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**Fiscal Turnarounds:  
International Success Stories  
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The United States needs a “fiscal turnaround.”

Because we ran budget deficits for most of the postwar period (the most notable exception being four years of fiscal surplus from 1998 - 2001), the U.S. national debt piled up. For years, the United States has been able to easily finance its annual shortfalls in the absence of sufficient domestic savings. Growth was fast enough to accommodate additional borrowing, and creditor interest in the U.S. market remained keen, so demand for our Treasury debt was strong.

However, the fiscal situation has changed. To prevent the economic and financial crisis from getting even worse, the United States turned to unprecedented levels of peacetime borrowing to finance fiscal stimulus measures and the budget's automatic stabilizers. While these steps have helped limit the severity of the crisis, they have also left the United States with even larger deficits and debt, following upon previous fiscal deterioration throughout the decade. Under reasonable assumptions of future policy trends and growth, the Congressional Budget Office (CBO) estimates that U.S. public debt will rise to 98 percent of GDP by 2020, more than double its average over the past 40 years (36 percent of GDP).<sup>1</sup>

And, the country still faces the inexorable march of time. The present crisis has put the United States in worse fiscal shape to face the retirement of the Baby Boomers over the next 15 to 20 years. In the absence of policy action, the CBO estimates that approximately one generation from now (2035), U.S. debt will explode to 181 percent of GDP – a point which no economy can sustain.<sup>2</sup>

The United States is not alone nor is it the first nation to face this type of situation. Other countries have faced similar fiscal challenges – and gotten out of them. While some parallels between the United States and other countries are limited, there are important principles and experiences we can learn from other countries' fiscal turnarounds.

**Fig. 1: Summary of Fiscal Turnaround Episodes**

Country/ Dates	Fiscal Adjustment	Main elements	Tipping Point
Canada 1994-1998	Annual budget shift: chronic deficits to surpluses. Fall in debt/GDP from around 70% to 29% over 10+ years.	Tough spending cuts. More pension contributions. Credible anti-inflation, exchange rate policies. Contingency Reserve cushion. Public education.	Unsustainable debt. Market focus post-Mexican peso crisis. External financing stress, interest rates up, Moody's downgrade.
Denmark 1982-1986	Annual budget deficit/GDP improved over 15 percentage points. Debt/GDP stabilized after rise from 47% to 82%.	Higher revenues. Sharp spending cuts. Welfare, pension changes. Credible anti-inflation, exchange rate policies. Virtuous circle.	Exploding sovereign debt, very high interest rates, faced with possible credit downgrade to foreign debt.
Finland 1992-2000	Budget shift: deficit (8% GDP) to large surplus, annual. Debt/GDP reduced from over 70% to less than 45%.	Banking system stabilized. Mainly spending cuts. Tax increases (fees, payroll); tax reforms. Entitlement reform. Medium-term framework.	Sharp deterioration in fiscal position, banking crisis, external financing fears, desire to qualify for eurozone membership.
Ireland 1987-1989	Full employment primary budget deficit (8.4% GDP) improved by 7-8% GDP. Debt/GDP: 120% to 90%.	Tough spending cuts (transfer programs). Tax reform. Currency devaluation, anti-inflation policy. Virtuous circle.	Deep recession, deteriorating fiscal situation. Prime Minister thrown out; returned later to launch tough austerity program.
Sweden 1992-2000	Shifted from annual budget deficit over 11% GDP to surplus 5% GDP. Debt/GDP lowered from over 70% of GDP to 53%.	Stabilized banking system. Tough spending cuts. Revenues up (personal income taxes, social security fees, employee payroll taxes). Pension reform 1999.	Sharp fiscal deterioration from recession, banking crisis and initial fiscal expansion via tax cuts. Possible full blown banking and balance of payments crisis.

Sources: [see [http://crfb.org/sites/default/files/Country\\_Sources.pdf](http://crfb.org/sites/default/files/Country_Sources.pdf) ].

