
Jeffrey Sachs: How to Tame the Budget Deficit

The budget is the main arena in which the nation as a whole decides on the allocation of resources. What we spend money on – and what we don't – ultimately reflects what we value as a nation. But making those choices isn't at all simple. It is the federal budget in which the breakdown of consensus in America is the most vivid and most dangerous. One side of the political divide wants to cut taxes and shrink existing public services (including support for the poor) in the name of cutting wasteful government programs and insisting that the poor solve their own problems. The other side wants to increase public spending on social and economic needs – the poor, the unemployed, infrastructure, education and the environment – even as it remains unclear on how to fund the outlays.

With these divisions unresolved, we've landed in a first-rate mess. Compared with those in other rich countries, taxes in the U.S. are low. Yet government spending is persistently higher than taxes: the budget deficit is at record highs for peacetime, and Washington is utterly paralyzed when it comes to addressing urgent needs. The only thing that reliably grows in our economy is the public debt.

During the first full budget year of the Obama administration (fiscal year 2010, which runs from October 2009 to the end of September 2010), both sides «won» yet again: taxes were cut; spending was increased. According to the latest projections by the administration in presenting the fiscal year 2011 budget, the deficit is now projected to reach \$1.6 trillion, an astounding 10.6% of gross domestic product (GDP).

Some of that reflects the downturn in the business cycle, which cuts into tax revenues while boosting

unemployment compensation, bank bailouts and other spending. Yet there's nothing temporary about enormous deficits. Even the Obama budget office projects megadeficits for years to come – as high as \$752 billion, roughly 4% of GDP, in 2015 – despite some rosy economic and budgetary assumptions. Meanwhile, as the Treasury borrows to fill the gargantuan gap between revenues and outlays, the stock of government debt is soaring. In fiscal year 2010, the Obama budget office projects that the public debt will increase by \$1.75 trillion. That amounts to roughly \$15,000 per household. Through 2015 the cumulative rise in the debt is projected to exceed \$6 trillion.

How much does that matter? Some liberals say not to worry. They point out that the New Deal was funded by deficits; claim that interest costs on the debt will be minor; and insist that fiscal scolds are putting accounting niceties ahead of economic needs. They exaggerate on all of these counts. When the New Deal deployed deficit spending from 1933 to '36, the deficits were around 5% of GDP, compared with around 10% today. The publicly held debt was around 40% of GDP then, but it will soon reach 60% of GDP in 2010, and on the administration's budget plans will rise above 70% by 2012.

What's more, in the 1930s the debt was financed domestically – by Americans. Today about half of public debt is held by the rest of the world, especially China and Japan. In the New Deal era, taxes could easily rise to cover the increased cost of servicing interest on the debt. Today we have no agreement on how such debt servicing will be paid. And we face another unprecedented challenge: large increases in entitlement spending as a share of GDP are likely to

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continue into the 2020s and '30s, as the population ages and health care costs mount.

Let's look more closely at budget revenues and outlays. In a normal year, our federal tax system takes in around 17% of GDP -- less in the current recession and more in years of financial bubbles, when capital-gains-tax collections are high. It's important to understand what those revenues buy us. Military spending accounts for around 5% of GDP. Health spending (including Medicare, Medicaid and veterans' health) is around 5% of GDP, as is Social Security (retirement, disability and veterans' benefits). Interest payments on the debt will soon reach 2% of GDP. In short, the Federal Government collects tax revenues sufficient to cover just four budget items. The rest of the budget is funded by borrowing.

Here are some of the things not covered by government revenues that we are currently borrowing to pay for: homeland security, unemployment compensation, job training, support for state and local governments, federal higher-education outlays, satellites and manned space missions, the National Science Foundation, the National Institutes of Health, the National Oceanic and Atmospheric Administration, community development, food stamps, low-cost housing, roads, bridges, environmental protection and conservation, emergency relief and reconstruction (such as for New Orleans), the judicial and penal systems, international diplomacy and poverty reduction, renewable energy. These aren't temporary programs or things we can do without. They are core public services needed for an efficient and fair economy.

