



October 11, 2011

Letter from Washington

In a notably different outcome of a familiar scenario, with little discussion the House voted to avert a shutdown and extend funding for the government beyond the September 30th end of fiscal year 2011. The Continuing Resolution (CR) will fund the government only until mid-November, at which point the Congress will have to either pass a 2012 Appropriation or another CR, and the results could be quite different.

The CR will fund government operations until a point in November, close to the time when the Joint Select Committee on Deficit Reduction is supposed to report out its recommendations. The "Super Committee", as you recall, was formed as a way for Congress to finesse itself, since it could not agree on a package of spending cuts and revenue increases.

The committee is supposed to develop a program that will reduce the deficit by at least US\$1.2T over 10 years. Theoretically everything is on the table, including the defense budget and the tax code. Congress has given itself 30 days to approve the committee's recommendations in an up or down vote, with no amendments permitted. This process, much like the Base Realignment and Closure Commissions, is designed to give the members cover from the politically difficult vote that will be required. Unlike the BRAC process there is a real consequence attached to a down vote on the committee package, in that the US\$1.2T goal would then be assessed across the board with defense absorbing about half of that amount.

Even without the across-the-board cut, the DoD has been struggling to accommodate the first round of reductions enacted in the Budget Control Act that were supposed to equal about US\$350B. That number has grown by almost a third because the first estimate of cuts was based on the Congressional Budget Office's estimate of the 2012 Defense baseline budget, rather than the administration's submission. However, there is considerable partisan disagreement over what the size of the DoD reduction should be in the first place. Apparently the 350 figure did not appear in writing in the Budget Control Act legislation and is based on "common understanding" or a "gentleman's agreement".

The House Republican staff has been attempting to walk that number back, based both on the lack of specificity in the legislation and the real harm that would occur if reductions of that magnitude were enacted.

The state of play at the moment is that the DoD in its planning process is accommodating a decrease in funding over the next 10 years that equates to US\$35-40B per year. This level of decrease is painful but apparently achievable.

The wild card is the additional US\$600B that would be assessed if the Joint Commission is deadlocked on a way forward. A decrement of that amount, which would be assessed over nine years, would take DoD over the cliff. Not only would major programs like the JSF be canceled outright, the Navy would have to lay up several carrier battle groups and disestablish the associated air wings. The Army would have to disestablish division-sized units, and the Air Force would have to follow suit with similar draconian actions.

Despite the obvious damage to national security, the potential seems remote for the Joint Committee to compromise and report out a workable package that includes both curtailment of entitlement programs (mainly Medicare and Medicaid) and some increased revenue from either outright tax increases or streamlining the tax code to eliminate tax breaks. The committee composition of six Senators and six Representatives, divided equally between the parties, is a recipe for deadlock. Especially since the appointed members are all hard-line partisans, with a demonstrated inability to compromise on even the most simple things.

The voices from Defense, starting with Secretary Panetta, have become increasingly shrill regarding the negative effect on national security that the across-the-board cuts will have. The Congress placed itself in this doomsday situation through its inability to agree in August, and as the 2012 campaign begins in earnest, positions have become even less flexible.

The President has all but abandoned a leadership role, choosing instead to start the 2012 presidential campaign by insulating himself from the Congressional process. Ironically, President Obama has toured the country touting his "Jobs Bill" in a series of campaign-like appearances. The Jobs Bill is widely viewed as another stimulus bill with tax increases embedded in it, making it politically dead on arrival in Congress. The bill is sufficiently unpalatable that the Democrat-controlled Senate will not even schedule it for a vote, which would lead to the reasonable conclusion that the President never intended for it to be passed, and only proposed it to give himself a handy club with which to beat the Congress going into 2012.

The reality of the circumstance is that the US is still stuck above 9% unemployment, with the economic recovery feeble at best. The Jobs Bill would provide funding that would preserve some police, fire and teaching jobs that were enabled by funding from the first stimulus bill in 2009, but non-passage would give the President the ability to denounce the Republicans for "gutting public safety and education" --- conveniently ignoring that his own party won't pass the bill.