### 1. Canada: Unsustainable Debt and the “Maple Leaf Miracle” (1994-1998)

*On the verge of a fiscal crisis, Canada took tough budget steps, mainly on the spending side. With a strong anti-inflation program and an export boost, Canada shifted from chronic fiscal deficits to fiscal surpluses and sharply lowered its debt-to-GDP ratio in one of the largest turnarounds.*

Because it had run fiscal deficits nearly every year since the 1960s, the debt of Canada's federal government had mounted up. By 1992-93, the government faced a fiscal deficit of 5.6 percent of GDP, and the debt-to-GDP ratio was around 64 percent. It would peak at around 70 percent of GDP in 1995-96. (Over 100 percent including the provinces.)

The tipping point came in the aftermath of the Mexican peso crisis in the fall of 1994. The *Wall Street Journal* suggested that the Canadian dollar could be next. When Moody's (the credit ratings agency) put Canada on a credit watch in February 1995, the Canadian dollar slid sharply against the U.S. dollar and investors sold Canadian bonds. Interest rates rose, which increased taxpayer borrowing costs. Moody's downgraded Canada's debt a few months later. (Canada did not get its AAA rating back until over seven years later.) Finance Minister Paul Martin warned that creditors and the International Monetary Fund (IMF) might have to impose conditions to rescue the economy.

To turn things around, Canada adopted the landmark 1995 budget and more steps later:

- Adjustment came primarily on the spending side: drastic civil service cuts (25 percent or 50,000 people), sharp program reductions, tougher eligibility criteria for federal unemployment insurance, wage freezes, privatizations, transfer of some responsibilities and powers plus a cut in cash transfers to the provinces. The provinces made similar changes. Later, pension funding was improved.
- No tax measures were adopted initially because taxes were considered too high.
- Conservative economic forecasts for “prudent” budgeting were used. A Contingency Reserve (or cushion) was put in the budget in case of a shortfall.

Sound economic policies provided important support for the turnaround. A tough anti-inflation stance resulted in lower interest rates. A competitive exchange rate allowed exports to be boosted by the U.S. pick-up. Canada’s growth was stronger as a result.

To build consensus for the tough measures proposed, the government devoted considerable political capital to educating taxpayers about the unfairness of borrowing from future generations to finance current consumption and the crowding out of other measures by higher debt service. Transparent, simple, annual deficit targets were used.

As a result of the government’s efforts and the global economic recovery, Canada shifted from chronic budget deficits to consecutive surpluses (1997-98 to 2008), and reduced its debt-to-GDP ratio from a peak of over 68 percent in 1995-96 to around 29 percent in 2008-09 – a fall of around 40 percentage points in over 10 years, one of the largest improvements anywhere. Because it had sustained its turnaround, Canada had more “fiscal space” than most countries to respond to the current crisis.

## **2. Denmark: Debt Sustainability and a Remarkable Turnaround (1982-1986)**

*Denmark took dramatic action to get its fiscal house in order, partly in response to credit ratings agency pressures. Spending (including social transfer payments) was sharply reduced and taxes were raised at a time of recession. Denmark’s fiscal turnaround was one of the largest ever.*

In the 1980s, Denmark’s public debt exploded. Denmark’s debt-to-GDP ratio rose from 29 percent in 1980 to 65 percent in 1982. Like most of its European neighbors, Denmark’s debt had mounted up when stimulus policies were adopted to address the early 1980s global recession. High global interest rates, adopted to combat inflation, made debt service even more costly. The primary budget deficit rose to 6.5 percent of GDP.

In October 1982, when long-term interest rates reached 22 percent, public concern over public debt sustainability increased. The credit ratings agency Standard & Poor’s added a “credit watch” warning to its AAA rating of Danish foreign debt.

