

Introduction

The COVID-19 pandemic has not yet been brought under control, and recovery is not assured. Access to vaccines, the pace of vaccination, the effectiveness of other measures to curb contagion, and the scale and modalities of policy support differ widely across countries. As a result, economic recoveries are diverging, with *China* and the *United States* recovering the fastest while many economies are lagging or are still stagnant (April 2021 *World Economic Outlook*). Continued and flexible fiscal support is, thus, crucial until a durable recovery is under way. Government actions are also needed to manage the legacies of the crisis, including debt vulnerabilities, rising fiscal risks, and the disproportionate burden on poor and vulnerable households that exacerbates preexisting inequities (Chapter 2). Many governments are implementing multiyear fiscal actions to support health care systems, households, and firms (\$16 trillion globally since the beginning of the pandemic, with a data cutoff as of March 17, 2021). Such support varies across economies depending on the effect of pandemic-related shocks, the ability to access low-cost borrowing, and precrisis fiscal conditions. Public debt levels before the pandemic were higher than before the global financial crisis in 2007, but average interest payments are generally lower in advanced economies and many emerging market economies given the trend decline in market interest rates (Figure 1.1). The nonfinancial corporate sector in many countries entered the crisis with higher leverage than in 2007 (IMF Global Debt Database 2020), posing vulnerability to financial stress. Massive liquidity support to nonfinancial firms, although necessary, has increased private sector indebtedness (April 2021 *Global Financial Stability Report*). If bankruptcies increase, some private debt could migrate to the public sector through bailouts.

The longer the pandemic lasts, the greater the challenge is to public finances. Government deficits and debt have risen to unprecedented levels, given major fiscal support, along with a sharp fall in revenues caused by contractions in output (Figure 1.2, Tables 1.1 and 1.2). Average overall fiscal deficits as

a share of GDP in 2020 reached 11.7 percent for advanced economies, 9.8 percent for emerging market economies, and 5.5 percent for low-income developing countries. Global public debt climbed to 97.3 percent of GDP in 2020, a surge of 13 percentage points from the level projected before the pandemic. In pursuit of their mandates, central banks in advanced economies and some emerging market economies have lowered policy rates and purchased government bonds, thereby facilitating the fiscal responses to the pandemic (Figure 1.3). Even so, many emerging market and developing economies have faced borrowing constraints, particularly those economies with elevated debt, large gross financing needs (Figure 1.4), and a high share of external or foreign-currency-denominated debt. In advanced economies, higher deficits have resulted from roughly equal increases in spending and declines in revenues, whereas in emerging market and developing economies, on average, the rise in deficits has stemmed primarily from the collapse in revenues caused by lower economic activity. For commodity exporters, depressed prices and supply cuts have added to the challenge. Fiscal deficits in 2021 are expected to shrink as pandemic-related support expires or winds down and automatic stabilizers play out (through, for example, higher tax revenues and lower unemployment benefits). The global public debt is projected to stabilize at about 99 percent of GDP through 2021 and in the medium term.

Large fiscal actions have prevented a more severe global economic contraction, greater job losses, and higher social costs. Fiscal support, therefore, should continue as feasible and as needed while vaccinations continue, testing capacity and other preventive measures are enhanced, and the recovery strengthens. Such support should increasingly be tailored to country circumstances and changing economic and pandemic conditions. On the basis of announced measures, however, a retrenchment in fiscal support is projected in 2021, especially in emerging market and developing economies with elevated debt. To balance the risks from growing debt with those from premature withdrawal of policy support, policymakers need to

Figure 1.1. Interest Expense and Government Debt, 2007–21

(Percent of GDP; debt-to-GDP, left scale; interest expense, right scale)

Despite rising public debt levels, interest bills are lower in advanced and emerging market economies.



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

develop credible medium-term fiscal frameworks—thereby extending the horizon for fiscal policymaking beyond the annual budget. Fiscal policy should also enable a green, digital, and inclusive transformation of the economy in the post-COVID-19 environment. For example, efficient use of the Next Generation EU resources can facilitate such transformation in the *European Union*. Once the recovery is firmly in place, long-standing weaknesses in public finances must be tackled. Priorities include tax and social protection reforms as well as renewed efforts to achieve the Sustainable Development Goals (SDGs).

The remainder of Chapter 1 reviews recent fiscal developments and outlook by country income group,

considering risks to public finances; examines the effectiveness of discretionary fiscal policy responses to the COVID-19 crisis; and discusses near-term, then longer-term, policy priorities.

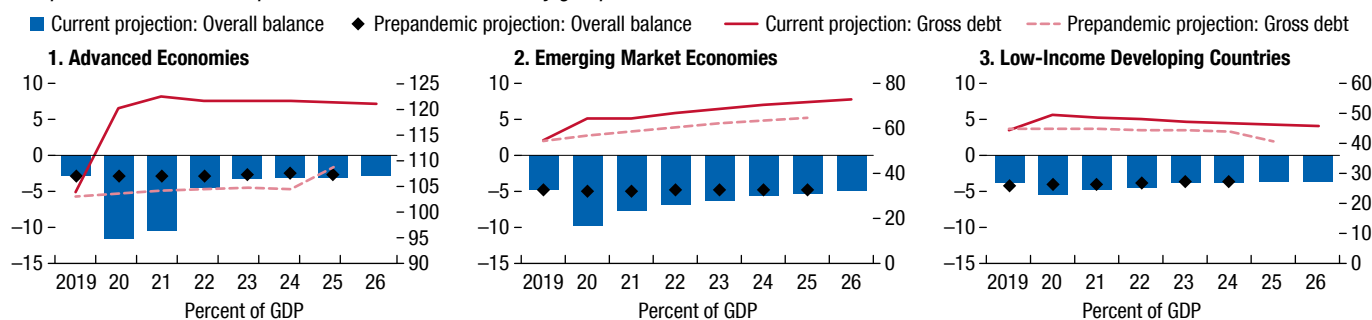
Recent Fiscal Developments and Outlook

Although fiscal support actions have been massive, especially in advanced economies, other factors—especially output drops—have largely driven the rise in public debt ratios during 2020–21. The major effect of output contractions on debt ratios is revealed by an extended accounting method (Mauro and Zilinsky 2016) that considers the separate roles of economic

Figure 1.2. The Effect of the COVID-19 Pandemic on the Forecast of General Government Gross Debt and Fiscal Balances, 2019–26

(Percent of GDP; overall balance, left scale; gross debt, right scale)

The pandemic has strained public finances across all country groups.



Source: IMF, World Economic Outlook database.

Note: Prepandemic projections are based on the January 2020 *World Economic Outlook Update*. The right scale is different for each country income group.

Table 1.1. General Government Fiscal Overall Balance, 2016–26
(Percent of GDP)