Indeed, many of these items are already deeply underfunded. Programs for the poor are often brutally squeezed. Shortfalls in education outlays are shortchanging young people, forcing many to leave college before they graduate, because families are unable to cover college tuition. The conversion to clean energy is stymied by a lack of cash. Future

NASA missions are being scrubbed. The list is long and perilous.

Until both political parties make a serious effort to improve the performance of government while shrinking its swelling deficits, Americans will watch both their quality of life and their country's standing in the world erode. Returning to fiscal responsibility while safeguarding needed public services and investments won't be easy, but it isn't impossible. Here's how it can be done.

Living Beyond Our Means

Some waste can surely be cut. Ending the wars in Iraq and Afghanistan, slashing pay to overpriced contractors and eliminating unnecessary weapons systems could perhaps save between 2% and 3% of GDP each year. These are areas where the U.S. is squandering its income and blood, yet the President's proposed budget for fiscal year 2011 would actually increase military spending to more than \$750 billion from around \$720 billion this year. Military spending dwarfs almost everything else. In the White House's proposed budget, military spending would be nearly six times the federal outlays on education and 26 times the outlays on development assistance and humanitarian aid -- despite the fact that the Administration often promotes development as a central pillar of our national-security strategy.

Medicare and Medicaid could surely be made more efficient, but cost cutting would only partly offset the rising bills that are inevitable given our aging population. We're not going to find great net savings in the core entitlement programs even if we reform them. And eliminating the infamous earmarks would save around \$11 billion, or less than 1% of the budget deficit.

At the state level, the fiscal situation is equally dire, though because of budget-balancing rules, most

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states are slashing public services rather than running large deficits. It's not just California; dozens of states are grappling with a combined deficit of tens of billions of dollars. Police, public health, education, roads, libraries and other services are all on the chopping block. The states currently collect an additional 10% or so of national income in tax revenues and receive about 3.5% of national income in transfers from Washington. The total tax take, federal plus state, of 28% to 30% of GDP, is more than 10 percentage points lower than the total revenue collections in Europe.

Is There a Middle Path?

Given those realities, any talk of new tax cuts to solve the economic crisis, an idea supported by many Republicans, is fiscal fantasy. But so too is Obama's campaign pledge of tax cuts for all households earning less than \$250,000 per year. That promise is impossible to honor if the government is going to maintain a shred of fiscal responsibility. We can and should claw back around 0.4% of GDP in revenues from taxpayers who make more than \$250,000, as Obama has proposed. But even with rollbacks of tax cuts for the rich, the fiscal gap will still remain enormous.

The hard truth is that even if the military is eventually trimmed by 2% to 3% of GDP, the Bush administration's tax cuts for the rich are ended, all earmarks are eliminated and entitlement programs are reformed, the budget deficit will remain large, and public services in many areas will remain threadbare. Inevitably we will have to raise tax collections as a share of national income in ways that will also hit the middle class.

We need a new political consensus. No doubt the Republicans are just waiting for Obama to reverse his campaign promise on taxes before they pounce, just as Democrats did when George H.W. Bush broke his «Read my lips,» no-new-taxes promise. Such is

politics, where the first rule is to pander to anti-tax sentiments. But if we carry on down that road, we will end up with a much deeper fiscal crisis -- the kind where the dollar collapses, foreigners stop buying Treasury bills and public services collapse while inflation soars.

Instead, we might, just might, begin to coalesce around a shared set of ideas, putting aside our ideological blinkers and forging compromises on shared ground. The essence of the compromise, I believe, would be for Republicans to accept higher tax revenues as a share of GDP, to be directed mainly at education, training, poverty relief, infrastructure and deficit cutting -- while Democrats discard a tax-only-the-rich approach and look instead for broad-based taxes and low marginal tax rates.

The full version of this article was originally [published in TIME magazine](#).

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