



November 1, 2013

## **Letter from Washington**

It has been an eventful and event-filled time since the last letter.

First, the House Republicans caused the US government to shut down for 16 days in early October. What originally started as a politically winning strategy to draw attention to the debt and deficits, was high jacked by the hard-core right of the party and became instead a hopeless quest to defund and dismantle Obamacare. When it became apparent that the Senate and the President would not give any ground on the healthcare issue, the shutdown still ground on for two weeks while the Republicans searched for a face-saving way out of their own trap.

Eventually the House Republicans were forced to capitulate in an unconditional surrender, reopening the government with a Continuing Resolution and raising the debt ceiling with nothing gained but a further descent into uncharted low poll numbers. What is new about the latest batch of poll numbers is that while the Republicans have taken the worst of it, all politicians including the President have seen their favorable ratings sink to new lows. In the latest WSJ/NBC poll a generic independent Congressional candidate gets 60% of the vote when matched against an incumbent Republican.

The deal that was struck to end the shutdown funds the government with a Continuing Resolution until mid-January and extends the debt ceiling for about a month beyond. During this time the House and Senate are supposed to go to conference on their widely different budget resolutions and come to some agreement on a way forward. Both plans identify funding increases but the House budget does it by cutting programs while the Senate raises taxes, so we are left with the core argument that defines both sides of the political debate. It is hard to see how a compromise can be reached or even what it might look like, given the six weeks available.

What is interesting is that the markets have not reacted more strongly to the threat of shutdown and default. In fact the market acted fairly calmly and decreased modestly over the 16 days of shutdown, but surged back when the agreement was reached. Investors and money managers have become complacent and see these recurring debt ceiling showdowns as a rerun of a familiar movie with the unthinkable always avoided at the last moment.

The other interesting observation is that there has been a complete loss of influence by the grownups in the Republican Party. The Speaker allowed the majority to be taken over the cliff by a minority of 40-some members of his caucus in a scenario that had no possible good outcome. Once over the cliff and in free fall, it was apparent that there was no agreement on goals and no strategy to achieve anything once the defunding Obamacare gambit proved unsuccessful. The result was a humiliating political defeat that may have done great damage to the Republican brand.

What is also apparent in all of this is that the Congress and the President once more successfully evaded an adult discussion of the real problem --- the uncontrolled growth of entitlement spending that is squeezing any discretionary capability out of the budget process. Failure by either side to frame the debate honestly has created a vacuum that has been filled with hypocrisy and populated by ideologues.

In the US system the President has two roles that often conflict: he is the partisan leader of his political party, but he and the Vice-President are at the same time the only political figures elected by all of the voters. In the role of national unifying figure, the President must sometimes put aside the partisanship and lead a recalcitrant Congress to a solution that serves the national interest, not just his own party. Clearly President Obama, elected as a transformational post-political figure, has not only abdicated the unifying role but has engendered even greater levels of partisan rancor.

Much has been written about the polarization of US politics, and the transition of the minority party from loyal opposition to blood-feuding sworn enemies of the party in power. The rhetoric during the shutdown and subsequently bears witness to the fact that the two parties view each other as not just political opponents but moral combatants in a struggle against true evil. Compromise in the national interest seems like a quaint notion, and farther away than ever.

US politics are less capable of finding compromise because the differences between the parties have become less about policy and more about ideology and core beliefs. Policy differences can be settled with give and take that may leave some hard feelings, but ideology goes beyond policy and incorporates basic notions of the direction of the country. The injection of so many single-issue believers into the political process has made solving even the small problems more difficult.

The violent disagreement over the Affordable Health Care Act has been playing out over the same time. The administration launched the Obamacare website on October 1<sup>st</sup>, the first day of the government shutdown. The website was supposed to be the only vehicle for people to sign up for coverage which has become mandatory. To say that the website, which has come to serve as a metaphor for the whole program, was not ready for prime time is an understatement. While the President has committed to having the

website up and running by the end of November, two months late, the damage has largely been done. The failure of the administration to adequately construct an enrollment process in the three years it had to get ready for October 1<sup>st</sup> just confirms for many that the government is incapable of getting anything right, and plays to the worst fears about the program. As one observer put it, "Obamacare has all of the efficiency of the Post Office combined with the compassion of the IRS".

The Affordable Care Act is Obama's legacy for good or bad, and most people would have thought that the President, often described as a "bystander" in his own administration, would have gotten a little more involved in ensuring its successful launch.

From the Democrats' standpoint the failed rollout is not just an embarrassment but may have a fatal outcome. Obamacare depends upon young healthy people entering the insurance pool and paying high rates for coverage they do not need to subsidize the sick and elderly who require most of the services. If a large number of the young do not sign up in the first year then the rates will be adjusted upward by the insurance companies to cover costs in the second and subsequent years. If insurance becomes unaffordable even with generous subsidies, the system will collapse of its own weight.

Obama's popularity went up after he won the shutdown showdown, but he is now taking a personal popularity hit over Obamacare. It turns out that one key provision of the program that was repeated over and over by the President --- people satisfied with their current medical insurance could keep it --- was not true. Or at least had enough fine print in the footnotes to make it seem an intentional distortion of the truth.

While Obamacare may seem a distant distraction from Defense and Homeland Security there is a direct effect. During the summer there was a coalition coming together in the Senate, mainly of pro-defense Republicans, that might have been able to come to agreement on modifying the effects of sequestration. If a package of cuts could have been agreed upon to substitute for the across-the-board sequester reductions then the worst of it could have been mitigated. Failing actual agreement on specific cuts to replace sequestration, there was general agreement that the DoD should be given the authority to apportion the reductions in a more rational manner.

Those Republicans in the Senate were then undercut by the House leadership making the shutdown about Obamacare and not about deficit reduction. As a result, sequestration cuts are likely to remain in place for the foreseeable future. Sequestration is beyond painful for Defense, but it is the one effective piece of budget reduction legislation that is in place, and the Republican majority in the House is not about to give it away lightly.

For DoD itself, after two years of creating budget plans that ignored sequestration in the hope that it would magically go away, the attitude is now like the fifth stage of grief ... acceptance. There may be the emergence of a consensus among DoD officials and some Defense-minded members of Congress that it is more productive to make the most robust and effective national defense with what is left than to continue to focus and argue on what has been taken away. Sequestration-level budgets do have the virtue of stability, which is critical to the whole process of multi-year program planning and execution.

That growing national defense consensus can agree that a compact, highly skilled and well-equipped force that can respond to likely threats is possible within the current budget constraints, but only if there are hard decisions taken to restructure military pay and health care costs while dramatically reducing DoD overhead. Current estimates are that 25-40% of current Defense spending goes to admin and overhead, which does little to enhance war fighting capability.

Many members of Congress can agree intellectually that the Defense establishment needs to be restructured ... as long as it does not affect their constituents. We have seen through the various Base Realignment and Closure processes how difficult it is to do painful things, even when the benefit is obvious. Most likely the only chance of insulating the members from the veterans' organizations and employee unions that would fight to the end against any changes in DoD structure would be a BRAC-like commission arrangement that would produce a set of recommendations for an up or down vote.

Just as stability in Defense budgeting is critical to an effective process, stability in global finance is critical to prosperity and growth. The US avoided a debt default on October 17<sup>th</sup> but did not solve any of the associated problems, merely deferred them until mid-January. The fact that the world economy is being held hostage each time the Congress arrives at one of these self-induced crisis points is causing an erosion in confidence in the US as the guarantor of global trade and commerce, and the power behind international financial governance.