	2016	2017	2018	2019	2020	Projections					
						2021	2022	2023	2024	2025	2026
World	-3.5	-3.1	-3.0	-3.6	-10.8	-9.2	-5.4	-4.4	-4.0	-3.9	-3.7
Advanced Economies	-2.7	-2.4	-2.5	-2.9	-11.7	-10.4	-4.6	-3.2	-3.0	-3.0	-2.8
Advanced G-20	-3.1	-3.0	-3.1	-3.6	-12.7	-11.5	-5.0	-3.5	-3.3	-3.4	-3.2
Canada	-0.5	-0.1	0.3	0.5	-10.7	-7.8	-3.9	-1.3	-0.2	0.1	0.2
Euro Area	-1.5	-0.9	-0.5	-0.6	-7.6	-6.7	-3.3	-2.3	-1.8	-1.6	-1.6
France	-3.6	-2.9	-2.3	-3.0	-9.9	-7.2	-4.4	-3.8	-3.6	-3.5	-3.5
Germany	1.2	1.4	1.8	1.5	-4.2	-5.5	-0.4	0.4	0.5	0.6	0.6
Italy	-2.4	-2.4	-2.2	-1.6	-9.5	-8.8	-5.5	-3.8	-2.2	-2.0	-1.8
Spain ¹	-4.3	-3.0	-2.5	-2.9	-11.5	-9.0	-5.8	-4.9	-4.3	-4.3	-4.3
Japan	-3.8	-3.3	-2.7	-3.1	-12.6	-9.4	-3.8	-2.5	-2.3	-2.3	-2.4
United Kingdom	-3.3	-2.4	-2.2	-2.3	-13.4	-11.8	-6.2	-4.0	-3.4	-3.3	-3.3
United States ²	-4.3	-4.6	-5.4	-5.7	-15.8	-15.0	-6.1	-4.6	-4.7	-5.0	-4.7
Others	0.5	1.2	1.0	-0.2	-6.0	-4.8	-2.6	-1.8	-1.4	-1.1	-0.9
Emerging Market Economies	-4.8	-4.1	-3.8	-4.7	-9.8	-7.7	-6.7	-6.1	-5.6	-5.2	-4.9
Emerging G-20	-4.9	-4.3	-4.3	-5.4	-10.4	-8.3	-7.4	-6.8	-6.3	-5.8	-5.4
Excluding MENAP Oil Producers	-4.4	-4.0	-3.9	-4.9	-9.8	-7.9	-6.9	-6.3	-5.8	-5.3	-5.0
Asia	-4.0	-4.0	-4.5	-5.9	-10.8	-9.2	-8.2	-7.4	-6.8	-6.2	-5.8
China	-3.7	-3.8	-4.7	-6.3	-11.4	-9.6	-8.7	-7.9	-7.2	-6.5	-6.0
India	-7.1	-6.4	-6.3	-7.4	-12.3	-10.0	-9.1	-8.4	-8.0	-7.7	-7.4
Europe	-2.8	-1.8	0.3	-0.7	-5.9	-3.5	-2.7	-2.7	-2.6	-2.5	-2.5
Russian Federation	-3.7	-1.5	2.9	1.9	-4.1	-0.8	-0.3	-0.5	-0.5	0.0	0.0
Latin America	-6.0	-5.4	-5.1	-4.0	-8.8	-5.7	-4.5	-4.2	-3.9	-3.7	-3.6
Brazil	-9.0	-7.9	-7.1	-5.9	-13.4	-8.3	-7.2	-7.3	-7.0	-6.6	-6.5
Mexico	-2.8	-1.1	-2.2	-2.3	-4.6	-3.4	-2.6	-2.6	-2.5	-2.5	-2.5
MENAP	-9.7	-5.5	-2.7	-3.9	-9.9	-5.7	-4.6	-4.3	-4.1	-3.8	-3.5
Saudi Arabia	-17.2	-9.2	-5.9	-4.5	-11.1	-3.8	-2.5	-2.0	-1.4	-0.9	-0.2
South Africa	-4.1	-4.4	-4.1	-5.3	-12.2	-10.6	-8.3	-7.1	-6.7	-6.7	-6.8
Low-Income Developing Countries	-3.8	-3.5	-3.4	-3.9	-5.5	-4.9	-4.4	-4.0	-3.8	-3.7	-3.7
Kenya	-8.5	-7.8	-7.4	-7.7	-8.4	-8.1	-6.6	-5.1	-4.0	-3.2	-2.5
Nigeria	-4.6	-5.4	-4.3	-4.8	-5.8	-4.2	-4.6	-4.4	-4.7	-5.1	-5.6
Vietnam	-3.2	-2.0	-1.0	-3.3	-5.4	-4.7	-4.4	-4.0	-3.7	-3.3	-3.0
Oil Producers	-5.3	-2.9	0.0	-0.5	-8.3	-4.3	-2.8	-2.0	-1.7	-1.5	-1.5
Memorandum											
World Output (percent)	3.3	3.8	3.6	2.8	-3.3	6.0	4.4	3.5	3.4	3.3	3.3

Source: IMF staff estimates and projections.

Note: All country averages are weighted by nominal GDP converted to US dollars (adjusted by purchasing power parity only for world output) at average market exchange rates in the years indicated and based on data availability. Projections are based on IMF staff assessments of current policies. In many countries, 2021 data are still preliminary. For country-specific details, see "Data and Conventions" and Tables A, B, C, and D in the Methodological and Statistical Appendix. MENAP = Middle East, North Africa, and Pakistan.

¹ Including financial sector support.

² For cross-economy 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 expenditures under the 2008 System of National Accounts (2008 SNA) adopted by the United States but not 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 US Bureau of Economic Analysis.

growth (including its effects on the primary surplus), the interest bill, policy measures, and the stock-flow residual (Figure 1.5). The overall effect of negative output growth on the debt-to-GDP ratio in 2020 amounted to 9.8 percentage points for advanced economies, 5.5 percentage points for emerging market economies, and 3.1 percentage points for low-income developing countries. The subsections that follow discuss fiscal developments by income group.

Advanced Economies: Extending to Multiyear Support

Beginning with the onset of the pandemic early in 2020, most advanced economies have undertaken sizable fiscal support measures to counter the health crisis and its economic fallout (Figure 1.6.A). Various emergency lifelines have been extended and new fiscal actions announced as a bridge to recovery and amid new infection waves of varying timing and intensity. Revenues fell sharply, largely from depressed

Table 1.2. General Government Debt, 2016–26
(Percent of GDP)

	2016	2017	2018	2019	2020	Projections					
						2021	2022	2023	2024	2025	2026
Gross Debt											
World	83.2	82.0	82.3	83.7	97.3	98.9	99.0	99.4	99.5	99.5	99.3
Advanced Economies	105.5	103.1	102.5	103.8	120.1	122.5	121.6	121.8	121.5	121.4	121.1
Canada ¹	91.7	88.8	88.8	86.8	117.8	116.3	112.8	109.3	105.7	102.0	98.1
Euro Area	90.1	87.7	85.8	84.0	96.9	98.2	96.5	95.6	94.4	93.1	91.9
France	98.0	98.3	98.0	98.1	113.5	115.2	114.3	115.2	115.9	116.3	116.9
Germany	69.3	65.1	61.8	59.6	68.9	70.3	67.3	64.8	62.2	59.6	57.1
Italy	134.8	134.1	134.4	134.6	155.6	157.1	155.5	155.1	153.7	152.0	151.0
Spain	99.2	98.6	97.4	95.5	117.1	118.4	117.3	117.3	116.8	117.7	118.4
Japan	232.5	231.4	232.5	234.9	256.2	256.5	253.6	252.9	253.4	254.0	254.7
United Kingdom	86.8	86.3	85.8	85.2	103.7	107.1	109.1	110.7	111.4	112.2	113.0
United States ¹	106.6	105.6	106.6	108.2	127.1	132.8	132.1	132.4	133.0	133.9	134.5
Emerging Market Economies	48.4	50.5	52.4	54.7	64.4	65.1	67.3	69.2	70.8	72.2	73.2
Excluding MENAP Oil Producers	50.1	52.2	54.2	56.3	66.1	67.1	69.2	71.1	72.7	74.0	75.0
Asia	50.0	52.8	54.4	57.3	67.6	69.9	73.0	75.6	77.8	79.8	81.4
China	48.2	51.7	53.8	57.1	66.8	69.6	73.7	77.3	80.4	83.3	86.0
India	68.7	69.5	70.2	73.9	89.6	86.6	86.3	85.7	84.8	83.8	82.6
Europe	32.0	30.1	29.7	29.2	37.6	36.9	37.2	37.7	38.2	38.4	38.8
Russian Federation	14.8	14.3	13.6	13.8	19.3	18.1	17.7	17.6	17.7	17.3	17.4
Latin America	56.4	61.1	67.5	68.4	77.7	75.9	76.0	76.3	76.5	76.2	75.8
Brazil ²	78.3	83.6	85.6	87.7	98.9	98.4	98.8	100.1	101.0	101.4	101.7
Mexico	56.7	54.0	53.6	53.3	60.6	60.5	60.5	60.7	60.7	60.7	60.8
MENAP	44.8	44.3	44.1	49.0	56.6	53.7	54.4	55.1	55.7	55.9	55.4
Saudi Arabia	13.1	17.2	19.0	22.8	32.4	31.0	31.7	31.1	32.2	32.4	31.2
South Africa	51.5	53.0	56.7	62.2	77.1	80.8	84.4	87.2	89.9	92.5	94.9
Low-Income Developing Countries	39.8	42.2	42.8	44.3	49.5	48.6	48.2	47.5	46.9	46.3	45.7
Kenya	50.5	56.9	60.2	62.1	68.7	71.5	72.9	72.3	71.8	70.0	68.1
Nigeria	23.4	25.3	27.7	29.2	35.1	31.9	32.5	33.0	33.9	35.3	37.0
Vietnam	47.6	46.3	43.6	43.4	46.6	48.0	47.3	46.8	45.8	44.9	43.7
Oil Producers	41.3	41.8	44.0	45.5	58.8	56.2	56.0	55.6	55.3	54.6	53.9
Net Debt											
World	69.3	67.9	68.0	68.6	83.2	86.3	86.6	86.9	86.9	87.2	87.3
Advanced Economies	76.9	75.0	74.8	75.2	90.8	94.2	94.4	94.7	94.8	95.4	95.8
Canada ¹	28.7	26.0	25.6	23.4	33.0	37.0	36.6	34.8	32.3	29.7	26.9
Euro Area	74.2	72.1	70.4	69.2	80.8	82.8	81.8	81.3	80.5	79.5	78.6
France	89.2	89.4	89.3	89.3	104.3	106.1	105.1	106.1	106.7	107.2	107.7
Germany	49.6	45.8	43.0	41.4	50.0	52.5	50.4	48.4	46.4	44.3	42.2
Italy	121.6	121.3	121.8	122.1	142.0	144.2	143.1	143.1	141.9	140.4	139.7
Spain	86.1	85.1	83.6	82.2	102.3	104.5	104.3	104.8	104.9	106.0	107.2
Japan	149.6	148.1	151.2	150.4	169.2	172.3	171.0	170.7	171.3	171.8	172.6
United Kingdom	77.8	76.8	75.9	75.3	93.8	97.2	99.2	100.8	101.5	102.3	103.1
United States ¹	81.7	81.4	81.7	83.0	103.2	109.0	109.5	110.1	111.0	113.2	115.3
Emerging Market Economies	35.0	36.1	37.0	38.7	46.0	47.7	49.1	50.3	51.2	51.6	51.3
Asia	...	...	...	...	...	...	...	...	...	...	...
Europe	31.5	30.3	30.5	29.3	38.9	39.9	40.7	41.4	42.2	42.7	43.0
Latin America	40.3	42.5	42.9	44.1	51.5	53.7	55.3	57.1	58.5	59.3	60.0
MENAP	32.2	32.3	34.6	40.5	46.7	46.4	47.5	49.0	49.4	49.4	48.3

