CHAPTER 1

RECENT FISCAL DEVELOPMENTS AND OUTLOOK

Advanced Economies: Proceeding with Consolidation while Supporting Employment and Growth

Fiscal efforts over the last five years have stabilized the average government debt-to-GDP ratio, albeit at a high level. Immediate pressures on public finances have eased with lower interest rates, but historically high debt ratios and a vacillating recovery, combined with looming pension and health costs, keep risks elevated.

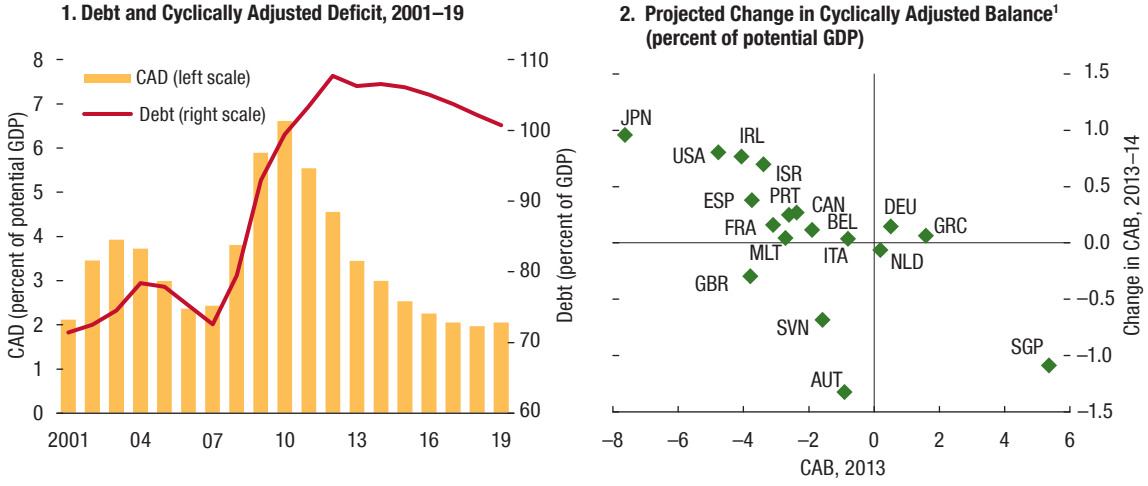
Fiscal Consolidation Is Proceeding According to Plans

The pace of fiscal consolidation in advanced economies is slowing in 2014, as expected, as many countries seek to balance deficit reduction objectives and support to a still uneven recovery. The average fiscal effort, measured by the change in the cyclically adjusted balance, is projected at 0.4 percentage point of potential GDP, compared to an annual average effort of about 1 percentage point over 2011–13 (Figure 1.1, panel 1; Tables 1.1a, 1.1b, and 1.2). Overall, revisions to the 2014–15 fiscal projections from the April 2014 *Fiscal Monitor* are relatively small and, in most cases, reflect changes in growth and inflation projections rather than discretionary policy changes.

Across high-debt countries, the adjustment effort is broadly proportional to the current level of the cyclically adjusted deficit (Figure 1.1, panel 2).

- *Ireland*, *Japan*, and the *United States* will see sizeable adjustment in 2014 (between ¾ and 1 percentage point of potential GDP). In Japan, the increase in the consumption tax rate should reduce the budget deficit by about 0.6 percentage point of GDP and contribute to a reduction in fiscal risks. In the United States, most of the adjustment reflects the expiration of exceptional unemployment benefits and depreciation allowances in early 2014. In Ireland, deficit reduction is driven by revenue buoyancy and reduced demand

Figure 1.1. Fiscal Trends in Advanced Economies



Source: IMF staff estimates and projections.
Note: For country-specific details, see Data and Conventions and Table A in the Statistical and Methodological Appendix. CAB = cyclically adjusted balance; CAD = cyclically adjusted deficit.
[1] For cross-country comparability, expenditure and fiscal balances of the United States are adjusted to exclude the imputed interest on unfunded pension liabilities and the imputed compensation of employees, which is counted as expenditure under the 2008 System of National Accounts (2008 SNA) recently adopted by the United States, but not so in countries that have not yet adopted the 2008 SNA. Data for the United States may thus differ from data published by the U.S. Bureau of Economic Analysis. See Box 1.1 in the April 2014 *Fiscal Monitor* for details.

Table 1.1a. Fiscal Balances, 2008–15: Overall Balance

(Percent of GDP)

							Projections		Difference from April 2014 *Fiscal Monitor*		
	2008	2009	2010	2011	2012	2013	2014	2015	2013	2014	2015
World[1,3]	–2.2	–7.3	–6.0	–4.3	–3.9	–3.2	–3.2	–2.7	. . .	. . .	. . .
Advanced Economies[1]	–3.6	–9.0	–7.8	–6.5	–5.8	–4.3	–3.9	–3.1	. . .	. . .	. . .
United States[1]	–7.0	–13.5	–11.3	–9.9	–8.6	–5.8	–5.5	–4.3	. . .	. . .	. . .
Euro Area	–2.1	–6.3	–6.2	–4.1	–3.7	–3.0	–2.9	–2.5	–0.1	–0.3	–0.4
France	–3.2	–7.2	–6.8	–5.1	–4.9	–4.2	–4.4	–4.3	0.0	–0.7	–1.3
Germany	–0.1	–3.1	–4.2	–0.8	0.1	0.2	0.3	0.2	0.2	0.3	0.3
Greece	–9.9	–15.6	–11.0	–9.6	–6.4	–3.2	–2.7	–1.9	–0.6	0.0	0.0
Ireland[2]	–7.1	–13.2	–29.3	–12.5	–7.8	–6.7	–4.2	–2.8	0.7	0.9	0.2
Italy	–2.7	–5.4	–4.4	–3.6	–2.9	–3.0	–3.0	–2.3	0.0	–0.3	–0.5
Portugal	–3.7	–10.2	–9.9	–4.3	–6.5	–5.0	–4.0	–2.5	–0.1	0.0	0.0
Spain[2]	–4.5	–11.1	–9.6	–9.6	–10.6	–7.1	–5.7	–4.7	0.1	0.2	0.2
Japan	–4.1	–10.4	–9.3	–9.8	–8.7	–8.2	–7.1	–5.8	0.2	0.1	0.6
United Kingdom	–5.0	–11.3	–10.0	–7.8	–8.0	–5.8	–5.3	–4.1	0.0	0.0	0.0
Canada	–0.3	–4.5	–4.9	–3.7	–3.4	–3.0	–2.6	–2.1	0.0	–0.1	–0.1
Others	2.5	–0.9	–0.2	0.4	0.4	0.1	0.1	0.4	–0.1	–0.3	–0.2
Emerging Market and Middle-Income Economies[3]	0.9	–3.7	–2.4	–0.6	–0.7	–1.5	–1.9	–1.9	. . .	. . .	. . .
Excluding China	1.2	–4.5	–2.9	–1.1	–1.1	–1.8	–2.5	–2.6	0.2	–0.2	–0.2
Excluding MENAP oil producers[3]	–1.1	–4.1	–3.2	–1.5	–1.9	–2.4	–2.6	–2.4	. . .	. . .	. . .
Asia[3]	–1.9	–3.4	–2.7	–1.2	–1.3	–1.9	–2.1	–1.8	. . .	. . .	. . .
China[3]	0.0	–1.8	–1.2	0.6	0.2	–0.9	–1.0	–0.8	. . .	. . .	. . .
India	–10.0	–9.8	–8.4	–8.0	–7.4	–7.2	–7.2	–6.7	0.0	0.0	0.3
Europe	0.8	–5.9	–3.8	0.3	–0.6	–1.6	–1.5	–1.4	0.0	–0.2	–0.1
Russia	4.9	–6.3	–3.4	1.5	0.4	–1.3	–0.9	–1.1	0.0	–0.3	–0.3
Turkey	–2.7	–6.1	–3.4	–0.6	–1.4	–1.5	–2.0	–1.9	0.0	0.4	0.4
Latin America	–1.0	–3.9	–3.2	–2.9	–3.2	–3.4	–4.0	–3.7	0.4	–0.1	–0.5
Brazil	–1.6	–3.3	–2.8	–2.6	–2.8	–3.3	–3.9	–3.1	0.0	–0.5	–0.6
Mexico	–1.0	–5.1	–4.3	–3.3	–3.7	–3.8	–4.2	–4.0	0.0	–0.1	–0.5
MENAP	13.8	–0.4	2.9	5.1	7.2	4.6	2.2	1.0	0.5	–0.6	–0.1
South Africa	–0.5	–4.9	–4.9	–4.0	–4.3	–4.4	–4.9	–5.1	–0.1	–0.5	–0.6
Low-Income Developing Countries	0.6	–4.4	–2.7	–1.1	–2.1	–3.2	–3.1	–3.1	1.0	0.4	0.1
Oil Producers	7.3	–2.5	–0.1	3.0	2.8	1.1	0.2	–0.3	0.5	–0.2	–0.3
Memorandum Items:											
World Output (percent)	3.0	0.0	5.4	4.1	3.4	3.3	3.3	3.8	0.1	–0.4	–0.2

Source: IMF staff estimates and projections.

Note: All fiscal data country averages are weighted by nominal GDP converted to U.S. dollars at average market exchange rates in the years indicated and based on data availability. Projections are based on IMF staff assessments of current policies. For country-specific details, see Data and Conventions and Tables A, B, and C in the Statistical and Methodological Appendix. MENAP = Middle East and North Africa and Pakistan.

[1] For cross-country comparability, expenditure and fiscal balances of the United States are adjusted to exclude the imputed interest on unfunded pension liabilities and the imputed compensation of employees, which is counted as expenditure under the 2008 System of National Accounts (2008 SNA) recently adopted by the United States, but not so in countries that have not yet adopted the 2008 SNA. Data for the United States in this table may thus differ from data published by the U.S. Bureau of Economic Analysis. See Box 1.1 in the April 2014 *Fiscal Monitor* for details. Because of the change in methodology, the data are not comparable with those in the April 2014 *Fiscal Monitor*.

[2] Including financial sector support.

[3] China's deficit numbers have been revised to include, in addition to official authorities' estimate: (1) transfers to and from stabilization funds; (2) state-administered state-owned enterprise funds and social security contributions and expenses (about 1¼–1½ percent of GDP per year after 2008); and (3) off-budget spending by local governments—estimated by net local government bonds issued by the central government on their behalf. The fiscal balances in this table are not consistent with debt reported in Table 1.2 because of the absence of official time series data in line with the National Audit Office debt definition. Because of the change in methodology, the data are not comparable with those in the April 2014 *Fiscal Monitor*.

for unemployment benefits under improved labor market conditions, as well as spending cuts affecting public wages and some social benefits.

