy expanded to full employment, federal spending would increase more rapidly than revenues by some \$17 billion.

Moreover, even if the money were available, the Brookings study concluded that the government simply did not know how to use it effectively to solve social problems. The voters evidently came to the same conclusion about costly, wasteful and tightly centralized social programs run by remote bureaucrats in Washington. Arrangements that had answered the needs of the country during the depression were no longer workable two generations later in an entirely different country. The New Deal belongs to history.

If the new federalism succeeds, it will constitute the single most important change in government since the New Deal. Forty years of centralization of power and money in Washington will be reversed. If the President holds in place a coalition of mayors and governors, and if he gets the special revenue-sharing bills through this year and next, and then has two more years to get the system established—well, by then it may be so firmly in place that even a liberal Democratic President in 1976 won't be able to dislodge it. The mayors and

governors will have the money, and will have built their own bureaucracies to spend it. They would fight like mad to keep it. The system would be virtually irreversible.

I've enumerated the obstacles, but remember that generally the single-minded chief executive is facing a fragmented opposition. The Congress is splintered into special interest groups, which do not stand together against any single proposal of the new federalism. The far left's slogan of "power to the people" is somewhat preempted by a process that has just that as its objective—the only amendment being "*legitimate* power to the people." When the rhetoric is stripped away this is revealed as a struggle for power. Authority and power are the stakes, not money for the poor and the unfortunate. The Congress threatens to fight the new federalism by "counter impoundment"—meaning that if the President impounds \$3 billion of appropriated funds, the Congress will counter-impound a like amount from the military budget. But the President has an array of buttons of power to push in response. He may have more power than any single group that opposes him.

It may be that lay readers of the news have not really gotten a grip on all this. A kind of mass-think about budget cuts has set in. You may recall the dictum by Schiller that "anyone taken as an individual is tolerably sensible and reasonable. But as a member of a crowd he at once becomes a blockhead." I'm afraid we have been victimized by some of this mass psychology.

A BIG question mark hanging over the whole enterprise is the capacity of state and local governments to undertake the new tasks given them by the new federalism. During the two generations when power and influence was flowing to Washington, governments below the federal level experienced a "brain drain,"

as capable people interested in public service went where the action was. The declining quality of state and local government became an argument for ever-increasing federal control and centralization. Simply cutting the strings and pouring money back into the states and localities won't guarantee the skills necessary to make the new federalism work. Only bright, able and energetic people can do that.

NOW LET ME relate the entirety of what I have said to the community of businessmen to which I belong. Businessmen have been preaching the new federalism, in one form or another, for 50 years. Now we must recognize and adjust to its emergence. If we decide we agree with it, we must assist in fulfilling its promises in concrete and practical ways. One of these, clearly, is to serve and to encourage others, particularly younger managers, to serve -that means to help local communities spend intelligently the billions that the President wants to give them.

The businessman, union official, professional, and educator who now devote their talents and energies to a single institution or organization may in the future be drawn into wider leadership roles in local government, becoming at least part-time politicians. I would applaud such a development for I believe it is what the founders of our democratic republic envisioned: that free and responsible men would naturally enter the political process as part of their birthright as citizens. It is only in more recent history that we have falsely divided the population between politicians and non-politicians.

FINALLY, what does all this mean to the markets and the marketplace? At Merrill Lynch, we are persuaded that the outlook for federal spending is very favorable for the economy as a whole. Some of the restraint that is being

applied may be lifted by congressional action. But generally, during the course of the year we will have what we badly need, namely restraint in government spending. We believe that the spending in fiscal 1974 is unlikely to exceed the \$269 billion set out in the budget. And with that kind of sustainable expenditure, there should be continued real growth in the economy, more progress against inflation, and slowly dropping levels of unemployment.

As far as the stock markets are concerned, they are clearly in a highly emotional state at the moment. We have seen the Dow Jones Industrial averages come down 15% since early January. Many individual stocks of course are down far more. Before the recent devaluation, the Dow was ranging around 1,000, but recently has been subject to considerable bearish sentiment. I think these emotions will pass. Corporate profits are high and most corporations are going to have good profit years, which will eventually be reflected in stock prices. We are not in a period to be marked by permanent disillusionment with the stock market, or by inevitable lower multiples. It is going to be a good year for the market and for the intelligent investor.

Of course we are all affected by the devaluation. Foreign goods will cost more; domestic producers of similar goods may raise their prices. Food prices are up here, but our agricultural commodities will cost less in foreign markets. Gasoline and insurance prices will go up. You may find Europe more costly this summer—try Canada or Mexico instead.

But don't overlook some favorable economic realities. The dollar is no longer an overvalued currency. The fundamental outlook for the dollar is good, and as other currency rates rise against the dollar, our competitive position both domestically and in foreign markets is enhanced. A psychological shift toward the recognition of the economic fundamentals,

which we think is on the way, could lead to a substantial improvement in the international financial markets. Foreign investors will be recognizing that the dollar is oversold, and they will find our markets a safer place for their assets than some of their own markets. We look to see these investors coming into our markets before long. We also expect less labor trouble, less inflation, and less social unrest in the U.S. than in Western Europe this year—adding some gloss to the attractions here.

So, even though you may have expected me to say so, Merrill Lynch remains bullish on America.

An understanding of the nature of the new federalism and the way it steers the new budget will certainly help bring these improving markets. Of course no miracles are to be expected because we alter the balance of power between Washington and the rest of the country. Our problems remain. Our resources are still limited. But the American, a 19th century observer remarked, “is nomadic in religion, in ideas, in morals.” We are still on our journey as a free people, and our driving discontent should not deny us a clear sense of our progress. So we should see-and appreciate-the unique adaptability of our system under the pressures of change. Through the fog of pessimism shines an ingenuity, a willingness to experiment, and a desire to find new ways of uniting democratic principle and practice, which are unmatched anywhere else in the world.