Facing a possible credit downgrade and with its supporters alarmed about fiscal sustainability, the new government turned to severe fiscal retrenchment in 1982:

- Higher revenues accounted for more than half of the fiscal improvement. (Mainly higher direct taxes on households and business; indirect taxes rose, too.)
- Government spending (54 percent of GDP in 1982) was sharply reduced. Cuts were large for benefit and other transfer programs (affecting unemployment insurance, pension parameters – mainly for public employees, and local government transfers). Public wage increases were limited.
- Employee contributions for some transfer programs were increased.

Denmark's fiscal turnaround was supported by a tough anti-inflation program plus an appropriate exchange rate policy. As a result, Denmark was well-positioned to take advantage of the recovery in global growth and decline in global interest rates.

Denmark experienced one of the largest fiscal turnarounds ever. Four years after fiscal consolidation began, the structural primary budget deficit as a share of GDP had improved by over 10 percentage points and the debt-to-GDP ratio was stabilized – although at a high level that would be finally tackled in the 1990s. While higher revenues accounted for more of the turnaround, experts think that spending cuts in fact drove the turnaround in a *virtuous circle of fiscal adjustment and rapid growth*.

### **3. Finland: Remarkable Turnaround after Crises (1992-2000)**

*Finland got into trouble when a major banking crisis devastated the economy at the same time global growth slowed. Taking dramatic action at a time of deep recession, the government gradually turned the situation around. It also addressed aging population challenges.*

Prior to its major banking crisis and related recession, Finland was running surpluses of around 6 percent of GDP and its economy was considered soundly managed. However, the crisis led to rapid and substantial fiscal deterioration, and the economy entered a very deep recession. From 1990 to 1993, Finland's fiscal balance deteriorated by around 14 percent of GDP, as the budget deficit hit 8 percent of GDP in 1993. Government debt (central government) rose rapidly, from around 10 percent of GDP in 1990 to 60 percent by 1994. It continued to rise, but at a slower pace, and exceeded 70 percent in 1997.

Facing external financing worries and with strong political support to qualify for the eurozone, Finland began a long period of fiscal consolidation, featuring back-to-back efforts of two successive governments, and supportive economic and financial policies:

- To stabilize and rescue the banking sector, the issue of blanket creditor guarantees covering depositors and other creditors; the injection of large amounts of capital into banks; and the takeover of some problem banks.
- Spending cuts (85 percent of the improvement), including across-the-board cuts in social benefits, smaller local transfers, plus reductions in capital spending,

- subsidies and public sector wages. A medium-term spending framework, which allowed priorities to be considered in a strategic and transparent way.
- Tax increases (higher user fees for health and education, increased payroll taxes and employee contributions for social security); tax reform (base broadening for personal and corporate income taxes with rate reduction, and VAT introduction).
- Entitlement reforms to lower spending and change structural employment incentives (including tighter qualification rules for unemployment benefits and a temporary halt to inflation adjustment; and calculation of relevant wages for pension determination based on work in the past ten years, not four).

Also important were a strong anti-inflation stance by the central bank and a devaluation of the currency in line with fundamentals to improve global competitiveness.

By mid-1997, the economy had recovered its 13 percent output loss from the severe recession. By 2000, Finland was once again running sizeable budget surpluses and had reduced the debt-to-GDP ratio to below 45 percent. Its successful turnaround reflected large, multiyear fiscal consolidation efforts and financial sector recovery measures, reinforced by economic recovery. In a virtuous circle, the economic recovery both benefited from and reinforced the fiscal turnaround.

#### **4. Ireland: Second Chance for a Fiscal Turnaround (1987-1989)**

*Ireland has gone through more than one episode of fiscal challenge. Two periods are particularly instructive. In the first part of the 1980s, Ireland's fiscal consolidation was large but considered a failure. Later in the decade, it tried again and succeeded through an "expansionary contraction."*

Ireland's fiscal position had deteriorated sharply by the early 1980s. Its primary full employment budget deficit was 8.4 percent of GDP in 1981. The country faced a debt-to-GDP ratio of 87 percent and debt service required 8.3 percent of GDP. The global shift to high interest rates from tough anti-inflation policies made debt service very expensive.

