

EXECUTIVE SUMMARY

Taxing better can support growth even when fiscal space is limited. High public debt levels, elevated borrowing costs, mounting spending pressures, and weak medium-term growth leave many governments little room for broad tax cuts. The challenge is to strengthen economic activity without eroding the revenue base. Removing unnecessary distortions in tax design and implementation can help governments meet that challenge.

This chapter complements the focus of the October 2025 *Fiscal Monitor* on improving the efficiency of public spending by examining the revenue side of the budget. It shows how revenue-neutral reforms within existing tax systems can lower production costs, encourage investment and the growth of firms, improve incentives to work and innovate, and ease compliance burdens, without worsening inequality. In other words, how governments raise revenue matters as much as how much they raise.

Gains in efficiency come from reducing specific distortions within existing tax systems. A well-designed value-added tax (VAT) taxes final consumption, not production. When firms can recover taxes paid on inputs, production costs fall and resources can move to more productive uses. Taxes on businesses can support investment by allowing faster recovery of investment costs while preserving the taxation of economic rents. Tax incentives can generate more innovation for a given fiscal cost when they target additional research and development (R&D) rather than firm size or profits only loosely connected to research activity. Employment taxes and benefits can be redesigned to make entering the workforce and earning more financially rewarding while maintaining distributional objectives. Stronger implementation of tax systems is critical to realizing these gains.

The potential gains from more efficient taxation are sizable. Tax reforms can raise the level of GDP by several percent in the long term when they address multiple distortions. Specifically, reducing VAT-related production and consumption distortions could yield economy-wide welfare gains of up to 0.8 percent of GDP in emerging market and developing economies. Removing tax-induced increases in the cost of capital could raise long-term GDP by an estimated 2.1 to 2.7 percent. Reforms that strengthen work incentives could increase employment rates by about 1.2 percentage points in emerging market and developing economies and 0.8 percentage point in advanced economies. Stronger tax administration can generate higher revenue: countries at the 67th percentile of the operational strength of tax administration collect about 1.7 percentage points of GDP more than countries at the 33rd percentile. Together, these findings show that better tax design and implementation can materially strengthen economic performance.

Better implementation of tax processes is essential. Stronger administration can increase the collection of taxes already due, reduce compliance burdens that fall disproportionately on small and young firms, and narrow productivity gaps between firms. It can also expand the range of feasible reforms. Reliable VAT refunds can make it possible to limit exemptions while managing fraud risks. Credible verification can improve the targeting of R&D incentives, and effective administration allows in-work support to reach intended recipients. Where capacity is limited, the priority is to strengthen registration, filing, payment, refunds, and compliance management as a foundation for further reform.

Countries should target the distortions that impose the greatest economic costs and sequence reforms according to implementation capacity. Much can be achieved within existing systems by limiting VAT exemptions and improving refunds, accelerating recovery of investment costs, smoothing thresholds that discourage the growth of firms, targeting R&D incentives more effectively, and redesigning in-work support. In many emerging

market and developing economies, unrecovered value-added taxes on business inputs, limited in-work support, and weaknesses in core administrative functions are key priorities to be targeted. In advanced economies, where tax-benefit systems and tax administrations are generally more developed, the emphasis may fall more on refining work incentives and using information and technology more effectively in tax administration. Across country groups, investment distortions and poorly targeted incentives warrant attention, while broader shifts toward rent-based taxation on businesses could offer additional gains where circumstances allow.

Political economy can impede reform even when the economic case is clear. The costs of reform are often immediate and concentrated among groups that lose tax-favored treatment, whereas the benefits of greater efficiency and growth are diffuse and emerge gradually. Successful reform therefore requires clear objectives, credible implementation, early engagement with affected stakeholders, effective communication, and, where appropriate, phasing and targeted measures to mitigate losses.

Taxing better is not a substitute for additional revenue measures where they are needed, and equity remains central. Rather, the aim of taxing better is to ensure that necessary revenues are raised at lower economic cost. Over time, a more productive economy provides a stronger foundation for both growth and public finances.