A.L. ROSS ASSOCIATES

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Letter from Washington

Amid all the euphoria over last week's last minute debt ceiling agreement, it may be useful to look at exactly what did happen, and more importantly what did not.

What did happen: First, Obama got his minimum requirement, which is a raise in the ceiling that will allow the United States to pay its already-incurred debts through the 2012 election. We won't have to deal with this again until sometime well in the future, but what did he have to give away in order to achieve it?

The President had tried to style himself as the adult in the conversation, the reasonable one willing to balance all of the competing interests and forge a compromise. It didn't turn out that way because the left wing of the Democratic party became alarmed at what they perceived he was willing to bargain away, and put him on notice that the deal he was working with House Speaker Boehner would not pass the Senate.

Boehner, who also had the same problem with the right wing of the Republican party, broke off the talks with the President when Obama's position changed regarding taxes mid-way through the discussion. At that point the discussion and deal-making shifted to the Congress, and the deal that was finally agreed to was done without the active participation of the White House.

The agreement that was reached was a classic Washington solution: agree on the relatively easy things, and then punt the tougher stuff to a special commission. The easy things amounted to US$900B in savings over 10 years, about US$350B of which will come from Defense. These savings were derived without touching entitlement programs and without raising taxes. The commission will be comprised of twelve members of Congress, divided evenly between House and Senate, Democrats and Republicans. The mission of the group is to come up with an additional US$1.5T in spending cuts across the entire federal budget, with the ability to recommend new taxes and entitlement cuts as appropriate. The heart of the agreement lies in the enforcement mechanism that will kick in if the commission deadlocks --- a highly probable outcome. In the event of a deadlock the US$1.5T will be taken in an across the board reduction of the federal budget, with Defense's share around US$600B.

The potential for deadlock is almost a sure thing since both sides will choose their commission members from the left and right wings of the two parties, where compromise is not an option. Defense then has the potential of absorbing almost US$1T reduction over the next 10 years. This is in addition to the self-imposed Gates savings initiatives, and the other marginal reductions that have already been imposed. *In the best case, there will still be a huge reduction in Defense spending, on the order of US$7-800B over 10 years.*

In this political dynamic that does not allow reform to entitlements or increasing taxes of any kind, Defense becomes the bill payer of first and last resort.

What did not happen: The United States did not solve its debt and deficit problem, it only managed a short-term solution to its liquidity problem.

The budget deficit over the next 10 years is forecast to be in excess of US$12T. This US$2.4T Congressional agreement just barely touches that staggeringly large number. In addition, the deficit projections are based on the assumption that the US economy will grow at a 3.6% rate. Given this year's performance at slightly over 1%, the US$12T forecast may be off by as much as US$5-7T, making the Congressional deal all the more insignificant.

In the debt ceiling deal, taxes were not raised and entitlements (Social Security, Medicare) were not touched. Since discretionary non-entitlement spending only amounts to about a third of the US federal budget, it's clear that this formula will not work again. It is also painfully clear that some reform of the entitlements, raising the eligibility ages and changing the method by which inflation-indexing is calculated, will have to be part of the mix. Also clear is that since there will still be a significant delta between federal income and expenditures after entitlement reform, that some additional revenue in the form of taxes will have to be included.

This seems to be pretty clear to Standard & Poors which assessed the effectiveness of the Congressional agreement and downgraded US debt from its historic AAA rating. S&P concluded that the US is not seriously addressing the issue and lacks the political will to enact the tough measures required. S&P does not seem to be questioning whether the US is capable of paying its bills, but whether the political environment will be stable enough to permit a compromise solution.

What happens next: The Congressional Democrats and Republicans will select their commission members and the deliberations will begin. Since the work of the commission will be undertaken in this highly charged partisan atmosphere, there will be plenty of leaks from each side that will keep the public apprised of progress, or the lack of it. In Washington, leaking is an art form, with information made public to either cause a desired outcome or to prevent something from happening. In won't be too hard to figure out which category the leaks will fit into.

The idea behind the commission was to create a "sword of Damocles", hanging over the heads of the Congress. The idea of an across the board cut is so damaging that no reasonable person would actually allow it to happen. Maybe a better metaphor for the process would be Cleavon Little as the sheriff in "Blazing Saddles", holding a gun to his own head and saying "one more move and DoD gets it".

The assumption that the across the board cut of $US1.5T would be so onerous that both sides would compromise to prevent it only works if both sides have a common view of the desired outcome. In this case they are widely divergent, and recall that a significant portion of the House Republicans thought that a debt default by the United States would not necessarily be that bad a thing.

Outlook for Defense: The Department of Defense has a budget planning and priorities system that has been in place for more than 40 years. That process assumes a high degree of stability and predictability in Executive branch and Congressional budget actions, which has been completely lacking over the last several years and only appears to be getting worse. The Senate for example has not passed a budget resolution, the key element in the entire process, for either 2011 or 2012.

Since the DoD budgeting process is both time insensitive and inflexible and is designed to look two years into the future, the politics of rapidly shifting Congressional priorities and appropriations levels have whipsawed the institution severely. For example, the services just submitted their 2013 budget requests to Office of the Secretary of Defense, and those requests have been made largely obsolete by the debt ceiling agreement.

Complicating things further, there is no common definition of the baseline from which the cuts are being made (CBO, OMB or DoD), and in one scenario the DoD reductions could grow to as much as US$500B. All of the projections are based on 10 year funding profiles, and since the farthest DoD ever projects is 6 years, anything forecast in years 6-10 is sketchy at best.

Last spring when the Obama administration first proposed cutting Defense spending by $400B over 10 years, then-Secretary Gates launched a study that would look at threats, necessary missions and budget levels, and recommend a way to absorb these cuts in a targeted manner that would preserve essential capabilities. This study will not yet be complete when the size of the required reductions may have already doubled.

Against this backdrop DoD program managers are trying to make day-to-day decisions regarding their programs. What we can look forward to when trying to do routine business will be:

- Huge uncertainty regarding program strategies and futures. The Army announced a civilian drawdown of 8,700 civilian personnel last week that was based on budget realities of several months ago. Many of the civilian program managers in the services will not even be sure if they will have a job, much less a program to run.

- Internal financial oversight of programs will be increased, and every dollar will be monitored. Money will be shifted more rapidly from under-performing programs, and comptrollers will no longer wait until the last quarter to make those decisions.

- The best-case scenario will require initial DoD cuts of 8-12%, and then sustain those budget levels for the remainder of the 10-year period, presumably with no real growth but inflation adjustment. The worst-case scenario will be a reduction in the 20-25% range, which will require answering difficult questions like:
    - Do we need a Joint Strike Fighter?
    - Do we need a Special Operations capability in every service?
    - What is the minimum number of carrier battle groups that we can afford to operate?
    - Do we need to reinstate conscription?

- New program starts will be difficult at best. There is no indication that the current Congressional earmark policy will change any time soon, so funding for new start programs will be unavailable.
    - One exception may be in technologies that permit extended use and life of existing platforms and systems, avoiding the cost of replacements.
    - Another exception might be with technologies that can result in a specific manpower savings that can be translated into cost reductions.

- The only area of potential growth in a curtailed budget might be in R&D. If the research establishment can focus on force multiplying technologies that can maintain a qualitative edge against a potential adversary, and can be produced quickly if required, some of the risk can be reduced.

- Ideally the national military strategy is defined by the threats, and money is appropriated to counter them. We are now in a place where strategy is defined by budget, and risk increases exponentially.