In 1982, the government attempted to solve the fiscal problem by applying the textbook recipe for fiscal adjustment – raising taxes, which many considered already too high. Fiscal consolidation was impressive, but the policy was in fact considered a failure: the austerity program put the economy into severe recession, the debt-to-GDP ratio continued to climb, and political support was lost.

In the February 1987 elections, the same prime minister who had been thrown out of office because of the earlier fiscal consolidation attempt was brought back. Charles Haughey's minority government launched a tough austerity program:

- The second tough austerity program emphasized spending cuts rather than tax increases, a reverse of the 1982 program. Many programs were cut, but the

largest decline was for transfer programs (2.5 percent of GDP). Public employment and wages were also targeted.

- On the revenues side, changes were made to improve the long-run efficiency of the tax system. The tax base was broadened, marginal tax rates fell slightly, and a one-time only tax amnesty was offered.

The government also sharply devalued its currency before launching the austerity program. A tough anti-inflation policy was also in place.

Within two years, the fiscal deficit (full employment primary deficit basis) improved by 7-8 percent of GDP. In contrast to the 1982 episode, real growth strengthened and debt began to come down as a share of GDP despite large fiscal consolidation. Debt fell from nearly 120 percent of GDP in 1987 to around 90 percent five years later.

### **5. Sweden: Big Turnaround after the Financial Sector Crisis (1992-2000)**

*Sweden's fiscal turnaround provides a model of a successful, large, and long-lasting multiyear program adopted at a time of crisis. Its financial sector-induced crisis has similarities to the present U.S. crisis. Sweden is considered a prime example of the virtuous circle at work.*

Sweden's fiscal situation deteriorated sharply in the early 1990s as a result of a major banking crisis and the government's initial policy response. To address the crisis, the government had first turned to fiscal expansion (tax cuts and banking sector bailout). However, its actions did not boost economic activity as expected. Instead, private consumption fell and Sweden experienced a very tough recession. Fiscal expansion had increased concern over fiscal discipline; and the financial sector, still in crisis, could not perform its normal job of allocating credit to the economy.

Sweden's public debt rose from just over 40 percent of GDP in 1990 to a peak of over 70 percent by the mid-1990s. The worsening debt position reflected a sharp deterioration in the annual budget, from surplus (over 3 percent of GDP) to deficit (-11 percent of GDP). Deterioration was particularly evident on the spending side. Spending-to-GDP rose from 59 percent in 1990 to 70 percent in 1993. Revenue, while also astonishingly high (59 percent in 1993), lagged spending, and the financing gap widened.

Under these circumstances, investor confidence plummeted by mid-1992 and Sweden faced a full-blown banking and balance of payments crisis. To turn around the situation, the government took bold steps, including fiscal consolidation, during a recession:

- In September 1992, it stabilized the banking system by announcing a blanket and unlimited guarantee to all creditors and depositors; and by adopting bank resolution legislation a few months later.
- After the 1994 general election, the government launched a fiscal consolidation program. Most adjustment was on the spending side (wide ranging cuts, plus tightening of housing grants and subsidies, sick leave benefits, unemployment



- insurance, family allowances and social insurance benefits). Revenues were increased (personal income taxes, social security fees, employee payroll taxes).
- Later on (1999), the government adopted dramatic pension reform to put the system on financially sustainable footing.

Credible exchange rate and anti-inflation policies helped support the turnaround by boosting export competitiveness and lowering interest rates.

With fiscal consolidation and supportive economic policies, Sweden's fiscal position shifted from a deficit of over 11 percent of GDP to a surplus of 5 percent of GDP, and the debt-to-GDP ratio was reduced from over 70 percent (1994) to 53 percent (2000). Most improvement was from spending cuts. Sweden illustrates the virtuous circle at work.

