



January 2, 2014

Letter from Washington

2013 ended pretty much with a whimper as the House and Senate negotiators developed a deal that will keep the government operating and budget priorities defined through 2016. The agreement is a small step toward returning to regular order in the budget process, and is not the grand bargain that many had hoped for.

Defense for once came out somewhat better than expected, and about a third of the budget reductions that would have come if the automatic sequestration cuts had been allowed to go forward are restored for 2014 and 2015. The administration had requested \$525B in Defense spending, but the sequestration reductions would have resulted in a budget of about \$474B if allowed to take place. As a result of the budget agreement, Defense spending will be increased by about \$20B in 2014. While this is still a sizable decrease from DoD and administration desired levels, it is a reprieve of sorts and gives the DoD some breathing room.

More importantly, the budget agreement represents a truce of sorts between the Republican-controlled House and the Democrat-controlled Senate for the next two years, as the threat of a government shutdown recedes, at least until the next debt-limit extension comes up later in the winter.

Now that the budget levels have been agreed and signed by the President, the hard work of actually assigning dollars to the various programs and projects falls to the Appropriations Committees. The existing Continuing Resolution runs out in mid-January, so the committees' time to develop and agree on spending plans for every government agency is short.

The Defense Authorization Bill that was passed just before the Congress left town for the Christmas recess is more of a wish list than a roadmap, and the House and Senate Appropriators are going to have to assign hard amounts to the competing priorities. Most likely all of the 12 individual appropriations bills will be rolled into one giant "omnibus" spending bill that will fund every sector of the government, and the members will be given an up or down vote because of the impending January 15th deadline.

The two parties have not really declared a permanent truce but more of a mutual tactical retreat, coming from the realization that the American public has had more than enough of gridlock, and that neither party could gain an

advantage in failing to fund the government. The agreement contains no reform of the tax code, no extension of long-term unemployment benefits and funds the FY-14 and 15 sequestration relief with savings that are not fully realized until 2023. These would have been unthinkable positions as recently as last summer.

The members of Congress, and certainly the President, have come to sense the sour mood of the electorate, and the potential for a wave election in 2014. The President's personal popularity has plummeted, largely as a result of the massive misfire in the Affordable Care Act rollout. Those problems continue for the President and his party, despite some indication that the website is starting to function at a minimally acceptable level.

The focus on the website is misplaced, however, and the real issues are with the mechanics of the law itself. This past fall about 5 million Americans with individual insurance policies had their health insurance cancelled and were forced into government insurance exchanges in which they generally received less coverage at higher prices. The resulting political fallout from that transaction has been devastating for the Democrats, and they are eyeing next year when close to 50 million people in company-sponsored plans will go through the same process in the run-up to the November elections.

November 22, 2013 was the commemoration of the 50th anniversary of the assassination of President Kennedy in Dallas, and people old enough to remember tend to view that period of time as the high water mark of American power, influence and capability. The political leadership was able to articulate big goals and the country was capable of responding --- landing a man on the moon by the end of the 1960's --- and the political machinery of government was able to work together in a bi-partisan way to achieve them.

In the mythology that has developed in the last 50 years, some evil genie was uncorked with the Kennedy assassination, and the country has been on a prolonged slide from grace ever since. Kennedy was the first in a series of public figures shot by disaffected loners (Martin Luther King, Robert Kennedy, George Wallace, John Lennon, Ronald Reagan), manifest more recently in the mass shootings in Arizona, Colorado and Connecticut.

In reality, those forces have always existed in American culture, and violence has never been uncommon. The memory of President Kennedy has become holy, and when viewed through the prism of Camelot today's political gridlock and inability to do even small things in the national interest seems even more diminishing.

