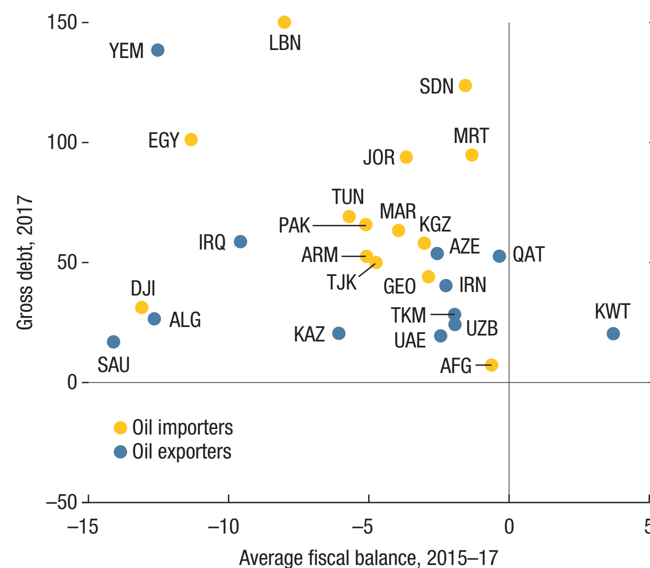
# 4. Fiscal Policy for Durable and Inclusive Growth in the Middle East and Central Asia

*Middle East and Central Asia policymakers face the challenge of boosting inclusive growth amid limited fiscal policy space. Further fiscal consolidation is needed across the region to secure debt and fiscal sustainability. While some adverse impact on growth may be unavoidable, the composition of adjustment can mitigate this impact. Currently, countries are adopting a mix of spending cuts and revenue-boosting measures that may not necessarily foster durable and inclusive growth. To ensure that future fiscal adjustment is as growth-friendly and equitable as possible, countries need to (1) rebalance the composition of expenditure toward growth-enhancing and high-quality capital investment, while fostering well-targeted social spending; and (2) move to a more progressive tax structure, diversify the revenue base, and eliminate distortions. Embedding the adjustment in a well-defined medium-term fiscal framework, coupled with greater fiscal transparency, would make fiscal consolidation more durable.*

**Figure 4.1. Fiscal Balance and Debt**
*(Percent of GDP)*




Sources: National authorities, and IMF staff calculations.
Note: Country abbreviations are International Organization Standardization (ISO) country codes.

## Why Is Fiscal Adjustment Necessary in the Middle East and Central Asia Countries?

The rapid accumulation of debt in recent years—exceeding 50 percent of GDP in nearly half the countries in the Middle East and Central Asia (Figure 4.1)—calls for further fiscal adjustment to put fiscal positions on a sounder footing (see Chapters 1–3). At the same time, some asset-rich oil-exporting countries in the region need further adjustment to ensure that the benefits of oil revenues are spread equitably across generations and to preserve long-term sustainability (see Chapter 1).[1]

The expected further tightening of global financial conditions makes the need for this adjustment even more urgent. This will mitigate the risk that rising financing costs crowd out other social and pro-growth spending, such as investment in physical and human capital. Creating space for pro-growth spending is also essential to address the demographic pressures from a rapidly expanding labor force and already high unemployment rates, especially for youth.

While the speed and optimal composition of the fiscal adjustment required varies among countries, the question is how such an adjustment can be designed to minimize the adverse impact on inclusive growth.

Against this backdrop, this chapter takes stock of the nature of fiscal adjustment in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) and the Caucasus and Central Asia

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[1]The intergenerational equity gap is the difference between the actual non-oil primary balance and the non-oil balance consistent with the Permanent Income Hypothesis.

(CCA) regions in recent years. It also discusses how future adjustment can be designed to support inclusive growth. The chapter concludes with policy recommendations.

## Growth-Friendly Fiscal Adjustment: Size and Composition Matter

Empirical studies on the assessment of fiscal multipliers confirm that public investment has a larger impact on growth and promotes more equal distribution of income than current spending or revenue (Bova and others 2013; Woo and others 2013).

Research also indicates that the success of fiscal adjustment, especially the growth response, depends on the quality and durability of the specific measures underpinning it. For instance, emerging market and developing economies with lower subsidies and transfers or higher revenues are more likely to sustain consolidations. Similarly, developing countries that cut selected current spending, while protecting capital spending, tend to experience longer-lasting benefits. For countries with low revenue-to-GDP ratios due to structural problems in their tax system (many emerging market and developing economies), revenue increases can also reinforce the duration of fiscal consolidation (Gupta, Clements, and Inchauste 2004; IMF 2010).

These findings suggest that fiscal adjustment programs that protect and enhance the quality of capital spending while reducing current expenditures (especially public wage bills or subsidies) or raising revenues would minimize the impact on growth and help make the gains more durable. Accompanying fiscal consolidation with measures to strengthen and simplify the tax system—by broadening the tax base and reducing exemptions—would not only improve revenue collection but also make revenue adjustment more equitable and efficient (see Table 4.1 in the Online Background Papers).

