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 — reflects what we value as a nation. But making those choices isn’t at all simple. It is in the federal budget that the breakdown of consensus in America is 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 a record high 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. (See TIME’s coverage of the 2010 World Economic Forum.)

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 expected 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 revenue while boosting unemployment compensation, bank bailouts and other spending. Yet there’s nothing temporary about the enormous deficits. 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 revenue 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 rather stable, 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, much of it by China and Japan. In the New Deal era, taxes could easily rise to cover the increased cost of servicing interest
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on the debt. Today we have no agreement on how such debt servicing will be paid for. And we face another unprecedented challenge: large increases in entitlement spending as a share of GDP are likely to continue into the 2020s and ’30s as the population ages and health care costs mount.

Let’s look more closely at budget revenue 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 that revenue buys 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 revenue sufficient to cover just four budget items. The rest of the budget is funded by borrowing.

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. (See spacescapes from the files of NASA.)

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 2% to 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 outlay for education and 26 times the outlays for 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
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reform them. And eliminating the infamous earmarks would save around $11 billion, or less than 1% of the budget deficit.

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At the state level, the fiscal situation is equally dire, though because of budget-balancing rules, most 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 revenue and receive about 3.5% of national income in transfers from Washington. The total tax take, federal plus state, amounts to 28% to 30% of GDP. That is more than 10 percentage points lower than the average 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 about 0.4% of GDP in revenue 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 remain enormous. (Read a review of Obama’s first year in office.)

The hard truth is that even if the military budget 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 deficit will remain large and public services in many areas will remain threadbare. There is no way to close the deficit merely by cutting waste, fraud and abuse and levying higher taxes on the rich. Inevitably we will have to raise tax collections as a share of national income in ways that will also hit the middle class. Fortunately, there are methods of doing this that will protect the economy, help the poor and those with urgent needs and spur economic competitiveness by putting America back in the forefront of science, technology and clean and reliable energy.

We need a new political consensus. No doubt the Republicans are just waiting for Obama to reverse his campaign promise on taxes so that they can 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 antitax sentiment. 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 fall apart 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 common ground. The essence of the compromise, I believe, would be for Republicans to accept collecting higher tax revenue as a share of GDP, with the money to be directed mainly at education, training, poverty relief, infrastructure and deficit cutting, while Democrats discard the tax-only-the-rich approach and look instead to broad-based taxes and low marginal tax rates.

Both sides could agree, for example, on a value-added tax (VAT) — a sort of national sales tax — combined with closing loopholes and reducing some marginal tax rates, including the corporate tax rate. Democrats traditionally champion tax progressivity. But they should learn from the European social democrats, who know that it’s more important to be progressive on the spending side — in education, poverty relief and public services — than to focus tax policy on the rich. Low corporate tax rates, meanwhile, help maintain global competitiveness and retain jobs. The Scandinavian countries of Den-
mark, Norway and Sweden, for example, avoid levying crushing taxes on businesses in order to keep their economies competitive. They establish fairness not so much by progressive tax regimes as through spending on health, education, training and child care. That has the effect of boosting the well-being of lower-income families alongside the middle class.

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A Grand Compromise
Both Democrats and Republicans could also coalesce around another concept: fiscal subsidiarity. This doctrine holds that problems should be solved at the lowest government level feasible; it means that more federal revenue would be transferred to states, cities and towns, leaving less for programs directed from Washington. Democrats have traditionally looked to federal programs as key for social relief and public investments. Yet more than ever, sustainable reforms need local design and backing. Suppose that we finally agree to collect more revenue in order to boost spending on health care, education and clean energy. The increased taxes would be collected by the Federal Government and then transferred to state governments, which would design and implement the public programs together with local governments.

A third point of convergence could be to rely on market-type solutions whenever possible. If Republicans accept the need for greater public revenue to address social needs, Democrats could accept the use of school vouchers and personalized health and education accounts as a means to instill personal responsibility within government-financed programs. Similarly, Democrats and Republicans could agree to implement a carbon tax rather than a cumbersome, Wall Street–run cap-and-trade system as the way to help us move to a low-carbon energy system. The government would phase in a gradually rising tax on carbon dioxide emitted into the air from coal plants and other facilities, with a lead time to encourage the shift toward nuclear, solar and wind power. Similarly, both parties could accept that upgrades in infrastructure (roads, power, environmental conservation and the like) would be financed through tolls and user fees; such mechanisms place the financing burden, as much as possible, on the beneficiaries of the spending.

Finally, our political leaders could agree to get the runaway military budget under control. Just as Republican President Dwight Eisenhower once warned us, the corporate lobbies for weapons systems are so powerful that Congress has a difficult time cutting wasteful programs even when they’re rejected by the brass. Perhaps we can also agree that pumping more than $1 trillion into Afghanistan and Iraq was a colossal waste of treasure that should finally be halted rather than ratcheted up yet again in Afghanistan. A few billion dollars for water, clinics, schools and improved agriculture for the peasant villages of Afghanistan’s countryside would bring stability much sooner than $100 billion per year in military spending, which is likely to perpetuate the cycle of violence and instability.

There’s a lot of potential common ground in that list. But compromises like these won’t happen unless two conditions are met. The first is that taxes can no longer be a game of political chicken, with each side waiting to pounce on whoever utters the T word first. Since that game has been the Republican strategy for 30 years, a national breakthrough will require Republican statesmen who will tell the public the truth: that higher tax revenue as a share of GDP must be part of the fiscal solution, just as much as sensible tax reform and compromises on how and where the revenue is spent. Unfortunately, a proposal for a bipartisan commission that might have moved the country in that direction was recently nixed by Senate Republicans, precisely out of fear that some Republican commission members might have signed on to such a compromise. The uncompromising, antitax Republican position is simply too good at the polls. So now we’ll need straight-up leadership, without the shield of a commission.
Second, Congress and the White House have to be weaned off lobbyists, who have done so much to foster the antitax mood. This past year saw another record for lobbying outlays, as corporate funds were shoveled into campaigns and the pockets of members of Congress, their staffs and their families. The recent Supreme Court ruling on corporate campaign financing may have temporarily killed the chance to restrain the pernicious role of money in politics. Only the size of our problem and the centrality of the U.S. in the world economy make the U.S. unique. Countless countries have gone through fiscal adjustments involving politically painful tax increases and spending cuts. Ireland and the U.K. are now raising taxes to reduce gaping budget deficits. Canada adopted a VAT-type tax in the 1990s. The U.S. has often pushed the International Monetary Fund to tell countries much poorer and more fragile than our own that painful fiscal adjustments are needed. Now the U.S. is acting with the same irresponsibility we've so often bemoaned elsewhere.

So here are the key questions. Will we kill our economic future by shortchanging the public on investments needed to modernize the economy and train the workforce? Will we borrow heavily from China and other countries to cover today's spending while racking up massive bills for our children? Or might we just decide to protect the future of our country through a judicious mix of tax increases and spending cuts that will bring honor to this generation and prosperity to the next?

Sachs is the director of Columbia University's Earth Institute and the author of Common Wealth

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