EXECUTIVE SUMMARY

High debt ratios amid persistently low growth in advanced economies and emerging fragilities in the developing world cast clouds on the global fiscal landscape. In advanced economies, with narrowing budget deficits (except, most notably, in Japan), the average public debt ratio is expected to stabilize in 2013–14. Yet it will be at a historic peak (about 110 percent of GDP, 35 percentage points above its 2007 level). Simulations show that maintaining the overall budget at a level consistent with the IMF staff's medium-term advice would bring the average debt ratio to about 70 percent of GDP by 2030, although in a few countries it would remain above 80 percent. However, the large debt stock, the uncertain global environment, weak growth prospects, and the absence of well-specified medium-term adjustment plans in systemic economies like Japan and the United States complicate the task. At the time of writing, a shutdown of the U.S. federal government and the failure so far to raise the debt ceiling add to uncertainty. Although a short period of government shutdown would likely have limited impact, a longer period could be more damaging. A failure to promptly raise the debt ceiling could have even more serious consequences. At the same time, fiscal vulnerabilities are on the rise in emerging market economies and low-income countries—on the back, in emerging market economies, of heightened financial volatility and downward revisions to potential growth, and in low-income countries, of possible shortfalls in commodity prices and aid.

Strengthening fiscal balances and buttressing confidence thus remain at the top of the policy agenda, although the degree of urgency varies from one country to another. In high-debt advanced economies, consolidation should be anchored in credible medium-term plans, defined in cyclically adjusted terms, leaving room for automatic stabilizers to cushion unexpected shocks. Its pace and composition should be calibrated (as long as financing allows) to reduce risks to near-term economic activity while enhancing long-term growth prospects. Those emerging market economies that have seen their fiscal space shrink or even disappear should start rebuilding their fiscal buffers, taking advantage of still generally favorable cyclical conditions. The pace should remain determined by debt and deficit levels, as well as financing access, although uncertainties about potential growth and interest rate prospects call for more proactivity to shield against sudden changes in market sentiment. In low-income countries, reduced access to concessional funds and, in resource-rich countries, declining commodity prices underscore the need to mobilize domestic revenue and increase the efficiency of spending.

Against that backdrop, this issue of the *Fiscal Monitor* explores whether and how tax reform can help strengthen public finances. Taxation is always a sensitive topic and is now more than ever at the center of policy debates around the world. The key challenges are: How can taxation best help bring down debt ratios in advanced economies and respond to mounting spending needs in developing countries? And how can equity concerns be balanced—especially in hard times—with the efficiency that is needed to secure long-term growth?

In practice, consolidation so far has been more reliant on revenue measures than was initially planned. But the options most often chosen have been guided by expediency rather than by a desire to build stronger and fairer tax systems, and they may be storing up problems for the longer term. Tax rates, for instance, have been raised when it would have been preferable to broaden the tax base and introduce new taxes to address environmental concerns or correct financial sector inefficiencies. With a large share of adjustment already behind in many countries but growth prospects still dim, policy design should now focus on addressing long-standing tax distortions and buoying potential growth.

Can countries tax more, better, more fairly? Results reported here show that the scope to raise more revenue is limited in many advanced economies and, where tax ratios are already high, the bulk of adjustment will have to fall on spending. Nonetheless, many (including some with the largest consolidation needs, like the United States and Japan) could still mobilize significant amounts while limiting distortions and adverse effects on growth. Broadening the base of the value-added tax ranks high in terms of economic efficiency (as new findings tend to confirm) and can in most cases easily be combined with adequate protection for the poor. In emerging market economies and low-income countries, where the potential for raising revenue is often substantial, improving compliance remains a central challenge. Recognition that the international tax framework is broken is long overdue. Though the amount is hard to quantify, significant revenue can also be gained from reforming it. This is particularly important for developing countries, given their greater reliance on corporate taxation, with revenue from this taxation often coming from a handful of multinationals.

Scope seems to exist in many advanced economies to raise more revenue from the top of the income distribution (and in some cases meet a nontrivial share of adjustment needs), if so desired. And there is a strong case in most countries, advanced or developing, for raising substantially more from property taxes (though this is best done when property markets are reasonably resilient). In principle, taxes on wealth also offer significant revenue potential at relatively low efficiency costs. Their past performance is far from encouraging, but this could change as increased public interest and stepped-up international cooperation build support and reduce evasion opportunities. Reforming international taxation will be harder, as it must go beyond the control of tax-minimizing tricks to address more fundamental aspects such as the allocation of tax bases across countries and finding better ways to realize mutual gains from closer cooperation in tax matters.

Political constraints can trump even the best-designed tax reform. History shows that meaningful, long-lasting tax reforms have most often been implemented in good times, when buoyant revenues can be used to compensate losers. But they can happen in lean times, too, if carefully attuned to a particular country's institutional setting and supported by extensive political consensus building and a broad communication strategy. They are certainly increasingly needed in the current, taxing times.