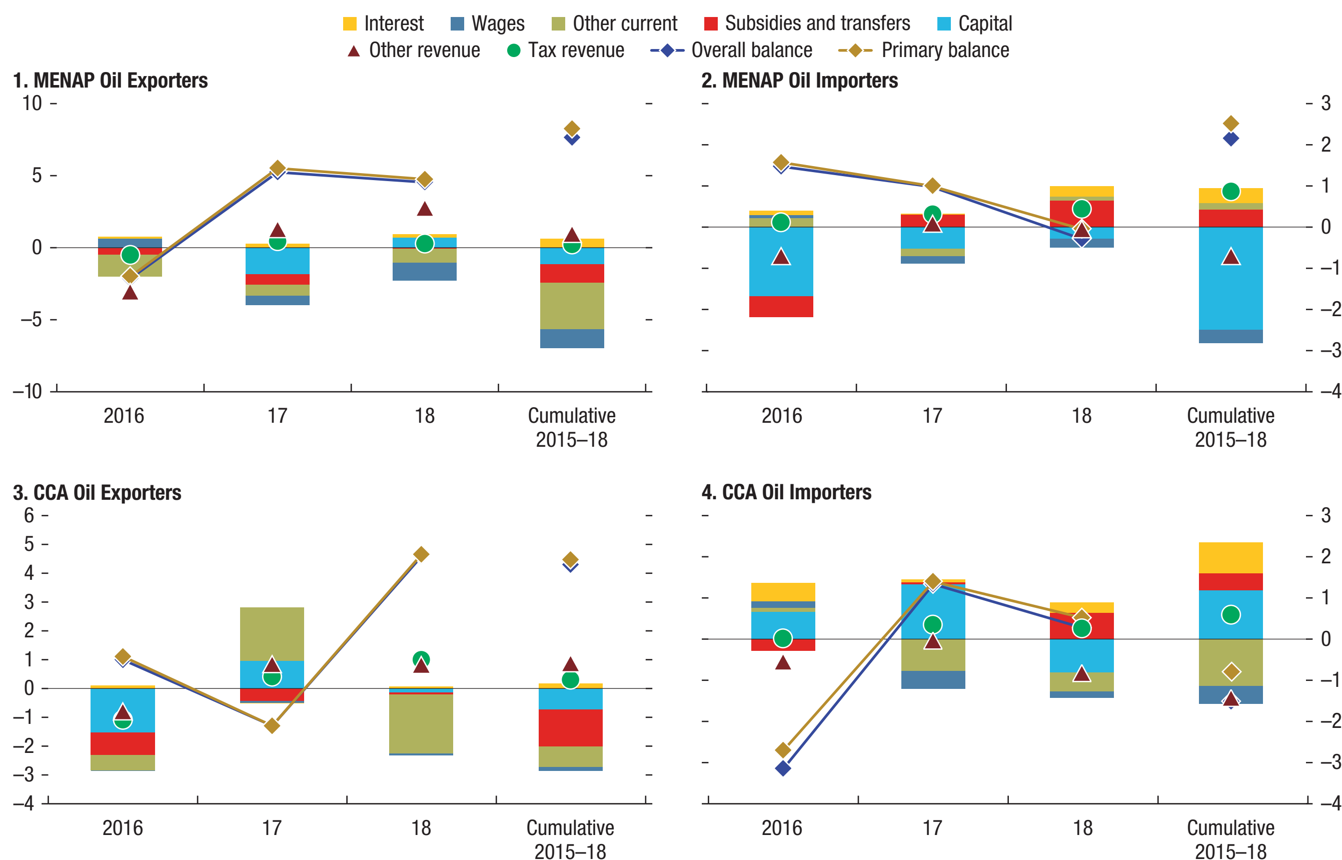
## What Has Been the Composition of Adjustment to Date?

On average, except for CCA oil importers, countries have improved their fiscal balances over 2015–18. However, the ways in which this has been achieved have differed through the years and across countries (Figure 4.2).

By end-2018, MENAP oil exporters are expected to see their primary and overall fiscal balances improve by, on average, nearly 9 percent and slightly more than 8 percent of GDP, respectively, relative to end-2015. This is equivalent to an improvement in their non-oil primary and non-oil overall fiscal balance of just under 8 percent and nearly 7 percent of non-oil GDP, respectively. While the recent recovery in oil revenue accounts for about 1 percent of this, most of the improvement (over 5 percent of GDP) is driven by a significant reduction in current spending. In particular, MENAP oil exporters are seeing the benefits of subsidy reform, with spending on subsidies reduced while capital expenditure protected, which has only been cut by 1 percent of GDP. In contrast, to date, tax revenues have only delivered 0.3 percent of GDP of the improvement. The impact of the rising debt burden and tighter financial conditions has led to a notable increase in interest expenditure (0.6 percent of GDP), absorbing about half of the improvements in revenues.

The pattern of adjustment in CCA oil exporters has been similar to that of MENAP oil exporters. Cuts in current expenditure have delivered the bulk of the adjustment—2 percent of the 4 percent of GDP adjustment (or an improvement of about 3.5 percent in the non-oil fiscal balance relative to non-oil GDP), with the underlying primary balance improving by an additional 0.2 percent of GDP (or 0.3 percent of non-oil GDP). Cuts in subsidies and transfers account for more than 1 percentage point of the adjustment, while cuts in the public wage bill represent a relatively smaller contribution of under 0.3 percent of GDP that is completely absorbed by higher interest payments. Similar to MENAP

**Figure 4.2. Changes in Government Spending and Revenues in MENAP and CCA**
*(Percent of GDP, change from prior year, simple averages)*




Sources: National authorities; and IMF staff calculations.
Note: Other revenue includes non-tax revenues and grants. MENAP oil exporters excludes Libya, Syria, and Yemen. CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

oil exporters, the savings secured on current expenditure have facilitated a relatively smaller adjustment in capital expenditure—of 0.7 percent of GDP. Again, to date, tax revenues have played a relatively small role in the adjustment, increasing by 0.3 percent of GDP during this period.

