

## EXECUTIVE SUMMARY

### Navigating a Risky World

The weakening of the global recovery and concerns about the ability of policymakers to provide an adequate and swift policy response have clouded economic prospects. As a result, risks to the global economy (April 2016 *World Economic Outlook*) and financial systems (April 2016 *Global Financial Stability Report*) have substantially increased. In this difficult environment, fiscal policies must be prepared to respond promptly to support growth and reduce vulnerabilities.

### Worsening Fiscal Trends

Fiscal positions have worsened significantly since the April 2015 *Fiscal Monitor*, with public debt ratios being revised upward in most countries. The revisions have been the largest in *emerging market and middle-income economies*, where fiscal deficit ratios in 2015–16 are now expected to exceed the levels observed at the beginning of the global financial crisis. The fiscal positions of *commodity exporters* have been especially hard hit. In the Middle East and North Africa, the cumulative fiscal balances of oil exporters alone are expected to deteriorate by over \$2 trillion in the next five years relative to 2004–08, when oil prices peaked. *Advanced economies* remain vulnerable in a context of high public debt (greater than 100 percent of GDP, on average), low inflation, and sluggish growth.

### Rising Fiscal Risks

Fiscal risks are rising almost everywhere. In *advanced economies*, the risk of persistently weak growth and low inflation makes a reduction in debt ratios even more challenging. In *emerging market and developing economies*, tighter and more volatile global financial conditions could significantly increase the interest bill at a time when gross financing needs are rising. The weak economic outlook also raises the likelihood that contingent liabilities will materialize. Finally, the electoral calendar or political gridlock could complicate policy implementation or discourage bold policy action in 2016 in a number of major economies.

Hence, the outlook remains very uncertain and the likelihood of a protracted lower-growth scenario has increased. In this environment of high risks, a comprehensive policy response is urgently needed to improve growth prospects and build resilience.

### Supporting Growth and Securing Long-Term Debt Sustainability

With policy rates near zero in many *advanced economies*, fiscal policy should stand ready to support demand and bolster monetary policy where needed and where fiscal space is available. The focus should be on fiscal measures that boost both short- and medium-term growth (such as infrastructure investment) and policy actions that support the implementation of structural reforms. To preserve debt sustainability and anchor expectations, any fiscal relaxation should be accompanied by a medium-term plan clarifying the long-term objectives of fiscal policy. In the euro area, member states should make full use of the existing room within the Stability and Growth Pact, in particular to increase public investment. In Japan and the United States, commitments to credible medium-term consolidation plans can create policy space in the short term. In countries where fiscal consolidation cannot be postponed, its pace and composition should be calibrated to reduce the short-term drag on economic activity.

A lasting solution to the debt overhang problem is not possible without higher medium-term growth. A sustained increase in growth of 1 percentage point could bring debt ratios in advanced economies to their precrisis levels within a decade. This underscores the need to accelerate structural reforms, including tax and expenditure policies that reinforce incentives to work and invest, and spur productivity growth.

If a significant decline in global growth materializes, a swift and bold multilateral policy response would be needed involving both demand and supply policies in the larger economies to help short-circuit the downward spiral of economic stagnation, low inflation, and rising public debt ratios. The policy package should be coordinated to generate positive spillover effects. It would also benefit other economies that cannot participate given market pressures, credibility challenges, or sustainability concerns.

In *China*, fiscal reforms should facilitate the rebalancing of growth by increasing on-budget support for household consumption while scaling down off-budget public investment. In *commodity exporters*, public spending has to be realigned with tighter resources. Nonetheless, the unavoidable adjustment can be made less painful by improving revenue diversification and cutting poorly targeted and wasteful spending, including

by reforming fuel subsidies. The availability of financial buffers and the intensity of market pressures will determine the pace of consolidation. Commodity exporters also need to devise long-term fiscal strategies to avoid procyclical fiscal policy and build sufficient savings to protect against the high volatility of revenues.

In *other emerging market and developing economies*, key challenges are to create budgetary room to respond to rising demand for public services, improve the provision of health and education, and develop infrastructure. These objectives can be achieved by implementing pro-growth structural reforms, better mobilizing revenue, and improving expenditure efficiency. Building capacity in the area of revenue mobilization is also essential for reaching the Sustainable Development Goals. In some oil importers with large fuel subsidies, windfall gains from lower oil prices could be used to finance growth-enhancing reforms.

### Reducing Vulnerabilities

The global financial crisis has exposed limitations in current fiscal risk management frameworks, which fail to effectively capture the nature of risks and do not offer specific measures to mitigate them. Countries should develop risk management strategies to reduce their exposure to risks and create adequate buffers to absorb them.

Fiscal frameworks of *emerging market and developing economies* need to adapt to a more volatile environment with possibly large shifts in commodity prices, capital flows, and exchange rates. Strong multiyear budget and debt management frameworks with effective commitment controls are crucial to enforcing discipline, guiding annual budgets, and dealing with unexpected shocks. *Oil exporters*, in particular, need to strengthen their fiscal frameworks to avoid procyclical fiscal policy, while generating adequate buffers to cope with the high volatility of fiscal revenue.

Comprehensive, reliable, and timely public reporting on the state of public finances can also reduce fiscal vulnerabilities by fostering more precautionary, informed, and accountable fiscal policy. In *China*, fiscal transparency could be enhanced by bringing on-budget more projects undertaken by local government financing vehicles and by continuing reforms to government accounting and financial reporting. In *emerging market and developing economies*, close monitoring of the rapid increase in corporate debt—which has quadrupled during the past decade—is warranted. Tax policy can complement macroprudential measures to limit excessive leverage.

### Fiscal Policies for Innovation and Growth

Productivity has moved to the top of the global policy agenda. The analysis in Chapter 2 shows that fiscal policy is a potent instrument for productivity growth through innovation. The analysis focuses on three channels of innovation: research and development (R&D), technology transfers, and entrepreneurship. The key policy messages are the following:

- *Governments in many countries should do more to promote R&D.* Private firms do not invest enough in R&D for two reasons. First, firms often find it difficult to finance these risky investment projects, especially during recessions. New analysis finds that fiscal policies that help stabilize output can effectively contribute to overcoming this problem. Second, R&D investments have beneficial effects for the wider economy as a result of knowledge spillovers. Firms do not take these effects into account in their decisions. If they did, R&D would be 40 percent higher than it currently is. Such an increase could lift GDP in individual economies by 5 percent in the long term—and globally by as much as 8 percent due to international spillovers. Fiscal policy can play an important role in promoting private R&D, for example, by providing subsidies and tax incentives. The design and implementation of these instruments are critical for their effectiveness. Best practices include payroll tax relief for researchers and refundable R&D tax credits.
  - *In emerging market and developing economies, governments should invest in education, infrastructure, and institutions* to facilitate imitation and absorption of technologies from advanced economies. Many countries sacrifice their tax base by granting costly tax incentives to lure foreign investment, but the evidence suggests that these incentives are not very effective.
  - *Fiscal policies to foster innovative entrepreneurship should be targeted to new firms rather than small firms.* High income tax rates exert only modest distortions to the entrepreneurial process. Yet innovation can be promoted by certain features in the design of taxes—in particular, generous provisions to offset taxable losses. To encourage entrepreneurship, many governments offer special tax incentives for small companies. However, these incentives are not cost-effective and can even discourage such firms from growing. It is more important to facilitate the entry of new firms, including by simplifying taxes.
- In sum, fiscal policies can contribute significantly to innovation. With appropriate design, they can generate a meaningful impact on productivity growth.