- Most other advanced economies (including *Canada, France, Greece, Portugal*, *Spain,* and the *United Kingdom*) are undertaking moderate fiscal adjustments (between 0.1 and 0.5 percentage point of potential GDP). In France, the bulk of the multi-year adjustment is coming this year from expenditure containment (with simultaneous tax cuts). Nonetheless, the authorities revised the deficit target from 3.8 percent of GDP to 4.4 percent of GDP due to lower than expected growth and inflation. Portugal is set to reach a primary surplus in 2014 for the first time in 20 years. In Spain, after a large adjustment, a stronger than expected recovery is now helping the consolidation efforts. In the United Kingdom, the adjustment is driven by cuts in current spending,

Table 1.1b. Fiscal Balances, 2008–15: Cyclically Adjusted Balance
(Percent of potential GDP)

							Projections		Difference from April 2014 *Fiscal Monitor*		
	2008	2009	2010	2011	2012	2013	2014	2015	2013	2014	2015
Advanced Economies[1]	–3.8	–5.9	–6.6	–5.5	–4.5	–3.4	–3.0	–2.5	. . .	. . .	. . .
United States[1, 2]	–5.3	–7.2	–9.1	–7.8	–6.3	–4.8	–4.0	–3.3	. . .	. . .	. . .
Euro Area	–3.3	–4.7	–4.9	–3.7	–2.7	–1.3	–1.2	–1.0	0.2	0.2	0.1
France	–3.7	–5.4	–5.6	–4.6	–4.1	–3.1	–2.9	–2.8	–0.1	–0.4	–0.7
Germany	–1.4	–1.2	–3.5	–1.3	–0.1	0.5	0.7	0.4	0.2	0.5	0.6
Greece	–14.3	–19.1	–12.3	–8.3	–2.3	1.6	1.6	1.2	–0.6	0.1	0.1
Ireland[2]	–12.1	–9.5	–7.9	–6.5	–5.1	–4.1	–3.3	–2.2	0.9	0.7	0.0
Italy	–3.7	–3.6	–3.6	–3.0	–1.5	–0.8	–0.8	–0.5	0.0	0.1	0.0
Portugal	–4.2	–9.3	–9.6	–3.5	–4.5	–2.6	–2.4	–1.5	0.2	0.3	0.2
Spain[2]	–5.3	–9.5	–7.8	–7.3	–4.4	–3.7	–3.4	–2.9	1.0	1.0	0.8
Japan	–3.5	–7.4	–7.8	–8.3	–7.6	–7.6	–6.7	–5.5	0.2	0.2	0.6
United Kingdom[2]	–6.7	–10.3	–8.4	–6.0	–5.8	–3.8	–4.1	–3.6	–0.1	–0.3	–0.5
Canada	–0.7	–2.9	–4.0	–3.1	–2.7	–2.4	–2.1	–1.8	0.0	0.0	–0.1
Others	–0.1	–1.8	–1.6	–1.3	–1.1	–1.1	–1.1	–0.9	0.0	–0.2	–0.2
Emerging Market and Middle-Income Economies[3]	–1.5	–3.5	–3.1	–1.7	–1.7	–2.2	–2.2	–2.0	. . .	. . .	. . .
Excluding China	–2.0	–4.4	–4.1	–3.0	–3.0	–3.4	–3.5	–3.2	0.3	0.0	0.0
Asia[3]	–2.1	–3.3	–2.8	–1.2	–1.1	–1.6	–1.7	–1.6	. . .	. . .	. . .
China[3]	–0.3	–1.8	–1.3	0.6	0.4	–0.5	–0.6	–0.5	. . .	. . .	. . .
India	–9.5	–9.5	–8.9	–8.4	–7.5	–7.2	–7.1	–6.6	0.0	0.0	0.3
Europe	–0.1	–4.9	–3.8	–0.8	–1.1	–2.0	–1.6	–1.4	0.0	–0.2	0.1
Russia	4.5	–5.0	–2.9	1.6	0.1	–1.5	–0.8	–0.8	–0.1	–0.3	0.0
Turkey	–3.1	–3.6	–2.8	–1.4	–1.6	–1.8	–2.1	–1.8	0.1	0.2	0.3
Latin America	–1.5	–2.8	–3.0	–2.8	–2.6	–3.1	–3.4	–3.0	0.6	0.2	–0.1
Brazil	–2.2	–2.4	–3.3	–3.0	–2.7	–3.5	–3.6	–2.8	–0.2	–0.4	–0.4
Mexico	–1.2	–4.4	–4.0	–3.3	–3.8	–3.7	–4.0	–4.0	0.0	–0.1	–0.5
South Africa	–0.8	–3.2	–3.6	–3.8	–4.2	–4.3	–4.6	–4.8	–0.3	–0.4	–0.6
MENAP	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .

Source: IMF staff estimates and projections.
Note: All fiscal data country averages are weighted by nominal GDP converted to U.S. dollars at average market exchange rates in the years indicated and based on data availability. Projections are based on IMF staff assessments of current policies. For country-specific details, see Data and Conventions and Tables A, B, and C in the Statistical and Methodological Appendix. MENAP = Middle East and North Africa and Pakistan.
[1] For cross-country comparability, expenditure and fiscal balances of the United States are adjusted to exclude the imputed interest on unfunded pension liabilities and the imputed compensation of employees, which is counted as expenditure under the 2008 System of National Accounts (2008 SNA) recently adopted by the United States, but not so in countries that have not yet adopted the 2008 SNA. Data for the United States in this table may thus differ from data published by the U.S. Bureau of Economic Analysis. See Box 1.1 in the April 2014 *Fiscal Monitor* for details. Because of the change in methodology, the data are not comparable with those in the April 2014 *Fiscal Monitor*.
[2] Excluding financial sector support.
[3] China's deficit numbers have been revised to include, in addition to official authorities' estimate: (1) transfers to and from stabilization funds; (2) state-administered state-owned enterprise funds and social security contributions and expenses (about 1¼–1½ percent of GDP per year after 2008); and (3) off-budget spending by local governments—estimated by net local government bonds issued by the central government on their behalf. The fiscal balances in this table are not consistent with debt reported in Table 1.2 because of the absence of official time series data in line with the National Audit Office debt definition. Because of the change in methodology, the data are not comparable with those in the April 2014 *Fiscal Monitor.*

while public investment is moderately increasing. Overall, the *euro area*'s headline deficit is expected to fall below 3 percent of GDP (1.2 percent of potential GDP in cyclically adjusted terms).

- With a broadly neutral stance, the deficit in *Italy* is expected to reach 3 percent of GDP, but fall short of the zero structural balance target under Italy's new fiscal rule.
- *Germany* is expected to have a moderately expansionary fiscal stance in 2014 in terms of the cyclically adjusted primary balance. Additional government spending (0.2 percent of GDP) will go to pensions, infrastructure, education, childcare, and other priorities. Lower debt servicing costs, however, will result in a higher cyclically adjusted overall balance. In *Austria*, the projected large fiscal deterioration (1¼ percent of potential GDP) reflects largely one-off support to the banking sector.

In most advanced economies, improvements in fiscal balances in 2015 are expected to remain moderate. Exceptions include Ireland and Portugal, both expected to continue adjustment efforts to reach headline deficits of 3 percent of GDP or less in 2015 and exit the excessive deficit procedure of the *European Union* (EU); and *Australia*, as the government is committed to return to budget surplus over the medium term. In Austria, after the 2014 banking sector support ends, the cyclically adjusted balance should improve by 1¼ percentage points. In Japan, the second stage of the

Table 1.2. General Government Debt, 2008–15

(Percent of GDP)

							Projections		Difference from April 2014 *Fiscal Monitor*		
	2008	2009	2010	2011	2012	2013	2014	2015	2013	2014	2015
Gross Debt											
World[1]	65.5	75.9	78.3	79.2	81.1	79.7	80.0	79.4	. . .	. . .	. . .
Advanced Economies	79.4	92.8	99.3	103.3	107.6	106.2	106.5	106.0	–0.8	–0.6	–0.7
United States[2]	72.8	86.1	94.8	99.0	102.5	104.2	105.6	105.1	–0.3	–0.1	–0.6
Euro Area	70.3	80.2	85.9	88.3	92.9	95.2	96.4	96.1	0.0	0.9	1.7
France	67.0	78.0	80.8	84.4	88.7	91.8	95.2	97.7	–2.1	–0.6	1.6
Germany	66.8	74.6	82.5	80.0	81.0	78.4	75.5	72.5	0.4	0.9	1.8
Greece	112.9	129.7	148.3	170.3	157.2	175.1	174.2	171.0	1.3	–0.4	–0.3
Ireland	42.6	62.2	87.4	98.9	111.4	116.1	112.4	111.7	–6.7	–11.2	–11.1
Italy	106.1	116.4	119.3	120.7	127.0	132.5	136.7	136.4	0.0	2.2	3.3
Portugal	71.7	83.7	94.0	108.2	124.1	128.9	131.3	128.7	0.1	4.6	3.9
Spain	40.2	54.0	61.7	70.5	85.9	93.9	98.6	101.1	0.0	–0.2	–0.9
Japan	191.8	210.2	216.0	229.8	237.3	243.2	245.1	245.5	0.0	1.5	0.4
United Kingdom	51.9	67.1	78.5	84.3	89.1	90.6	92.0	93.1	0.5	0.5	0.4
Canada[2]	70.8	83.0	84.6	85.9	88.1	88.8	88.1	86.8	–0.3	0.7	0.2
Emerging Market and Middle-Income Economies[1]	35.5	40.1	39.7	38.7	39.0	39.7	40.5	41.2	. . .	. . .	. . .
Excluding China	36.9	41.9	41.0	39.7	39.7	39.9	40.4	40.7	–0.3	0.2	0.3
Excluding MENAP oil producers[1]	38.3	42.5	42.2	41.6	41.7	42.5	43.5	44.1	. . .	. . .	. . .
Asia[1]	40.4	43.0	42.6	41.7	41.9	42.4	43.3	43.9	. . .	. . .	. . .
China[1]	31.7	35.8	36.6	36.5	37.4	39.4	40.7	41.8	. . .	. . .	. . .
India	74.5	72.5	67.5	66.8	66.6	61.5	60.5	59.5	–5.2	–4.8	–4.5
Europe	23.8	29.5	29.4	28.0	27.2	28.3	28.9	29.6	0.3	2.4	2.7
Russia	8.0	10.6	11.3	11.6	12.7	13.9	15.7	16.5	0.5	2.7	3.8
Turkey	40.0	46.1	42.3	39.1	36.2	36.3	33.6	33.1	0.4	–2.3	–2.8
Latin America	47.0	49.8	49.1	49.2	49.7	50.4	51.3	51.8	–0.3	–0.5	–0.2
Brazil[3]	63.5	66.8	65.0	64.7	68.2	66.2	65.8	65.6	–0.1	–0.8	–0.8
Mexico	42.8	43.9	42.2	43.2	43.2	46.4	48.0	49.0	–0.1	–0.2	0.6
MENAP	20.0	26.1	24.5	22.0	23.1	23.5	23.6	24.2	0.1	0.4	0.4
South Africa	27.2	31.6	35.3	38.8	42.1	45.2	47.9	50.8	0.0	0.6	1.1
Low-Income Developing Countries	30.0	33.4	30.7	30.4	30.8	31.0	31.4	31.2	–6.9	–6.9	–7.3
Oil Producers	22.0	25.0	23.2	21.2	21.4	22.2	22.6	23.0	–0.8	–0.1	0.1
Net Debt											
World	44.4	53.2	56.8	60.0	62.1	61.9	63.1	63.3	–1.1	–1.0	–1.1
Advanced Economies	50.3	59.7	64.8	69.6	72.6	72.5	73.6	74.1	–1.0	–1.1	–1.0
United States[2]	50.4	62.1	69.7	76.1	79.4	80.4	80.8	80.9	–1.0	–1.6	–1.8
Euro Area	54.0	60.0	64.1	66.4	70.1	72.3	73.9	74.0	–0.1	0.6	1.4
France	60.3	70.1	73.7	76.4	81.6	84.7	88.1	90.6	–2.9	–1.4	0.8
Germany	50.0	56.5	58.3	56.6	58.2	56.1	53.9	51.6	0.4	0.9	1.7
Greece	112.9	129.7	148.3	170.3	153.5	169.7	168.8	166.6	1.3	–0.5	–0.3
Ireland	20.4	37.2	67.5	80.8	88.0	92.2	93.0	93.1	–8.1	–10.5	–10.4
Italy	89.3	97.5	99.7	102.0	106.1	110.8	114.3	114.0	0.1	1.9	2.8
Portugal	67.5	79.7	89.6	97.8	114.0	118.5	123.8	123.6	0.1	3.9	4.3
Spain	30.8	24.7	33.2	39.8	52.6	60.5	65.6	68.8	0.0	–0.1	–0.7
Japan	95.3	106.2	113.1	127.3	129.5	134.0	137.8	140.0	–0.1	0.7	–0.1
United Kingdom	47.5	61.9	71.6	76.2	80.9	82.5	83.9	85.0	–0.5	–0.5	–0.6
Canada[2]	24.3	29.9	32.9	35.1	36.7	37.6	38.6	39.1	–0.9	–0.9	–0.9
Emerging Market and Middle-Income Economies	14.6	19.2	20.2	18.8	16.8	17.0	17.0	18.0	0.0	1.5	2.0
Asia	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Europe	23.4	29.4	30.2	28.7	26.4	27.0	24.7	24.5	0.4	2.5	2.0
Latin America	31.0	34.5	33.7	32.2	30.8	30.9	31.5	31.6	–0.2	0.0	0.2
MENAP	–22.4	–16.4	–14.5	–14.3	–16.6	–17.2	–15.3	–11.9	0.1	3.0	4.9
Low-Income Developing Countries	15.4	21.6	22.2	21.1	21.2	23.2	30.8	25.2	–9.6	–3.8	–9.2

