



January 7, 2013

Letter from Washington

After giving itself 500+ days to resolve the issues surrounding the fiscal cliff, the Congress had to go into overtime to pass a deal in the wee hours of 2nd January that was surprising in its minimalism.

The deal which was struck between Senate Minority Leader McConnell and Vice President Biden, after the President and Speaker Boehner had failed, raises income and capital gains taxes on individuals with more than \$400,000 income. While the agreement did not reach down to the \$250,000 level that the President made the centerpiece of his reelection "fairness" campaign, it is significant in that the Republicans acknowledged the inevitability of the situation and passed a bill that actually raised taxes on anyone.

The Democrats are crowing that they were finally able to force the Republicans to violate their core principle on taxes. The Republicans respond that because of the 2011 Budget Control Act that put the sequester of funds and package of tax increases on autopilot for 2nd January, that they averted a much worse outcome in which everyone would have had a tax hike. More importantly from the Republican side, the tax rates for those making less than \$400,000 were permanently frozen at the current rates as part of the deal, as well as achieving some concessions on inheritance taxes and other issues.

The deal is more significant for what it did not do than what it did, and on the top of that list is the sequestration issue. The agreement moves the January deadline for the across-the-board cuts two months downrange to the first week of March. It adjusts the ten-year amount of the sequester downward slightly --- the DoD portion is reduced from \$55B down to \$42B, but requires the DoD to achieve the FY-13 reductions in seven months rather nine.

Since the summer of 2011 when the sequester deal was first hatched, the DoD had refused to make any plans for coping with the automatic reductions. This was based, probably correctly, on the belief that any planning for reductions on this scale would inevitably leak, and once they were known the plans would become self-fulfilling. That policy was changed in December, and the DoD is now acknowledging that the unthinkable worst case might actually come to pass.

The sequestration deadline was moved ahead two months, which now roughly coincides with the Treasury Department reaching the debt ceiling limit of \$16.4T, beyond which no further borrowing is permitted without Congressional authorization. Additionally, at the end of March, the Continuing Resolution funding all government operations in the absence of a regular budget appropriation for 2013 will also expire. The President and the Congress have demonstrated that when given 18 months to resolve these issues they were incapable, so we should assume now that they will wrap up all these trivial loose ends in the next two months. Really.

Since the fiscal cliff was averted, that tired metaphor should be replaced. The US political and economic system is now screaming toward a fiscal brick wall, in which the potential for a simultaneous debt default and a government shutdown is better than even money.

For observers of the US political system who still harbor the notion that the elected representatives, starting with the President, are capable of coming together and developing principled compromise in the national interest, the next two months will be instructive. US politics, even involving the most serious issues, have devolved to a series of tactical engagements in which the interests of the party and short-term advantage have become paramount.

The President has stated that he views that November election as conferring a mandate on his administration, for tax increases at least, and that everyone should just do what he wants. Speaker Boehner has claimed a mandate for spending reductions since Republican control of the House was reaffirmed. 15 Republican members won House seats in districts that voted for Obama for President. It's not really clear who has a mandate and for what, but Americans have again approved divided government.

In two months time when the delayed sequester, the debt ceiling and the 2013 appropriation all come due simultaneously, neither side will feel inclined to compromise. The Democrats, having forced the Republicans to surrender on taxes, will want to revise the tax code to eliminate loopholes and deductions for corporations and the wealthy to generate more revenue. The Republicans will be focused on spending reductions, and will want to restructure the big entitlement programs to achieve them.

Recall that in the cliff-averting agreement, the Democrats got their tax increase on the wealthy, but they agreed to make the other tax rates permanent, and no longer subject to periodic negotiation. That may have been not just a tactical error but a strategic mistake. What brought the deficit hawks to vote reluctantly for the agreement and pass the bill was the threat of tax hikes going into effect across the board for everyone. The Democrats have given away that bit of leverage for the coming battle, and may have relegated themselves to playing defense for the next four years.

