



November 28, 2012

Letter from Washington

Now that the dust has settled from the US elections, it would be tempting to embark on a post-mortem of how Mitt Romney could have lost what should have been a slam dunk sure thing. While that might be interesting to some, it probably wouldn't be all that helpful in trying to predict what will happen next, and is probably best left to others.

That said, there are several take-aways from the election that are worth noting:

- Obama won not by appealing to a broad consensus on the direction the country should take, but on cobbling together a number of small-bore programs that appealed to specific interest groups (Latinos, gays, college students, etc), while fanning the resentments of each. While this may be an effective strategy for winning elections, it isn't very enlightening as policy. More importantly, Obama now has to try to reach common ground with the very same people he spent the last six months demonizing. There are grudges there that won't soon be forgotten and forgiven.
- While playing to the grievances and resentments of his special interest coalition of subgroups, the only overarching theme in his campaign was that "the rich" are not paying their fair share of taxes and should be punished accordingly in the interests of fairness. That punishment will take the form of higher tax rates on both income and capital gains.
- More importantly, the Affordable Health Care Act, more popularly known as "Obamacare", has been legitimized by national referendum, and a myriad of higher costs, user fees and taxes will take effect in 2014, intentionally pushed off beyond the election by the law's authors in 2009. In order to extend coverage to the presently uninsured and to cover the potential costs of adding high risk people to the insurance pool, premiums for the healthy insured will need to rise dramatically as the insurance industry passes these costs on to the consumers. In addition, small and large businesses are incentivized by the law to revert full time employees to part time so that the companies do not have to provide health insurance.

- There is an existential crisis in the polling industry, with some of the election predictions way off the mark, especially on the Republican side. Romney's internal polling apparently showed him much closer in the swing states than was warranted, and most of the editorial observers found the race too close to call even on election day. The firm belief by many Republicans that Romney would win has added to the sense of grievance and given life to the conspiracy theorists.

The larger crisis, the impending fiscal cliff, has not been altered particularly by the election. While Obama won the electoral vote convincingly (332-206), the popular vote was much closer with about 3.5 million votes separating the two candidates. The actual closeness of the election can be seen in the fact that if 400,000 people had voted differently in the key swing states, Romney would have won. While the country appears to have doubled down on hope rather than management in the Oval Office, the Congress remains divided with the House still firmly in Republican hands. Neither side can claim a mandate for anything.

What makes things even more difficult for the political leadership is that the American public is not at all clear on what it wants. Polling data (presumably more reliable) show that a majority of Americans want government spending scaled back and the debt brought under control. A majority also wants no change in Medicare, Medicaid or Social Security, the three main drivers of the debt problem. A majority wants the Democrats and Republicans to cooperate and solve the problems, as long as those solutions don't affect current entitlement programs.

For their part, the two party leaders in the Senate made conciliatory statements after the election, raising hopes that partisanship might give way to compromise. That has quickly dissipated as the Democrat majority proposed new rules to eliminate the widespread use of the filibuster. The filibuster has always been the minority party's weapon, and the Republicans have used it extensively in the past two years, partly because the Democrats eliminated the minority's ability to propose amendments to legislation, hoping to shield their members from difficult votes that could come back as sound bites in the future. As a parliamentary tactic, the filibuster threat forces any major legislation to pass the Senate by at least 60 votes --- the required number to shut off debate. Over the years, depending on which side was in the majority, both have proposed eliminating the "super majority" requirement, but doing it by a simple majority of 51 votes as a Senate rules change. Since neither side has recently enjoyed a 60-vote majority, the filibuster has been a major contributor to gridlock. The two sides have come to an agreement on the issue, but not after many heated words on the Senate floor which further poison the atmosphere and make compromise on the big issues more difficult.

House Speaker Boehner, now by default the effective head of the Republican Party as Mitt Romney is relegated to obscurity, will need to resume the

budget talks with President Obama that led to the sequestration agreement in 2010. As you recall, Boehner and Obama were close to an overarching "grand bargain" on tax increases and spending cuts, but Boehner could not deliver his House Republican caucus. Many of those recalcitrant Republicans had been elected in the 2010 anti-spending wave and would not go along with the deal. They have now been around for two years and have a better understanding of how sausage is made and may be more amenable to solutions.

It was never really clear if Obama could deliver his own Democrats since the bargain included cuts to the social programs that Democrats view as central to their fundamental beliefs. The election has emboldened liberal Democrats to push back against the President on any cuts or changes to Social Security and Medicare, and will put him in the position of having to negotiate with both the Republicans and his own base. This will require Mr. Obama to lead from the front, and not allow him to take his usual tactic of having someone else put an idea on the table first.