Source: IMF staff estimates and projections.

Note: All fiscal data country averages are weighted by nominal GDP converted to U.S. dollars at average market exchange rates in the years indicated and based on data availability. Projections are based on IMF staff assessments of current policies. For country-specific details, see Data and Conventions and Tables A, B, and C in the Statistical and Methodological Appendix. MENAP = Middle East and North Africa and Pakistan.

[1] China's debt numbers have been revised to include the explicit local governments' debt and fractions (ranging from 14–19 percent, according to the National Audit Office estimate) of the government guaranteed debt and liabilities that the government may incur. Staff estimates exclude the central government debt issued for China Railway Corporation. Because of the change in methodology, the data are not comparable with those in the April 2014 *Fiscal Monitor.*

[2] For cross-country comparability, gross and net debt levels reported by national statistical agencies for countries that have adopted the 2008 System of National Accounts (Australia, Canada, Hong Kong SAR, and the United States) are adjusted to exclude unfunded pension liabilities of government employees' defined benefit pension plans.

[3] Gross debt refers to the nonfinancial public sector, excluding Eletrobras and Petrobras, and includes sovereign debt held on the balance sheet of the central bank.

consumption tax rate increase is planned for October 2015, which combined with expenditure measures, is expected to improve the cyclically adjusted balance by 1.2 percentage points of potential GDP.

With continued uncertainties regarding the strength of the recovery, fiscal policies now often incorporate measures aimed at increasing competitiveness, employment, and long- term growth. The challenge is how to absorb the ensuing costs in a budget-neutral manner, through tax shifts or compensatory spending cuts.

- In the euro area, the adjustment is relying more on expenditure cuts than in earlier years, and in some cases, it is accompanied by tax cuts.
- A number of countries are undertaking (or are planning) tax reforms to reduce the tax burden on labor and corporations with a view to boosting employment and competitiveness. This year, Greece and the *Netherlands* implemented targeted cuts in employers' social security contributions;[1] Italy and *Norway* lowered the personal income tax rate; and *Finland* and the United Kingdom reduced the corporate income tax rate. Italy and France plan additional labor tax cuts in 2015, and Japan has announced plans to cut the corporate income tax rate while minimizing the impact on revenue through a broadening of the tax base and other reforms.[2] Spain has also announced tax cuts.
- Some countries are scaling up public investment (Canada, Germany, Italy, and the United Kingdom, among others). Most are pushing structural reforms to increase potential GDP, with often non-trivial budgetary costs. Reforms are broad based, generally aimed at increasing the flexibility of labor markets; improving the business environment by reducing administrative burdens, increasing the flexibility of retail hours, and improving the efficiency of the judicial system; liberalizing product markets, particularly the energy and transportation sectors; and strengthening the financial sector by modernizing insolvency regimes and easing access to bank financing for small and medium enterprises.

Notwithstanding continued budgetary effort, debt ratios and gross financing needs remain high for many advanced economies (Table 1.3). The average overall deficit in advanced economies has declined by about 5 percentage points of GDP since its peak in 2009 (3 percentage points of potential GDP in cyclically adjusted terms), with spending reductions contributing about 2½ percentage points, and the discontinuation of the financial sector support that took place at the peak of the financial crisis another percentage point. The average debt ratio is expected to stabilize in 2014 and start declining in 2015, but would still remain high—over 100 percent of GDP—by the end of the decade. By then, only three out of ten countries where debt peaked above 100 percent of GDP during the crisis will have debt ratios below that level.

Adjustment Fatigue and Low Inflation Pose Risks to the Fiscal Outlook

In most advanced economies, immediate pressures on public finances have receded in recent months, but historically high debt ratios and a hesitant recovery, combined with lowflation in the euro area, keep risks elevated.

Record-low borrowing costs and the gradual strengthening of banks' balance sheets have relaxed immediate budget constraints in many advanced economies. Market conditions have eased markedly, with bond spreads falling in many countries to historic lows, particularly in Europe. Other things equal, these lower borrowing costs have improved the debt outlook for many economies, and markedly so for some. For example, in Ireland and Spain, the debt-to-GDP ratio is now projected to be, by 2018, about 8 and 4 percentage points, respectively, below the October 2013 forecast. Record low sovereign yields have thus given many countries useful breathing space. However, they are still exposed to risks of sudden reversals, as the current yield levels are, in some cases, arguably below the levels warranted by fundamentals (see the October 2014 *Global Financial Stability Report*). At the same time, banking-sector-related risks are gradually ebbing away, and paybacks from past financial sector support continue to build up in a number of countries, lowering the net fiscal cost of these operations (Table 1.4). But the pace in the recovery of financial sector support varies greatly among countries. In some cases (for example, *Belgium,* the Netherlands, Spain, and the United States), it is faster than the historical average of previous experiences.[3] However, fresh support to the

[1] France also implemented targeted cuts in employers' social security contributions in 2013.

[2] See De Mooij and Saito (2014) for a discussion on how corporate income tax reform can help Japan increase investment and boost potential growth, as well as on the budget implication of the reform.

[3] Historical episodes of financial sector support in advanced economies during the period of 1991–2006 had an average recovery rate, five years later, of 30 percent of the gross support provided (Laeven and Valencia, 2012).

Table 1.3. Selected Advanced Economies: Gross Financing Needs, 2014–16
(Percent of GDP)

	2014			2015			2016		
	Maturing Debt	Budget Deficit	Total Financing Need	Maturing Debt[1]	Budget Deficit	Total Financing Need	Maturing Debt[1]	Budget Deficit	Total Financing Need
Japan	51.0	7.1	58.1	50.2	5.8	56.0	43.5	4.6	48.1
Italy	24.9	3.0	27.9	26.5	2.3	28.8	23.4	1.2	24.6
United States[2]	18.1	5.5	23.6	17.2	4.3	21.6	16.1	4.2	20.3
Portugal	16.7	4.0	20.8	16.3	2.5	18.8	15.4	2.3	17.8
Spain	14.8	5.7	20.5	15.3	4.7	20.0	15.6	3.8	19.4
France	13.0	4.4	17.4	14.5	4.3	18.8	13.7	3.7	17.4
Slovenia	11.1	5.0	16.1	8.8	3.9	12.7	15.7	3.5	19.2
Canada	13.4	2.6	16.0	13.3	2.1	15.4	11.7	1.7	13.4
Belgium	12.7	2.6	15.3	15.6	2.2	17.8	15.0	1.6	16.6
Greece[3]	12.7	1.8	14.5	8.8	1.2	10.0	3.7	0.6	4.3
Netherlands	10.6	2.5	13.1	13.7	2.0	15.8	9.5	1.8	11.3
Austria	8.6	3.0	11.7	5.3	1.5	6.8	5.2	0.8	6.1
United Kingdom	6.4	5.3	11.6	6.2	4.1	10.3	5.9	2.9	8.8
Malta	8.0	2.7	10.7	6.1	2.4	8.5	8.2	1.8	10.0
Sweden	6.9	2.0	9.0	5.9	0.8	6.7	4.2	0.1	4.3
Denmark	6.3	1.4	7.7	7.3	3.0	10.3	4.5	2.3	6.9
Czech Republic	6.5	1.2	7.7	6.4	1.4	7.8	6.8	1.2	8.0
Finland	5.2	2.4	7.6	5.4	1.4	6.7	6.2	0.9	7.1
Ireland[4]	3.1	4.6	7.6	1.9	3.2	5.1	5.8	1.1	6.9
Slovak Republic	3.8	2.9	6.7	3.8	2.3	6.1	5.9	1.3	7.2
Germany	6.9	–0.3	6.6	6.9	–0.2	6.8	5.6	–0.3	5.2
Australia	2.1	3.3	5.5	2.4	1.8	4.2	1.7	1.0	2.7
Korea	3.4	–0.3	3.1	3.4	–0.8	2.6	3.0	–1.0	2.0
Switzerland	3.2	–0.5	2.7	2.8	–0.7	2.1	3.6	–1.0	2.7
New Zealand	1.8	0.7	2.5	6.6	0.4	7.0	2.2	–0.2	2.1
Iceland	3.9	–1.9	2.1	2.4	0.5	2.9	9.7	1.3	11.0
Average	17.5	4.2	21.7	17.2	3.4	20.6	15.5	2.9	18.3

Sources: Bloomberg L.P.; and IMF staff estimates and projections.
Note: For most countries, data on maturing debt refer to central government securities. For some countries, general government deficits are reported on an accrual basis. For country-specific details, see Data and Conventions and Table A in the Statistical and Methodological Appendix.
[1] Assumes that short-term debt outstanding in 2014 and 2015 will be refinanced with new short-term debt that will mature in 2015 and 2016, respectively. Countries that are projected to have budget deficits in 2014 or 2015 are assumed to issue new debt based on the maturity structure of debt outstanding at the end of 2013.
[2] For cross-country comparability, expenditure and fiscal balances of the United States are adjusted to exclude the imputed interest on unfunded pension liabilities and the imputed compensation of employees, which are counted as expenditure under the 2008 System of National Accounts (2008 SNA) recently adopted by the United States, but not so in countries that have not yet adopted the 2008 SNA. Data for the United States in this table may thus differ from data published by the U.S. Bureau of Economic Analysis. See Box 1.1 in the April 2014 *Fiscal Monitor* for details. Because of the change in methodology, the data are not comparable with those in the April 2014 *Fiscal Monitor.*
[3] Maturing debt and budget deficit refer to state government. The deficit is on a cash basis while figures in Table 1.1 and Statistical Table 1 are on an accrual basis and for general government.
[4] Ireland's cash deficit includes exchequer deficit and other government cash needs and may differ from official numbers because of a different treatment of short-term debt in the forecast.

banking system has recently been necessary in Austria and Portugal.[4]

Geopolitical tensions in Eastern Europe and the Middle East raise difficult-to-assess fiscal risks. They have so far had limited fiscal spillovers beyond the affected countries and close trading partners. Further unrest, however, could trigger wider spillovers—including from adverse financial market reactions and oil price volatility—with associated negative fiscal consequences (October 2014 *World Economic Outlook*).