Source: IMF staff estimates and projections.

Note: All country averages are weighted by nominal GDP converted to US dollars (adjusted by purchasing power parity only for world output) at average market exchange rates in the years indicated and based on data availability. Projections are based on IMF staff assessments of current policies. In many countries, 2021 data are still preliminary. For country-specific details, see "Data and Conventions" and Tables A, B, C, and D in the Methodological and Statistical Appendix. MENAP = Middle East, North Africa, and Pakistan.

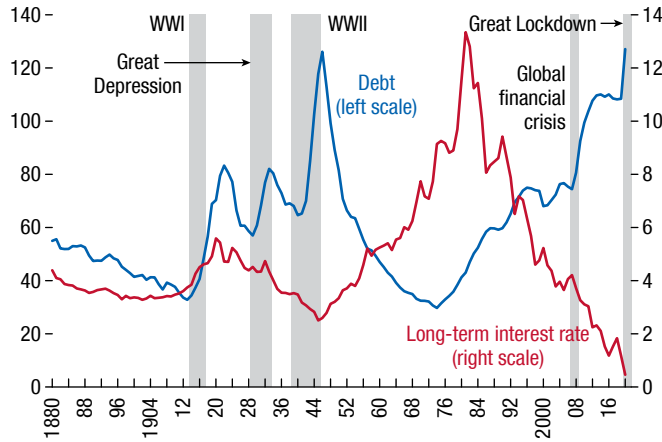
¹ For cross-economy comparability, gross and net debt levels reported by national statistical agencies for economies that have adopted the 2008 System of National Accounts (*Australia, Canada, Hong Kong SAR, United States*) are adjusted to exclude unfunded pension liabilities of government employees' defined-benefit pension plans.

² 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.

Figure 1.3. Public Debt and Bond Yields in Advanced Economies, 1880–2020
(Percent of GDP, left scale; percent, right scale)

(Percent of GDP, left scale; percent, right scale)

Government debt has reached unprecedented levels, whereas interest rates are at historical lows.



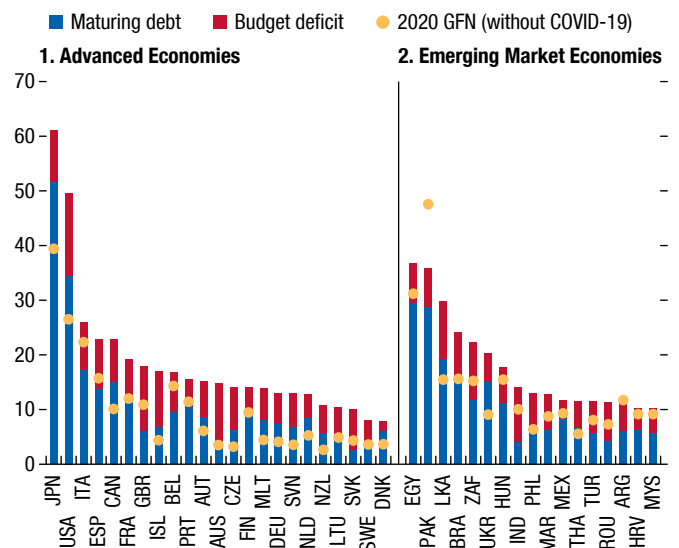
Sources: IMF, Historical Public Debt Database; IMF, World Economic Outlook database; JST Macro-History database; Maddison Database Project; Thomson Reuters Datastream, Global Financial Data; and IMF staff calculations. Note: The public-debt-to-GDP and long-term interest rate series for advanced economies are based on a constant sample of 20 countries, weighted by GDP in purchasing-power-parity terms. WWI = World War I; WWII = World War II.

economic activity (Figure 1.6.B). The average cyclically adjusted primary deficit of advanced economies jumped to 7.6 percent of GDP in 2020. The *United States* provided assistance equivalent to 16.7 percent of GDP in 2020 to households, firms, and state and local governments. *Japan* and the *United Kingdom* provided 15.9 percent and 13 percent, respectively, of GDP of above-the-budget-line support in 2020. Similarly, national fiscal policies in the *euro area* (totaling more than 5 percent of the region’s GDP) and sizable automatic stabilizers (amounting to about 5 percent of GDP) have provided critical support for workers and firms. With severe economic contraction and massive fiscal support, the average government gross debt-to-GDP ratio of advanced economies soared to 120 percent in 2020.

The average fiscal deficit in 2021 is expected to narrow, as several pandemic-related support actions expire or wind down and automatic stabilizers play out. Several measures have, however, been extended to 2021 and beyond. In *Canada*, the timeline for the withdrawal of fiscal support will not be locked into a

Figure 1.4. Gross Financing Needs, 2021
(Percent of GDP)

Gross financing needs have been boosted by the COVID-19 crisis.

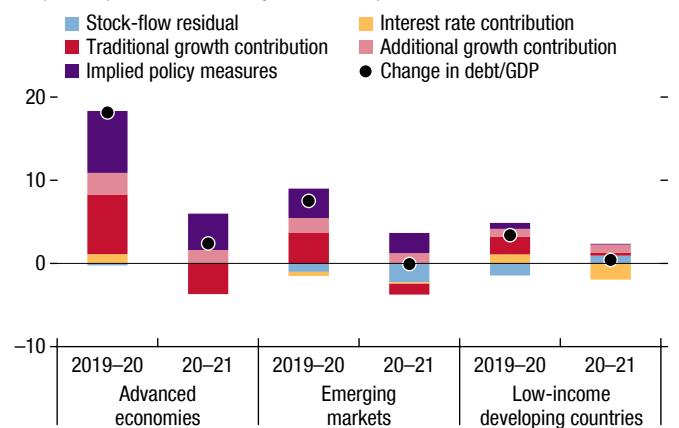


Sources: Bloomberg Finance L.P.; IMF, World Economic Outlook database; and IMF staff estimates. Note: Data labels use International Organization for Standardization (ISO) country codes. GFN = gross financing needs.

