

### Recent Fiscal Developments and Outlook

In the last six months, low interest rates and subdued volatility in bond markets have led to declining pressures on public finances in most countries. However, underlying fiscal vulnerabilities persist, while new risks are emerging.

In advanced economies, the envisaged slowdown in structural deficit reduction will provide welcome support to economic activity. Fiscal efforts in the last five years have stabilized the average debt-to-GDP ratio. Nevertheless, it is still expected to exceed 100 percent of GDP at the end of the decade. It is important to continue to reduce debt to safer levels and rebuild fiscal buffers. Hesitant recovery and persistent risks of lowflation and reform fatigue call for fiscal policy that carefully balances support for growth and employment creation with fiscal sustainability.

In emerging market and middle-income economies, debt ratios and deficits remain generally moderate, although, on average, above precrisis levels. Prospects of tighter financing conditions and possibly lower potential growth, coupled with rising contingent liabilities, call for rebuilding the policy room for maneuver that was used during the last few years; and for strengthening the fiscal frameworks to manage risks from government activities not currently covered by budgets. Countries facing difficult financing conditions would benefit from taking early fiscal action.

In low-income developing countries (LIDCs), fiscal risks are generally modest, although debt ratios have increased significantly in a few cases. The recent Ebola outbreak is producing severe strains and disruptions to the budgets of the affected countries. The challenge for LIDCs remains to scale up the provision of essential public services and growth-enhancing investment in a manner compatible with a sustainable fiscal path. To this end, revenue mobilization through tax policy and administration reforms, and careful expenditure prioritization, are key policy priorities—as is strengthening fiscal governance, especially for the growing number of LIDCs that are gaining access to global financial markets.

### Can Fiscal Policies Do More for Jobs?

Job creation is at the top of the policy agenda globally. High and persistent levels of unemployment call for a broad policy response, generally encompassing labor market reform and other economic policies. While fiscal policy cannot substitute for comprehensive reforms, it can support job creation in a number of ways.

First, the design of fiscal consolidation matters for labor market outcomes. The debate on the growth and employment impact of spending-based versus revenue-based consolidations is not settled in the literature. Some studies find that short-term spending multipliers are larger than revenue multipliers, while others have found the opposite. Our analysis, which should be seen as suggestive rather than definitive, suggests that in advanced economies, tax-based consolidations appear to be associated with a more adverse effect on jobs in normal times. However the situation differs if the starting point of the adjustment is a protracted recession, when expenditure adjustment is found to have a larger short-term adverse effect on employment. In emerging and developing economies, expenditure-based adjustments tend to have a more adverse effect on jobs, possibly due to cuts to already low levels of public investment and public services. Ultimately, what may matter most is the nature of the specific revenue or expenditure measures implemented.

Second, under certain conditions, the fiscal stance can buy time for labor market reforms. Labor market reforms can and often do have sizeable fiscal costs—either directly, such as labor tax cuts, or indirectly, through measures adopted to mitigate the undesired short-term redistributive effects of some reforms. A higher deficit or a slower pace of consolidation can absorb these, and offset the adverse short-term impact of reforms on output or employment. When appropriate, this could make space for increased public investment, further enhancing the long-term growth potential of the economy (as discussed in Chapter 3 of the October 2014 *World Economic Outlook*). A looser fiscal stance in support of the reforms could be considered if it does not raise debt sustainability risks;

if the reforms' costs and benefits are well identified and constrained in size and duration; and if there is sufficient certainty that reforms will be carried to their end.

Third, reducing labor taxes can have a significant positive impact on employment in advanced economies, but often comes at a high fiscal cost. The cost can be reduced by targeting tax cuts to specific groups, such as low-skilled workers or youth, where the unemployment problem may be more severe. These targeted measures have proven quite effective because employment of these groups is relatively sensitive to tax cuts. The success of these measures, however, depends crucially on minimizing new distortions, as well as on the scope for employment substitution effects. In

emerging market and developing economies, removing tax barriers and providing basic public services and greater access to finance and training could help address the challenges of informality and low growth in labor productivity.

Finally, some countries may choose to address declining old-age labor force participation with targeted pension reform measures. The evidence shows that increases in the statutory retirement age do not, by themselves, necessarily lead to an increase in labor force participation for older workers. Complementary reforms could include tightening rules for early retirement, rationalizing benefits, and adopting other financial incentives, together with policies that boost labor demand for those who postpone retirement.