Looming increases in health and pension expenditures, and historically high debt ratios, continue to raise considerable medium- and long-term challenges for many advanced economies, calling for a lasting period of adjustment. Maintaining deficit reduction efforts over a prolonged period can be a daunting task. Historical experience shows that advanced economies were generally able to keep their cyclically adjusted primary balance in positive territory for a number of

[4] In Austria, the restructuring of Hypo Alpe Adria and KA Finanz AG is expected to increase the government's debt by over 7 percentage points of GDP in the second half of 2014.

Table 1.4. Selected Advanced Economies: Financial Sector Support
(Percent of 2013 GDP, except where otherwise indicated)

	Impact on Gross Public Debt and Other Support	Recovery to Date	Impact on Gross Public Debt and Other Support after Recovery
Austria[1]	4.7	1.5	3.2
Belgium	7.6	3.4	4.2
Cyprus	21.2	0.0	21.2
Germany[2]	12.5	3.8	8.7
Greece[3]	33.6	7.9	25.7
Ireland[4]	41.1	7.6	33.4
Netherlands	18.7	14.5	4.2
Slovenia[5]	12.0	0.0	12.0
Spain[6]	7.7	3.2	4.5
United Kingdom	10.5	2.6	8.0
United States	4.5	4.9	–0.5
Average	7.4	4.8	2.7
US$ billions	1,967	1,252	716

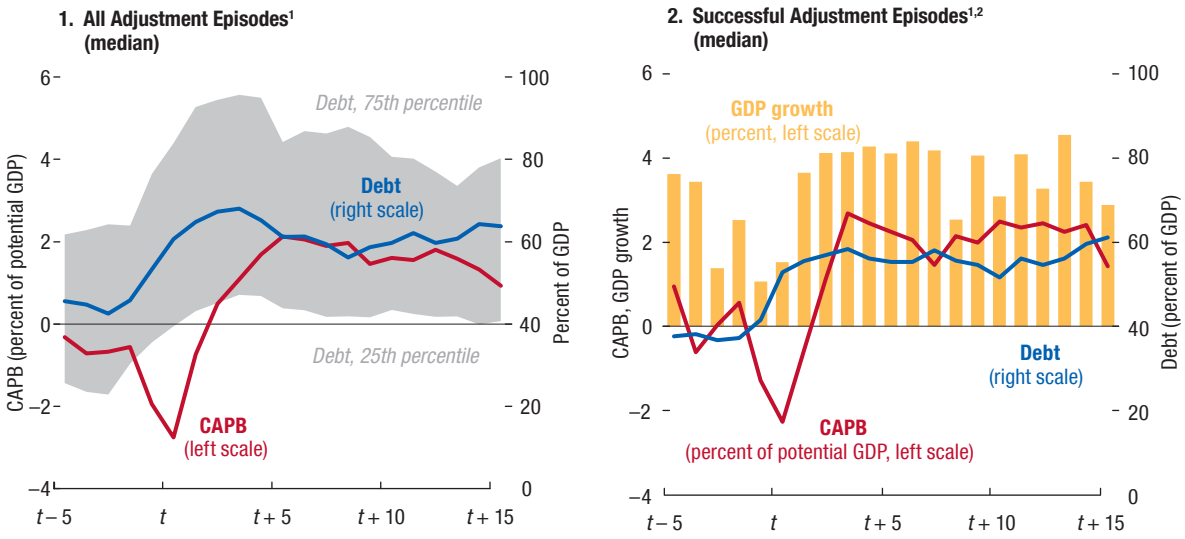
Sources: National authorities; and IMF staff estimates.
Note: The table shows fiscal outlays of the central government, except in the cases of Germany and Belgium, for which financial sector support by subnational governments is also included. Data are cumulative since the beginning of the global financial crisis in 2007—latest available data up to June 2014. Data do not include forthcoming support.
[1] In the second half of 2014, the creation of a defeasance structure for Hypo Alpe Adria Bank will lead to a further increase in the government's debt by around 5½ percent of GDP. An additional debt increase, estimated by staff at below 1¾ percent of GDP, arises from the inclusion of an already existing "bad bank" (KA Finanz) into general government, because of the new European System of National Accounts rules.
[2] Support includes here the estimated impact on public debt of liabilities transferred to newly created government sector entities (about 11 percent of GDP), taking into account operations from the central and subnational governments. As public debt is a gross concept, this neglects the simultaneous increase in government assets. With this effect taken into account, the net debt effect up to 2012 amounted to just 1.6 percent of GDP, which was recorded as a deficit.
[3] Support includes the disbursements from the Hellenic Financial Stability Fund, but excludes the undisbursed amount of the financial sector envelope.
[4] The impact of the direct support measures is mainly on net debt, as significant recapitalization expenses were met from public assets. Direct support does not include asset purchases by the National Asset Management Agency, as these are not financed directly through the general government but with government-guaranteed bonds.
[5] Support provided by the general government.
[6] Direct support includes total capital injections by the Fondo de Reestructuración Ordenada Bancaria and liquidity support.

years in the context of adjustment episodes, but on average they did not sustain it for long enough or at a level high enough to generate substantial declines in their debt ratios.[5] In the majority of cases, debt ratios stabilized, but remained above the pre-adjustment episode levels (by 20 percentage points of GDP for the median country). Some countries (about one-third of the sample) did manage to reduce debt to or below pre-adjustment episode levels through a combination of higher primary balances maintained for a longer period, and growth slightly above the pre-adjustment episode average. This contributed to falling interest-rate–growth differentials (Figure 1.2). Conversely, in unsuccessful episodes—those whose debt did not fall to or below pre-adjustment episode levels—primary balances declined relatively soon after debt ratios stabilized.

Persistently low inflation could further complicate the task, particularly in the euro area. Box 1.1 shows that during the last 100 years, there have been very few episodes of low inflation (with prices increasing by 1 percent or less annually over three years or more). These few episodes, however, were systematically accompanied by increases in the government debt ratio. Simulations for the euro area show that if inflation were to remain very low over a period of five years, the debt-to-GDP ratio would increase by 5¾ percentage points of GDP by the end of 2019 (relative to baseline projections which incorporate currently planned adjustment efforts). These results, however, consider only the impact of low inflation on debt dynamics and seigniorage through higher real effective interest rates. The effect on debt ratios would be significantly larger should persistently low inflation hamper the expected economic recovery. Stagnant growth would then result in a sustained deterioration of primary balances, compounding the adverse debt dynamics.

[5] Based on 48 episodes identified by Escolano and others (2014), covering the time period between 1945 and 2012 across 30 advanced economies. Fiscal adjustment episodes are identified by the existence of a significant primary balance gap (Blanchard, 1993) and intention to undertake a fiscal adjustment. For further discussion on the determinants of successful fiscal adjustments in advanced economies, see for example Afonso and Jalles (2012) and Eichengreen and Panizza (2014).

Figure 1.2. Historical Fiscal Adjustment Episodes in Advanced Economies



Sources: Escolano and others (2014); and IMF staff estimates.
Note: CAPB = cyclically adjusted primary balance.
[1] The chart shows the median from an event-study analysis of 30 advanced economies using data for 48 fiscal consolidation episodes during 1945–2012, as detailed in Escolano and others (2014). The episodes are selected based on adjustment episodes where countries needed and wanted to adjust in order to stabilize their debt-to-GDP ratio. The shaded area represents the 25th to the 75th percentiles of the debt-to-GDP ratio.
[2] Economies that managed to reduce debt to or below pre-adjustment episodes levels.

Fiscal Policies Including Measures Supporting Long-Term Growth and Employment Can Help Avert Adjustment Fatigue

Further fiscal adjustment is needed in most advanced economies to bring down debt ratios to safer levels, but issues of pace and composition should increasingly take center stage. In particular, as disappointing growth outcomes fuel risks of persistent low inflation and adjustment fatigue, policies should strive to include elements supportive of a faster rebound in growth and employment within the constraints often imposed by limited fiscal space (Chapter 2 elaborates on the scope for fiscal policy to support labor market reform).

- Well-designed tax reform can help boost growth and employment, but countries with little fiscal space must be aware of its budgetary impact.[6]
- Scaling up public investment can help boost potential output and may provide positive spillovers to the rest of the world (see the October 2014 *World Economic Outlook*). But here again, caution must be used to avoid negative market reactions and elusive output returns.
- Some (but not all) structural reforms can entail near-term fiscal costs. Whether or not these costs should be absorbed through a slower pace of consolidation depends on the existing fiscal space, prospective vulnerabilities, and the commitment to carry the reforms to their end. As a general rule, the fiscal costs should be contained, both in size and in duration.
- In the case of negative growth surprises, countries should let automatic stabilizers operate, unless they face binding financing constraints.

Credible medium-term fiscal plans are needed as part of sound fiscal policy frameworks. This is particularly important in higher-debt countries facing large projected increases in health care and pension spending. Notably, in Japan, the implementation of the second consumption tax increase and the identification of fiscal measures beyond 2015 would help stabilize and bring down the debt-to-GDP ratio. In the United States, a medium-term plan could combine steps to lower the growth of health care costs, reform social security, and increase revenue through comprehensive tax reform. In other countries, reining in age-related

[6] The October 2013 *Fiscal Monitor* discusses the impact of different taxes on growth and equity. Chapter 2 in this issue considers the impact of payroll tax cuts on employment.

spending could reduce longer-term fiscal risks while supporting growth.[7]

Emerging Market and Middle-Income Economies: Contingent Risks on the Rise

Although budget deficits and debt ratios remain moderate on average, fiscal positions and risks vary widely across emerging market and middle-income economies. While immediate pressures on public finances have eased, lower potential growth, prospects of tighter financing conditions, and rising contingent liabilities are looming risks. In many cases, the time has come to rebuild the fiscal buffers used during the crisis, and to strengthen the institutional fiscal policy framework.

A Broad Range of Fiscal Stances

The fiscal stance for the group of emerging market and middle-income economies as a whole is projected to remain broadly neutral in 2014 and 2015, with the cyclically adjusted deficit hovering around 2 percent of potential GDP and the debt ratio slightly above 40 percent of GDP (Tables 1.1b and 1.2; Figure 1.3). But these averages mask important differences across countries and regions.

At one end of the spectrum, oil exporters will generally experience a decline of their fiscal balances. With falling revenues (due to declines in oil output and price) and rising fiscal breakeven oil prices,[8] the average headline fiscal balance is expected to shift from surplus to deficit in 2015. In addition, in a number of countries (*Iran, Kazakhstan*, and *Oman*) recent wage bill increases raise fiscal vulnerabilities. Further increases in the wage bill are envisaged in several oil-exporting countries.