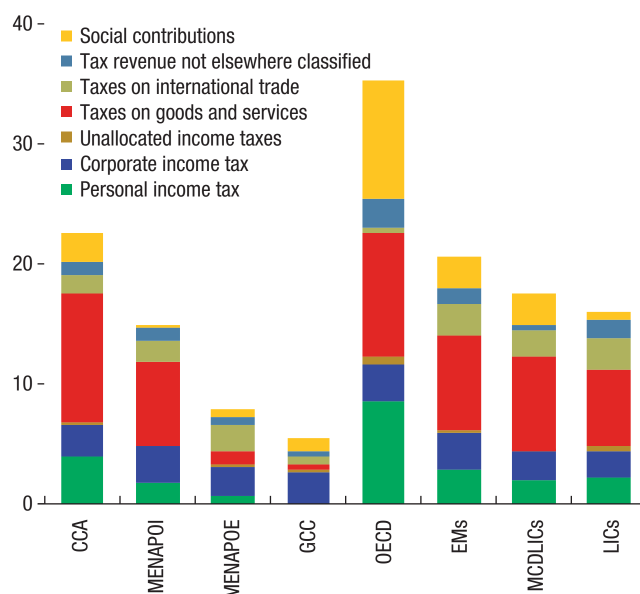
MENAP oil importers improved their overall fiscal balances by slightly more than 2 percent of GDP on average. However, the composition of adjustment has been very different from that of oil exporters. Tax reforms have made an important contribution to this adjustment—accounting for more than 1 percentage point of GDP—although these efforts were offset by a decline in other revenues. In addition, spending on subsidies and transfers dropped significantly in 2016, only to increase again with the recent increase in oil prices. This episode illustrates how gains can be short-lived in the absence of complete reform. Finally, while progress has been made on cutting public wage bills, these improvements were again offset by higher debt-servicing costs and higher subsidies. Consequently, current expenditure has actually increased by 0.3 percent of GDP relative to 2015, and the burden of adjustment has fallen on capital expenditure, which dropped by 2.5 percent of GDP.

In contrast to other countries, the fiscal balance of CCA oil importers has widened over 2015–18. Important savings have been generated through cuts in the public wage bill (0.3 percent of GDP) and other current spending (0.8 percent of GDP),

as well as through extra tax revenues mobilized (0.7 percent of GDP). However, higher interest payments (0.5 percent of GDP) and increased subsidies and transfers (0.4 percent of GDP) mean that current expenditure has only narrowed by 0.3 percent of GDP. At the same time, capital expenditure has increased by 0.7 percent of GDP. Combined with a decline in other revenues (1.3 percent of GDP), this has resulted in an accumulation of new debt over the period.

Overall, oil exporters appear to have undertaken a relatively more growth-friendly fiscal adjustment. This shows the importance of completing energy subsidy reforms and further reducing public wage bills to strengthen the durability of fiscal adjustment and to facilitate greater spending on public investment (Sdralevich and others 2014; Tamirisa and Duenwald 2018).

**Figure 4.3. Composition of Selected Taxation Items in 2017**
*(Averages, percent of GDP)*




Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; EM = emerging market economies; GCC = Gulf Cooperation Council; LIC = low-income countries; MENAP = Middle East, North Africa, Afghanistan, and Pakistan, and Pakistan; OE = oil exporters; OI = oil importers. MENAPOE excludes Libya, Syria, and Yemen.

## What More Is Needed? Fiscal Policy Design for Inclusive Growth

Even if consolidation efforts go as planned in 2018, debt will remain very high in a number of countries. In particular, debt in Bahrain, Egypt, Jordan, Lebanon, Mauritania, Morocco, Pakistan, Sudan, and Tunisia will remain above the 60 percent vulnerability threshold for emerging market economies. The importance of addressing the debt burden is also illustrated by the significant gains from fiscal adjustment being lost through rising interest payments. Accordingly, going forward, a significant fiscal adjustment is still needed.

To avoid myopic thinking and to prevent slippages, this adjustment should be grounded in a medium-term fiscal framework.[2] For instance, in oil exporters, a fiscal anchor independent of oil price fluctuations (for example, the non-oil primary balance) would be particularly important for guiding policy decisions and managing the inherent fiscal procyclicality in such economies. Multi-year budgeting, the use of explicit fiscal rules, and enhanced expenditure controls over line ministries would help ensure that fiscal policy is consistent with longer-term policy objectives, such as debt sustainability and intergenerational equity (see the April 2015 *Fiscal Monitor*). At the same time, the composition of adjustment should be carefully designed to minimize the potential negative impact on growth.

### Increasing the Role of Revenue Reforms

Although there is still likely to be scope for further adjustment on the expenditure side, shifting some of the burden to enhancing revenues is warranted going forward. Indeed, total tax revenue collection in the MENAP region is significantly less than in other emerging market economies (Figure 4.3). The largest discrepancy is for oil exporters, where non-oil tax revenues represent less than 10 percent

[2]To support higher growth, fiscal policy should be well coordinated with other macroeconomic policies (including monetary and exchange rate policies).

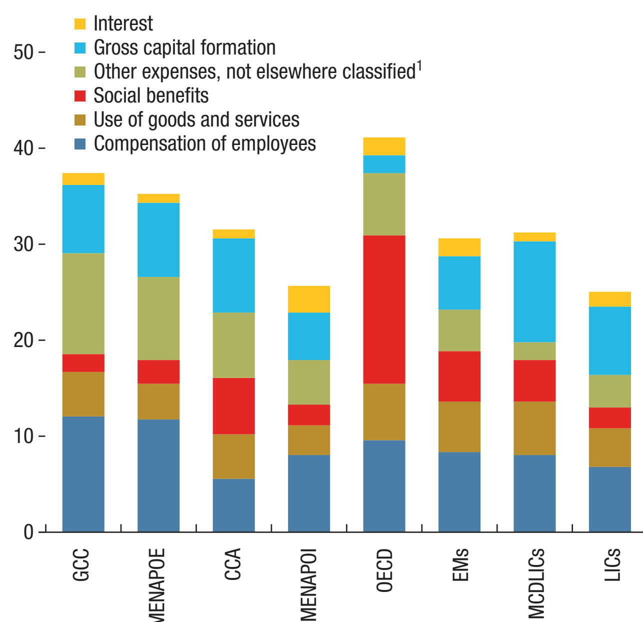
of GDP, against more than 20 percent of GDP in emerging market economies.

