



May 21, 2012

## **Letter from Washington**

In order to understand how Defense and Homeland Security appropriations are likely to play out for 2013, you first have to understand where we are and how we got here.

Life in Washington these days is like being trapped in a bad movie. The cliché du jour is that the country is going to go "off a cliff" on January 1, 2013. Whether you prefer the cliff visual or the train wreck option, the result will be the same. There is a confluence of bad things, all set to occur in early January. Everyone knows it, everyone knows that these things cannot be allowed to happen, but no one seems willing to take the political steps to prevent them.

A partial list of the bad things is as follows:

- "Sequestration" of an additional \$1.3T, with an additional \$500B coming from the DoD budget
- The restoration of 2001 level income tax rates as the "Bush tax cuts" are allowed to expire
- A 5% increase in the capital gains tax rate
- Numerous different taxes associated with the Affordable Health Care Act (Obamacare) that were deferred for two years to lessen their impact during the debate over passage and will now effect both businesses and individuals

There are other bad things that may happen unless the Congress takes bipartisan action to prevent them:

- More middle-income taxpayers captured by the Alternative Minimum Tax
- Lower Medicare reimbursement rates that will force doctors out of the system.
- Default on US sovereign debt through failure to raise the debt ceiling

All of these things add up to the largest single tax increase on the American public in history. Right at the time when the economy requires additional stimulation through consumer spending, more discretionary income will be revoked by the government in the form of higher taxes.

The Keynesian argument that taxes should not be increased during a struggling recovery would normally carry the day intellectually, but that bit of policy has been subsumed into the larger existential struggle between the two parties as the November election stifles rational thought.

Both political parties have been complicit in developing and perpetuating a system of rewards and benefits that has become fiscally unsustainable. The Washington of popular myth is one in which lobbyists representing moneyed special interests develop tax loopholes and breaks for their wealthy clients, while the average person shoulders the cost. The Occupy movement has been based in part on the feeling of helplessness that comes from playing by the rules, while the rewards all go to the people who do not.

In reality, the upper 20% of the population pays 70% of all federal taxes, with the wealthiest 10% paying a whopping 55%. If the "wealthy", currently the scapegoat for the President's election year demagoguery on taxes, were really so powerful and influential, it seems that they would have cut themselves a better deal.

In the Washington of reality, both political parties have made a series of promises to the electorate that are unaffordable. To make matters even worse, along with these intergenerational obligations, both parties have promised not to raise the taxes required to sustain the entitlements. The problems that the state of California is facing in 2012 may foreshadow the direction of the US in a year or two down the road if leaders continue to fail to lead, and instead of addressing the real issues continue to blame the problems on scapegoats (liberals, the rich, the tea party, etc).

California, if rated on the basis of GDP would be the eighth largest economy in the world, right behind Italy. For many years the politics of the state have resulted in a disproportionate amount of power accumulated by the public service unions (teachers, nurses, police, firefighters, etc). The unions contribute heavily to elect representatives who in turn provide more generous benefits, in a death spiral of mutual accommodation. California has an annual operating budget of \$49B and a deficit estimated at \$16B (and climbing) for 2012. The state has run out of places to borrow the money to sustain this level of budget shortfall, and a federal bailout is very unlikely. Unlike Greece, California can't opt out of the dollar and revert to its own currency, so the only solution appears to be a combination of service cuts and walking back the promises made to current and retired public workers. This will be extremely painful.

On a national scale the situation is not that different. Entitlement spending, primarily Social Security and Medicare in an aging population, have long outpaced the revenue required to operate them. As a result the US government has been borrowing roughly 40 cents of every dollar and amassing a huge national debt obligation. Added to the growth in entitlements, the US fought two wars in the last decade without raising the

revenues to pay for them. On a national scale the public service unions are not as powerful, but they are replaced by different equally well-organized recipients of public generosity, primarily the elderly who receive the Social Security and Medicare benefits.

Both parties understand that the solution lies in a "grand bargain" in which the entitlements would be reformed, revenues raised, and the fiscal trajectory readjusted to a more favorable future. The Democrats will not agree to reforming entitlements without increasing taxes on the "rich", the Republicans will not raise taxes without reforming the tax code and the system of entitlements. Checkmate.

Adding to this situation is the belief by both parties that there is no benefit to compromise until after the November election, when it is clear who won, on what issues and by what margins. So the result has been this long period of stalemate in which both parties jockey for partisan advantage without seriously addressing the underlying issues. Given the list of bad things that are set to happen on January 1<sup>st</sup> without bipartisan Congressional action, there does not seem to be enough time between November and January to prevent most of them, or a plausible scenario in which the fixes would receive the bipartisan support required for approval.

All of this backstory finally brings us to the 2013 outlook for Defense and Homeland Security appropriations.

The administration has submitted its 2013 budget requests to the Congress, which largely reflect the reductions agreed to in the 2011 Budget Control Act. The House Appropriations Committee has approved a bill which would give the DoD about \$3B more than the President's request, but rearranges many of the priorities, particularly in regard to aircraft procurement, ship building rates, and personnel reductions.

Defense Secretary Panetta, Chairman Dempsey and the service chiefs have been in the rare position of pushing back against proposed Congressional budget additions, hewing to support of the administration budget proposal. Panetta and the Chiefs recently conducted a meeting of the combatant commanders to discuss and war game the strategy that was developed in response to the first round of defense reductions last summer. Claiming that the strategy is not budget-driven but reflective of changing priorities in a dynamic world, Panetta has made the case for troop reductions to a skeptical Congress.

Meanwhile, the elephant in the room is the very real threat of sequestration on January 1. SECDEF Panetta has said that DoD has not undertaken any detailed planning on how it would address the possibility, but that the newly-minted national military strategy would be unachievable if sequestration occurs. The service vice chiefs recently testified and painted a very bleak picture regarding the effect of sequestration on manpower. The Marines' end

strength would drop by 18,000 to 162,000, the lowest since the 1950s, leaving the Corps unable to meet any major contingency. The Navy would drop from 285 to 235 ships and be unable to focus on the Pacific as the strategy requires, and the Army would be similarly decimated.

The irony of sequestration is that it was never intended to happen, and the prospect was supposed to be so appalling that it would never be allowed to take place. The real target was not defense --- no one really wants to cut defense any further --- but the knot of taxes and entitlements that no one seems able to untie.

The likelihood of the House and Senate being able to conference and agree on a defense bill prior to November seems remote at best. More likely there will be a continuing resolution to fund the government from the end of FY-12 until after the election. Candidate Romney has indicated he wants to increase defense spending if he wins. If Obama wins, he will use sequestration as a club to extract the tax increases he wants the Republicans to agree to.

Obviously none of this makes any sense, except in the context of election year politics in a system that has become dysfunctional.