At this point there are three different pieces to the financial disaster that awaits on January 2nd that Obama and Boehner need to come to grips with:

- The first is that the tax cuts enacted ten years ago to stimulate the economy after 9/11 are set to expire unless extended by Congressional action. The raise to the previous tax rates is roughly 3-5% depending on the specific bracket, with the highest level returning to 39% for the top earners. Cutting taxes to stimulate growth is fundamental to Republican ideology, and keeping the reductions in place for all tax brackets is central to the party strategy. Obama campaigned and won on the premise that taxes should rise for those taxpayers making more than \$250,000 and is unlikely to give any ground on that issue.
- The second piece is that the debt ceiling will need to be raised again near the first of the year, so the same set of issues that was unsolvable in 2011 and led to the sequestration agreement will be a necessary part of any attempt at another grand bargain.
- The final piece is the sequestration of funds that will take place indiscriminately on January 2nd, absent an agreement. If allowed to happen, Defense will take the heaviest hit, and an additional \$500B will be taken out of the budget over ten years. This is in addition to the \$487B already factored out of the DoD budget, and presents an insurmountable challenge to defense program management.

The likelihood of negotiations presenting a solution in the next 30 days seems remote, despite the brave words and faces and good intentions that the two sides have put forward since the election. Regardless what Obama and Boehner may agree to, they still will have to sell the deal to their

respective parties. Organized labor is hoping for a return to relevance after losing considerable ground this past year, and has already started running TV spots warning against tinkering with Social Security and Medicare. For their part, Republicans have held firm against the tax rate increases, and have suggested that since Obamacare has so many different taxes and fees associated with it that it should be back on the table as part of any overarching agreement.

Obama has proposed as a starting point the budget that he presented to the Congress at the beginning of the year, in which he claims \$4T in deficit reduction. That \$4T is based on his plan taking credit for the reductions agreed to in the 2011 negotiations, as well as the cost avoidance of winding down involvement in Afghanistan. The Republicans stance is that the prior reductions have already been accounted for once, and that the war cost reductions is a budgetary gimmick without a factual basis. These two points of disagreement put the two sides about \$2.5T apart in even agreeing what the starting baseline is, none of which augurs well for an overall agreement in 30 days.

With all of this heavy lifting required by the Congress, it seems clear that any hope of reforming export controls is now gone for 2012. The Obama administration had proposed a set of modifications to the Arms Export Control Act that would have given the executive branch the authority to move categories of items from the US Munitions List to the Commerce Control List. Perhaps the most important administration supporter was former Secretary of Defense Gates, and without his support much of the energy has gone out of the initiative. There is hope for 2013, however, since there will be term limit changes to the House Foreign Affairs Committee leadership, and a more change-friendly Chairman may result. Meanwhile, status quo for the export modernization effort.

The most likely outcome at this point is that there will not be a miraculous agreement that will bring the sides together before January 2nd. The Republican leadership has acknowledged that increased revenue is necessary in addition to spending reductions, but the rank and file will likely reject increasing the tax rates. By doing nothing and allowing the Bush-eras tax cuts to expire, the rates will be raised automatically but without any Republican fingerprints on them. In a best case, the tax increases will take place on schedule, but the Congress will pass legislation that postpones the sequestration funding reductions until some point later in 2013. The government is running on a Continuing Resolution that will expire at the end of March, and that appears to be a logical deadline for an agreement that would rescind the tax hikes for all but the top bracket. The borrowing authorization to raise the debt ceiling will complicate all of this, and appears to be the area that the Republicans hold the most leverage in any negotiation, having already demonstrated their willingness to shoot the hostages in 2011.

From a purely defense perspective, the best possible outcome might lie in a proposal put forth by Sen. Carl Levin (D-MI), chairman of the Senate Armed Services Committee. Levin has proposed a \$100B cut over ten years as a “down payment” on defense reductions in lieu of the full sequestration amount. Levin is trying to forestall defense paying an even larger price in any possible grand bargain that Obama and Boehner may come to in the next several months.

What is clear is that the new Congress that will be sworn in in January will be more polarized and more partisan than the previous. There will be 12 new Senators and about 80 new Representatives, roughly 20% of the Congress, mostly replacing more moderate members. Few of them have any background in defense issues, which sets the table for partisanship without any knowledge basis.

Bottom line: a bumpy ride ahead.