Figure 1.5. Accounting for Changes in Government Debt, 2019–21
(Percent of GDP)

(Percent of GDP)

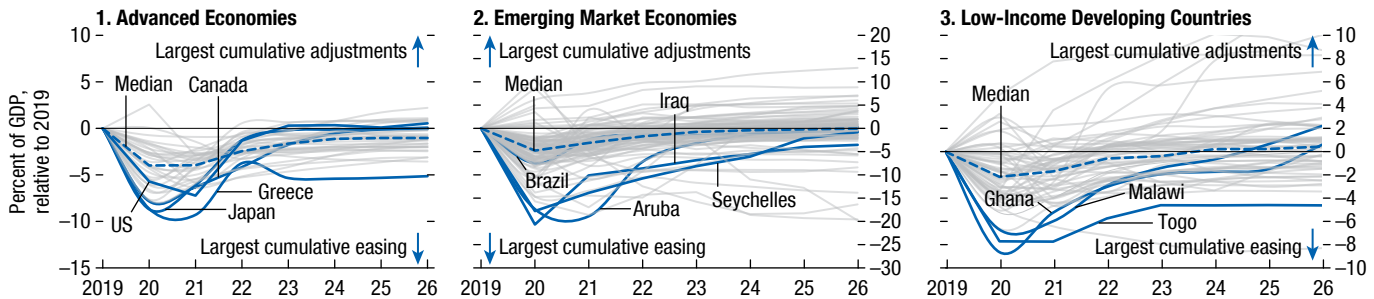
Output drops have had a major effect on public debt.



Sources: IMF, World Economic Outlook database; and IMF staff estimates. Note: Additional growth contribution refers to the effect on the primary surplus through lower revenues. The stock-flow residual is the change in the debt ratio resulting from factors (such as bailouts or exchange rate changes) other than those listed. The overall effect of output growth on debt-to-GDP ratio is measured by the sum of traditional and additional growth contributions (dark and light red bars).

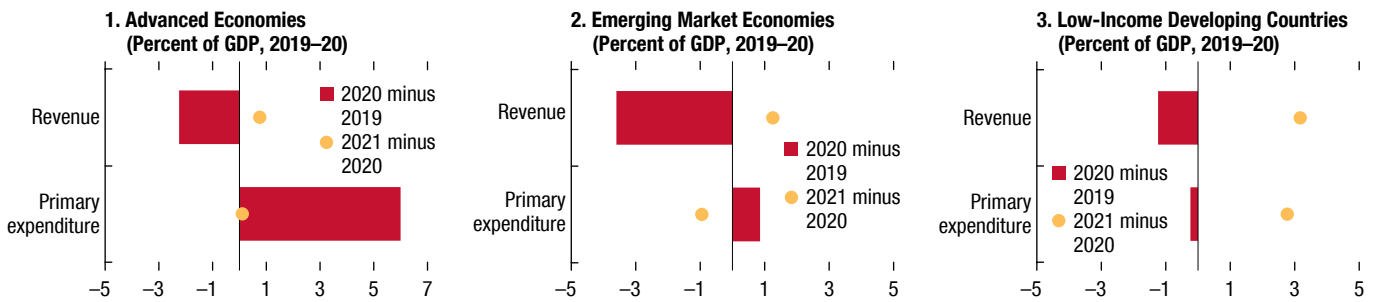
Figure 1.6. Recent Fiscal Developments and Outlook across Income Groups, 2019–26
A. Cumulative Change in Fiscal Balance (Percent of GDP, relative to 2019)

Fiscal support is expected to unwind over the medium term.



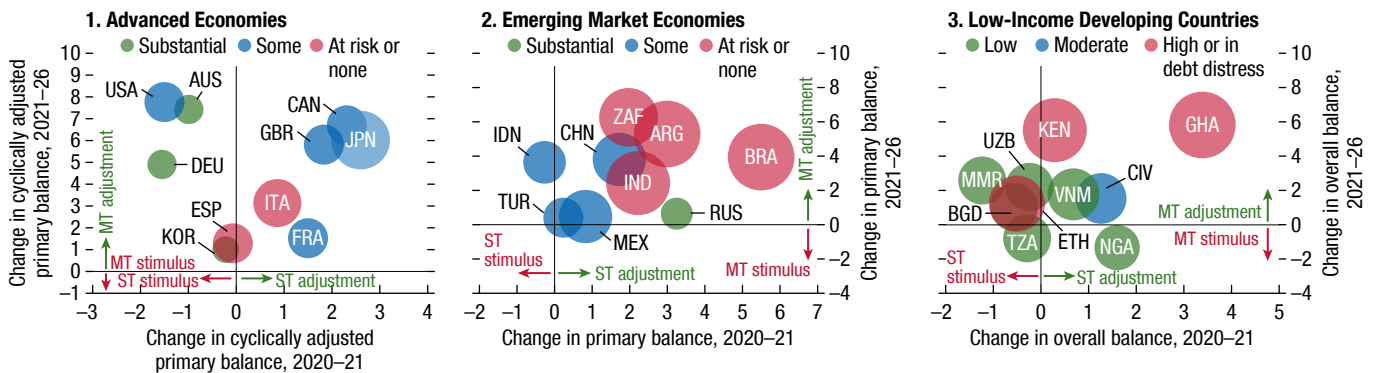
B. Change in General Government Expenditure and Revenue (Percent of pre-COVID-19 GDP)

Revenues fell everywhere, whereas pandemic-related spending was higher mostly in advanced economies.



C. Fiscal Adjustment and Public Debt for Selected Economies, 2020–26 (Percent of GDP)

Countries with fiscal space at risk are projected to adjust more in the coming years.



Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Note: Figures 1.6.A and 1.6.C use the cyclically adjusted primary balance for advanced economies, primary balance for emerging market economies, and overall balance for low-income developing countries. Numbers in each year refer to the cumulative change since 2019. Figure 1.6.B reports the weighted averages across income groups. Pre-COVID-19 GDP refers to the GDP outturn in 2019 and the October 2020 *World Economic Outlook* projections of GDP for 2020 and 2021. Colors in Figure 1.6.C indicate fiscal space in panels 1 and 2 and risk of debt distress in panel 3. The bubble size refers to debt-to-GDP ratio relative to the respective income group average. Data labels use International Organization for Standardization (ISO) country codes.

predetermined calendar. In the *United Kingdom*, the fiscal year 2021/22 budget strengthens short-term support to the economy, including by extending the pandemic-related support through September 2021, while laying out a strategy to restore medium-term fiscal sustainability centered on corporate and income tax increases. The 2021 budgets of *European Union*

countries remain supportive and should be bolstered by grants from the European Union’s Recovery and Resilience Facility. *Japan* has announced sizable fiscal support for 2021, including public investment for climate-resilient infrastructure and incentives for firms to invest in digital technology. More support is likely forthcoming in several countries. By providing

additional resources to tackle the public health crisis (including through vaccinations) and supporting those in need (including through unemployment benefits, the earned-income tax credit, child tax credits, and food assistance), the American Rescue Package in the *United States* would create much-needed lifelines as well as a large frontloaded fiscal impulse in the next two years.

Over the medium term, fiscal deficits are projected to shrink in most advanced economies as recoveries accelerate and gradual fiscal adjustments resume. The average cyclically adjusted primary deficit is projected to fall from 7.6 percent of GDP in 2020 to 2.3 percent in 2026, slightly higher than the pre-COVID-19 levels (Figure 1.6.C). *Germany* continues to guide its medium-term budget plan by the policy priority of promoting greener, smarter, and more inclusive growth. Several countries are expected to have larger cyclically adjusted primary deficits compared with the pre-COVID-19 levels (*Belgium, Denmark, Italy, Korea, The Netherlands, Spain*), of which a few would benefit from spending and/or revenue reforms (*Belgium, France, Italy*). In *Japan*, the large increase in fiscal imbalances from COVID-19 and age-related budget pressures point to the need to reanchor the medium-term fiscal policy to ensure that debt remains sustainable. Favorable interest-growth differentials and projected fiscal adjustment plans—likely to occur at a faster pace than projected before the pandemic—are expected to stabilize the debt-to-GDP ratios in most advanced economies over the medium term. The average public debt for this group is projected to stand at 121 percent of GDP by 2026, 17 percentage points higher than the pre-COVID-19 levels. Public debt in several countries, however, is projected to rise in the medium term (*Korea, United States*). In *Korea*, increased expenditures to strengthen social safety nets, support job creation, and foster innovation over the medium term are likely to put public debt on an upward trajectory. In contrast, the average public debt for the *euro area* is projected to gradually decline to 92 percent of GDP in 2026.