Idiosyncratic shocks are expected to contribute to higher fiscal deficits in a number of emerging market economies. In *Thailand*, political turbulence has made a major dent in growth and government revenues, contributing to a widening of the overall deficit by 2.3 percentage points of GDP. In the *Philippines*, a higher deficit is expected, due to additional post-hurricane reconstruction spending. In *South Africa*, strikes in the mining and engineering sectors, electricity shortages, and tighter financing conditions put downward pressure on real GDP growth in the first half of the year, leading to lower than budgeted revenues.

Little change in the fiscal stance is expected this year in the largest emerging market and middle-income economies, including *China*, *India*, *Mexico,* and *Turkey*. China is expected to maintain a neutral fiscal position, excluding off-budget operations. In India, some decline in the cyclically adjusted deficit is forecast for 2014. In Mexico, the government's slightly expansionary target for 2014 is expected to be met, and deficit reduction is set to start in 2015. In Indonesia, rising energy subsidies and lagging revenue growth point to a moderate increase in the structural deficit in 2014. In Brazil, the primary surplus is expected to fall short of the authorities' target of 1.9 percent of GDP, largely due to a lower than expected pace of economic activity in the year.

At the other end of the spectrum, some countries are starting or resuming fiscal adjustment efforts in 2014. In Egypt, *Malaysia*, and Morocco, the consolidation strategy includes important subsidy reform. In *Russia*, the general government non-oil balance is envisaged to improve by about ½ percent of GDP due to reductions in value-added tax (VAT) refunds and implementation of the federal fiscal rule, which caps spending. However, weakness in the economy from the ongoing geopolitical conflict may undermine these efforts. *Poland* is on track to reduce its deficit by more than 1 percent of GDP by 2016. Starting in 2014, *Croatia,* under the Excessive Deficit Procedure of the European Union, aims to bring the deficit down below 3 percent of GDP by 2016, with significant revenue measures in the first year.

Old and New Risks

As in advanced economies, immediate pressures on emerging markets' public finances have eased in recent months, as sovereign-bond yields and volatility have declined. Nonetheless, fiscal risks are on the rise in most countries.

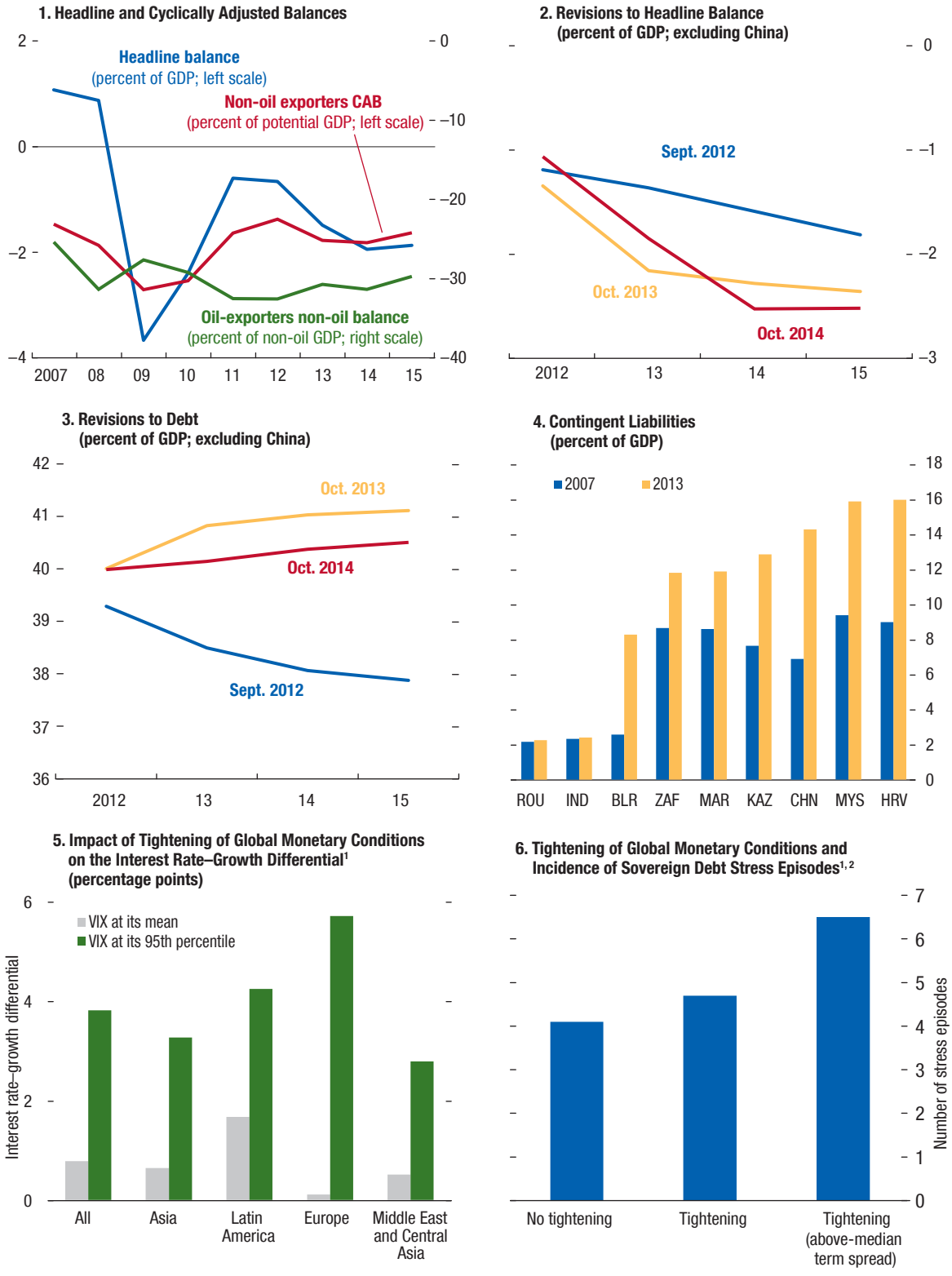
The first risk relates to a possible reversal in investors' sentiment when U.S. interest rates begin to rise. This could have large fiscal implications in emerging markets with high gross financing needs (Table 1.5), large holdings by nonresidents, or limited budget space to absorb higher financing costs (see IMF, 2014a).

The historical record indicates that the unwinding of monetary policy support in advanced economies can have a material impact on emerging market public debt costs and on the incidence of fiscal stress episodes (Figure 1.3, panels 5 and 6). Estimations based on a panel of 30 emerging

[7] See IMF (2010, and 2011) and Karam and others (2010) for a discussion of health and pension reforms and their growth impact.

[8] The fiscal breakeven oil price is the average oil price that is needed for an oil exporting country to balance its budget in a particular year.

Figure 1.3. Fiscal Trends in Emerging Market and Middle-Income Economies



Sources: Escolano, Kolerus, and Lonkeng Ngouana (forthcoming); CEIC; Haver Analytics; national sources; and IMF staff estimates and projections.
Note: For country-specific details, see Data and Conventions and Table B in the Statistical and Methodological Appendix.
CAB = cyclically adjusted balance; VIX = Chicago Board Options Exchange Volatility Index.
[1] Tightening is defined as a 1 percent increase in the United States 10-year real government bond yield.
[2] Term spread is defined as the difference between the 10-year government bond yield and the United States federal funds rate.

Table 1.5. Selected Emerging Market and Middle-Income Economies: Gross Financing Needs, 2014–15
(Percent of GDP)

	2014			2015		
	Maturing Debt	Budget Deficit	Total Financing Need	Maturing Debt	Budget Deficit	Total Financing Need
Egypt	33.3	12.2	45.5	33.6	11.5	45.1
Pakistan	24.5	4.7	29.2	26.2	4.4	30.6
Hungary	20.9	2.9	23.8	16.7	2.8	19.6
Croatia	15.0	4.7	19.7	16.4	2.9	19.3
Sri Lanka	14.2	5.2	19.4	13.8	4.7	18.5
Ukraine	10.6	5.8	16.4	12.4	3.9	16.3
Brazil	12.1	3.9	16.0	12.1	3.1	15.2
Uruguay	11.5	3.5	15.0	14.9	3.4	18.3
South Africa	7.7	4.9	12.6	7.2	5.1	12.4
Mexico	8.2	4.2	12.4	4.9	4.0	9.0
Argentina	7.8	4.5	12.3	6.7	5.5	12.2
India	4.4	7.2	11.6	4.6	6.7	11.3
Morocco	5.7	5.0	10.7	5.6	4.3	9.9
Poland	7.2	3.2	10.4	6.0	2.5	8.5
Malaysia	6.0	3.6	9.6	6.6	2.7	9.3
Romania	7.2	2.2	9.4	7.9	1.8	9.7
Turkey	6.8	2.0	8.8	5.1	1.9	7.0
Thailand	6.2	2.5	8.7	5.8	2.6	8.5
Philippines	6.4	0.3	6.8	5.6	1.0	6.6
Dominican Republic	3.5	2.9	6.4	2.9	3.2	6.1
Ecuador	1.8	4.3	6.0	2.3	4.6	6.9
Colombia	2.9	1.5	4.3	2.7	1.3	4.1
Indonesia	1.6	2.5	4.1	1.5	2.3	3.8
Chile	0.8	1.8	2.5	0.9	1.2	2.0
Peru	2.4	0.1	2.5	2.0	0.1	2.1
Russia	1.2	0.9	2.2	1.5	1.1	2.6
Average	7.1	3.7	10.8	6.7	3.5	10.2

Source: IMF staff estimates and projections.
Note: Data in the table refer to general government. For some countries, general government deficits are reported on an accrual basis. For country-specific details, see Data and Conventions and Table B in the Statistical and Methodological Appendix.

markets over 1993–2013 suggest that a rise in real bond yields of 100 basis points in the United States translates into an average increase of about 50 basis points in the average real effective interest rate paid by emerging market economies on their sovereign debt.[9] Countries with deeper integration in global financial markets and where non-residents own a higher share of debt are likely to be more affected. This spillover is also more pronounced if monetary tightening is accompanied by a rise in risk aversion (Figure 1.3, panel 5)—as witnessed during recent episodes of market turmoil in response to prospects of rate hikes in the United States. Also, the incidence of fiscal stress episodes appears to be higher during monetary policy tightening cycles in key advanced economies. This is particularly so when these changes are accompanied by rising expectations of sustained future rate hikes, as reflected in widening term spreads (Figure 1.3, panel 6).

[9] See IMF (2014a), Chapter 2, Box 4.

Second, there is increasing evidence that public contingent liabilities are on the rise in emerging market economies and in many cases already account for several percentage points of GDP. Contingent liabilities are, by definition, difficult to track. Only a few countries follow basic reporting practices or conduct regular monitoring of fiscal risks stemming from them. In China, contingent liabilities amount to more than 14 percent of GDP, and they are also substantial in other countries, including India, Malaysia, and South Africa. Sources of contingent liabilities vary and include off-budget local government borrowing in China, bank recapitalization needs and liabilities of the electricity distribution companies in India, and public enterprise borrowing in South Africa (Figure 1.3, panel 4). In *Bulgaria*, banking sector support could increase government debt.

