EXECUTIVE SUMMARY

Recent Fiscal Developments and Outlook

A moderate and uneven recovery is taking place in advanced economies, supported by lower oil prices, continued accommodative monetary policy, and slower fiscal adjustment. However, high public and private debt levels continue to pose headwinds to growth and debt sustainability in some advanced economies. In addition, inflation is below target by a large margin in many countries, making the task of reducing high public debt levels more difficult. Growth in emerging economies is softening and financial and exchange rate volatility has increased public financing costs for some of them. Meanwhile, lower oil and commodity revenues have created challenges for exporting countries.

In this challenging environment, fiscal policy continues to play an essential role—alongside accommodative monetary policy and structural reforms—in building confidence and, where appropriate, sustaining aggregate demand. With narrow margins for policy maneuvering, three courses of action for sound fiscal policy stand out:

Use fiscal policy flexibly to support growth, while mitigating risks and ensuring medium-term debt sustainability. The degree and type of flexibility will depend on individual countries' fiscal positions, macroeconomic conditions, and relevant fiscal risks. Countries with fiscal space can use it to support growth, particularly where risks of low growth and low inflation have materialized. For example, higher public investment in infrastructure could raise aggregate demand in the short term and increase potential output in the medium term. Countries that are more constrained should pursue more growth-friendly fiscal rebalancing and structural reforms to boost potential growth. Meanwhile, in countries where mounting fiscal risks may lead to market pressure, rebuilding fiscal buffers should be a priority. In oil- and commodity-exporting countries, the government's financial assets, if sufficient, can be used to adjust gradually to the shock from lower oil prices. Nonetheless, spending cuts may be unavoidable in some financially constrained oil exporters. In economies with oil subsidies, the windfall gains from lower prices should be used to increase spending that can boost growth and, where macroeconomic vulnerabilities are high, to rebuild fiscal buffers.

Seize the opportunity created by falling oil prices. Energy tax reform can help reduce negative externalities caused by energy consumption and provide breathing room for rebalancing the tax burden—for example, by lowering taxes on labor to boost employment. In developing economies, further reform of energy subsidies could provide space for productive spending on education, health, and infrastructure, as well as for programs to benefit the poor.

Strengthen institutional frameworks for managing fiscal policy. Fiscal frameworks anchor fiscal policy and guide it toward its medium-term objectives. These frameworks help enhance the play of automatic stabilizers over the course of the business cycle and thus reduce output volatility and raise medium-term growth. Well-grounded fiscal frameworks are particularly necessary in countries with high levels of public debt and a looming increase in the burden of age-related spending.

Can Fiscal Policy Stabilize Output?

In an environment of tepid growth and persistent downside risks, finding ways to enhance fiscal policy's ability to smooth the effect of shocks to economic activity is high on the policy agenda. As is clear from the evidence gathered in this *Fiscal Monitor*, fiscal policy has often served this purpose over the last 30 years. Since the mid-1990s, some advanced economies have also increasingly turned to fiscal policy to help stabilize economic conditions. Many emerging market and developing economies, however, seemed less inclined to use this approach, given their less potent fiscal instruments and the prominence of policy objectives other than output stability, such as building economic and social infrastructure geared toward economic development, and addressing social needs.

Fiscal policy can seek to stabilize output in two ways. One way is through so-called automatic stabilizers (tax payments that move in sync with income and spending and social transfers, such as unemployment benefits, that automatically boost aggregate demand during downturns and moderate it during upswings). Another way is through deliberate fiscal policy measures adopted in response to specific shocks. Automatic stabilizers are timely, but often have adverse side effects for efficiency (such as high marginal tax rates or overly generous transfers that undermine incentives to find work or create jobs).

Automatic stabilizers have played an important role in fiscal stabilization, often accounting for more than half the stabilizing response of fiscal policy in advanced economies. However, they have generally not been allowed to play fully in good times, because spending a portion of revenue windfalls is tempting. The resulting asymmetry in the policy response to output shocks prevents the restoration of fiscal buffers when growth is strong and can contribute to significant accumulation of public debt over time.

If the past is any indication of the future, making fiscal policy more responsive to output shocks could substantially reduce macroeconomic volatility. The dividends of greater fiscal stabilization are especially large in advanced economies, where it could lower output volatility by up to 20 percent. Reduced volatility and uncertainty could in turn foster medium-term growth. An average increase—by one standard deviation in the sample—in the responsiveness of fiscal policy to output could boost annual growth by about 0.3 percentage point in advanced economies. Dividends appear much smaller in emerging market and developing economies, where fiscal stabilization is less effective and is dominated by developmental priorities.

In sum, stability and growth could both benefit when procyclical fiscal measures are avoided. Well-designed fiscal rules and medium-term frameworks can help by allowing automatic stabilizers to play in good as well as in bad times. Countries seeking to augment automatic stabilizers should pursue measures that do not entail large efficiency costs (for example, making tax exemptions such as the investment tax credit or the mortgage interest deduction less procyclical). The decision and implementation lags associated with discretionary stabilization could be eased, for instance, by moving quickly to identify easy-to-implement capital and maintenance spending.