



January 24, 2011

## **Letter from Washington**

Two weeks ago a female member of Congress was shot in a constituent meeting in her home district in Arizona. A number of people were also killed and wounded, including a nine-year-old girl. Despite the attempts by both sides to paint the gunman as politically motivated, it appears that he was a solitary nut case without any political agenda. Obama addressed the memorial service for the victims, and for the first time in his term came across as actually presidential. Any US President in the capacity of chief mourner will always be compared to Ronald Reagan and come up short. Obama came close, however, and made the case for a return to civility and tolerance in the national discourse. As a result, his standing has gone up with the independents that had deserted last November.

Sarah Palin had the opportunity to also show that she could rise above the partisan noise level and act presidential, using the Tucson tragedy as a national "teachable moment". She took the opposite tack however, and conducted a video rant against the media for portraying her as bearing some responsibility for the shootings. She may have had a fair point, but she chose to make it in a way that confirms her as the head of a faction in the Republican Party, not a credible national leader. Her standing with the independent voters necessary for national elective office was never high, but has fallen even further.

The media love Palin because she is quotable, slightly outrageous, and always willing to mix it up in public in the defense of her privacy. As a result, the media perpetuates the idea that she is a viable Presidential candidate. Palin for her part needs the media attention to burnish her brand as a television personality, speaker and author with a kamikaze approach to politics.

Article II, Section 3 of the US Constitution requires that the President provide the Congress periodically with information on the state of the union. Modeled originally on the British monarch's speech from the throne opening a new session of the Parliament, the State of the Union message has in modern times been delivered in person by the US President, usually in January.

Since in the US system the President is both the head of state and the head of the government, the message was intended to convey the executive

branch priorities to the Congress, so they could be considered for enactment into law. In recent times the address has become more of a partisan pep rally than a serious form of communication, and has become symptomatic of the toxic atmosphere in the Congress with the President not receiving the respectful attention due to the head of state.

All of this is by way of introduction to the Obama presidency, Part II. Tonight the President will address the joint session, and the landscape will have changed considerably since his last appearance. Last January the health care bill was still several weeks away from final passage and emotions were high when the President spoke, but he was still riding a wave of rock star-like adulation. Fast forward to one year later, with unemployment still riding near 10% with no significant turnaround in sight, little or no progress in Afghanistan, culminating in the devastating defeat at the polls in November and the shine has worn off the Obama brand.

Years one and two of the Obama era were spent largely in pursuit of an anti-business, expansionist government agenda that resulted in several significant legislative victories for the President, specifically health care reform and the Dodd-Frank financial reform bill. Those legislative "victories" were passed over united Republican Party opposition, and were viewed by a significant majority as exceeding the mandate given to the Democrats in 2008. Punishment was exacted in November with the Republicans regaining control of the House with a significant majority.

The President and his advisors understand that for him to be reelected in November 2012 that two things need to happen. First, the economy needs to improve to the point that it starts creating employment at a rate that outpaces population growth. That is largely out of the President's hands and in the control of market forces that he can only affect tangentially. The second thing is within his ability, and that is a change in the partisan atmosphere in Washington. Ironically, the Republicans have also arrived at a point where they need some cooperation from the White House to achieve any of their goals. The one clear message from the November elections is that the public's tolerance of partisan politics has grown quite thin, and that every politician is at risk. The public is increasingly willing to hire new management abruptly, so that some level of cooperation is going to be required for either side to survive. New House Speaker Boehner in his acceptance speech referred explicitly to the need for the Republican majority to show concrete results not just debating points.

Obama seems to have internalized the message from November, and has transitioned from electoral road kill left for dead to retaking control of the initiative and the agenda from the Republicans. It turns out he has actually been a pro-business, limited-government conservative all this time, just waiting to be set free.

