

A Greater Role for Fiscal Policy (Chapter 1)

The global economy is undergoing major transformations, including a productivity slowdown, technological change, and global economic integration. This creates new demands for public policies to facilitate these transformations, while cushioning the effect on those negatively affected. Fiscal policy has a greater role to play in fostering sustainable and inclusive growth. At the same time, the high degree of uncertainty surrounding the outlook as well as stretched government balance sheets require a better understanding and management of risks. Fiscal policy therefore has the difficult task of achieving more and better in a more constrained environment.

Shifts in Fiscal Positions and Elevated Risks

Advanced economies eased their fiscal stance by one-fifth of 1 percent of GDP in 2016, breaking a five-year trend of gradual fiscal consolidation. Their aggregate fiscal stance is expected to remain broadly neutral in 2017 as well as in the following years. As a result, public debt in advanced economies should stabilize in the medium term, averaging more than 100 percent of GDP, rather than decline as previously expected.

In *emerging market and developing economies*, the deterioration in fiscal positions seems to have come to an end, although the expected improvement depends crucially on developments in commodity markets. Oil exporters are implementing large consolidation plans to realign spending with revenues, and their fiscal deficits are expected to fall by about \$150 billion between 2016 and 2018 (with the improvement next year coming mainly from the non-oil balance). In oil importers, the fiscal deficit should remain broadly stable as a share of GDP in 2017, followed by a gradual consolidation over the medium term.

Uncertainty regarding future policies as well as macroeconomic risks cloud the global fiscal outlook. The lack of specificity about the size and composition of the expected fiscal stimulus in the United States, a number of elections in Europe, and the upcoming

party congress in China all contribute to policy uncertainty. In emerging market and developing economies, a more rapid increase in interest rates, a significant appreciation of the U.S. dollar, and lower commodity prices could exacerbate debt vulnerabilities and trigger the materialization of contingent liabilities, in particular those related to implicit government guarantees on corporate borrowing.

Setting the Course for Fiscal Policy

The role of fiscal policy has been reassessed in the past decade, reflecting specific circumstances, notably the global financial crisis, as well as new academic research using macroeconomic and survey data. Fiscal policy is generally seen as a powerful tool for promoting inclusive growth and can contribute to stabilizing the economy, particularly during deep recessions and when monetary policy has become less effective. At the same time, high debt levels, long-term demographic challenges, and elevated fiscal risks place a premium on sound public financial management. In particular, policies should be anchored within a credible medium-term framework that ensures debt sustainability, manages risks adequately, and encourages countries to build buffers during upturns.

Overall, three main objectives should guide the conduct of fiscal policy, although limited budgetary room and possible trade-offs constrain governments' ability to pursue these objectives simultaneously.

Fiscal policy should be countercyclical. A countercyclical fiscal response should rely mostly on automatic stabilizers and be symmetric (that is, it should expand in bad times and tighten in good times). Nevertheless, in countries suffering from a protracted lack of demand and with constrained monetary policy, like Japan, discretionary fiscal support, combined with structural reforms and continued monetary accommodation, can be used to break away from debt-deflation traps by raising nominal GDP. In the euro area, the aggregate cyclical position also argues for a slightly more expansionary aggregate fiscal stance in 2017. At the other end of the spectrum, economies with limited economic slack and signs of inflationary pressures

should, in general, withdraw fiscal support to rebuild buffers. In the United States, where the economy is close to full employment, fiscal consolidation could start next year to put debt firmly on a downward path. In China, given robust employment levels and the expected pickup in inflation, the “augmented” fiscal deficit should decline in the medium term to support economic rebalancing, with fiscal resources reallocated from off-budget public investment toward on-budget spending for social assistance, education, and health. Yet using fiscal policy flexibly to stabilize the economic cycle is not always feasible. In some countries, fiscal consolidation is warranted regardless of the cyclical conditions in order to ensure fiscal sustainability in the face of large shocks (for example, in commodity exporters) or to restore market confidence.

Fiscal policy should be growth friendly. Tax and expenditure measures can be used as structural instruments to support the three engines of long-term growth: the stock of physical capital, the labor force, and productivity (the short-term effect of these measures on activity may nonetheless depend on overall economic conditions). The case for increasing public investment remains strong in many countries in light of low borrowing costs and substantial deficiencies in infrastructure, although careful project selection, management, and evaluation should also ensure that investment is efficient. More growth-friendly business tax systems that focus on taxing rents and reducing burdensome tax administration practices can promote private investment. For instance, in the United States, reforming corporate taxation could help revitalize business dynamism and investment. Countries should also continue efforts to create a better environment for job creation—in advanced economies by reducing labor taxation where it is high, making more intensive use of active labor market policies, and adopting targeted spending measures for vulnerable groups; and in emerging markets and developing economies by improving access to health care and education. Almost all countries need to boost female labor force participation. With respect to productivity, a range of policies can foster innovation, including tax measures that reduce the misallocation of resources across firms (see the summary of Chapter 2).