## Conclusion

As the U.S. economy starts to recover from the economic and financial crisis of the past two years, it is imperative that policymakers adopt a credible plan to bring about – and sustain – a fiscal turnaround. The fiscal deterioration from the crisis has left the U.S. economy vulnerable to unexpected developments at home and abroad and in far worse shape to face fiscal pressures from an aging population and rising health care costs. While most agree fiscal consolidation should not begin until the economy is stronger, many experts think plans to restore fiscal health should be drawn up and announced now.<sup>3</sup> The sooner we take steps, the less draconian measures will be.

The experiences discussed in this paper offer a cautionary tale to U.S. policymakers of the risks of not taking timely, appropriate action. Countries with severe fiscal and macroeconomic imbalances which have tried to muddle through circumstances similar to those now facing the United States were, in the end, forced to make dramatic fiscal adjustments by a crisis or by the threat of a crisis. Forced adjustment is very costly for the economy – and the taxpayer. While the dollar's reserve currency status may provide the United States with more running room for bad policies (essentially because the United States can issue debt in its own currency), it is crucial to recognize that the nation will ultimately not be immune to fundamental economic, financial, and political forces, particularly since it must rely heavily on foreign creditors to compensate for low domestic savings. It is always better for policymakers to take action on their own terms.

There are also positive reasons for pursuing a fiscal turnaround. As the experiences in this paper illustrate, successful fiscal turnarounds have beneficial effects. Countries that have undertaken large fiscal adjustments have greater flexibility to fund new spending priorities, cut taxes, or rebalance spending and tax measures. Increased "fiscal space" from a turnaround means that a country will have more fiscal capacity to respond to future crises. A well-designed fiscal turnaround will also mean that growth, investment and employment will be stronger and standards of living higher than otherwise.

Successful fiscal turnarounds have some common features. Large, multiyear adjustments have been more successful in terms of both fiscal outcomes and economic results. International experience seems to argue for fiscal turnaround packages that are heavily weighted toward spending cuts, although there are examples where tax increases had a positive impact. The optimal design is, however, also related to the starting point. Many of the countries which have had successful turnarounds had extremely high tax and spending levels, so lower spending almost certainly had the positive effect of “crowding in” private demand. Raising taxes even more was often not a realistic option, and would likely have been counterproductive by dampening growth and thereby lowering revenues. In countries where the initial conditions are not as tax and spending heavy, there is more room to raise revenue, though the design of the tax system is always critical to its effect on the economy.

Policymakers have frequently used fiscal consolidation packages as vehicles to tackle structural tax and spending problems (such a narrow tax base or pension programs designed for another era). Addressing sensitive fiscal areas enhances the credibility of the fiscal program and usually brings fiscal payoff in the longer run.

Many fiscal turnarounds have been particularly successful because other sound and reinforcing policies were adopted at the same time. Credible fiscal rules and fiscal goals have helped policymakers and taxpayers maintain discipline. A credible anti-inflation policy helps keep inflation and interest rates subdued, which improves fiscal balances through stimulating growth and reducing the cost of debt service. An appropriate exchange rate policy plus open trade and capital markets will support the turnaround, particularly if the world economy is picking up at the same time. Experience shows that the additional boost to growth will probably accelerate fiscal adjustment and make the turnaround even more powerful. International policy coordination can help a lot.

Many countries’ experiences also show the importance of a public dialogue in building support for a fiscal turnaround. Particularly in Canada and Sweden, the government took great care to educate the public about why it was in their interest to have large fiscal adjustments – and why there was no realistic alternative.

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#### **Endnotes**

<sup>1</sup> Congressional Budget Office (CBO), The Budget and Economic Outlook: Fiscal Years 2010 to 2020, January 2010; CBO, The Long-Term Budget Outlook, June 2009, p.11.

<sup>2</sup> CBO, The Long-Term Budget Outlook, p.6.

<sup>3</sup> See recent reports by the Peterson-Pew Commission on Budget Reform; and the National Research Council and National Academy of Public Administration.