Overall, and in line with other emerging market economies, consumption-based taxes (including the value-added tax—VAT) provide the broadest source of tax revenues in most of the region—61 percent of taxes in the CCA and 49 percent in MENAP oil-importing countries (46 percent in emerging market economies). The exception is the MENAP oil-exporting countries where, as of 2017, consumption-based taxes contributed only 17 percent of total tax revenues. In this context, the recent introduction of the VAT and excise taxes in some Gulf Cooperation Council (GCC) countries is welcome and should be completed in the remaining countries as soon as feasible.

The relative roles of personal and corporate income taxes differ more widely across the region. In emerging market economies, the contribution across personal and corporate income taxes is broadly balanced, with both contributing 17 percent to total tax revenues. In contrast, there is a heavier burden on personal income taxes in the CCA (22 percent) relative to corporate taxes (15 percent), while the reverse is true in MENAP oil-importing countries (14 percent through personal income taxes and 21 percent through corporate income taxes).

This difference is even more pronounced in MENAP oil exporters, especially in the GCC, where there is no personal income tax. In these countries, although the level of income tax collection is relatively small, corporate taxes bear most of the burden (35 percent for MENAP oil-exporters overall, and 62 percent in the GCC). The GCC is also notable for its reliance on other taxes, including items such as fees and stamp duties, which account for 17 percent of total tax revenues in the GCC countries, compared to 10 percent in emerging market economies. Against this backdrop, gradually introducing personal income taxes in GCC countries would provide an opportunity to reduce or remove these more regressive and administratively costly fees and stamp duties (for example, user-based fees

**Figure 4.4. Composition of Selected Expenditure Items in 2017**
*(Averages, percent of GDP)*




Sources: National authorities, and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; EM = emerging market economies; GCC = Gulf Cooperation Council; LIC = low-income countries; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OECD = Organisation of Economic Co-operation and Development; OI = oil importers. MENAPOE excludes Libya, Syria, and Yemen.
[1]Other expenses include defense, consumption of fixed capital, subsidies, grants, and other expenses. MENAPOE excludes Libya, Syria, and Yemen.

on government services) (IMF 2015a, 2016) and bring the balance of the tax burden more in line with other countries.

The other notable area where MENAP countries differ from other emerging market economies is social contributions, which account for approximately 4 percent of total tax revenues across the region, compared to 16 percent for emerging market economies. This likely reflects a large informal sector, but could also indicate weak administrative capacity. In contrast, the collection of social contributions in the CCA is similar to emerging market economies. Mirroring this, spending on social benefits is also notably lower in MENAP countries than emerging market economies (Figure 4.4), but is much more comparable with countries in the CCA. This suggests that finding ways to increase social

contributions in MENAP countries, such as by encouraging an increase in the formality of the economy, strengthening tax administration, or decoupling social contributions from wage earnings, would help broaden the financing and increase the scope to spend on social benefits.

Tax reforms vary by their very nature, involve trade-offs between growth, government revenue, and equity, and can be painful in the short term because they require changes in the social contract between governments and citizens. Analyzing the welfare and macroeconomic effects of fundamental tax reforms indicates that a broad-based package of reforms, coupled with improved social safety nets, could provide a better outcome than more partial measures (Box 4.1).

## Room to Simplify the Tax System and Remove Distortions

There seems to be significant scope to further reduce exemptions, improve the progressivity of the tax structure, and broaden the tax base. This would not just make a significant contribution to the needed fiscal adjustment effort but also help make it more equitable, efficient, and growth-friendly.

Reducing exemptions would make the tax regime simpler and less complex, by reducing administrative costs and minimizing the scope for tax avoidance (Mansour 2015).[3] For instance, widespread corporate tax exemptions (especially in the GCC, where corporate tax for the most part applies to foreign-owned firms but not to domestic firms) lead to fiscal losses, make the system more complex, and create a bias in favor of large corporations over small and medium enterprises that are pivotal for growth and job creation (Box 4.1; see also Jewell and others 2015). The equity implications of VAT exemptions on consumer goods should be carefully considered to ensure that well-off consumers do not benefit more than the poor.

The tax systems of most countries in MENAP rely overwhelmingly on regressive indirect taxes (Alvaredo, Assouad, and Piketty, 2017). Introducing or increasing taxes on the wealthier segment of the population (property, inheritance, capital gains, dividends, interest), would help make tax systems more progressive and fair (see Table 4.1 in the Online Background Papers). In particular, in countries where introducing personal income tax may not be feasible in the short run, taxes that target the wealthy could provide a partial substitute (Jewell and others 2015).

Reducing the complexity of the tax system (exemptions, income brackets) in countries with limited tax administration capacity and large informal sectors would also make implementation simpler, enhance compliance, and reduce a key impediment to greater revenue mobilization. Personal income tax regimes with multiple income brackets, while more progressive, are not practical in the absence of well-functioning tax administration, as this can generate incentives for informality, underreporting, and tax avoidance.

While because of these exemptions and distortions, tax expenditures in the region can be large (Jewell and others 2015), very few countries undertake a comprehensive inventory of special tax arrangements and explicitly assess the related fiscal costs. This process, when properly implemented, enhances transparency and accountability but also fosters the rationalization of tax codes and fiscal provisions. In this area, Morocco has led the way, by including an annex on tax expenditures with the annual budget law since 2006. According to the Moroccan tax expenditure report annexed to the country's 2018 budget law, partial and total fiscal exemptions stood above 3 percent of GDP in 2017. Djibouti is also making progress and is expected to publish a report on exemptions and special tax regimes with the 2019 budget law. A 2014 study for Jordan indicates that tax expenditures were estimated at 11.4 percent

[3]Tax incentives in the form of tax holidays have contributed to lower corporate income tax yields, while setting up free economic zones with minimal taxation have led to the creation of dual economies with minimal linkages in some countries. Similarly, differentiated sectoral taxation has made tax regimes very complex and provided incentives for tax avoidance, leading to revenue erosion.

of GDP (Heredia-Ortiz and Timofeev 2016), confirming that such expenditures are large.