Lower growth prospects (see the October 2014 *World Economic Outlook*) further complicate the picture. With deteriorating cyclical conditions, the pressure to support the economy is likely to build. The risk is that this support

is channeled through off-budget measures in a non-transparent manner. Indeed, a number of economies are already implementing quasi-fiscal stimulus via off-budget items, higher public banks lending, and an expansion of government guarantees. For example, in China, the broadly neutral stance suggested by central government budget data underestimates the significant fiscal stimulus provided off-budget. In Russia, fiscal projections may overstate the fiscal tightening in the economy, as the government is issuing guarantees for multi-year projects and financing infrastructure projects through the National Wealth Fund. India's public banks are encouraged to expand lending for infrastructure spending. The Philippines has more than doubled the number of public-private partnership (PPP) projects, with a total identified cost of 9 percent of GDP over the last year. While some of these off-budget operations, such as PPPs, can play a positive role in mobilizing resources to foster growth, they create budgetary risks, which require strict monitoring, transparent reporting, and prudent management. When fiscal support to activity is warranted, it is preferable to channel it through the budget. If other public agencies are to be involved, the risks should be acknowledged and integrated into a comprehensive macroeconomic policy framework.

Geopolitical conflicts in *Ukraine* and the Middle East could also raise fiscal risks, but these are difficult to estimate at this point. The budget impact on the countries directly affected has been severe. An escalation of tensions could have significant adverse spillovers on the budgets of neighboring countries and trading partners.

Time to Rebuild Fiscal Buffers

Although the urgency and specifics vary across countries, the buildup of risks calls, in most cases, for prompt policy action to restore fiscal buffers and the scope for fiscal policy action if these risks were to materialize. When revenue ratios are low (a frequent occurrence in this group), further revenue mobilization efforts, including tax reform, would be warranted. Only a few countries have embarked on important tax reforms this year, notably Chile, Egypt, and Mexico. Stepped-up efforts in the reform of fuel subsidies are also needed, although some countries (including Egypt, Iran, Malaysia, Mexico, and Morocco) are making meaningful progress in this area. Reining in off-budget spending and quasi-fiscal operations is also called for, particularly where they have surged in recent years, given the increases in fiscal risks they entail.

Improved monitoring and reporting of contingent liabilities is essential to prudent fiscal policies, as these liabilities tend to be significantly underestimated in good times. It is crucial at this juncture for emerging market economies to strengthen their legal, institutional, and reporting budgetary processes so as to better manage long-term fiscal risks and risks arising from contingent liabilities.

Low-Income Developing Countries: Time to Seize the Positive Momentum

With a few important exceptions, immediate fiscal risks are generally moderate in low-income developing countries (LIDCs). Looking forward, efforts should focus on improving fiscal outcomes through revenue mobilization, budget prioritization, and improvements in public spending efficiency.

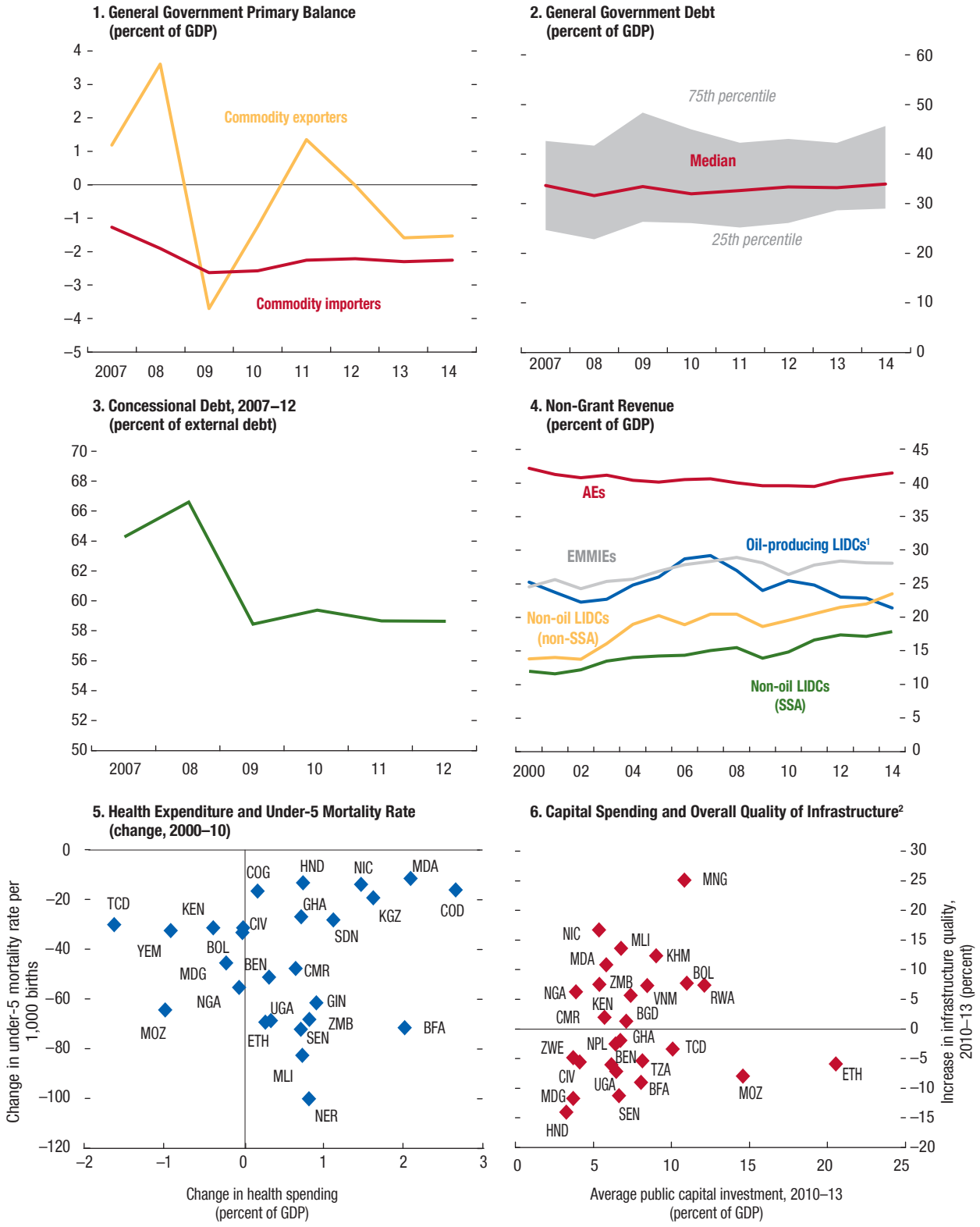
Efforts to Improve Fiscal Buffers Have Been Uneven

Spending restraint in 2014 has halted the deficit expansion that LIDCs experienced in 2013 (April 2014 *Fiscal Monitor*). The average overall deficit is expected to remain broadly unchanged at 3.1 percent of GDP in 2014 (Figure 1.4), but here again, the path differs across countries.

In about half of LIDCs, the overall fiscal deficit will decline or stabilize in 2014, mostly because of spending restraint. Delays or cuts in public investment are forecast in *Haiti* and *Zambia*, coupled with wage bill freezes in *Lao P.D.R.* In *Chad,* improvements come from higher oil revenues as new oil projects are coming on stream and from efforts in expenditure rationalization; in *Burkina Faso* and *Honduras*, they reflect dividends from revenue administration and tax policy reforms. In the largest economy of this group, *Nigeria*, the overall balance is expected to improve slightly, after a sharp deterioration in 2013, because of reduced current spending and higher non-oil revenues; however, oil revenues have so far been below expectations owing to lower production. In *Ghana*, fiscal adjustment is proceeding at a slower pace than budgeted, due to delays in broadening VAT coverage, in adjusting utility tariffs, and in implementing an ad valorem tax on petroleum products.

In contrast, fiscal deficits are expected to widen in about half of LIDCs. Lower growth and commodity prices in *Mongolia* and tax policy reforms in *Vietnam* have reduced revenues. Higher capital spending is the main factor behind higher deficits in *Mali*, following the resumption of donors' project financing, and in *Niger* because of frontloading of infrastructure projects. In *Uganda*, the deficit is envisaged to widen in calendar year

Figure 1.4. Fiscal Trends in Low-Income Developing Countries



Sources: United Nations; World Bank, *World Development Indicators,* 2014; World Economic Forum, *Global Competitiveness Report,* 2014; World Health Organization; and IMF staff estimates.
Note: For country-specific details, see Data and Conventions and Table C in the Statistical and Methodological Appendix. The shaded area in panel 2 represents the 25th to the 75th percentiles of the debt-to-GDP ratio. AEs = advanced economies; EMMIEs = emerging market and middle-income economies; LIDCs = low-income developing countries; SSA = Sub-Saharan Africa.
[1] Includes Bolivia, Cameroon, Chad, Republic of Congo, Côte d'Ivoire, Nigeria, Papua New Guinea, Uzbekistan, Vietnam, and Yemen.
[2] The overall quality of infrastructure index compounds indicators and survey data on the efficiency of transport, electricity, and telephony infrastructure in a country.

2014 owing to increased capital spending and reduced growth. In *Mozambique*, the deficit is projected to expand by more than 6 percent of GDP, reflecting steady increases in the wage bill and public investment, and also the regularization of quasi-fiscal operations associated with a public sector company. Exceptional increases in current spending are also expected in some countries, such as higher military spending (Uganda and *Rwanda*) and election-related spending (*Moldova* and Mozambique). In addition, with weak budgetary control, some countries are recording a substantial accumulation of arrears (*Tanzania*, *Guinea*, Zambia, and *Yemen*).

The average nominal debt ratio for the LIDC group is expected to increase slightly to almost 31½ percent of GDP in 2014. However, debt ratios have increased significantly in a few countries. In Niger, the debt-to-GDP ratio is expected to increase by almost 15 percentage points in 2014 largely because of the assumption by the government of a publicly guaranteed private loan. Since 2012, debt-to-GDP ratios have increased by 15 percentage points in Ghana, 12 percentage points in Honduras and *Papua New-Guinea*, around 8 percentage points in Haiti, and around 7 percentage points in Zambia. In some countries, the rising share of nonconcessional loans pushes up debt servicing costs (Figure 1.4, panel 3). This is particularly the case in LIDCs that have newly accessed international bond markets (Box 1.2).

Short-Term Risks Look Manageable, with a Few Exceptions

LIDCs face generally moderate immediate fiscal risks. As mentioned, their public debt ratios and borrowing costs are, in most cases, relatively low (with a few exceptions). Their integration into international capital markets, although growing, remains modest, limiting their exposure to capital flow reversals. And they have generally benefited from the commodity super cycle through higher production and revenues.

However, rapid spending growth has raised fiscal vulnerabilities in some countries (IMF, 2014b). Lower growth in emerging market economies, particularly China, would dampen fiscal prospects in many LIDCs through weaker foreign direct investment, less favorable terms of trade, and lower commodity prices. There are also a number of country-specific risks, including protracted fiscal imbalances in Ghana and Zambia, political instability in Yemen, and uncertainty regarding the Petrocaribe arrangement with Venezuela in Haiti and *Nicaragua*. The Ebola outbreak could substantially lower growth in the affected West African countries, causing revenue shortfalls and requiring larger public outlays.

Improving Revenue Mobilization and Prioritizing Spending Remain Key Challenges

A key policy challenge in LIDCs is to ensure increased provision of public services in response to rising social demand and growth-enhancing infrastructure, health, and education. These objectives, however, are often stymied by low tax ratios, limited fiscal space, and poor spending efficiency. Thus, efforts should focus on improving fiscal outcomes through revenue mobilization, and a better prioritization and efficiency of expenditure.

