



April 15, 2009

Letter from Washington

While the Obama administration has struggled to complete and forward its 2010 defense budget request to the Congress, Defense Secretary Gates preempted the process somewhat by unveiling his list of program recommendations this week.

The submission of the first Obama defense budget has been delayed until mid-May for a variety of reasons: partly because the budget numbers and national security strategy underlying the request were late in coming together, and partly because the placeholder Bush budget had to be pared down by approximately \$US50B to meet the \$534B defense goal that was announced several weeks ago.

So what Gates did was to outline his thoughts on how the budget should be restructured. Gates is a canny Washington player, who by all reports has been working hard to gain the trust and confidence of the fledgling President. It seems unlikely that he would go completely off the reservation with his budget recommendations, so I think it is safe to assume that his recommendations and the administration's May budget will be closely aligned.

More likely, by having Gates announce the program recommendations, he then has become the lightning rod for Congressional outrage. By the time the President submits his budget in May, a lot of the air will have gone out of the various constituents' arguments and will be easier to deflect.

What Gates' recommendations do is clearly pick some winners and losers. He has been very vocal over the last year that the defense acquisition system is broken, and cannot deliver anything in a timely or cost-effective manner. What it does deliver is not appropriate to the world that we are living in now nor the threats that we will face.

He has been especially critical of the over-budget systems that are designed to take on a peer competitor, such as the Army's FCS or the Air Force F-22.

In his announcement Gates laid out three broad priorities:

- First, invest in the people by providing both pay increases and facility upgrades.
- Second, restructure the investment portfolio and jettison the programs that are not working or are not relevant.
- Third, fix the acquisition system.

The priorities themselves are not controversial but their implementation will be a bloody and difficult process because of the program cuts they propose.

Among the restructuring that Gates proposed:

- Capping the Air Force F-22 program at 187 airplanes rather than the 250 in the current plan.
- Killing the VH-71 presidential helicopter program, the Airborne Laser, the Air Force Transformational satellite and the Combat SAR helicopter.
- Delaying the Ford Class aircraft carrier, a move that will at least temporarily take the Navy down to nine carrier battle groups, below the Congressionally-mandated 10.
- The Navy's DDG-1000 destroyer program will be terminated after three ships if they can all be constructed at Bath Iron Works. If not, terminate at one, while restarting DDG-51 production at Ingalls Shipyard.
- Terminate the vehicle portion of the Army Future Combat System while spinning out the useful technologies.
- Terminate some portions of the Ballistic Missile Defense program, and transform that organization to a small R&D role.

Each of these programs has a powerful Congressional support group, and it will remain to be seen how much of this the House and Senate will actually go along with. In particular the F-22 and the FCS will have the most organized and effective opposition, orchestrated by Lockheed and Boeing.

Recalling that then-Defense Secretary Cheney attempted to terminate the VH-22 program three separate times, but was rolled by the Congress each time, makes the Gates program seem perhaps overly ambitious. In attempting to do too much he risks accomplishing none of it.

On the other hand, by underpinning the program cuts with strategic logic, as well as singling out the over-budget non-performers, he has effectively seized the high ground in the argument, and can use that megaphone for the next several weeks until the President's budget is presented.

How these program changes will fare will likely depend on how much political capital President Obama is willing to spend to push them through. Between now and then, he does have some other significant issues that will require him to spend much of his capital and risk his popularity.

For example, the President fired the CEO of General Motors and has now taken ownership of the US car industry, hinting that it just might be allowed to fail. The White House will be bombarded by intense pressure from his own party and traditional Democrat constituents, such as the United Auto Workers and other unions, fighting the closure of every last car plant in the Midwest. To have a prayer of survival the automakers will have to be allowed to restructure their union contracts, which is political suicide for the Congressional Democrats.

The government operating an industry sector would be hard enough if the industry was vibrant and growing. In this case, government intervention in a failing industry spells disaster. The most likely outcome seems to be some sort of restructuring with ongoing government subsidies to keep the industry afloat, which has been described as the "world's most expensive jobs program".

More importantly, Congressional mandating of specific environmental car requirements, which has been demonstrated that the American public will not buy, will doom any chance of success and raise the protectionist tendencies in the Congress to new heights.

The government has always been involved in industrial policy but what is different about this time is that the government rather than market has started to pick the winners and losers. GM has been put on notice and the CEO fired, but AIG bailed out to the tune of US\$160B (and growing) with no strings and no accountability. Goldman Sachs was bailed out but Lehman Brothers was allowed to fail. The only credible way the government could have proceeded would have been to treat all equally or not at all. Once having started down this road of selecting the winners and punishing the losers, it becomes impossible to go back, and the issues become impossible to manage.

So this then will be the backdrop this summer to the President having to spend all of his political capital to restructure the defense budget and make the Gates proposals real. I'm willing to bet that will be lower on his priority list than it needs to be for success.