## Expenditure Reforms

A comparison of spending across the region provides some insight into the potential priorities for more sustained expenditure reforms. In 2017, expenditure as a share of GDP in the region stood at almost 38 percent, compared with 31 percent in other emerging market economies (Figure 4.4). While spending levels are broadly comparable on aggregate with other emerging market economies, spending in the GCC tends to be substantially higher (IMF 2017a).

On average, for MENAP oil exporters, while capital spending and spending on goods and services are broadly comparable with other emerging market economies, public wage bills and other expenses, including subsidies and transfers, are larger. This suggests that, despite recent efforts, streamlining public-sector wage bills should continue to be a priority (Tamirisa and Duenwald 2018). Reforming public compensation in the GCC could also improve the incentives for nationals to take employment in the private sector, which would foster private-sector growth and economic diversification (see Chapter 5; see also Behar and Mok 2013).

In MENAP oil importers spending on the public wage bill is similar to other emerging market economies. However, on average, capital spending—which has the highest multiplier—is lower, at a time many countries need infrastructure upgrading. As discussed earlier, capital expenditure has also borne most of the burden of adjustment so far, suggesting that finding ways to increase capital spending within the current fiscal envelope should be a priority. Again, the importance of reducing the debt burden is highlighted by the relatively high debt service costs compared to emerging market economies.

For countries in the CCA, while the compensation of employees is relatively low compared to other emerging market economies, and while capital expenditure marginally higher, the scale of spending on other categories, such as transfers to state-owned enterprises (SOEs) is more of a concern, particularly since many SOEs are incurring losses, rather than contributing to growth.[4] This suggests that reforms focused on enhancing the governance and profitability of SOEs and on limiting budget transfers may be most beneficial. More broadly, scaling back the role of SOEs in the economy by transferring these activities to the private sector may be more economically efficient and boost private sector growth (see Chapter 5).

For low-income countries in the region, as is the case of low-income countries worldwide, expenditure is dominated by capital spending, particularly to address large infrastructure gaps (especially in Djibouti and Mauritania). However, spending on goods and services and public wage bills are relatively high. This suggests that there is scope for expenditure rationalization.

Other expenditures are relatively large in the MENAP region compared to emerging market economies. For instance, these expenditures account for 35 percent of total spending in the GCC (or 10 percent of GDP), about twice as much as in emerging market economies. Given the burden of conflict in the region, this partly reflects relatively large defense spending.[5] This is a further indication of the economic costs of conflict (see Box 1.1 in Chapter 1) and highlights the potential benefits of securing greater stability in the region.

## Ensuring the Quality of Spending

Regardless of the scale of spending, the quality of spending is also important, especially where resources are constrained. Where countries still face a large infrastructure gap, higher spending is justified (Albino-War and others 2014).

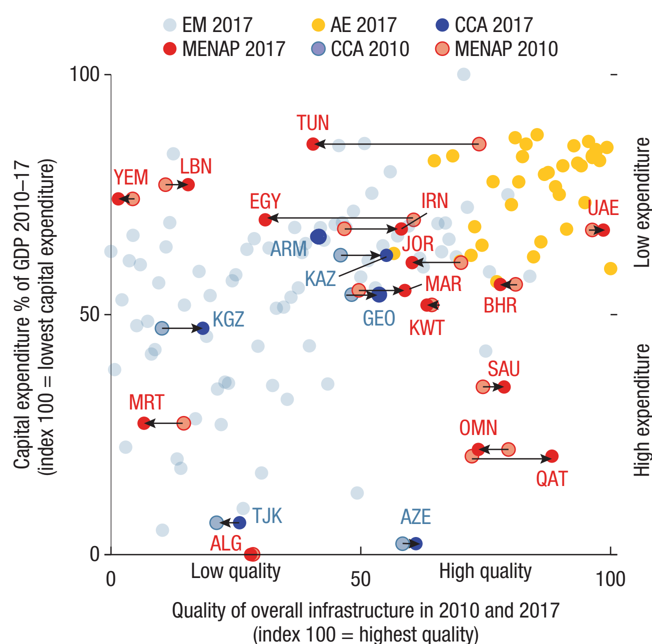
[4]Transfers to SOEs is also an issue in some MENAP countries.

[5]For instance, countries in the MENAP region spend about 5 percent of GDP on average on military expenditure, compared to about 3 percent in the CCA and about 1.6 percent in other emerging market and developing economies. See the Stockholm International Peace Research Institute's Military Expenditure Database at https://www.sipri.org/databases/milex.

However, where the quality of infrastructure remains relatively low despite relatively high public investment, close attention needs to be paid to the public investment management framework, including project appraisal, selection, and evaluation, to ensure additional capital expenditure is truly productive (Figure 4.5). Overall, stronger public investment management frameworks will ensure not only better use of resources and value to the taxpayer, but also promote growth.

Similarly, spending on education and health care, which has been shown to promote long-term growth and lower inequality by benefitting the poor (Dollar and Kraay 2002), is not delivering quality outcomes. For instance, even in countries where this spending is in line with international peers, it has not translated into high educational attainment and health outcomes, with most countries falling below the estimated health and education efficiency frontiers (Figure 4.6; see also Tamirisa and Duenwald 2018).

