



April 29, 2011

Letter from Washington

A well-developed sense of irony seems almost a prerequisite these days for even the most casual observer of US politics and government. It turns out that President Obama has really been a closet deficit hawk all this time --- who would have guessed?

Since the last letter there have been several significant happenings that have led up to the President's battlefield conversion. First, the great government shutdown showdown took place, and both sides blinked at the last moment and agreed to a hybrid continuing resolution to fund the government for the remainder of FY-11.

House Speaker Boehner appears to have played his hand better than the President, and extracted spending cuts approaching \$40B in the non-defense discretionary accounts. Reductions that the Democrats had previously declared unacceptable, but the President nonetheless accepted in the continuing resolution on their behalf.

The continuing resolution was unusual in that it contained the language of a full defense appropriation bill within it, so that defense programs and activities have been assigned specific funding amounts, while the rest of the government will continue to spend at FY-10 levels. While this is good for DoD in that it has an appropriation, that amount came in at about \$530B, less by about \$10B than the amount that Secretary Gates had previously set as the absolute floor for 2011. The bad news for DoD is that it has had a full year's worth of money dumped on it with less than six months to obligate it and get contracts written. More clearly now, DoD will need to attempt large-scale reprogramming in the fourth quarter to shift funds from the programs that are unable to execute within the short time frame.

In the after-action spin, the reductions that the Republicans forced on the President appear to be less than meet the eye, and based largely on accounting gimmicks that make the actual cuts quite small.

Depending on where you sit, the President was either taken to the cleaners by the Republicans in the negotiations, or he cleverly dodged a bullet while extracting the best deal possible. The whole negotiating exercise provides a window into the mind and method of the President. Instead of leading and taking control of the process, forcing the other players to react to him, he

lets everyone else show their cards first and then attempts to meet them in some compromise. That may work well in an academic setting, but in budget politics it means that the first move is a concession, which has a snowball effect. Obama used this same strategy with the health care plan, which he allowed the Democratic Congress to write before he became involved, so he usually ends up negotiating over something that he shares no personal ownership. To the Democrat base, his willingness to give away their priorities has been highly maddening.

Similarly, he has allowed the Republican House majority to propose a deficit reduction plan as part of the 2012 Budget Resolution. The plan calls for almost \$6T in reductions over 10 years, while fundamentally changing the way Medicare and Medicaid are delivered and funded. Among other features, the resolution calls for shrinking the federal work force through attrition, and only allowing one new hire for every three retirements. The Budget Resolution has become the de facto Republican vision for the future, reshaping the relationship between the people and the government.

The President made a prime time rebuttal of the Republican plan, in his newly assumed role as deficit-hawk-in-chief, and true to form, decried their Draconian vision of the future without offering anything in its place. Obama is against the deficit, but not in favor of changing Medicare. He's for making "tough choices" and "smart cuts" but won't propose any and defend them. He has numerous times proposed an "adult conversation" on the federal budget, but then shrinks from the role of head adult. Meanwhile the 2012 Obama reelection campaign core group has set up shop in Chicago, underlining the fact that the process has already started and every decision and every statement will be viewed through that prism.

All of this may be good politics for Obama but there is one key group that isn't buying it. Standard & Poor's warned that it would likely downgrade US government debt because of the apparent inability of the Republicans and Democrats to agree on a way forward. What should have been received by both President and Congress as an absolutely clear warning shot has been largely shrugged off.

Meanwhile the President has a bigger and more immediate problem. The Congress must approve an increase to the debt ceiling by mid-May in order for the Treasury to sell bonds on the market to continue financing the deficit, estimated at \$1.3T for 2011. Absent Congressional authorization, the US Treasury will begin to default on its obligations in July.

The Republicans have made clear from the beginning that they would not approve an increase to the debt without a corresponding reduction in spending, and commitment to a long-term strategy to reduce the debt itself. This sets the stage for another round of negotiations between Speaker Boehner and the President, with the potential consequence more serious than just a government shutdown.

