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PRINT

The Budget's a Sham

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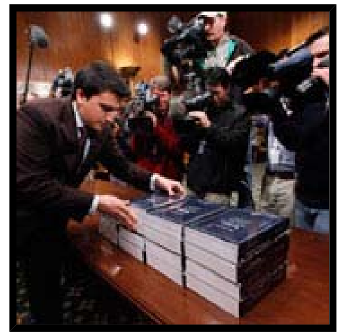
Obama's economic blueprint is based on rosy assumptions and political impossibilities. Yale Professor Jeffrey E. Garten on why it may take a scare from China to force America to get its financial house in order.



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The budget submitted by President Obama is not quite dead on arrival, but it's not even worth debating the point.

Set aside the fact that it is based on overly optimistic growth assumptions and policy decisions that are only remotely feasible. For example, the underlying economic projections on which the budget is based presupposes a full recovery, even though nearly all experts believe high unemployment on the order of 9 percent to 10 percent is likely to remain for all of next year and maybe beyond. From such a rosy scenario stems unrealistic projections of tax revenues and reduction of various social-welfare subsidies. The budget also assumes that a good deal of the Bush tax cuts are repealed, which is hardly a certainty.

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But beyond all that, the proposed budget will be subject to dozens of hearings by dozens of congressional committees, and the insufferable politicking of a polarized Congress in an election year. The time it takes for the dust to clear on Obama's fiscal blueprint will not make an iota of difference in dealing with America's acute financial situation, typified not just by the largest deficits relative to our GDP since the post-World War II era, running some 11 percent of GDP when a respectable level, in the eyes of financial markets and our creditors, would be closer to 3 percent.

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The real action will have to be next year, after the mid-term elections. But even then, it's not clear whether our political system can deal with the crisis of deficits and debt, or whether it will take our foreign creditors, on whose lending we are totally hooked, to administer the shock we need to get our financial foundation on a sound footing. I suspect the latter. They wouldn't have to do much, just a few public pronouncements in Beijing that China's central bank plans to invest excess reserves in a different way than it did in the past. In other words, there would not have to be withdrawals of foreign investments, just no increases to feed our ever-growing needs, to induce widespread panic in the markets and in Washington.

If I suspended my instincts about how the crisis would ultimately be resolved, and make an assumption that our political system could rise to the occasion—an assumption of historic proportions—what would Washington have to do?

Most important, it would have to set a few simple goals, such as reaching a ratio of debt-to-GDP of, say, 60 percent within a decade, with interim targets along the way. By way of comparison, it is close to 70 percent now. Washington would have to establish a process that would kick in when the U.S. missed its targets, a process that would result in a combination of raising taxes and cutting spending across the board. That mechanism would have to be established in law and be subject to override only by, say, a recommendation of the president and a positive vote of two-thirds of the Senate.

To meet the targets, it would be necessary to establish new sources of revenue. Start with a national sales tax (refunded for low-income families), which, according to the Tax Policy Center, a joint venture of the Brookings Institution and the Urban Institute, could produce some $400 billion annually by the end of this decade ($200 billion this year.) Add to that a gasoline tax, one that would have the additional benefits of cutting CO_2 emissions and reducing imports and hence boosting national security. A $1 per gallon tax could produce over $3 billion per week, according to the Congressional Research Service (but it could start lower and eventually get beyond a dollar.) Both of these taxes are in effect in virtually all major developed nations. We would need health-care reform that holds down spending, particularly with respect to Medicare. Those with higher incomes should pay more for Medicare and Social Security as a result of a means-testing process.

We would also need a major revamp of the tax system to favor entrepreneurial activity, the major creator of jobs (and hence income, and hence more revenue and less subsidy payments from Uncle Sam.) This means special incentives for starting a business, such as easy write-offs for initial investments, and permanent tax credits for R&D.

These measures are not the entire universe of policy requirements, and some may prove infeasible. But they illustrate the arena in which we must play, and by comparison they show why the budget announced on Monday is a sham and why, in the end, it may take China and others to force us into doing what we cannot do ourselves.

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