**Figure 4.5. Infrastructure Quality and Capital Expenditure in 2010–17**
*(Index)*



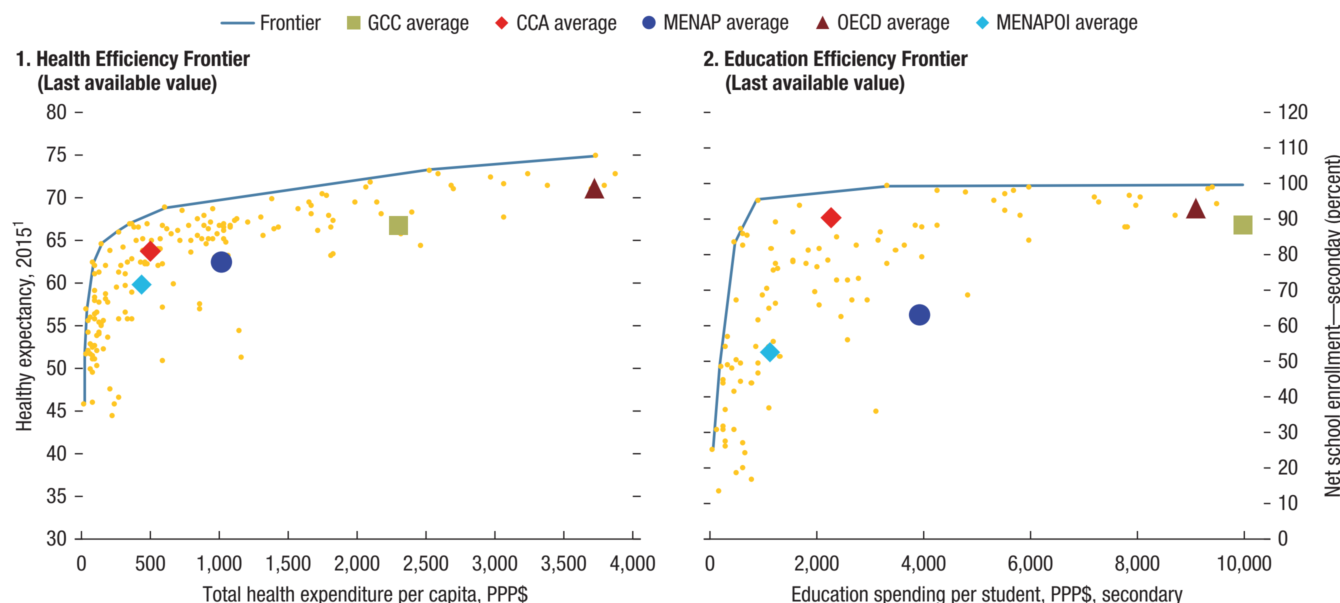

Sources: National authorities; World Economic Forum; and IMF staff estimates.
Note: Infrastructure quality is an index constructed using the rank from the 2nd pillar: infrastructure from the Global Competitiveness Index 2017–18.
AE = advanced economies; EM = emerging market economies; CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan. Country abbreviations are International Organization for Standardization (ISO) country codes.

## Transfers and Subsidy Reforms for Fairness and Efficiency

Completing subsidy reform would help build and preserve fiscal buffers, increase the durability of adjustment, remove market distortions, free up budget resources for social spending, and reduce overconsumption and overproduction (energy, water, agriculture). Most subsidies are also highly regressive—for instance, distorted tariff structures for water and electricity benefit the rich, while the poor suffer from lack of access (Sdralevich and others 2014; IMF 2015b). In oil-exporting countries, fuel subsidies promote capital- and energy-intensive industries at the expense of labor-intensive industries that could provide jobs for the rapidly growing workforce. Some studies suggest that the elimination of fuel subsidies across the MENAP region would save about 2 percent of GDP and allow for a 40 percent increase in social protection spending (IMF 2015b; 2017b).

As noted above, some countries have made important progress in reducing subsidies, especially fuel subsides, and, consequently, in improving their fiscal resilience. In parallel, to enhance the equity of reform and support growth, some countries (Egypt, Jordan, Pakistan, Oman, Saudi Arabia) have coupled subsidy reforms with strengthening targeted social safety nets. It is notable that the level of social spending is relatively low across the MENAP region. In contrast, social spending in the CCA is comparable with other emerging market economies, reflecting higher social contributions. This supports the observed improvements in inequality in the CCA region (see Chapter 3).

**Figure 4.6. Social Spending Efficiency**




Sources: IMF Fiscal Affairs Department (FAD); Expenditure Assessment Tool (EAT); World Bank; and World Health Organization.
Note: CCA = Caucasus and Central Asia; GCC = Gulf Cooperation Council; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OECD = Organisation of Economic Co-operation and Development; OI = oil importers; PPP$ = purchasing power parity dollars.
[1]Healthy life expectancy (HALE) is a measure of health expectancy that applies disability weights to health states to compute the equivalent number of years of life expected to be lived in full health.

## Transparency and Accountability in Fiscal Policy

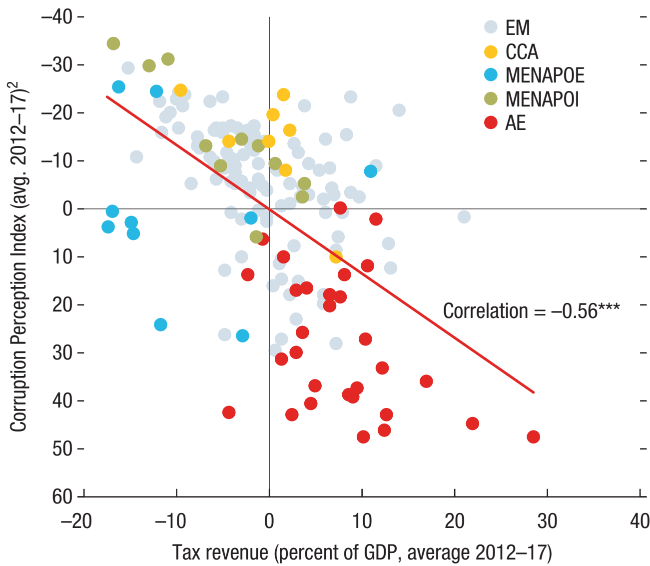
Increased transparency facilitates greater public accountability not only by supporting spending controls and fiscal discipline (Benito and Bastida, 2009) but also by reducing the scope for corruption, misappropriation of public resources, and boosting tax revenues (Figure 4.7; see also the October 2013 *Fiscal Monitor*; Cimpoeru and Cimpoeru 2015; and Brusca, Manes Rossi, and Aversano 2017).