The Republicans have enormous leverage in these ongoing negotiations, and are really punching above their weight because of one key provision in the US Constitution. As Boehner says, they only control one half of one third of the US government, but that piece they do control, the House of Representatives, is the only place that revenue and tax bills originate. As a result, the President ends up negotiating with Boehner, and the Democratically controlled Senate is largely a spectator.

In order to get a deal on the debt ceiling the President is going to have to give a lot, and his base is increasingly concerned that he will give too much too easily. Boehner goes into the negotiation having to satisfy his base as well, mainly the tea party-affiliated new House members, and he can use their unpredictability and unmanageability to his advantage. The Democrats view the tea party people like the Taliban --- rigid, uncompromising and ultra conservative. The tea party version of sharia law involves amputating government agencies rather than body parts, however. Boehner can say "look I'm trying to be reasonable, but I'll never sell this to my people", and extract more from the President.

Sensing the direction of the wind, several key Senate Democrats up for reelection in 2012, have stated that they wouldn't back a debt ceiling increase without a deficit reduction package to accompany it. With his Senate majority defecting, Obama either has to work out some grand bargain on the deficit, or face a series of short term raises, each with more reductions attached. The grand bargain seems unlikely given the impending election and the political posturing that goes with it. The White House has tried to sell the notion that a clean vote (i.e., with no spending reductions) is the patriotic thing to do, which hasn't passed the Republican laugh test.

In his deficit reduction speech the President proposed to cut defense spending by \$400B over twelve years (Author's Note: Any politician that proposes painful reductions that take place *after* his term of office is not serious and just playing to the crowd). Nevertheless, he has directed the DoD to undertake another strategy review, and to align objectives and resources for the world of the future. Besides the fact that DoD just did this supposedly in the last Quadrennial Review, this process reverses the priorities. Ideally, the threats and risks are assessed and a strategy is developed to hedge against them. That strategy then has a cost associated with it, and it becomes the national priority. In this instance, the cost has already been established and now the DoD must make the new strategy fit a cost parameter. The difference between the strategy we need and the strategy we can afford then becomes risk we must accept, which just became open-ended.

This wide-ranging DoD strategy review will also involve reexamining roles and missions, which is Pentagon-speak for rice bowls. The services are already circling the wagons to defend against what they see as a fight for resources. The Marines, for example, having lost the Expeditionary Fighting

Vehicle program, will see this as an existential threat to their existence as a separate force. Amphibious landing forcible entry has been the Marines reason for being from a doctrinal standpoint, and they are less and less capable in that regard.

Secretary Gates is probably happy that he will be departing in June and will not have to referee the internecine warfare that will take place. His replacement, Leon Panetta, currently CIA director, has a history as a tough budget cutter. He was chairman of the House Budget Committee, director of OMB, and White House Chief of Staff in the Clinton years, and has been a surprisingly effective CIA director.

For those of us who appreciate inside-the beltway politics, Obama's appointment of Gen. David Petraeus as the new CIA director is a masterstroke. First, he will probably be a very good director, but in one move the President has eliminated him as a potential presidential rival in 2012, while keeping him viable as eventual Chairman of the Joint Chiefs. With the Army chief having just turned over, there really was no place for Petraeus to go, so this assignment will keep him both upwardly mobile while still in the Obama tent.

While all of these domestic concerns continue to plague the President, largely because of his passivity (or "leading from behind", as one of his advisors termed it), his handling of international issues hasn't fared any better. He allowed himself to become fully invested in removing Gadhafi from power, and then hamstrung the military effort required to do so which guarantees the stalemate. Similarly, the US has made the Rwanda-moral equivalency argument for intervening in Libya to prevent the government from killing its citizens, but doesn't see the inconsistency in then not intervening in Bahrain or Syria.

Generally when a US President is having domestic political difficulties he can change the subject to focus on international issues to restore some luster to his brand. For Obama, unfortunately, that is even less friendly territory.