The Case for Bigger Government --

Thursday, Jan. 08, 2009
By JEFFREY SACHS

Thirty years ago, Americans were told that government was part of the problem, not the solution. We bet on the magic of the marketplace, but the magic proved illusory. Every major part of the economy — health care, energy, transportation, food and finance — is deeply troubled. Now we are ready to invite government back in to help solve our problems, if the price is right and the strategies are convincing. By spending more through government and treating government as a partner rather than an enemy of the private sector, we can potentially save vast sums in the long run through a more efficient health-care system, safer climate, more competitive economy and more secure country.

President-elect Barack Obama's challenge will be twofold: to capture the potential benefits of a new age of government activism, while still protecting the country's long-term fiscal health. On Jan. 6, Obama warned that the cost of a major stimulus package and the continued effort to bail out the financial system could result in years of «trillion-dollar deficits.» Deficit spending is needed to help revive the economy from recession, but trillion-dollar deficits for years to come would sink us in debt and risk a collapse of the currency. We need a sensible strategy that deals with the present crisis while preparing for the future. We need more government, and to pay for it we'll need to raise taxes relative to GDP over time.

Even as our economy worsened, many Americans consoled themselves with the belief that at least we were better off than people in other rich nations. No more. When you compare the U.S. with Canada, Western Europe and Japan, the news is sobering. Our child-poverty and infant-mortality rates are the highest, our life expectancy is the lowest, our budget deficit as a share of gross domestic product (GDP) is the highest, and our 15-year-olds rank among the lowest on tests of math and science.

A big difference between the U.S. and the rest of the rich world is that for the past 30 years or so, Americans consistently rejected «government solutions» to the problems of health, poverty, education and the environment. We've kept our taxes as a share of national income lower than Europe's by focusing on the private sector. But we're getting much less for our money. Markets are great at providing consumer goods and services. We don't want the government running our restaurants, movie houses, bookstores and manufacturers. Markets are not so good, though, at some very important things. A pressing example: our mostly private health system, at $8,000 per American, is twice the cost of Europe's mostly public system, yet with worse outcomes. And nearly 50 million Americans lack health insurance.

President-elect Obama inherits the worst economic crisis since the Great Depression: the financial sector is in ruins; the budget is hemorrhaging red ink; debt-ridden households have clamped down on spending, thereby pulling the rug out from under the economy; unemployment is soaring; the country is in two wars; and the unmet social and environmental needs are vast. These conditions demand a fundamental realignment in strategy that ultimately comes back to taxation: Will we pay for the govern-
ment we need? Obama’s big domestic program, the American Recovery and Reinvestment Plan, proposes doubling renewable-energy production and making public buildings more efficient. It calls for better schools and classrooms and the rebuilding of our crumbling roadways and bridges. The President-elect wants our fill-out-the-forms health-care system to be computerized, which will save both lives and money. (See the global financial crisis in photos.)

He’ll certainly have to add to that list. Don’t forget bailing out the financial system, helping deficit-ridden state and local governments, revamping the auto industry and funding more global-development assistance to defeat terrorism and overcome instability. Add it up and it will require perhaps 5% of national income on top of our current spending, or approximately 25% of our total GDP.

Here’s the problem with that math: the tax system brings in about 18% of GDP, less in a recession — and Obama is even floating a two-year, $300 billion tax cut (roughly 1% of GDP per year). Even worse, our federal revenues are nearly exhausted by just four areas of spending: Social Security and other retirement programs, health programs such as Medicare and Medicaid, defense, and interest payments on the public debt. Almost all the rest of our expenditures — from education and infrastructure to international diplomacy and much more — have to be funded by borrowing. We are racking up trillions of dollars in debt, to be paid in the future through taxation or inflation, in order to carry the year-in, year-out responsibilities of government.

There are certainly some straightforward ways to start closing the budget gap. The Bush tax cuts for the rich should be rolled back this year, not next, to start collecting about 0.5% of GDP in extra revenues from those who can most easily pay, though this might just partly offset other tax cuts and recession-induced declines in tax collections. The spending on the wars in Iraq and Afghanistan should be ended, not prolonged, saving at least 1% of GDP. We’d still probably be close to $1 trillion (perhaps 6.5% of GDP) shy of budget balance. With the economy in a tailspin, deficit financing of up to $1 trillion could make sense, but it’s a fleeting option because foreign nations have lost confidence in the U.S. economy and currency.