Countries in the region are making important progress in reducing corruption and strengthening government transparency and accountability. Tunisia has recently moved forward in modernizing and strengthening anti-corruption institutions to help curb fraud and improve the compliance culture of taxpayers. Afghanistan and Iran have made significant progress in improving government transparency by publishing and disseminating detailed budget data in 2018 for the first time. The adoption of new procurement laws in Egypt and Saudi Arabia will increase the transparency of public procurement and enhance public oversight. This will help increase the efficiency of public expenditure and improve fairness in the selection process, both of which will support growth.

Better perceptions of government accountability can also help reduce the cost of borrowing for both the sovereign and the private sector, further boosting investment and growth (see Chapter 5). By ensuring better management of public funds, this reduces the probability of default, thereby lowering the risk premium. Kemoe and Zhan (2018) find that the openness of the budget process, fiscal data transparency, and accountability of fiscal actors reduce sovereign interest rate spreads and increases foreign holdings of sovereign debt.

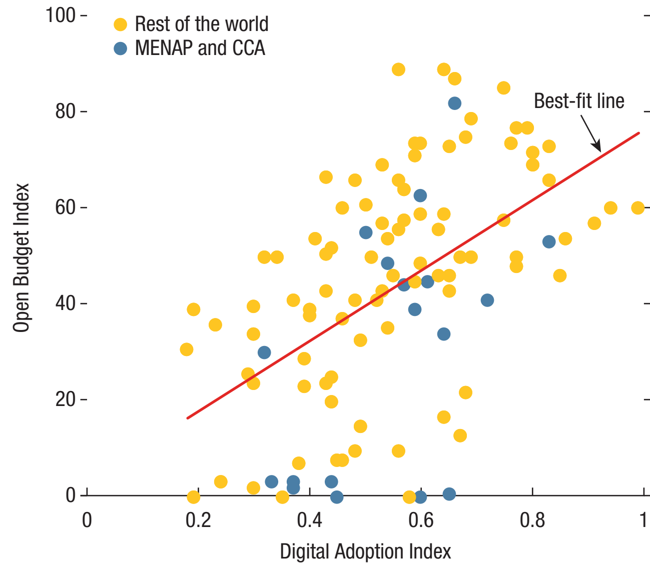
Digitalization can play a major role in fostering openness and transparency (Figure 4.8; see also Bertot, Jaeger, and Grimes 2010), lowering

**Figure 4.7. Corruption and Tax Revenues[1]**
*(Average 2012–17)*




Sources: National authorities; Transparency International; and IMF staff estimates.
Note: AE = advanced economies; CCA = Caucasus and Central Asia; EM = emerging market economies; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.
[1]Variables are deviations from values predicted by income level.
[2]Large numbers indicate lower perceived levels of public sector corruption. The correlation is significant at the 1 percent.

**Figure 4.8. Digital Adoption Index by Governments 2016 and Open Budget Index, 2017**
*(Index, 0 is the least and 1 is the most adoption and 100 the most open budget)*




Sources: World Bank, *World Development Report 2016*; and International Budget Partnership.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan.

administrative costs, improving indirect tax collection (see the October 2018 *Fiscal Monitor*), and ensuring better targeting of expenditure. Bahrain, Kazakhstan, and the United Arab Emirates rank as top performers on the United Nations e-government development index. Together with Morocco, Oman, Tunisia, and Uzbekistan, these countries also perform particularly well on the United Nations e-participation index, which measures access to information and public services and participation in policymaking.

Finally, a comprehensive approach to governance and corruption that encompasses areas outside the direct scope of fiscal governance can generate substantial dividends. For instance, simplifying regulations can both improve the business environment and preserve revenues by limiting or reducing tax exemptions.

## Policy Recommendations

Most countries in the Middle East and Central Asia need to undertake further fiscal adjustment. While the size and speed of fiscal adjustment depends on each country's unique circumstances, there appears to be scope to make such adjustments more growth-friendly and equitable. Some of the key priorities going forward include the following:

- There is room to increase the contribution of revenue reforms to the adjustment effort. MENAP oil importers should focus on rebalancing direct and indirect taxation, including gradually increasing the contribution of personal income taxes to revenues. Introducing or increasing taxes on the wealthier segments of the population in MENAP oil exporters would also improve the progressivity of the tax system. For CCA countries, there is scope to raise the

contribution of corporate taxes to revenues, in line with personal income taxes.

- All countries should undertake a regular and detailed evaluation of the revenue and efficiency losses associated with tax exemptions.
- Reducing the complexity of tax systems in countries with limited tax administration capacity and large informal sectors (MENAP oil importers) would simplify collections and promote greater revenue mobilization.
- Reducing informality in the economy may increase social contributions and allow for greater social spending in the MENAP region.
- On the expenditure side, all countries should focus on strengthening public investment management frameworks to ensure the quality of public investment.
- There is further scope to streamline spending on the public wage bill in MENAP countries, in particular the GCC countries, coupled with structural reforms to ensure a durable adjustment.
- MENAP oil-importing countries should focus on completing energy subsidy reforms to augment benefits of other fiscal reforms.
- Strengthening the governance of SOEs would also help contain spending on subsidies and transfers, especially in the CCA.
- Low-income countries in the region should explore the scope to scale back current expenditure in order to secure fiscal space to maintain needed public investment.

Overall, fiscal adjustments need to be guided by strong medium-term fiscal frameworks and operationalized by multi-year budgeting and credible fiscal targets. Strengthening fiscal institutions and modernizing public financial management frameworks could help enhance the credibility of fiscal adjustment programs.

Transparency and accountability should go hand in hand with fiscal adjustment measures. Strengthening audit institutions and anti-corruption agencies could help bolster growth and preserve fiscal resources. To build public support and increase the durability of reform, country authorities should consult with key stakeholders on the design of adjustment programs and communicate transparently with the public.

