



May 15, 2013

### **Letter from Washington**

Since the last letter, Washington has been characterized more by what did not happen than what did --- the world did *not* end on March 1st when sequestration went into effect.

Despite dire predictions that airplanes would fall from the sky and that orphans would starve, the federal government has continued to operate in much the same fashion as before. The Obama administration way overhyped the immediate catastrophic effects of sequestration, and lost all credibility on the subject in the process.

One of the by-products of the "sky is falling" strategy that the administration adopted is the belief in Washington and elsewhere that has taken hold that sequestration really wasn't all that bad, and that it is a reasonable approach to solving the country's debt problem. Members of Congress seem nowhere closer to agreeing on an overall plan for going forward, especially since they are not being bombarded by irate constituents. The one notable exception was the FAA's rollback of air controller furloughs, which did tie up the air traffic control system for several days running, and resulted in a large backlash.

Again, the public drew the wrong lesson from the FAA experience, and a majority believes that the agency was only trying to make a political point and was not acting out of fiscal necessity. The Congressional "fix" for the controller problem was to allow the FAA to reprogram funds from an airport improvement fund, essentially trading short-term delays this summer by guaranteeing long-term delays in the future.

The experience with the Department of Defense has been similar, and the perception is that the department seems to have weathered the first round of \$47B in reductions without too much effect. The reality is that the DoD leadership has chosen to protect its major programs at the expense of operations and maintenance, and has created "savings" by deferring ship overhauls, cutting flight hours and other training to the bare minimum for qualification and furloughing civilian employees. These are more in the category of accounting gimmicks than sustainable savings, and cannot be carried over more than one year without causing irreversible damage.

Since the perception is that sequestration has not been that difficult or harmful, and that the political process remains locked up tight, the likelihood is that there will be a second year of mandatory reductions, and that the DoD will have to come up with \$52B of cutbacks in FY-14. Several senior members of the Congressional military oversight committees have expressed alarm at the prospect, and have asked the SECDEF to report back by June 1 on his plan for absorbing another round of large reductions.

Secretary Hagel, widely believed to have been selected for the job on the basis of his willingness to take an axe to DoD, has chartered a "Strategic Choices and Management Review" (known by the acronym SCMR but pronounced "scammer" in the Pentagon). This wide-ranging review reportedly has eighteen sub-groups focused on specific areas for analysis and potential cost savings. A casual observer could reasonably wonder how a gaggle this large could develop meaningful strategy and programmatic options before dissolving into agenda-driven factionalism.

The budget that DoD has proposed for FY-14 does not take any of the possible sequestration reductions into account, and actually includes 3% growth in acquisition programs. Secretary Hagel spent enough time in Congress to know that if he responds to the June 1 deadline with a good-faith outline of \$52B in possible FY-14 reductions, those cuts will be pocketed immediately and become the baseline for a further drawdown, so he is unlikely to respond with anything meaningful.

At this point it appears that the only thing that might save the DoD from another round of really damaging sequestration cuts is the elusive "grand bargain" between the Congress and the White House, that would set the trajectory for deficit elimination. This seems highly unlikely in the present environment.

The President seems to have become a bystander in the process, and in a news conference last week which was reminiscent of his low-metabolism debate performance during the election, essentially said that since he can't make the other kids play nice that he has stopped trying. The White House strategy going forward will be to blame the Republicans for everything and hope to regain control of both Houses in 2014. At this point that seems an unlikely outcome, so we are destined for at least two more years of political stalemate.

The President, coming off his reelection victory last fall, should be at the peak of his political power and influence before descending into irrelevance in his last eighteen months in office. Instead, he has been handed two stinging defeats that have eroded his political clout and credibility.

- First, despite a circus-like effort to rally the country to rise up and demand an alternative to sequestration, he seriously overplayed his

hand with the dire predictions, and ended up looking foolish when they did not materialize.

- Second, his efforts at new gun control legislation also fell short when the Congress declined to take up his package of specific gun and magazine bans. The one issue which had tremendous support nationally (80% +) would have required universal background checks for any firearm purchase, but it fell victim to the overreach of the whole package.

This would normally be the scene-setter for a summer of bloody political trench warfare, especially when the debt limit extension comes due again with a weakened President negotiating with an energized Republican House. However, two factors have come into play that will tend to cool things down.

- As a result of the improved economy and the tax increases enacted at the end of 2012, the Treasury has realized substantially increased revenues.
- The spending reductions associated with the sequester have had the desired effect and outlays have decreased at the same time, making the Treasury Department balance sheet the best it has been in five years. Rather than hitting the debt ceiling limit in early summer, Treasury may be able to make it all the way through 2013 before having to borrow more.

Washington loves a good scandal, both as entertainment and as a tool for beating up the party in power. The Obama administration has obliged with two that are sucking the oxygen out of the political atmosphere.

- First is the executive branch handling of the attack on the consulate in Benghazi, Libya. We have been treated to mid-level State Department staffers contradicting the administration's version of events in Congressional hearings, which at a minimum indicate the White House's clumsy attempt to spin the story just before the election.
- Second, it has become apparent that the Internal Revenue Service (the tax enforcement agency) subjected conservative political organizations to a level of scrutiny bordering on harassment in the approval of tax-exempt status. At first portrayed as the limited actions of a handful of rogue agents, it now appears that this special treatment was approved at least at the upper levels of the agency, reminiscent of the Nixon White House enemies list. Even more titillating is the fact that administration officials initially mischaracterized the problem in an effort to minimize the fallout, once more proving the Washington axiom that it's never the original crime but usually the cover-up that gets you into trouble.

The scandals and the political positioning have distracted the Congress from the appropriations process, but have also cost the President heavily in political capital that the conventional wisdom says he should have gained as the result of winning the election last November. The real fight that will come during the summer will involve the implementation of the Affordable Medical Care Act or "Obamacare". All indications are that the rollout of coverage and the associated costs will not go smoothly, and that many of the details which were sketchy when the bill was passed have not become any more detailed. Obama needs to be out selling the plan, but instead has to answer questions about other things.

As in his passive performance in his news conference, the President remains oddly detached from the give and take. What was viewed as cool and above the fray in 2008 seems more like remote indifference in 2013. The prospects are not good that things will improve for him any time soon since the administration seems unable to deal with the growing scandals in a credible way that will put them to rest. Instead, they will continue to be the focus of attention as facts dribble out in a death-of-a-thousand-cuts. The other Washington axiom that the President's staff seems to have forgotten is that it is vital to get all the information out at once, control the narrative and move on quickly.

With all of the sideshows and distractions at least one good thing happened in Washington this month. The State and Commerce Departments published the first increment of the long-awaited update of the International Traffic in Arms Regulation (ITAR). The rules, which will go into effect in October, represent a major change to the concept of arms export control, and will be a major benefit to US companies doing business overseas. Fundamentally, greater specificity and focus has been brought to the ITAR, and whole categories of aircraft, as well as their parts and sub-assemblies are no longer subjected to commerce-killing regulations. Eventually the restrictions on nineteen different ITAR categories will be relaxed and control shifted from the State Department's Munitions List to the Commerce Department's Commerce Control List.

In a separate but related action, the DoD has requested a modest \$3.8M in FY-14 for a pilot program called the Defense Exportability Features (DEF) program. The goal of DEF is to build exportability factors into major weapons systems that the DoD would like to see in the hands of NATO and other major allies. The full concept envisions DoD's payback in economies of scale as a result of expanded Foreign Military Sales, as well as ensuring that major allies maintain forces and systems that are compatible with US forces. Both the ITAR revision and the DEF will make it easier for US companies to compete in the international defense market place.