Emerging Market Economies: Varied Outlook for Fiscal Responses and Adjustments

Nearly all emerging market economies eased fiscal policy in 2020. The average overall fiscal deficit more than doubled relative to 2019 to reach 9.8 percent

of GDP. *China* shifted to broader demand support over time after bringing the pandemic under control earlier than most other countries. *India* announced a support package in November 2020 that included multiyear investment incentives, additional agricultural subsidies, and measures to support housing as well as formal and rural employment. *Brazil* expanded the social safety net and provided a job-retention program, as well as implementing other measures. The fiscal deficit in *Saudi Arabia* widened sharply despite an increase in the value-added tax rate, hikes in custom duties, and the removal of 2018 cost-of-living allowances. Revenue and expenditure measures in oil exporters were smaller than the emerging market average, partly reflecting such economies' ability to absorb additional health care costs in existing budget envelopes. Double-digit deficits in many countries contributed to a surge in average government debt ratios to 64.4 percent of GDP at the end of 2020, a 10 percentage points rise from the previous year, reflecting severe economic contraction and—for commodity exporters—lower natural resource revenues. Central banks' asset purchases and other global support measures helped reduce debt-service costs.

The average overall deficit is set to narrow in 2021 to 7.7 percent of GDP under the output recovery projected in the April 2021 *World Economic Outlook* baseline. Revenues are expected to recover somewhat, and pandemic-related spending is set to decline gradually, with significant variation across countries. *China's* fiscal policy is expected to tighten mildly. Despite the partial unwinding of exceptional fiscal measures, *Indonesia's* 2021 budget envisages a moderate expansionary fiscal stance as some unspent 2020 budget allocations are carried over and other spending, including public investment, is expected to increase. *India's* fiscal year 2021/22 budget focuses on health care, education, and public infrastructure and predicts a continued accommodative fiscal stance with increased flexibility in the financing envelope for state governments. Some countries expect large fiscal adjustments. For example, the *Russian Federation* foresees reducing non-oil deficits by gradually unwinding pandemic-related fiscal measures, aiming to return to the fiscal rule in 2022. *Saudi Arabia* has planned a significant central government fiscal consolidation in 2021. *Mexico* approved a “no policy change” conservative budget compared with 2020. In *Brazil*, the expiry of the COVID-19 response “war budget” implies a sizable tightening of primary expenditures.

The average overall deficit is projected to shrink from 9.8 percent of GDP in 2020 to 4.9 percent in 2026. Fiscal adjustments are envisaged through spending restraint (3.3 percentage points of GDP on a cumulative basis) and moderate revenue mobilization efforts. *China* is projected to tighten off-budget investment. *India* aims to gradually reduce the central government fiscal deficit, although it will be important to lay out a medium-term fiscal framework with concrete measures and targets. In *South Africa*, fiscal adjustment relies largely on containing the wage bill rather than expediting reform of state-owned enterprises and rationalizing costly and inefficient subsidies. *Indonesia* plans adjustments of 1.5 percent of GDP annually during 2022–23 to return to the deficit ceiling, relying on expenditure cuts as the cyclical recovery in tax revenue is offset by the permanent reduction in corporate income tax rates initiated in 2020. Most oil-exporting countries (*Kazakhstan*, *Saudi Arabia*) foresee significant spending restraints and additional non-oil revenues to reduce sizable deficits, considering that oil revenues are projected to remain more subdued over the medium term than in the pre-2014 period.

With moderate fiscal adjustments, the average government debt-to-GDP ratio is projected to rise further in 2021 and remain on an upward trajectory to exceed 73 percent of GDP by 2026 (largely driven by *China* over the medium term). Although the average interest-growth differential is expected to remain favorable, sizable primary deficits continue to weigh on debt, which is expected to rise further in two-thirds of emerging market economies in 2021. General government debt in *China* is expected to reach 69.6 percent of GDP in 2021, higher than the average in emerging market economies. Likewise, in *South Africa*, the pandemic-related increase in debt is estimated to continue, reaching 95 percent of GDP by 2026. Debt-to-GDP ratios are projected to stabilize at high levels in several emerging market economies, including *Brazil* (98.4 percent) and *India* (86.6 percent) in 2021. For all countries, a credible medium-term fiscal framework, anchored on revised fiscal objectives and revenue mobilization, can enhance confidence and reduce vulnerabilities.

Low-Income Developing Countries: Challenging Trade-Offs

In 2020, the average overall fiscal deficit of low-income developing countries increased by 1.5 percentage points of GDP to reach 5.5 percent of GDP,

and the average public debt increased by 5 percentage points to reach 49.5 percent of GDP at the end of 2020. Despite large revenue shortfalls from output drops and a concurrent fall in commodity prices, deficits rose by less than in other income groups because total spending remained essentially constant (Figure 1.6.B) as financing remained constrained—even after larger external grants and exceptional emergency and concessional financing (including from the IMF). Many governments reprioritized spending—for example, 60 percent of countries in the group cut capital expenditures as a ratio of GDP levels projected before the COVID-19 pandemic. Less severe economic contractions compared with advanced economies have served as mitigating factors. Spending needs are expected to rise for vaccination and safety nets, in addition to financing requirements for preexisting development goals.

In 2021, the average fiscal deficit is projected to decline to 4.9 percent of GDP. As economies recover, revenue collection is projected to improve. Capital spending is expected to recover partially in most countries after the temporary cuts in 2020 (*Guinea*, *Haiti*, *Malawi*, *Nigeria*, *Tajikistan*). However, deficits are expected to widen in a few countries as revenue-to-GDP ratios only partially recover, while spending and debt-service costs continue to rise (*Kenya*). Over the medium term, the average fiscal deficit is projected to return to its prepandemic level by 2026, largely aided by revenue increases (*Republic of Congo*, *Haiti*, *Lao P.D.R.*). Average expenditure is projected to broadly stabilize, although some countries with high public debt ratios are projected to restrain spending to secure debt sustainability (*Republic of Congo*, *Mozambique*, *Zambia*). In the absence of renewed policy efforts domestically and internationally, achieving the SDGs by 2030 would be extremely difficult.

Near-term debt vulnerabilities remain high. Financing large deficits is challenging, given limited market access and restricted ability to increase revenues in the near term. Average debt levels are projected to peak in 2021 while continuing to climb in some countries. Nonetheless, average debt is projected to stabilize over the medium term, with elevated debt service relative to tax revenues in many countries (exceeding 20 percent in *Ghana*, *Kenya*, *Nigeria*, and *Zambia*) and debt distress risks in several others. Actions were taken in 2020 to provide low-income developing countries with

grants, concessional loans, and debt relief to address a steep rise in public debt. Beneficiaries included 38 countries (out of 70) assessed to be at high risk of or in debt distress, according to the IMF–World Bank Debt Sustainability Assessments. Fiscal adjustments in several countries (*Vietnam*) and debt restructuring (*Chad, Republic of Congo*) are expected to contribute to debt reduction. As of the end of December 2020, 45 countries (or more than 60 percent of eligible countries) had requested to join or extend the Debt Service Suspension Initiative, benefiting from the suspension of \$5 billion total debt service (or an average of 0.6 percent of countries’ public debt) as reported by the Group of Twenty (G20) economies for May through December 2020.

Risks to the Fiscal Outlook

Risks to the fiscal outlook abound on both sides. On the upside, faster-than-expected vaccinations, particularly in emerging market and developing economies, could bring an end to the pandemic sooner than assumed in the baseline, boosting revenue collections and allowing governments to unwind temporary lifelines sooner. On the downside, risks include a more protracted economic downturn, abrupt tightening of financing conditions amid high debt, or materialization of contingent liabilities from liquidity support measures, volatile swings in commodity prices, and rising social discontent. Risks are intertwined and reinforce one another.

- *Protracted economic downturn:* Growth could be weaker if implementation of the announced measures lags or if lockdowns from renewed waves of infections persist. Delays in vaccine deployment and lower vaccine efficacy against new variants of the virus could dampen hopes of a quick exit from the pandemic and increase the scale of long-term scarring. For example, an adverse scenario presented in the April 2021 *World Economic Outlook* shows that high and rising infections would further restrict mobility and activity, leading to 0.5–1 percentage point lower growth in 2021–22 than the baseline and larger fiscal deficits and debt. A premature scaling back of policy support would likely cause losses in employment and income, particularly exacerbating poverty and inequality for vulnerable individuals, such as informal workers and low-income groups.