### Box 4.1. Getting the Balance Right: Revenue Reforms for Growth and Equity

A tax reform package implies a complex trade-off between growth, government revenue, and equity. A comprehensive approach associated with better targeted social programs, broadens the tax base, removes tax distortions, better distributes the tax burden, and mitigates adverse distributional effects (that is, improves welfare) by making the tax system more progressive and reducing inequalities.

The welfare and macroeconomic effects of fundamental tax reforms can be assessed using a dynamic stochastic general equilibrium model. The general model presented here has been designed to match the characteristics of emerging markets and developing economies and represents a closed economy with households composed of four types of workers: informal sector workers, formal manufacturing and service workers, rural workers, and entrepreneurs. The economy produces three goods: food, manufacturing, and informal services. The large number of households and products allows the model to capture elements of a complex tax system—in particular, allowing for differential tax rates for value-added taxes (VAT), personal income taxes, and corporate income taxes. Tax reforms change the marginal costs/benefits of economic agents (for instance, marginal utility, relative prices), which triggers a reallocation of consumption and production factors, and ultimately affects growth, tax revenue, and welfare. The model has been calibrated to oil-importing countries in the Middle East and Central Asia region.

The impact of a range of tax reforms has been simulated. For instance, model simulations indicate that a marginal increase of 1 percent in the VAT rate would raise government revenue by an average of 0.7 percent. However, given the relatively high share of food in the consumer basket in the region, the incidence of this increased VAT rate has different effects on household's welfare and on GDP. Specifically, if the VAT is increased on manufactured goods, consumers switch consumption towards more food and services, and firms respond to this extra demand (generating extra employment for workers) thereby increasing profits for entrepreneurs. Overall, this results in an increase in GDP of 0.13 percent. In contrast, if the VAT is increased on food, there is less scope for consumers to switch consumption and overall demand falls resulting in a decline in profits and a 0.03 percent decline in GDP. With food consumption relatively inelastic and no increase in production by firms, workers are relatively worse off under the second scenario. Note that a well-targeted social safety net could mitigate the adverse effects of a VAT increase on workers, but at the expense of reduced revenue yield.

In contrast, a scenario in which corporate income taxes are reduced (to support growth) and all tax exemptions are also minimized (to broaden the tax base and make it more inclusive), would boost both government revenue and output. In this case, a 1 percent decrease in both corporate income taxes rates and exemptions would increase output by an average of 0.6 percent and government revenue by 0.4 percent in the long-run. While some households would be negatively affected by the loss of VAT exemptions, overall, this mix of fewer tax exemptions and lower corporate income taxes would increase profits for entrepreneurs. Again, depending on the design of the policy, a well targeted social safety net could mitigate some of the negative effects on workers from the loss of VAT exemptions.

More broadly, Figure 4.1.1 shows that a comprehensive reform package yields better outcomes (represented by the blue area in the figure) than a partial reform. Such a comprehensive package combines: (1) increasing VAT rates, (2) reducing tax exemptions, (3) raising property taxes, (4) lowering corporate tax rates, and (5) strengthening safety nets, (more specifically, better targeting transfers to rural households).

Applying this simulation to a specific country context shows that, for instance, the impact of the comprehensive reform package planned in Morocco could raise government revenue by 1.5 percent of GDP, and boost GDP by about 1 percent over the long term. In this case, the reform package is aimed at making

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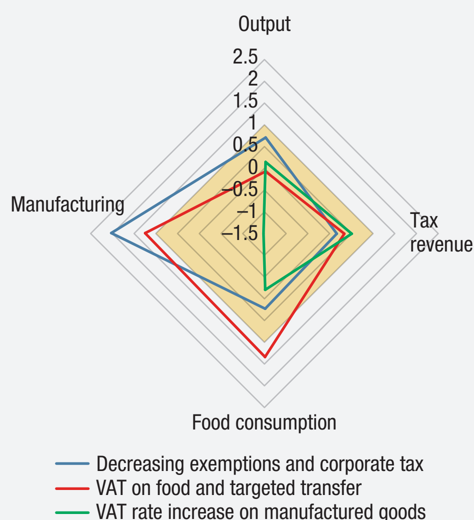
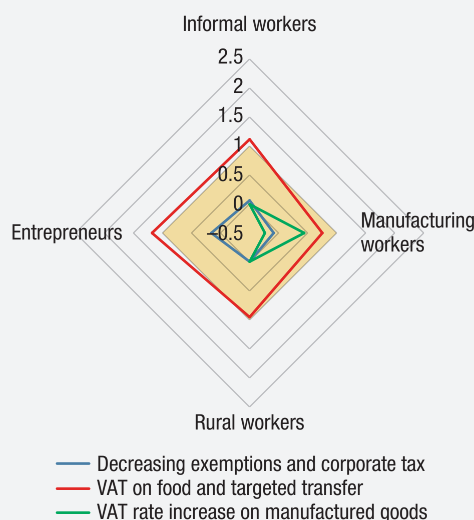
**Box 4.1** *(continued)*

**Figure 4.1.1. Model Simulation Results**

**1. Change in Macroeconomic Aggregates Relative to Comprehensive Scenario (Comprehensive scenario = 1)**




**2. Change in Household Welfare Relative to Comprehensive Scenario (Comprehensive scenario = 1)**




Source: IMF staff calculations.
Note: The outcome of the comprehensive reform scenario on key factors is normalized to 1 and represented by the blue area in the figure. For individual tax reform scenarios, the impact is shown relative to this comprehensive reform scenario, with better outcomes shown as greater than 1. VAT = value-added tax.

the tax system more equitable and supportive of competitiveness. It includes plans to align the VAT on manufactured goods and services with the standard VAT rate, reduce tax exemptions while reducing and simplifying corporate tax rates, raise property taxes, and better target social programs (IMF 2018).

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