



March 14, 2011

Letter from Washington

Usually in US politics when no one likes something the President has done, it means he has gotten it calibrated about right. However, President Obama's 2012 budget submission to the Congress seems to be the exception to that rule.

In order to understand the present US budget debacle, a quick recap of how we got to this position is in order.

The first thing to understand is that the current fight in the Congress is over the budget for FY-11, which started October 1, 2010 and is now almost half over. The government agencies have been operating on a series of Continuing Resolutions which authorize spending at the previous budget year (FY-10) levels, but new program starts, contract renewals, etc, are all very difficult in a CR environment. Operating at the previous year's level obviously eliminates any real growth, and does not even account for inflation.

Last fall, the Democrats controlled both branches of the Congress but recognized that they would be in a hard fight in the November elections. To spare their members what would have been difficult votes just prior to the elections, they punted on FY-11 and passed a CR that was to last only until December. When they returned to session after the elections, the Democratic leadership cobbled an omnibus spending bill together that would have funded all of the agencies of government in one huge appropriations bill. By December, however, the landscape had changed dramatically and the Republicans knew that if they held out for the seating of the new House in January, they would have far more influence.

The Republicans, who now control the House, were elected on a promise to scale government spending back and have a stated goal of cutting \$100B out of FY-11 as a down payment on long term deficit reduction. The Democrats, who still control the Senate and White House, philosophically favor government stimulation of the economy and are not so concerned by the \$1.3T deficit.

The newly-seated House Republicans passed a CR that would fund the government for the rest of the year, but would cut about \$60B out of non-defense, non-entitlement (i.e., social security, medicare) spending. The Democrats have countered with a package of \$5B in reductions, leaving the

two sides way apart and accusing each other of lack of seriousness. The present CR expires on March 18th.

There are three possible scenarios:

1. The two sides are so far apart that the potential of a negotiated compromise before the expiration of the CR on March 18th seems remote. Another short (two week) CR will be passed with additional Republican cuts, and the whole process gets pushed out to the end of March.
2. In recognition of the fact that the country is involved in two wars simultaneously, the Democratic leadership in the Senate brings a stand-alone Defense bill forward to fund the DoD for the remainder of 2011. This Defense bill would be passed at some level lower than the \$540B that Gates says is the minimum he needs to carry on. This scenario is very unlikely because the Democrats believe that the only leverage they have in the process is in keeping Defense rolled in with the rest of the government agencies. With Defense removed from the equation, the Democrats fear that the Republicans would gut all of their non-Defense priorities.
3. The two sides cannot agree on even a short term CR and the government is forced to shut down for some period. More likely this will come at the expiration of the next short-term CR around April Fools Day.

A shut-down of the government generally involves a political calculation by both Democrat and Republican leadership that they can blame it on the other party, and stand to gain more than the other side. This is not a normal situation, however, since the 90 new Republican House members are motivated by deficit reduction, almost as an ideology. They believe that as a matter of principle budget cuts in the \$100B range are required to keep faith with their electorate. Most do not have either the background or interest in defense issues to understand the damage that is being done, and simply believe that deficit reduction trumps national security.

The real nightmare scenario for DoD is that even if we get through the year without a government shutdown on a series of CR's, the DoD will have been funded at FY-10 levels, which amounts to a significant reduction in budget authority from the expected 2011 levels and will result in great program disruption.

Recall that at the beginning of this letter we described general unhappiness with the President's 2012 budget. The Congress, while failing to agree on FY-11, is concurrently reviewing that FY-12 budget, the Defense portion of which was developed in mid-2010 and submitted last fall. The FY-12 budget process assumed that the FY-11 budget would be passed in some form, and

programs would be started, contracts written, etc. If the FY-11 budget is never approved, none of the building block assumptions for FY-12 are valid. There is no procedure nor enough time for DoD or any of the other agencies to rework their FY-12 budget submissions, so we are faced with the potential of a geometrically expanding disconnect between the Congressional budget process and reality.

In fact, things are so disorganized that it's difficult to understand the basic terms of reference. The Deputy Secretary of Defense in testimony before the Senate Finance Committee referred to the DoD's \$553B request for 2012 as a decrease, because it is \$13B less than DoD's previous projections. However, it is considerably more than the current FY-10 CR amount, and constitutes a large increase in spending compared to this year. Just the semantics of the budget issues are confusing enough without adding spin to it.

No one in either party is happy with the President at this point. Most believe that he has been AWOL from this process, and rather than leading the two parties to a compromise, he has been content to let the process play out. The last government shut down occurred in 1994, and one of its results was a surge in popularity for then-President Clinton. The people believed that the Congress had over-reached, and Clinton was able to separate himself from his own party and run against Congress for the next two years, resulting in his impressive 1996 reelection victory.

Obama's strategy may be then to let the budget process unravel and for the government to shut down. He can then step in and mediate, but not have to take any of the blame for the failure of the two sides to function properly. We do have recent history to make that tactic seem plausible, but in 1994 Bill Clinton was leading the fight against the House Republicans, not shrinking from it.

No matter which of the budget scenarios plays out, grave damage will have been done to the DoD. Congress enjoys beating up on Defense officials for poor program management and cost overruns, but hypocritically accepts none of the responsibility for the damage that they cause by failing to enact timely appropriations bills. The first reasonable questions that any program manager needs to understand are "how much money do I have, and when will I receive it?" The current process denies that basic information and forces a series of bad choices onto the services. For example, operating on a CR for the rest of 2011 will cause great disruption to the Navy's shipbuilding program. The Navy will not be able to sign new contracts, and will violate existing agreements for multi-ship deals. All of which will incur additional costs, and the Congress will then flog the Navy for poor program management.

Defense Secretary Gates has been able to remain above the fray up until now. He has had the advantage of great moral authority since coming

aboard and successfully concluding the Iraq adventure. Congress has largely deferred to his judgment and his requests, but since Gates has made clear that he is leaving this year he has become a short-timer and lost much of that deference. This past week Gates and the Republican chair of the Defense Appropriations sub-committee were involved in a public spat over a DoD reprogramming request. That just wouldn't have happened even a year ago, and Gates seems to be losing his influence right when the DoD needs it the most.

What does this mean for companies trying to do business with DoD? Obviously a lot depends on how the rest of FY-11 is funded, and whether there is a CR for the rest of the year and whether that CR contains reductions from the FY-10 levels. For the big program vendors, such as shipbuilders, there will be continuing confusion as the Navy attempts to restore some order to its long term acquisition strategy. The KC-46 tanker contract has been awarded since it was funded with FY-10 dollars, but other new starts will be difficult if not impossible.

On the brighter side, for the smaller existing programs there is the likelihood of significant amounts of fallout funds being available in the last quarter due to other programs being unable to execute their planned spending. Look for massive reprogramming in the 3rd and 4th quarters.

At this point it is too soon to understand what effect the earthquake, tsunami and possible nuclear events in Japan will have on the US. It is clear though that in the reconstruction process there will be increased competition for resources, mainly cash and mainly from China. At a minimum it will make the cost of US borrowing more expensive, which will be felt throughout the budget process.

What a mess.