The President has done a couple of smart things to send a peace overture to the markets. First, he appointed Bill Daley, former Commerce Secretary, to replace the departing hyper-partisan White House Chief of Staff. Daley comes straight from the upper echelon of JP Morgan Chase and is a trusted agent for the business community. Second, Obama appointed Jeff Immelt, CEO of GE, to head a "Jobs and Competitiveness" panel that will advise him directly. Politics does make strange bedfellows, and GE has probably transferred more US jobs overseas than any other large company over the last five years. Obama has figured out that waging war against the US corporate world is both bad electoral politics and bad economic policy.

Obama hopes that Immelt and Daley can give US business the degree of confidence that it needs to start spending the hoard of cash it has largely been sitting on for the past two years, and to start investing in capital projects that will edge the unemployment rate down just in time for 2012.

US politics generally require that a newly elected President feed the base for the first part of the four-year term, then "tack back to the center" in time for reelection. Most likely in his message to the Congress the President will do more than tack, and will perform a hard right turn. His embrace of the economy in the last weeks has included a directive to the executive branch to look at regulations that are redundant or no longer useful, and are having the effect of limiting economic growth. This is largely Washington theater since the bureaucrats in charge are unlikely to unravel any of their regulatory basis for existence, but highly ironic as well. The aforementioned health care reform and financial reform laws created more additional regulations in a three-month period than any time previously in US history. President Obama as born-again deregulator strains the imagination.

Meanwhile, when the Congress sits down to listen to the President deliver his message their thoughts should be on the unfinished business they left behind in December. For various political reasons the Senate Democratic leadership was unwilling to vote on any of the necessary appropriations bills required to fund the government, and attempted to roll them all into one Omnibus appropriation that would have funded all departments in one huge bill at the last moment. Senate Republicans had initially agreed to the procedure, but when the party won control of the House in November it became apparent that they could hold out for more control of the process. As a result the government is operating under a Continuing Resolution (CR), which is a legislative device that permits government functions to continue at the same rate as the previous year.

Under CR rules programs can neither be started nor terminated, so the departments have very little flexibility in managing their funding and the process is very disruptive to contracting. Secretary Gates has been up the hill several times, literally begging the Congress to pass a defense bill. The current CR expires in early March so there is little incentive for the Congress to deal with it before then. What is clear, however is that defense will not be

allowed to continue to grow in real GDP terms and will be on the receiving end of substantial reductions. It's quite possible that the Congress will pass a 2011 defense bill but leave the CR in place for the rest of the government.

Most of the newly elected Republicans, whether overtly Tea Party types or not, are fiscal conservatives. Most were elected on the platform of reducing the size of government, the cost of government operations and the size of the budget deficit. Unlike their Republican predecessors who have historically favored defense growth, these new players are more motivated by balanced budget ideology and view defense as fair game for reductions.

The real issue in the US budget is not discretionary spending, of which defense is the major piece, but the mandatory programs. In 2010 discretionary spending was about US\$1.4T or 38% of the total. The remainder is taken up by the mandatory entitlement programs that are required by law to provide a specific benefit, such as Medicare and Social Security. In order to get at the structural deficit that currently exceeds US\$1T, the entitlements will have to be trimmed as well. Entitlement reform has always been a political death wish in the US, but there seems to be a growing consensus, even among the entitlement beneficiaries, that the course is unsustainable.

This then presents the President with the opportunity to regain the initiative from the Republicans in tonight's state of the union address. By making deficit reduction his cause for the remainder of his first term he will be able to take credit in two years time for any progress made. The Republicans will be willing to do budget deals with him to see their agenda enacted, and the good faith efforts toward deficit reduction will have a positive ripple effect throughout the economy, hopefully pushing unemployment down.

Reincarnating himself as a deficit hawk is risky business for the President since it is doctrinally counter to the Democratic Party platform. He has evidently made the calculation that since his base has nowhere else to go, he needs to regain major ground with the independents and fiscal conservatives to have a second term. In order to lead the deficit charge he will have to out-Republican the Republicans or risk being seen as an uncommitted opportunist.

Unfortunately for the President, the Republicans hold most of the high cards. The need to extend the Continuing Resolution in March, as well as the required extension of the debt ceiling, give them great leverage to extract major spending concessions from the administration.

Bottom line for defense: Difficult days ahead, major program cuts and stretch outs.