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The Proper Role of Taxes in Deficit and Debt Reduction

By
David S. Logan

Introduction

The White House and Congress are currently embroiled in debate concerning how to best reduce the nation's deficit[1] and debt. Similar international experiences provide evidence of what the most effective methods have historically been. These methods have been analyzed in studies by Goldman Sachs (GS) and the European Central Bank (ECB), comparing the experiences of countries which have attempted to regain control of similar deficit and debt problems. Though the two papers take slightly different methodological approaches to their analyses, the results and conclusions are remarkably similar:

1. Spending cuts are more effective than tax hikes.[2]
2. Deficit and debt reduction can occur while taxes are being cut.[3]

Lower Taxes *Can* Accompany Spending Cuts

Perhaps the most striking and counterintuitive result of the literature is that spending cuts and tax decreases *can* yield a successful reduction of a nation's deficit and debt.[4] According to the 2010 GS report, since 1975, 20 countries have needed large deficit/debt reductions.[5] One-fourth of these reductions were driven by government expenditure cuts rather than tax increases. These proved successful in that each:

1. Positively affected the deficit
2. Reduced public debt
3. Generally boosted economic growth
4. Resulted in significant bond and equity market outperformance

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David S. Logan is an economist at the Tax Foundation.

[1] Henceforth, "deficit" will be assumed to exclude interest payments.
[2] Ben Broadbent and Kevin Daly, "Limiting the Fall-Out from Fiscal Adjustment," *Goldman Sachs Global Economics Paper No: 195*. April 2010.
[3] Sebastian Hauptmeir, Martin Heipertz and Ludger Schuknecht, "Expenditure Reform In Industrialised Countries: A Case Study Approach," *European Central Bank*, Working Paper No. 634. May 2006.
[4] S. Alesina and R. Perotti, "Fiscal Expansions and Adjustments in OECD Economies," *Economic Policy*, n. 21, 207-247, 1995.
[5] Broadbent et al, 2010.

In successful episodes, a reduction in the expenditure/GDP ratio accounted for approximately 80 percent of the improvement in the deficit (excluding interest payments). In contrast, the deficit/debt reduction attempts driven by tax increases typically failed to correct imbalances and, furthermore, generally proved damaging to growth.[6]

The successful deficit reduction plans studied by the ECB *and* GS not only relied on spending cuts over tax increases as their primary strategy; they also tended to pair tax cuts with the spending reductions. For example:

1. The top marginal individual income tax rate was **decreased** 11 times, **increased** 4 times, and **unchanged** in the remaining years.
2. The top marginal corporate income tax rate was **decreased** 19 times, **increased** 1 time, and **unchanged** in other years.
3. The value-added tax was **decreased** 1 time, **increased** 4 times, and **unchanged** during other periods.[7]

Thus, successful episodes were three and a half times more likely to use tax decreases than increases. In addition, countries that raised any tax rates in the first of two deficit/debt reductions never increased rates during their second attempt.

Examples: Sweden and the United Kingdom

Below is a table outlining Sweden's remarkable turnaround of the 1990s. Much like the conditions preceding the need for U.S. deficit/debt reduction, the necessity of a Swedish consolidation arose from a recession coupled with a financial crisis. As of 1993, public expenditure had increased to an intimidating 73 percent of GDP while public debt stood at 70 percent of GDP. Between 1993 and 2000, transfers, subsidies, government consumption, and pensions were reduced by an average of 3.3 percent of GDP. These cuts facilitated double-digit decreases in government spending and public debt, as well as double-digit improvements in the deficit.[8]

Table 1
The Swedish Experience
7-Year Changes (% of GDP)

	1993-2000
Total revenue	0.8
Total spending	-15.7
Deficit improvement	16.5
Public debt	-18.4
Real GDP growth (%)	6.3
Employment growth	1.4

Source: Ameco, OECD (Hauptmeier et al. 2006).

[6] Broadbent et al., 2010.
[7] OECD, 2009.
[8] Hauptmeir et al, 2006.

The next table illustrates the two-phase experience of the United Kingdom. These episodes are useful to U.S. policymakers because of defense spending similarities: U.K. defense spending is 4 percent of GDP while the U.S.'s is 5 percent of GDP.[9] The U.K. undertook massive deficit/debt reduction efforts in both 1981 and 1992. Consequently, the deficit was improved by 4.8 percent and 7.5 percent of GDP, respectively.

Table 2
The U.K. Experience
7-Year Changes (% of GDP) (two phases)

	T0-T7 1981-1988	T0-T7 1992-1999
Total revenue	-5.6	0.4
Total spending	-10.5	-7.1
Deficit improvement	4.8	7.5
Public debt	-11.3	5.6
Real GDP growth (%)	6.4	2.8
Employment ratio	3.3	2.9

Source: Ameco, OECD, National statistics (UK) via Hauptmeier et al. 2006

Conclusion

The international experience suggests that deficit reduction plans driven by tax increases over spending cuts are far less likely to succeed. Moreover, the most successful efforts put all spending programs on the table, not a select few programs. But contrary to the conventional wisdom in the United States, the international experience indicates that pairing spending cuts with tax cuts can produce meaningful deficit reduction and improved economic performance. That should be the goal for both the While House and the Congress during these intense negotiations.

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National Press Building
529 14th Street, N.W., Suite 420
Washington, DC 20045
202.464.6200
www.TaxFoundation.org

[9] Stockholm International Peace Research Institute, Military Expenditure database, http://milexdata.sipri.org/, accessed 7/15/2011.