- Tax revenue remains at very low levels in LIDCs compared to middle- and high- income countries, though it is gradually increasing in non-oil exporting countries (Figure 1.4, panel 4). Tax policy reforms should aim at expanding the tax base, reducing and streamlining exemptions, and strengthening real estate taxes. There is also scope to improve revenue administration. Simplifying procedures for taxpayer registration, filing, and payment would improve revenue collection and reduce taxpayer costs. Moreover, adopting IT-supported systems, segmenting the taxpayer population, and using third-party information on taxpayers would reduce compliance risk. Finally, improving audit and enforcement procedures would result in higher collections and limit incentives for rent seeking.
- Channeling spending to investment, health, and education away from non-priority spending remains a key policy priority in many countries. Improving the effectiveness of investment and social spending is another important challenge. Higher public capital spending is not always associated with improvements in the quality of infrastructure (Figure 1.4, panel 6), suggesting, in some cases, that inefficiencies can be significant (see October 2014 *World Economic Outlook* and April 2014 *Fiscal Monitor)*. Better procurement practices together with strengthened processes to select, execute, and monitor public investment projects are needed. Similarly, while social spending has increased substantially over the past few decades, social indicators have improved only slowly (Figure 1.4, panel 5). Efforts should also focus on consolidating and improving the targeting of social assistance programs. More generally, strengthening fiscal institutions through, among others, the adoption of medium-term fiscal frameworks, would improve budget planning and execution.

Box 1.1. Lowflation and Debt in the Euro Area

Low inflation has been pervasive in the euro area since 2013. Both headline and underlying inflation rates are less than 1 percent. Surveys suggest that the risk of persistent deflation—of widespread, self-feeding, price declines—is relatively limited. However, should low inflation persist, it could complicate governments' debt reduction efforts.

In theory, low inflation increases the public debt ratio through three main channels.

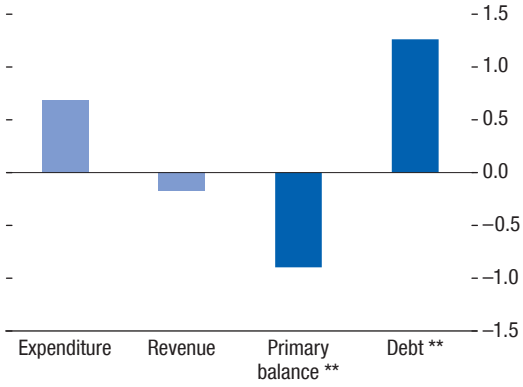
- First, governments would capture fewer real resources through base money creation (seigniorage).
- Second, low inflation could increase the debt-to-GDP ratio through worsening debt dynamics. The impact of this channel depends on the maturity structure and currency denomination of the debt, as well as on the interest rate response to lower inflation. The impact of low inflation is lowest on short-term and floating-rate debt. Foreign currency-denominated debt ratios would not be affected if the exchange rate fully reflects inflation differentials.
- Third, low inflation can affect the primary balance both from the revenue and the expenditure sides. The direction and degree of these effects depend on institutional settings. For example, tax collection lags may increase tax-to-GDP ratios in the short run, since income taxes are based on income generated in the previous year. Therefore, the nominal value of income tax collections may temporarily increase faster than current prices. In contrast, in countries with imperfect or no inflation indexation of tax brackets, lower inflation reduces revenue ratios through less bracket creeping (as slow-growing nominal incomes reduce the shift of taxpayers into higher tax brackets). On the expenditure side, the wage-bill-to-GDP ratio could increase if it is determined by past multi-year settlements or if inflation expectations are slow to come down.

From an empirical standpoint, evidence on the impact of low inflation on debt ratios is limited. Over the past 100 years, in advanced economies, only in four cases did inflation move from the 1–4 percent range to the 0–1 percent range in a persistent manner (i.e., a period of three years).[1] During those episodes, public debt ratios increased on average by 1¼ percentage points of GDP per year, driven both by a worsening of the primary balance and less favorable interest–growth differentials (Figures 1.1.1 and 1.1.2).

[1] Those cases include Italy (1912), Switzerland (1996 and 2001), and Japan (1986). The years in the parentheses indicate the years when the low inflation started. In addition, over the past 100 years, there were 24 episodes of deflation that continued for three years or more in advanced economies (21 of them before World War II).

Figure 1.1.1. Annual Impact of Persistent Low Inflation on Fiscal Variables

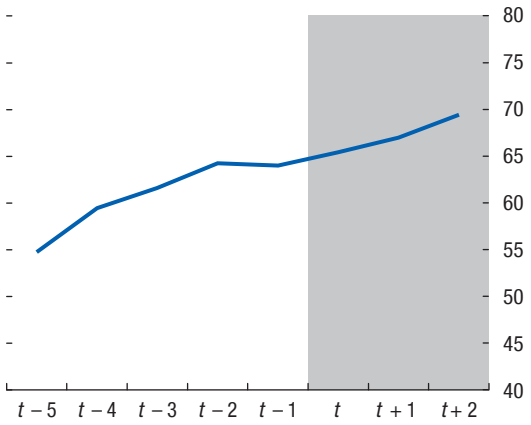
(Percentage points of GDP)



Source: IMF staff estimates.
Note: The figure is based on the four historical cases where inflation moved from the 1–4 percent range to the 0–1 percent range in a persistent manner. It shows the degree of deviation of the main fiscal variables under the four historical cases from overall sample means, after controlling for growth and interest rates. ** indicates statistically significant at the 5 percent level.

Figure 1.1.2. Government Debt under Persistent Low Inflation

(Percent of GDP; sample mean)



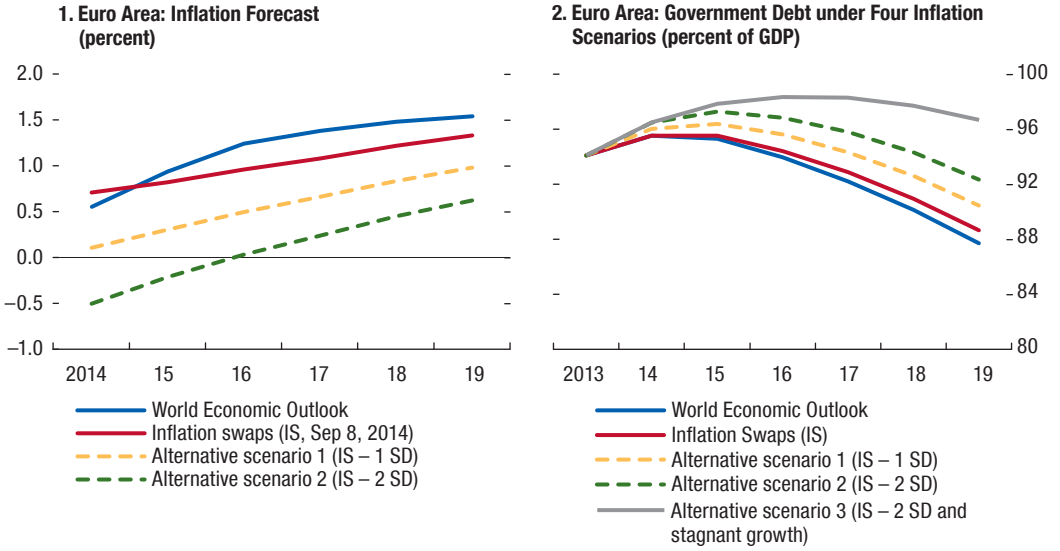
Source: IMF staff estimates.
Note: The figure is based on the four historical cases where inflation moved from the 1–4 percent range to the 0–1 percent range in a persistent manner. The variable *t* indicates the year when inflation moved to the 0–1 range, and inflation stayed in the 0–1 range for three years through *t* + 2.

Box 1.1 *(concluded)*

Using the analytical framework of Akitoby, Komatsuzaki, and Binder (2014), simulations are used to estimate the potential impact of low inflation through seigniorage and debt dynamics on the euro area's debt ratio.[2] Interest rates on newly issued debt are assumed to adjust one for one to lower inflation (a full Fisher effect). Under that assumption, a lower inflation path would delay the peak of government debt by one year from the baseline forecast, through the debt dynamics channel, and also raise the average gross debt-to-GDP ratio by about 4¾ percentage points above baseline projections by 2019 (Figure 1.1.3). The effect of less seigniorage (not included in the figure) is more modest—an increase in the debt ratio of about 1 percentage point by 2019. In addition, if low inflation were associated with stagnant growth, primary balances would deteriorate due to depressed revenue and expenditure pressures, further worsening debt dynamics. In a scenario combining low inflation and stagnant growth—annual growth at the 2014 level through 2019—the increase in the average gross debt-to-GDP ratio goes up to 9 percentage points over the baseline.

[2] Euro area excluding Cyprus and Malta. The growth path is assumed to remain unchanged from the WEO projection. The simulations do not take into account the impact of lower inflation on government debt through the primary-balance channel. The simulations consider two alternative inflation scenarios (1 and 2) which respectively assume the inflation path is below the baseline forecasts by one and two standard deviations (based on inflation swaps as of September).

Figure 1.1.3. Simulation of Low Inflation on Euro Area Debt



Source: IMF staff estimates.
Note: IS = inflation swaps; SD = standard deviation.

Box 1.2. The Fiscal Implications of International Bond Issuance by Low-Income Developing Countries

International sovereign bond issuances by low-income developing countries (LIDCs) in Africa and Asia have grown significantly, particularly since 2010. Most of these were first-time issuances that attracted considerable investor interest against the backdrop of generally low market volatility (Figure 1.2.1). In many cases, sovereign governments have been able to tap the international bond market at least a second time after their debut issuance.

This unprecedented surge in LIDCs issuance responded to both "push" and "pull" factors, namely the search for yield amid ultra-low interest rates in most advanced economies, and improved fundamentals in LIDCs (see Box 1.2 in the October 2013 GFSR; Gueye and Sy, 2010; and Sy, 2013). Interestingly, most recent international bond issuances were destined primarily to finance public infrastructure projects (Figure 1.2.2). This is in sharp contrast to historical experience on bond financing by sovereigns in general, and infrastructure financing by LIDCs in particular (Bordo, Eichengreen, and Irwin, 1999; Eichengreen, 1994).

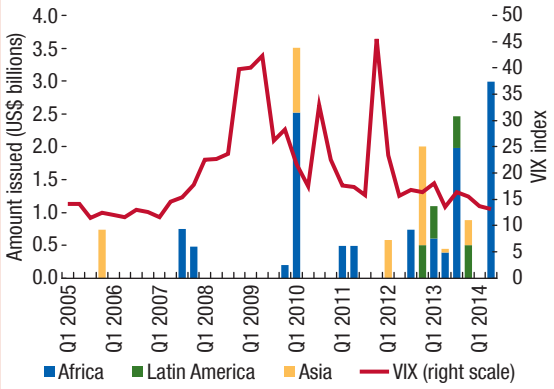
The size and yield of recent bond issues have varied considerably, as issuers are quite a heterogeneous group in terms of the size of their respective economies, growth prospects, and degree of financial stability (Table 1.2.1). Issuances have ranged between 47 million and 1.9 billion of constant U.S. dollars, or between 0.2 percent (Nigeria) and 14.5 percent of GDP (Mongolia). The associated yield to maturity ranged from 1.4 percent to 10.2 percent.

