Growth-Friendly Fiscal Policy[1]

Reforms in taxes and government spending can have an important impact on long-run growth. Their design should reflect the conditions of a given country. For example, countries with fiscal space can scale up productive spending in support of long-term growth, such as higher public investment or health and education spending. Where fiscal space is lacking, growth-promoting tax and spending reforms would need to be designed in a budget neutral manner. All fiscal reform packages should be designed to balance growth-equity trade-offs.

Growth-Friendly Tax Policies

1. **The focus of growth-friendly tax policies depends on the tax structure and taxation levels of a country.** Few advanced economies have scope to raise tax revenues. Therefore, the focus of tax policies in these countries should be on eliminating distortions (for example, by removing VAT exemptions and reduced rates). Many emerging market economies, on the other hand, have the potential for raising additional revenue in a growth friendly manner, including by improving compliance and reducing policy gaps.

2. **Taxes on residential property and on excess returns or rents, particularly in resource-rich economies, are considered the least distortive for growth.** Broad-based consumption taxes, and particularly the VAT, have the advantage of not discouraging saving and investment decisions. At the other end of the spectrum, income taxes and social contributions are thought to have the most adverse effects on growth as they interfere directly with economic decisions (e.g., labor force participation). Within income taxes, corporate taxes are typically seen as the most harmful to growth, primarily because they discourage capital accumulation and productivity improvements, while introducing a bias toward the use of debt finance. Shifting the composition of the tax system from direct to indirect taxes may have positive effects on growth, but this may come at the expense of equity. For instance, the VAT is generally regressive in advanced economies—at least when assessed against current income rather than current consumption.

3. **The design of individual taxes strongly affects their impact on growth.** Improving the design of the corporate income tax (possibly through the introduction of an allowance for corporate equity) might be better for growth than a poorly designed VAT. Similarly, well-designed energy taxation can correct negative externalities associated with consumption and production of energy products, and generate important revenues that can be used to reduce other more distortive taxes.

4. **Tax expenditures (such as tax exemptions or reduced tax rates) are overall costly**

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[1] Prepared by the Staff of the International Monetary Fund

and ineffective. For instance, allowances or deductions under the personal income tax help only those who fall into the tax net—effectively excluding many poor households—while corporate tax breaks are of little use to companies with no taxable income. Thus, eliminating distortive tax expenditures in a revenue-neutral way—for example, by broadening the tax base—makes room for lowering the tax rate, and ultimately supports economic growth. Well-designed measures to mitigate social or political costs for those benefitting from the tax expenditures can help ease resistance against their removal and still leave a net benefit.

5. **Specific tax expenditures may be justified for particular purposes.** For example, many advanced economies use tax credits or benefits for low-wage earners ("in work" tax credits) to provide income support and stimulate labor force participation. Such tax credits reduce the net tax liability and increase the net income gain from accepting a job relative to the alternative of being out of work. Similarly, in the midst of the Great Recession, several advanced and emerging economies temporarily introduced a more favorable depreciation schedule to support investment.

6. **Tax reforms must be considered as a package— in light of complex trade-offs between the different goals that tax systems try to achieve—and also take into account the administrative dimension.** For example, a shift in the tax structure from personal income to consumption taxes, justified to reduce distortions and promote growth, could raise equity concerns due to lower progressivity of consumption relative to personal income taxes. In addition, the assessment of each revenue measure should take into account its impact on tax avoidance and evasion, as well as tax compliance and enforcement costs. Therefore, while recognizing the limits and potential of each tax instrument, an effective reform should avoid a "tax-by-tax" policy approach. Revenue administration reforms could support growth by addressing high levels of informality, lowering compliance costs, and reducing corruption. This is particularly relevant in emerging economies that have relatively small domestic revenue bases or are dependent on volatile revenue sources, including from natural resources.

More Productive Expenditures

7. **Fundamental expenditure reforms can support long-run growth by reducing inefficiencies and directing resources to areas with the greatest social rate of return.** In advanced countries, these reforms include containing increases in age-related spending, containing the government wage bill, as well as streamlining social benefits—while finding room for public investment that addresses infrastructure bottlenecks. Spending reviews can help raise the efficiency of public spending. In emerging countries, the focus of expenditure reforms should be on improving the composition of spending, rationalizing subsidies, and strengthening the public investment-growth link. In all countries, reform of quasi-fiscal activities can reduce inefficiencies and contingent liabilities, with potentially positive effects on confidence, investment and growth.

8. **An increase in public capital investment can support long-term growth, but its financing costs, effectiveness and risks need to be assessed carefully**. Empirical evidence shows that the growth dividend of public investment will depend on the investment's return, the way in which capital expenditure is financed, and the quality of the investment process (i.e., project selection and implementation). Projects should be carefully selected and implemented—including by making use of medium-term expenditure frameworks, competitive bidding, and internal audit. In this regard, it is critical to have in place effective public financial systems that support project selection and implementation, as well as to set aside sufficient resources for proper maintenance.

9. **Investments in human capital offer a number of advantages, including boosting long-term growth**. Well-designed social transfers and health and education spending can serve equity objectives, and—by building human capital—raise the long-term growth potential of the economy. Moreover, they can build crucial political support for growth-oriented structural reforms.

10. **Reform of untargeted subsidies, especially on fuel, can also enhance productivity in a number of ways.** Cutting spending on costly energy subsidies can free up valuable resources to finance growth-enhancing spending; it can also boost growth by removing obstacles to critical investment in the energy sector, and encouraging a more efficient allocation of resources away from overly energy-intensive industries, towards "greener" technologies.

11. **Finally, reorienting spending to Active Labor Market Programs (ALMPs) can have a positive effect on labor market participation and long-term growth.** In many G20 economies, high unemployment and low labor market participation (particularly for youth, women and older job market participants) pose threats to social stability and long-term growth prospects. These countries may benefit from re-orienting spending on "passive" benefits towards well-designed ALMPs, such as job search assistance, wage subsidies and training, with some programs particularly tailored to the needs of unemployed youth.

Balancing growth–equity trade-offs

12. **Both tax and expenditure policies need to be carefully designed to balance distributional and efficiency objectives.** These can be designed to minimize efficiency costs through applying the following principles: (i) use means-tested cash transfers where possible or use tagging where means testing is not feasible; (ii) make income taxation progressive; and (iii) design indirect taxes to raise revenue in an efficient manner (e.g., minimize the use of exemptions or reduced VAT rates).