



November 24, 2011

## **Letter from Washington**

As if we needed any further evidence of the present dysfunctionality of US politics, the so-called congressional "Super Committee" failed to agree on any steps to trim the deficit by the mandated November 23<sup>rd</sup> deadline. The partisan divide remained firmly in place throughout the committee's three months of discussions, and nothing was agreed to.

The committee had been stood up as part of the Budget Control Act of 2011, when the Congress as a whole could not agree on a way forward, and had been ceded extraordinary latitude to come up with proposals to reduce the federal budget deficit over the next 10 years. With nothing off limits from the tax code to entitlements, the proposals would have been fast-tracked to an up or down vote with no amendments permitted.

That procedure itself, generally reserved for politically dangerous but necessary votes like base closure recommendations, is further evidence of the rising sense of desperation in the Congress to do something --- anything. The Congress as a whole has the incredibly low approval rating of 9% (as a benchmark, Richard Nixon's approval rating was 28% when he resigned). The American public is increasingly convinced that the two political parties are only concerned with momentary tactical advantage, and are incapable of acting for the common good or governing in the common interest.

In setting up the Super Committee, the Congress built in a penalty for failure that at the time was thought to be so Draconian that it would force agreement. If no consensus could be reached, the US\$1.3T deficit target would be assessed as an across-the-board cut for the entire federal budget, with defense absorbing half of that total. This additional US\$650B decrease would be on top of the US\$500B or so already agreed to.

In context, the committee's US\$1.3T target for reductions over the next ten years represents a very small percentage of the total deficit which is forecast to be slightly over US\$44T during that period. Even that small and unambitious a target is beyond the reach of the two parties.

Defense Secretary Panetta and others in the DoD have been very vocal regarding the effect that this additional decrease would have on US capability. At the \$500B level there would be program terminations, ship and aircraft deactivations, and large personnel reductions. The \$1.15T

reduction level forces existential questions such as “do we need all three legs of a nuclear triad”, and “do we need a Marine Corps and an Army Airborne Corps?”

Now that the unthinkable has happened, the members of the committee have been freely laying the blame on each other. The over-simplified version of the story is that the six Democrats would not agree to reductions in entitlement benefits and the six Republicans would not agree to any tax increases.

An unintended and unforeseen consequence of the situation is that in addition to the deficit reduction measures, the Super Committee’s bill was supposed to be the vehicle for several other key financial issues: extended unemployment benefits, raising the threshold for the Alternative Minimum Tax, extending the “Bush tax cuts” beyond 2012, delaying Medicare reimbursement reductions for doctors, and extending the payroll tax reduction. These are “key” measures because they are all popular, especially in an election year.

If nothing is done to restore these tax breaks, which are presented as “economic stimulus” rather than requiring further borrowing, they will result in greatly increased revenue collection. The entire deficit reduction result of the Congress doing nothing then is in the US\$6-7T range. This may be a highly desirable outcome but it will be purchased at the cost of large-scale economic disruption. First, the tax bite on individuals will increase dramatically, right at the time that consumer confidence and economic participation is needed to sustain the anemic recovery. Second, reducing the defense budget by more than US\$1T will cause a major contraction in the industry, with additional consolidations in the first tier, and inevitable company closures in the second and third tiers and below --- right when the government focus needs to be on increasing employment.

In previous times, the Republicans were seen as the party of national defense and security. Since 2008, party policy has increasingly been controlled by the Tea Party faction, which is primarily motivated by debt and deficit reduction. As a result, there is a large constituency within the party that sees the \$6-7T in deficit reduction as worth the economic pain, and worth the risk to national security that functional disarmament would entail. In their view, the US\$15T national debt is a bigger threat to American security than North Korea, Iran or China.

The one ray of sunshine here is that Congress put itself in this position, so it can undo it. None of the across-the-board cuts actually go into effect until January of 2013 so theoretically the Congress has more than a year to unscrew the situation. Politically, however, it will be very difficult for the Congress to walk back its stated intent of making a meaningful reduction in the deficit. The President has already said that he will veto any bill that

attempts to do that, so the stage is set for continued gridlock while the budgetary train goes over the cliff.

Perhaps the largest irony is that Republicans have maneuvered themselves into the position where there may be a reduction in defense spending so large that it will force paradigm-shifting decisions on the defense leadership, with no corresponding adjustments in the Democrats' treasured entitlement programs. Back in the summer, the idea that there would be so much pressure on the Super Committee that it could not fail, overcame the Republicans' usual demand for entitlement reform to accompany any defense reduction.

Incredibly, while the DoD had stood up a high level internal working group to guide the execution of the first increment of US\$500B in reductions, there has apparently been no official acknowledgment that the Super Committee might fail and the doomsday scenario might actually occur. Helpful voices are now urging the department to map out the whole trillion + in the least damaging way, rather than simply waiting for the across-the-board option.

Even though the second increment of defense cuts do not come until 2013, in reality the DoD will have to start posturing to accommodate the forecast budgetary level almost immediately, since it is not possible to build half of a ship or an airplane.

While the members of the committee and the party mouthpieces have not been shy in laying the blame on each other, the President has largely escaped. Truth be told, he deserves as much of the blame as the two parties, since he decided to remain strictly hands off during the committee negotiations. As the head of the executive branch, he could have played a forceful role both behind the scenes and in public. Instead he appears to have made a political decision that the committee failure actually works to his benefit by allowing him to run against the failure of government in his 2012 reelection bid.

Clearly the President can't run for reelection based on his record, so his strategy will have to be to run against something --- the Congress and the politics of gridlock. Does anyone else see the contradiction in the President using the failure of the government he is supposed to be leading as a political positive?

The President's political needs and the needs of his party are diverging rapidly. The Democrats control the Senate, but in 2012 when a third of the Senate will be up for reelection, they will have to defend 23 of the 33 seats. The Republicans will have to defend ten seats but only need to pick up four additional in order to gain control of the Senate as well as the House. The President running against the "do-nothing" Congress will work directly against the interests of his Senate Democrats.

At this point the Congress will need to pass another Continuing Resolution (CR) by December 16<sup>th</sup>, or pass the required appropriations bills. Passing the bills seems highly unlikely in the time remaining unless they are all kluged together into one trillion dollar plus "Omnibus" spending bill. Republicans will probably not go along with that effort because the number is so high, and represents no real decrease in government spending following the July budget and debt extension agreements.

The likelihood of an extended CR is fairly high again for 2012, and the President has no incentive to exert any leadership since the lack of Congressional action suits his purpose at the moment.

In 1992 Ross Perot received about 20% of the votes in the Presidential election as a third party candidate. In that year, 38% of the American public thought the country was on the wrong track, and that the two major parties were incapable of correcting it. In the most recent poll, 81% of likely voters believe the country is on the wrong track, and the opportunity is there for another third party candidacy if a reasonable candidate comes forward.