Gaining or expanding access to international capital markets is a welcome development for LIDCs. It is often a crucial step in their financial development and a key component of a sustainable growth strategy (King and Levine, 1993; Levine, 2004). It also reflects improvements in fiscal and financial governance in LIDCs. From a public finance standpoint, international financial integration can provide a broader scope of funding sources, mitigate crowding out of domestic investment, and expand the policy room to respond to shocks. It adds an additional degree of market scrutiny, potentially improving policy discipline and transparency. Also, international access by the sovereign government often facilitates better access conditions for private borrowers.

At the same time, however, sovereign bond issuances can also raise complex fiscal challenges—which have received little attention to date, as most of the policy discussion has focused on capital flows and debt management.[1] There are at least two fiscal dimensions to

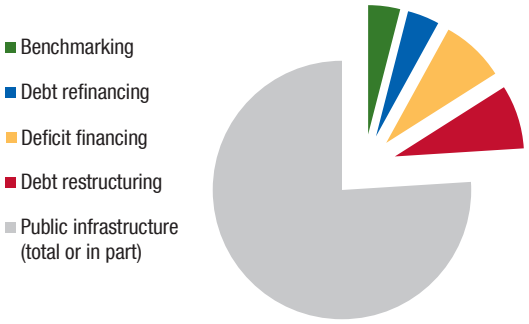
[1] Alleyne and others (2014); Guscina, Pedras, and Presciuttini (2014).

Figure 1.2.1. International Bond Issuance since 2005



Sources: Bloomberg L.P.; Dealogic; and IMF staff estimates.
Note: VIX = Chicago Board Options Exchange Volatility Index.

Figure 1.2.2. Intended Purpose for Proceeds from International Bond Issuance



Sources: IMF staff calculations based on various IMF country reports.
Note: The calculations are based on 25 bond issuances by low-income developing countries from 2005 to 2014, and capture intended rather than actual use of bond proceeds (defined in IMF staff reports and press articles). Benchmarking is defined as pricing information for assessing the yield spread and serving as a reference for other issuance. "Infrastructure (in part)" refers to cases where bond proceeds are intended for allocation between infrastructure financing and other purposes, including benchmarking, refinancing of public debt, and public debt management.

Table 1.2.1. Summary Features of Bond Issuance by Low-Income Developing Countries since 2005

	Deal Total Value (2009 US$)	Yield to Maturity (percent)	Amount (percent of GDP)
Minimum	47,447,693	1.4	0.2
Maximum[1]	1,861,538,748	10.2	14.5

Source: Authors' calculations based on data from Dealogic and Bloomberg L.P.
[1] Excludes bonds issued for debt restructuring purposes by Côte d'Ivoire in 2010.

Box 1.2 *(continued)*

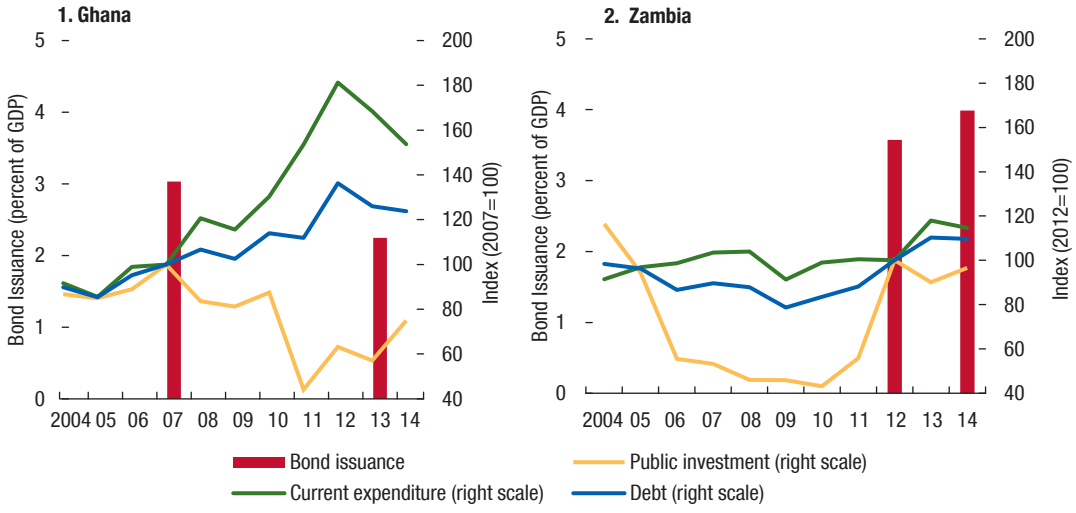
consider—both of which can place significant pressure on LIDCs' often fragile fiscal institutions:

- Bond financing is relatively costly for LIDCs. It is generally more affordable than domestic financing[2] at the margin, but subject to sizeable refinancing and exchange rate risks. It is also considerably more expensive than concessional loans, which tend to constitute the largest part of LIDC financing. Thus, unless bond flows finance projects with sufficiently high returns on government revenue and growth to offset the increased share of nonconcessional debt, they can give rise to fiscal sustainability issues. This underscores the importance of good project selection and execution capacity.
- Given the transaction costs of tapping international bond markets, issuances tend to be large—both in absolute terms (to finance projects that span several budgets) and relative to the size of the economy. Thus, international bond financing can lead to spending pressures (the so-called "voracity effect," also present in small middle-income economies) or come up against absorptive capacity constraints. The recent experiences of Ghana, Zambia, and Mongolia are illustrative. In Ghana, the 2007 bond debut (US$750 million) was followed by a sharp increase in primary spending the following year, driven by current spending, while capital spending declined (Figure 1.2.3). Spending on wages and subsidies increased sharply in Zambia in 2013, financed by part of the Eurobond proceeds that had been intended for investments. In Mongolia, the cumulative size of issuances in 2012 reached close to 15 percent of GDP, putting pressure on an already stretched construction sector and on domestic prices. In addition, a significant share of the bond proceeds was used for off-budget spending not subject to the scrutiny or to the provisions under the newly adopted Fiscal Stability Law (IMF, 2012; World Bank, 2013).

Given these complex fiscal challenges, it is important to ensure disciplined use of external borrowing opportunities. A strong, multi-year budget framework with effective commitment controls and binding institutional oversight is therefore critical.

[2] This is the case when euro bonds are used for debt management, substituting more expensive domestic borrowing and/or the repayment of expensive bank financing (as in Côte d'Ivoire and Senegal).

Figure 1.2.3. Evolution of Key Fiscal Variables after International Sovereign Bond Issuance



Sources: Bloomberg L.P.; Dealogic; and IMF staff estimates.
Note: Fiscal variables are normalized to 100 in the year of the first bond issuance, shown on the right scale. This corresponds to 2007 for Ghana and 2012 for Zambia.

References

Afonso, A., and J. T. Jalles, 2012, "Measuring the Success of Fiscal Consolidations," *Applied Financial Economics,* Vol. 22, No. 13.

Akitoby, B., T. Komatsuzaki, and A. Binder, 2014, "Inflation and Public Debt Reversals in the G7 Countries," IMF Working Paper 14/96 (Washington: International Monetary Fund).

Alleyne, T., C. A. Gueye, J. Arze del Granado, R. Garcia-Verdu, M. Hussain, B. K. Jang, M. Mecagni, S. Weber, and J.S. Corrales, 2014, "Managing Volatile Capital Flows: Experiences and Lessons for Sub-Saharan African Frontier Markets," African Department Departmental Paper 14/01 (Washington: International Monetary Fund).

Bettendorf, L., A. van der Horst, and R. De Mooij, 2009, "Corporate Tax Policy and Unemployment in Europe: An Applied General Equilibrium Analysis," *The World Economy Special Issue: Europe Special Issue–Taxation and the Globalisation Process,* Vol. 32, No. 9, pp. 1319–47.

Blanchard, O., 1993, "Suggestions for a New Set of Fiscal Indicators," in *The Political Economy of Government Debt,* ed. by H.A. Verbon and F.A.A.M Van Winden (London: Elsevier).

Bordo, M. D., B. Eichengreen, and D. A. Irwin, 1999, "Is Globalization Today Really Different than Globalization a Hundred Years Ago?" NBER Working Paper 7195 (Cambridge, Massachusetts: National Bureau of Economic Research).

De Mooij, R., and I. Saito, 2014, "Japan's Corporate Income Tax: Facts, Issues and Reform Options," IMF Working Paper 14/138 (Washington: International Monetary Fund).

Eichengreen, B., 1994, "Financing Infrastructure in Developing Countries: Lessons from the Railway Age," Policy Research Working Paper 1379 (Washington: World Bank).

Eichengreen, B., and U. Panizza, 2014, "A Surplus of Ambition: Can Europe Rely on Large Primary Surpluses to Solve its Debt Problem?" NBER Working Paper 20316 (Cambridge: National Bureau for Economic Research).

Escolano, J., L. Jaramillo, C. Mulas-Granados, and G. Terrier, 2014, "How Much is A Lot? Historical Evidence on the Size of Fiscal Adjustments," IMF Working Paper 14/179 (Washington: International Monetary Fund).

Escolano, J., C. Kolerus, and C. A. Lonkeng Ngouana, "Global Monetary Tightening: Emerging Markets Debt Dynamics and Fiscal Crises," IMF Working Paper (Washington: International Monetary Fund, forthcoming).

Gueye, C. A., and A. N. R. Sy, 2010, "Beyond Aid: How Much Should African Countries Pay to Borrow?" Working Paper 10/140 (Washington: International Monetary Fund).

Guscina, A., G. Pedras, and G. Presciuttini, 2014, "First-Time International Bond Issuance—New Opportunities and Emerging Risks," Working Paper 14/127 (Washington: International Monetary Fund).

International Monetary Fund (IMF), 2010, "Macro-Fiscal Implications of Health Care Reform in Advanced and Emerging Economies," IMF Policy Paper (Washington). https://www.imf.org/external/np/pp/eng/2010/122810.pdf.

———, 2011, "The Challenge of Public Pension Reform in Advanced and Emerging Economies," IMF Policy Paper (Washington). http://www.imf.org/external/np/pp/eng/2011/122811.pdf.

———, 2012, "Mongolia, 2012 Article IV Consultation and Third Post-Program Monitoring," November 2012, IMF Country Report 12/320 (Washington: International Monetary Fund).

———, 2014a, *2014 Spillover Report* (Washington). http://www.imf.org/external/np/pp/eng/2014/062514.pdf.

———, 2014b, *Macroeconomic Developments in Low-Income Developing Countries: 2014 Report* (Washington).

Karam, P., D. Muir, J. Pereira, and A. Tuladhar, 2010, "Macroeconomic Effects of Public Pension Reforms," IMF Working Paper 10/297 (Washington: International Monetary Fund).

King, R. G., and R. Levine, 1993, "Finance and Growth: Schumpeter Might be Right," *Quarterly Journal of Economics,* Vol. 108, No. 3, pp. 717–37.

Laeven, L., and F. Valencia, 2012, "Systemic Banking Crises Database: an update" IMF Working Paper 12/163 (Washington: International Monetary Fund).

Levine, R., 2004, "Finance and Growth: Theory and Evidence," NBER Working Paper 10766 (Cambridge, Massachusetts: National Bureau of Economic Research).

Sy, A. N. R., 2013, "First Borrow," *Finance & Development* 50, no. 2: 12–15.

World Bank, 2013, "Mongolia Economic Update," November 2013 (Washington: World Bank).