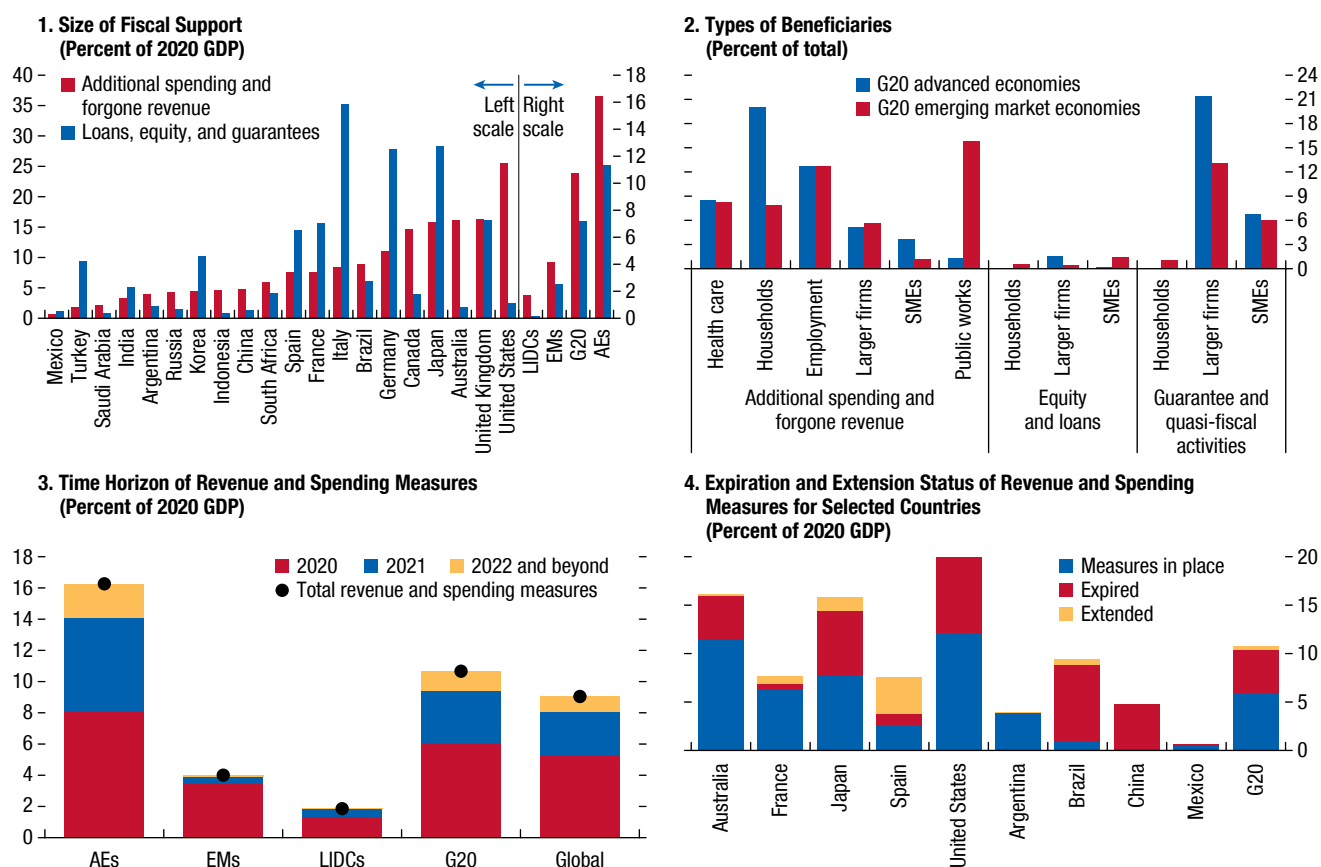
- *Abrupt tightening of financing conditions:* Higher and rising debt leaves governments and nonfinancial firms more exposed to abrupt changes in financing conditions from the current accommodative levels. An abrupt surge in yields—possibly driven by diverging paths of recovery (with *China* and the *United States* recovering faster than others), policy response to higher inflation expectations, or investors losing confidence in fiscal policy credibility or debt repayment capacity—could worsen financing constraints for emerging market and developing economies, particularly those with large financing needs or debt denominated in foreign currency (April 2021 *Global Financial Stability Report*).
- *Materialization of contingent liabilities:* Nearly 40 percent of global fiscal support constitutes governments’ liquidity support measures through provision of loans or guarantees, equity injections, and other forms of quasi-fiscal operations, including through public corporations. Although liquidity support has helped limit bankruptcies, calls on government guarantees or widening losses in state-owned enterprises could cause contingent liabilities to materialize that could eventually weaken government balance sheets (Box 1.1; Mbaye, Moreno Badia, and Chae 2018). Surges in bankruptcies could further strain public balance sheets through corporate-bank-sovereign links.
- *Volatility in commodity prices:* Renewed weakness in commodity prices could worsen the revenue outlook, posing challenges to already stretched budgets in commodity-exporting countries.
- *Rising social discontent:* Social tensions could erupt as the pandemic or an inadequate policy response—including unequal access to vaccines—lead to more deaths or socioeconomic hardship (unemployment, poverty, malnutrition, inequality, food shortages, or price increases) and exacerbate deep-rooted discontent. These factors could weaken the trust in and policy effectiveness of governments and put public finances at risk.

Effectiveness of Discretionary Fiscal Policy Responses to COVID-19

The size, composition, and duration of fiscal support has varied across countries (Figure 1.7, panel 1) and has influenced its effectiveness. Of the \$16 trillion in global pandemic-related fiscal actions taken

Figure 1.7. Government Fiscal Support in Response to COVID-19, 2020–21

The size, nature, and duration of fiscal support varied significantly across countries.



Sources: IMF, Fiscal Monitor Database of Country Fiscal Policies in Response to COVID-19; and IMF staff estimates.
 Note: Data refer to fiscal measures announced between January 2020 and March 17, 2021. AEs = advanced economies; EMs = emerging market economies; G20 = Group of Twenty; LIDCs = low-income developing countries; SMEs = small and medium enterprises.

through March 17, 2021, \$10 trillion consists of additional spending and forgone revenue, and \$6 trillion of government loans, guarantees, and capital injections. Among G20 advanced economies, half of the above-the-line support was devoted to employment protection and household income support (Figure 1.7, panel 2). Among emerging market economies, public works (typically aimed at infrastructure investment) and employment protection received the most support. In G20 advanced economies, large firms benefited more from government support (dominated by guarantees and quasi-fiscal activities). Many advanced economies have announced multiyear fiscal actions with revenue and spending measures of 6 percent of GDP in 2021 to contain the health crisis, provide lifelines, and support the recovery. In contrast, pandemic-related fiscal support in emerging

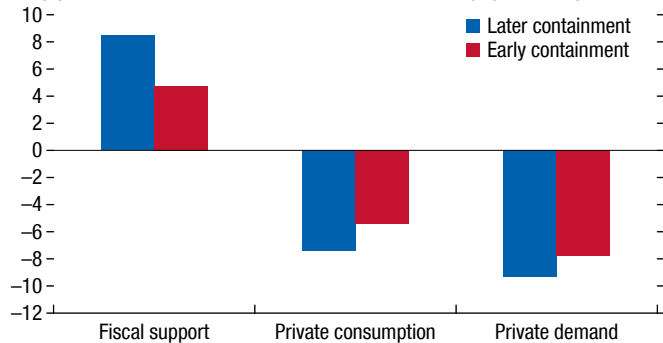
market economies has been frontloaded (Figure 1.7, panel 3). A large part of fiscal support is expiring (*Brazil, China*) and in only a few cases is it being replaced with new measures or substantial extension of existing programs (*France, Japan, Spain, United States*) (Figure 1.7, panel 4). The rest of this section assesses how effective support measures have been in mitigating the adverse impact of the pandemic on output, employment, and incomes.

Output effects of fiscal measures. Empirical analysis suggests that government spending and revenue actions have prevented a more severe global economic contraction—including through spillovers. It is estimated that, at the global level, such actions have mitigated the fall in global growth in 2020 by 2 percentage points (Chudik, Mohaddes, and Raissi 2021). The effect of the fiscal actions is likely stronger as

Figure 1.8. Forecast Revisions in Private Consumption and Demand, 2020

(Percent of GDP for fiscal support; percentage points for private consumption and demand)

Early public health containment measures saved taxpayer money.