For their part, in 2011 a sizable number of the Republicans in the House and Senate were willing to take the US into technical default rather than increase the size of the deficit. They will undoubtedly use the debt ceiling again to force Obama and the Democrats to reform entitlements and cut spending in general.

(Ed. Note: This whole debt ceiling thing is rank hypocrisy on the part of the Congress. They blame the President for the deficit, but in reality, it is the Congress that originates and passes the spending bills. In refusing to raise the debt ceiling they are essentially refusing to pay the tab that they have themselves run up).

If the threat of the across-the-board tax hike was enough to make the Republicans cave on 2nd January, the threat of the sequester will have the same effect on the Democrats in March. Originally, the chunk of spending that would be taken out of Defense was unthinkably large for the Republicans to swallow, but 18 months later it doesn't look so terrible. In fact, the amount that the sequester and budget caps will take (\$47B over ten years) is probably not that far off of what many of the deficit hawks would contemplate anyway, but would prefer it in a targeted manner rather than a one-size-fits-all DoD haircut. The Democrats now will have huge difficulty facing up to the other half of the sequester when a similar amount is taken out of the environment, health and social programs.

The public that reelected both Barack Obama and John Boehner is hugely conflicted on spending. Sizable majorities want the deficit reduced, but equally large majorities want no change to Social Security, Medicare and Medicaid, the main drivers of the deficit. That is probably because 49% of Americans receive some specific benefit from the government in the form of pensions, medical care or other subsidies, in addition to the roads, bridges and air traffic system that benefit all.

Mitt Romney walked into the trap during the election with his "47% of the population" comments, which were taken only slightly out of context. Some number of people are getting something for nothing and are incentivized to continue, however a larger number are receiving an entitlement that they paid a lifetime of taxes to earn. Entitlements are tricky to deal with fairly, but very easy for politicians to demagogue.

The bottom line for Republicans is that the sequester may be the only way that sizable cuts in spending can be achieved in the short term. In the same vein, some Republicans have actually started sounding nostalgic for the two government shutdowns that occurred in 1994. They were ugly at the time, but did result in the two sides coming together and making compromises that led to a period of prosperity in the US. All this is to say that the Republicans may have flinched on taxes in the first round, but they have most of the leverage coming up and have demonstrated that they will use it.

Rather than dismissing sequestration as unlikely or unthinkable, most DoD contractors are now making plans for its execution. The first impact has already been felt by companies anticipating contract awards that have been delayed or outright canceled due to uncertainty. Additionally, since new program starts are not allowed under the Continuing Resolution rules, there have been significant delays in bringing new systems on line.

The waterfall effect of a delayed sequestration decision and FY-13 appropriation until March means that the administration can't submit the FY-14 budget to Congress in early February as is the norm. As a result, if the government continues to function past the March expiration of the Continuing Resolution, it will likely be April or May before the FY-14 President's Budget is rolled out.

In a best case, the Congress and the administration will strike a large bargain that will fix agreement on FY-13 spending levels, as well as settle the debt ceiling issue for some period. The FY-13 levels will undoubtedly contain some DoD spending reductions below the level of the Continuing Resolution, which Congress will retroactively approve in the actual FY-13 appropriations bills. At that point, the FY-14 planning can be done from a state of certainty regarding the baseline.

It is entirely possible that the Congress will not be able to come to agreement on FY-13 and the sequester will be allowed to occur by default, viewed as the least bad of a series of bad choices.

The debt limit and the expiration of the Continuing Resolution are abstractions for most Americans, unlike the January tax increases that were highly personal, and there is less constituent pressure on the Congress to resolve the issues ahead of time.

In what may be the most contentious and partisan period of his Presidency, Obama has nominated former Republican Senator Chuck Hagel to replace Leon Panetta as Secretary of Defense. Hagel is unusual as a former Senator in that he is not well liked by many of his former colleagues on either side, and will have a rough road to confirmation. It is interesting that the President, with all of the other issues going on, would choose to expend his personal capital on Hagel in a fight that could have been easily avoided.