Americans have always harbored suspicion of their government, going back to the debate over the articles of the Constitution and the Bill of Rights. The function of those documents was not to spell out what the government's responsibilities in the new country would be as much as to define what the

government could not do to its citizens. The federal government has not responded well to challenges recently (reorganizing the Homeland security system, poorly run acquisition programs, Hurricane Katrina, Obamacare, etc.) all of which go to confirm the perception that the government cannot function without mismanagement and massive cost overruns. A part of the problem may lie in the fact that talented young people are not inspired to become government bureaucrats, and the entry into government service is made the more difficult by conflict of interest rules and disclosure requirements that discourage many of the best potential aspirants.

The Congress compounds the problem by vilifying the bureaucracy as a recurring election theme, and shutting down the government is always seen as a reasonable political option. Both sides are to blame, and on the right the theme of attacking and defunding the bloated government has left agencies demoralized and unable to do anything but short-term damage control. On the left, the government has become the repository for objectives that cannot be realized elsewhere, although the federal sector unions and workforce rules have largely eliminated flexibility and innovation, and promotions are not merit-based.

The last several years have been particularly hard on the DoD, given the great uncertainties that have existed regarding budgets and appropriations. Like good troops, the services and OSD have learned to adapt to the reality, and this year actually produced internal spending plans for several different budget levels, depending on whether full sequestration occurred or something less. Piecemealing the budget in Continuing Resolutions with the threat of sequestration always present, only leads to higher costs as programs are stretched out or terminated unexpectedly.

One can argue that the Congress is playing dangerously with national security, mainly because the pro-defense members of both parties have been eclipsed by their more doctrinaire wings. Holding the line against new taxes or against any decreases in social spending has become more important than funding a robust national defense to all but a small core of Senators and Representatives.

Congress doesn't just make it difficult for the DoD to plan and program, however. On December 31st, 55 items in the tax code reached sunset and were not renewed, which has become an annual occurrence. Some of these 55 are inconsequential, but some are major and involve the way that corporations can handle taxes, depreciation and internal R&D. The Congress has always come back and reenacted these tax provisions before corporate tax returns are due, but the companies need to plan for the contingency that they will not, and millions of dollars are at stake.

While the defense establishment inside the Pentagon walls has had several hard years, the perception of the defense industry that serves it is quite different. Defense stocks have had a good year, mainly the result of

efficiencies and buy-backs, while defense sales have gone down. Since the industry appears to be doing well it is difficult to get any policy maker's attention. The DoD has however begun to look seriously at the health of the industrial base, and to look at options to ensure that critical capabilities are retained.

The DoD published a report at the end of 2013 that evaluated the industrial base as of 2012, concluding that budget cuts and sequestration will lead to the loss of vital national security capabilities. While this may seem intuitively obvious, the report, which was signed out by Undersecretary for Acquisition, Technology and Logistics Frank Kendall, is an opportunity for the DoD to respond to the Congress with some specific strategies for maintaining the base.

Specifically, the Kendall report lays out several options that include a "hedging approach". Under this scenario the DoD would fund development of cutting-edge technologies and take the designs through prototype but not full production. The idea is that the human capital required to develop the technology is protected, and full production can be undertaken rapidly in the event of a breakout that threatens the US vital interests.

We have seen this movie before, and we know that it doesn't work because it is based on a couple of fictions. First, while companies may be quite willing to perform funded R&D for the government, once the project is complete the research engineers become overhead, and no company is going to be willing to maintain a redundant group of highly paid engineers in some corporate bullpen waiting for the balloon to go up. Second, maintaining a complex modern production line in warm but idle status is very expensive. When the budgetary choices are being made, tomorrow's contingency production capabilities will always lose out to today's problems. In theory, a nice concept but in practice very difficult to maintain.

Perhaps the most interesting part of the Kendall report deals with export policy, and calls for a review of the regulations so that the US unmanned aircraft industry does not suffer the same fate as the US satellite sector, and that the potential market is ceded to foreign competition because of the US companies' statutory inability to compete. While this is also intuitively obvious, the Congress and administration just recently agreed on a major rewrite of the export rules and are not likely to revisit them again any time soon.

The debt ceiling will need to be raised sometime early in the spring, and that will be the first major test of the newfound bipartisanship in the Congress. 2014 will be an interesting year.