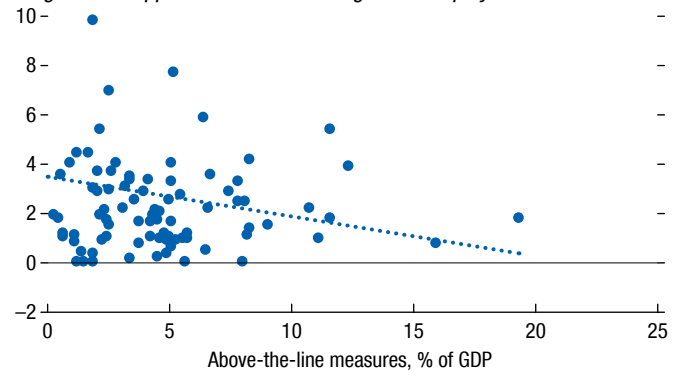
Source: IMF staff calculations.

Note: Early containment is achieved if the aggregate stringency index is above the cross-sectional median after the country had reached 100 cases of infections.

Figure 1.9. Unemployment Forecast Revisions and Fiscal Measures, 2020

(Percentage points)

Large fiscal support restrained the surge in unemployment.



Source: IMF staff calculations.

Note: "Above-the-line measures" refers to additional spending and forgone revenue in response to the COVID-19 pandemic.

the analysis does not include loans, guarantees, and equity injections, because their more limited use in past years compared with the present crisis makes their macroeconomic effects difficult to quantify.¹ For individual countries, the effects depend on country-specific factors, cross-border spillovers, and the size and composition of policy support. In general, countries with larger spending and revenue actions (mostly advanced economies) have experienced smaller output contractions. The growth effects of fiscal measures were especially large in *Canada*, *Germany*, and the *United States*. Such effects occurred sooner in countries that relied on consumption- and income-support measures, whereas they have taken place with longer lags but also longer duration in countries, such as *China*, that made greater use of public investment (in addition to relief for households and businesses) to support the recovery soon after the pandemic was initially brought under control. Although emerging market economies have provided smaller fiscal packages, on average, many have benefited from spillovers from massive monetary and fiscal policy responses by advanced economies, which eased global financial conditions, limited capital outflow pressures in emerging markets, and supported global demand (despite supply disruptions).

¹Moreover, the analysis focuses on discretionary policy measures and may not fully capture the effects of automatic stabilizers (for example, automatic increases in unemployment benefits as employment falls).

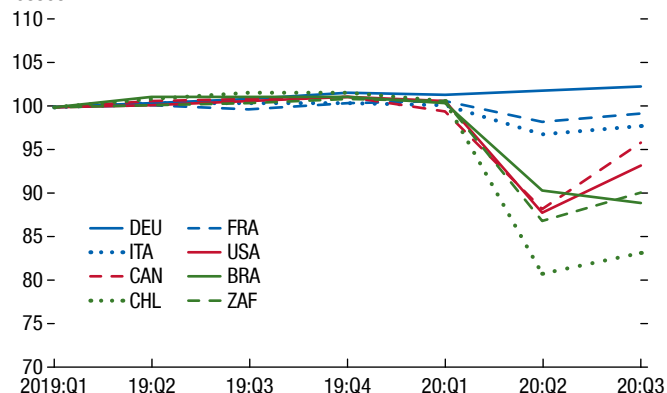
Private demand and employment effects of fiscal measures. Fiscal support has also mitigated the adverse effects of the pandemic on private demand, private consumption, and unemployment. The scale and effect of fiscal support has also been influenced by public health containment measures designed to limit the spread of the virus (October 2020 *Fiscal Monitor*). Such containment measures have differed across countries in size and timing. Countries that adopted stronger containment measures earlier in 2020 deployed smaller fiscal packages and experienced smaller downward revisions in forecasts of real private consumption and real private demand (Figure 1.8).² Fiscal measures have also dampened job losses: larger above-the-budget-line fiscal support for employment (such as wage subsidies to firms and employment-retention programs) is associated with a smaller upward revision in the unemployment rate (Figure 1.9).

Labor market effects of fiscal measures. The measures chosen to protect jobs or support workers' incomes have influenced the effects on employment and well-being. For example, high-frequency data indicate that countries that relied primarily on wage subsidies or job-retention programs often experienced adjustments by reducing the number of working hours

²Forecast revisions refer to the 2020 estimate of private consumption and demand from the October 2020 *World Economic Outlook* minus the projection of the same variable for the year 2020 from the October 2019 *World Economic Outlook*.

Figure 1.10. Effects of the Pandemic on Employment, 2019:Q1–2020:Q3
(Index; 2019:Q1 = 100)

Countries with extensive job-retention programs experienced fewer job losses.



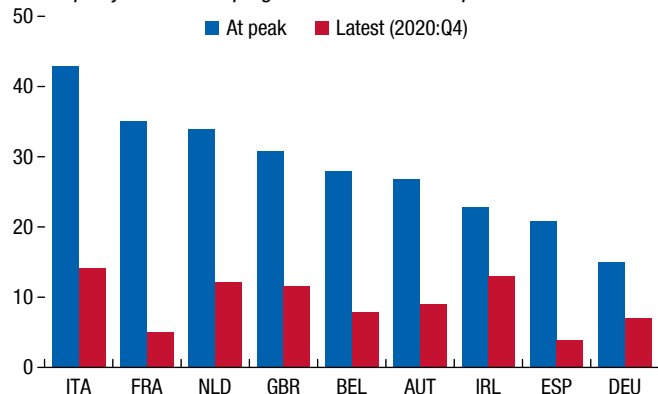
Sources: Eurostat; and Haver Analytics.
Note: Data labels use International Organization for Standardization (ISO) country codes.

(France, Germany, Italy, United Kingdom), whereas more jobs were lost in countries that extended unemployment benefits (Canada, United States), although lost incomes were largely replaced (Figure 1.10).

The long-term implications of different forms of labor market support also depend on the duration of the pandemic. Whereas job-retention programs are powerful at reducing separations and preserving ultimately viable job matches, they could, if such programs are overextended, hamper reallocation to the jobs that will be created in the postpandemic era (Barrero, Bloom, and Davis 2020). High-frequency data show that job-retention programs have so far adjusted flexibly in line with an increase in working hours—as reflected in a decline in the take-up of such programs relative to the spring of 2020 (Figure 1.11). The effects of recent extensions of job-retention programs remain to be seen. Another risk is that wage subsidies have postponed—rather than averted—layoffs that could occur when support is withdrawn. For countries that relied largely on unemployment benefits, displaced workers may ultimately be structurally unemployed if their skills erode before job creation resumes. Effective support would, therefore, need to be adjusted over time to account for these trade-offs and the evolving path of the pandemic, with support relying more on reallocation measures during the recovery phase (Chapter 3 of the April 2021 *World Economic Outlook*).

Figure 1.11. Take-Up of Job-Retention Schemes for Selected Advanced Economies
(Percent of employees)

Take-up of job-retention programs has fallen from peak levels.



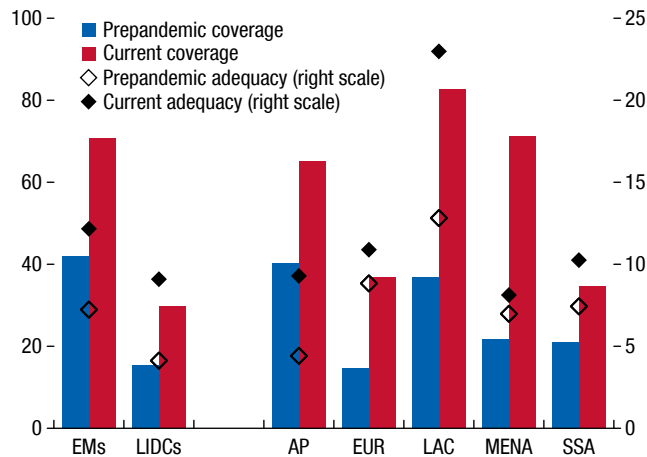
Sources: *The Financial Times*; Organisation for Economic Co-operation and Development; UK Office of National Statistics; and University of Oxford.
Note: Data labels use International Organization for Standardization (ISO) country codes.

The effect of fiscal measures on social safety nets.

Additional social protection spending in response to the COVID-19 pandemic was 0.6 percent of GDP on average during the first three quarters of 2020, including to widen social safety nets (Gentilini and others 2020). Increased social protection spending has mitigated the rise of global extreme poverty by about 10 million people (October 2020 *Fiscal Monitor*). The effectiveness of social safety nets can be assessed along several dimensions, including coverage, adequacy, and cost efficiency. During the COVID-19 crisis, the share of the population covered by social safety nets has increased in emerging market and developing economies, with significant cross-country variation (Figures 1.12 and 1.13). Some countries, such as the Philippines, have reached a large portion of the population through social assistance to low-income households, displaced workers, and small businesses. In addition to broader coverage, the existing beneficiaries of social safety nets have received higher transfers as well, resulting in improved adequacy levels in 2020. Across regions, Middle East and North African countries have recorded the highest rise in coverage but the lowest increases in terms of adequacy of benefits—reflecting untargeted support (for example, subsidies) for many countries in the region. In Latin American and Caribbean countries, adequacy levels doubled while keeping a relatively high coverage of the population.