More importantly, as the doomsday scenario for defense unfolds, taking more than a trillion dollars out of DoD appropriations over the next 10 years will more than negate any temporary effect from a jobs stimulus bill. With numerous major programs canceled, the ripple effect across the economy will be severe and many second and third tier suppliers will be forced out of business. Just like the collapse of the auto industry in 2008 decimated the network of small suppliers across the mid-west "rust belt" states, the effect on defense suppliers will be equally dramatic and national in scope.

Since the Super Committee is all but guaranteed to end up deadlocked, the only way that the across the board cuts can be avoided will be for the Congress to either repeal the Budget Control Act that created it in the first place, or pass new legislation that exempts defense. At this writing, neither of those seems highly likely.

The one potential salvation for defense is that since the full effect of the cuts does not occur until 2013 and beyond, if the Republican Party were to gain control of the Senate as well as the House in 2012, disaster might be averted and only serious damage done. That would depend on whether the newly-elected Republicans were more aligned with the Tea Party wing and focused on deficit reduction. The Tea Party phenomenon was spawned in large measure as a negative reaction to the first rounds of stimulus spending in 2009, and philosophically would allow defense to be compromised in the name of fiscal responsibility.

The other possible outcome in 2012 is that the Republicans might also gain control of the White House. The field of Republican candidates appears set now with Governor Christie of New Jersey opting out. The nomination then will likely come down to a contest between Mitt Romney and Rick Perry, with other unelectable candidates enjoying brief surges in popularity before the reality sets back in that in order to defeat Obama, the Republicans must field a candidate acceptable to the moderate center of the US electorate.

At this point in the electoral process the Republican contest is pretty much of a sideshow with little serious attention being paid. The President is highly unpopular with a rating in the 30's and falling. The only other group less popular than the President is the Congress, with 12% favorable ratings. No wonder that the Obama strategy has then devolved into running against the only group more unpopular than he is.

Going into the last quarter of the year we have the country on an unsustainable fiscal trajectory, operating on a Continuing Resolution. The President, having calculated that his chances of reelection are enhanced by running against the Congress rather than exerting any effort to lead toward a solution, is demagoging rather than offering anything constructive. The Congress, which depends on principled compromise to succeed legislatively, is so polarized that it is unable to look beyond anything but tactical politics and is only concerned with reelection. That inability to compromise has led to

the budget Super Committee in which the long-term security of the country has been relegated to a dozen partisans who collectively represent 10% of the population. Failing some national emergency like 9/11 that forces the Congress to work cooperatively for common solutions, the outlook is bleak.

With all of this as the backdrop, outgoing Joint Chiefs Chairman Mike Mullen was thinking out loud in one of his last public appearances. In response to a question about the size of the coming defense cutback Mullen posited that it has become necessary to review the traditional allocation of approximately one third of the defense budget equally to the Army, Navy and Air Force. The Army has absorbed the lion's share of defense appropriations over the last 10 years as Iraq and Afghanistan have consumed resources and equipment. As the US strategic focus shifts from counterinsurgency to a long-term military competition with China, the neglected Navy shipbuilding program and Air Force global strike program deficiencies must be addressed.

In the past, when serious budget reductions were on the horizon the services turned on each other, with the process viewed very much as a zero sum game. Thus far, at least in public, there has been very little of that with credit going to the uniformed leadership.

The DoD undertook a reexamination of national security strategy with the goal of defining what the irreducible minimum core capabilities are for defense in the coming decades, which most people thought had already been done with the most recent Quadrennial Review. In reality, the current defense effort is not about what the US needs, but what the US can afford with at least US\$400B+ eliminated from the equation, making it a budget drill rather than a security strategy exercise. If the larger number is imposed on DoD by the Super Committee's inability to compromise, then it becomes a survival exercise for the services and all of the niceties of jointness will go by the board quickly.

At this point it is difficult to understand what a defense company can do to best position itself, especially since the magnitude of the budget problem has yet to be defined. The one thing that is overwhelmingly clear is that the pie will be dramatically smaller.