Fiscal policy should promote inclusion. Global economic integration and technological change have contributed to economic growth and prosperity, lifting one billion people out of poverty since the 1980s. But

gains at a global level have not always been widely shared within countries. For instance, in advanced economies, the incomes of the top 1 percent have grown almost three times faster than those of the rest of the population over the past 30 years. Fiscal policy can play an important role in ensuring that the poor and the middle class share in the growth dividend. One challenge is to identify transfer and tax instruments that promote inclusiveness, while creating sound incentives to invest and work. For instance, conditional cash transfer programs—transfers to poor households that require, in some cases, children to attend health clinics and school—could be expanded in a number of emerging markets and developing economies. Inclusive fiscal policies can also help people fully participate and adapt to a changing economy through better access to quality education, training, and health services, as well as through social insurance.

Achieving Sustainable and Inclusive Growth While Coping with High Debt

The three objectives outlined previously provide a road map for policymakers, but in most countries, limited fiscal buffers will require them to be selective in their budgetary choices. If additional resources are necessary, they should be raised in a way that is the least harmful for growth, while keeping debt on a sustainable path.

For countries that have fiscal room, one option is to finance the policies through additional borrowing. But debt should be used wisely. The return on debt-financed projects should clearly outweigh the cost and risks that higher leverage creates. Assessing the extent to which public debt can be safely increased is a difficult task. The IMF has recently developed a new framework that combines a variety of indicators and tools to assess “fiscal space” more systemically and consistently across countries. In this context, the persistent decline in interest rates may have relaxed government budget constraints in advanced economies; if the differential between interest rates and GDP growth were to remain durably lower than it has been in past decades, countries could be able to sustain higher levels of public debt.

For countries that do not have fiscal space, room must be created within their budgets: they can raise more revenue or save on expenditures to implement desired policies in a budget-neutral way. On the revenue side,

identifying the least distortionary measures available—meaning those that least reduce incentives to work, save, and invest—should be a priority. Options include broadening the tax base (by eliminating tax exemptions and preferential tax rates) and raising indirect taxes and property taxes. In China, for example, significantly raising taxes on fossil fuel would raise revenue, while helping curtail emissions and improve energy efficiency. On the spending side, better targeting of expenditure as well as increasing efficiency, preferably as part of comprehensive expenditure reviews, can often generate savings. In particular, countries can eliminate generalized subsidies that disproportionately benefit higher-income groups in favor of targeted measures to those in need. While all these measures could raise some additional resources, reallocating taxes and expenditures within a given budget envelope may, however, be difficult to achieve politically.

Upgrading the Tax System to Boost Productivity (Chapter 2)

A top challenge facing policymakers today is how to raise total factor productivity, the key driver of living standards over the long term. Tackling this challenge calls for the use of all policy levers, and in particular growth-friendly fiscal policies. Chapter 2 makes the case that upgrading a country's tax system is important to boosting productivity because it can reduce distortions that prevent resources from going to where they are most productive. The chapter offers several key findings:

- Countries can reap substantial productivity gains by reducing resource misallocation across firms. Resource misallocation results from a number of government policies or poorly functioning markets that allow less efficient businesses to gain market share at the expense of more efficient businesses. Estimates show that eliminating the distortions that cause resource misallocation could generate sizable productivity gains and lift annual real GDP growth rates by roughly 1 percentage point for about 20 years.
- Countries can chip away at resource misallocation by upgrading the design of their tax systems to ensure that firms' decisions are made for business and not tax reasons. In particular, countries can achieve important productivity gains by reducing tax discrimination by asset type, by sources of financing, or by firm characteristics such as formality and size.
- Minimizing differentiated tax treatments across capital asset types and financing can help tilt firms' decisions toward investments that are more productive, rather than more tax favored. For instance, tax treatments that favor debt over equity financing create resource misallocation by imposing a higher marginal tax on research and development investment, which is more dependent on equity compared to other capital spending. Disparity in taxes across capital asset types also affects firms' investment decisions. These two distortions can be eliminated by shifting to a cash flow tax or by adopting an allowance for corporate equity system, which allows a tax deduction for the normal rate of return on equity.
- Governments should encourage the growth of productive firms by leveling the playing field. For example, informal firms, by evading taxes, are able to stay in business despite low productivity. Stronger tax administration can help reduce the unfair cost advantage that these firms enjoy over their more productive, tax-compliant competitors. Another example of leveling the playing field is to encourage growth and productivity among small firms by reducing tax compliance costs and by targeting tax relief to new firms rather than small firms in order to avoid disincentives to growth that result in the "small business trap."

In sum, how governments tax matters for productivity. Improving the design of tax policies helps remove the distortions that are holding more productive firms back, generating a positive impact on aggregate productivity and growth.