Instead, we will have to look for a variety of solutions. Infrastructure can be financed in part by borrowing against future user fees, like tolls on roads and higher electricity rates for more reliable and cleaner power, rather than against general government revenues. This strategy can probably cover as much as 1% of GDP per year. We can introduce new taxes on the carbon emissions from coal, oil and gas to hasten our transition to sustainable energy. For example, instead of letting gasoline prices tumble now only to see them soar again shortly, we could set a floor on prices at the pump and collect the difference between the wholesale and retail prices in federal revenues. Various carbon and gasoline taxes could raise another 1% or so of GDP. The public will also probably accept taxes on health care if they convincingly help save even more in private outlays on health insurance. A well-managed system of public financing of health care can do that and allow us to cut the horrendous sums paid to health-insurance companies. And in the end, though almost no U.S. politician will say it now, the U.S. will probably have to follow Europe down the path of the value-added tax — a kind of national sales tax.

In the past 50 years, arguing for tax increases to fund the expansion of federal programs has been a political death wish. Lyndon Johnson could not sell the public on tax increases to pay for his War on Poverty when the Vietnam War intruded. Jimmy Carter failed to close the deficit through higher taxes in the late 1970s. And Ronald Reagan made tax cuts the down payment on every election since. George W. Bush, of course, imitated Reagan in cutting taxes, thereby creating huge new budget deficits. Voters
are still willing to permit the government to expand its share of GDP, particularly in the face of national crises — and we are certainly in the middle of one. Tax revenues jumped from just 5% of GDP in 1936 to 15% to 20% during and after World War II, creating our modern tax system. At the end of the war, the level of federal taxation averaged around 18% of GDP, a rate that has remained nearly constant ever since.

What has changed is the way we spend that 18%. In the 1950s, during the Korean War and at the height of the Cold War, about 10% of GDP was devoted to defense. Over time, that share of spending on defense declined, making room for proportionally more spending on things like health care, education and infrastructure. By the late 1970s, as defense spending declined to 4% to 5% of GDP, there wasn’t a lot more room to squeeze defense for higher domestic spending. Even with the end of our current wars in Iraq and Afghanistan, it’s most unlikely that we’d save as much as 2% of GDP, given the vocal demands for increases in military budgets.

As our budget choices were getting tougher in the 1970s, Europe faced similar dilemmas and took a different course. While Americans rejected new taxes and new domestic programs, Europeans elected governments that introduced higher taxation, mainly value-added taxes, to cover the rising costs of health care, education, infrastructure, poverty relief and international-development aid. Ultimately, the Europeans restrained excessive growth in the welfare state in order to maintain global competitiveness and rebalance their economies and succeeded in sustaining the public-private partnerships and welfare-state benefits.

The European strategy, with levels of taxation and government spending roughly 8% to 10% of GDP higher than in the U.S., has many successes to show for it: less costly and more reliable health care, the elimination of hard-core poverty, solid educational achievements, and social services that ensure better care for children and more flexibility for mothers and the elderly. The U.S. will not mimic Europe for many reasons — size, diversity, tradition and, of course, vested interests — but we can learn from Europe. Most important, we can see how government can be a partner of the private sector, not an enemy. (Read «Merkel’s Caution on Economy Draws Fire».)

The time has arrived to restore national prosperity and security with a smartly rebalanced partnership between the public and private sectors. Fiscal policy will be President Obama’s biggest political hurdle. Expanded spending by government — for health care, climate change, energy security, education, infrastructure and peaceful diplomacy — is urgently needed, but large deficit financing is not a long-term option. Although Obama’s tax cuts might stimulate consumer spending — and placate Republicans — any permanent cut would be a huge error, and even short-term tax cuts are an unnecessary risk. Obama’s long-term success will depend on his ability to lead Americans to a new, even revolutionary consensus that the U.S. government can offer value for money.