Figure 1.12. Adequacy and Coverage of Social Safety Nets
(Percent of eligible beneficiaries, left scale; percent of household pretransfer income, right scale)

Social safety nets expanded during the pandemic.



Sources: Gentilini and others 2020; World Bank ASPIRE; and IMF staff estimates. Note: Adequacy is the total transfer amount received by beneficiaries as a share of pretransfer total income and coverage denotes the share of population that receives social assistance. AP = Asia and Pacific; EMs = emerging markets; EUR = Europe; LAC = Latin America and the Caribbean; LIDCs = low-income developing countries; MENA = Middle East and North Africa; SSA = sub-Saharan Africa.

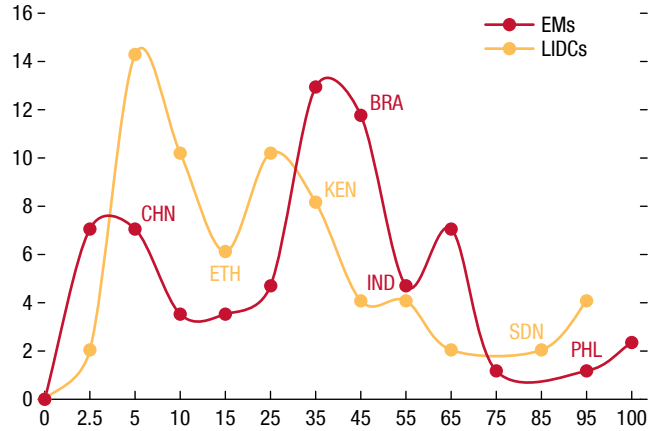
Despite these efforts, preexisting gaps in social protection systems could hamper cost efficiency and should be addressed durably (for example, by reducing leakages of benefits to high-income groups and program fragmentation and by expanding coverage).

Near-Term Policies: Win the Vaccination Race and Target Support More Effectively

The strength of the recovery hinges on when the pandemic is controlled and how policy support will continue. It is, therefore, imperative to ensure that health care systems everywhere are adequately resourced and that global cooperation on producing and distributing vaccines to all countries at affordable prices is reinforced, particularly because many low-income countries rely on external grants to finance their vaccination plans. Vaccines are a global public good. Efforts to increase funding for COVAX—the multilateral mechanism for equitable access to vaccines—must be scaled up. The sooner global vaccinations control the pandemic, the quicker economies can return to normal and will need less government support. Under the April 2021 *World Economic Outlook* upside scenario in

Figure 1.13. Coverage of COVID-19 Social Assistance
(Percent of countries, vertical axis; percent of population, horizontal axis)

Coverage of safety nets rose across the board, but to varying degrees.



Sources: Gentilini and others 2020; World Bank ASPIRE; and IMF staff estimates. Note: Coverage denotes the share of population that receives social assistance. Some countries have a high coverage (sometimes exceeding 100 percent of the population) owing to program duplications. Those exceeding 100 percent of the population are excluded. Post-COVID-19 data are constructed by adding COVID-19 social assistance to pre-COVID-19 information. Data labels use International Organization for Standardization (ISO) country codes. EMs = emerging markets; LIDCs = low-income developing countries.

which faster global vaccination brings the virus under control sooner, the global gain in GDP is \$9 trillion cumulatively through 2025, with two-fifths of that gain accruing to advanced economies. Assuming a tax-to-GDP ratio of 30 percent on average and unit elasticity of revenues with respect to output, this would translate to a \$1 trillion cumulative gain in revenues for advanced economies, plus savings from reduced spending on lifelines for people and firms. Such an increase would provide an excellent return on investment for public money, paying for itself, given that the cost of global vaccination is estimated in the tens of billions of dollars.

As lockdowns become increasingly more localized and recoveries accelerate, lifelines should be better targeted and focus on people still significantly affected by the pandemic. As economies open up, support policies should rotate toward structural transformation (for example, supporting vocational training, providing hiring incentives, or facilitating the balance sheet repair of nonfinancial firms).

Under current policies, many programs are set to expire before the race between vaccinations and new waves of infections end. Countries need to maintain

support measures flexibly but refine their design and eligibility criteria as trade-offs between policy instruments (for example, job-retention programs versus income-support programs) evolve according to the path of the pandemic. Support measures should therefore focus on the most vulnerable households and viable or systemic firms and on helping workers prepare for the post-COVID-19 economy. Emergency lifelines should be withdrawn only gradually where local transmission has been persistently low and activity has begun to normalize. If policy space permits, resources freed from expiring lifelines can be reallocated to support the recovery and structural transformation (Chapter 3 of the April 2021 *World Economic Outlook*). Yet, if the pandemic and economic indicators worsen, withdrawal of support should be paused or reversed. Measures may need to be extended with contingent spending plans through supplementary budgets or established COVID-19 contingency funds. Ensuring transparency in usage and carefully managing fiscal risks from contingent liabilities will be crucial given their scale, coverage, and novelty (IMF 2020e).

More targeted support to vulnerable households. The pandemic has had a disproportionately adverse effect on poor people, youth, women, minorities, and workers in low-paying jobs and the informal sector (Chapter 2). Policymakers should ensure social protection spending is sustainable over the potential duration of the crisis and enhance the effectiveness of such spending through better targeting:

- Improving the coverage of social safety nets in a cost-effective way can be achieved by limiting the leakage of benefits to unintended beneficiaries. Other options include enhanced means testing in advanced economies and proxy means testing in emerging market and developing economies, whereby targeting is improved by identifying needy households on the basis of characteristics strongly associated with welfare, such as household size and composition, age of the household head, number of dependents, employment status, position of significant assets, and so on (Coady and Le 2020). Countries can use instruments that are effective in reaching individuals most in need, including individuals in the informal sector. For example, two-thirds of workers in the informal sector in sub-Saharan Africa do not have access to banking or other financial services. Effective instruments could therefore include government-to-person payments,

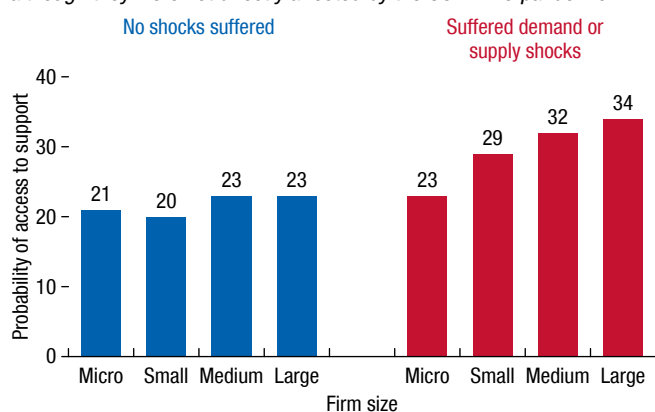
mobile money, in-kind transfers such as food assistance, basic education and health care services, matching databases of beneficiaries to create a single registry, and use of community-based methods to identify needy households.

- Increasing the progressivity of net transfers by reducing the benefit withdrawal rate as earnings increase would improve the design of safety net programs. Beyond social safety nets, there is opportunity to extend unemployment benefits for longer periods (but possibly at reduced levels) and to implement gender budgeting.

Support to otherwise viable nonfinancial firms. Government support to nonfinancial firms in 2020 was timely, and it reduced liquidity shortages, job losses, and bankruptcies (Ebeke and others 2020). However, with limited information about firms' viability, the support was sometimes not sufficiently targeted. For example, one-fifth of nonfinancial firms that received government support did not experience a large direct adverse effect on their operations, leading to substantial mismatches in access to public credit or other liquidity programs (Cirera and others 2021; Figure 1.14). In some cases, low demand, administration capacity constraints, or conditionality contributed to a low take-up rate of loan guarantees (*Germany, United States*).

Figure 1.14. Nonfinancial Firms' Access to Public Support, by Size and Type of Shock
(Percent)

Larger firms had better access to support. Many firms received support although they were not directly affected by the COVID-19 pandemic.



Sources: Cirera and others 2021; World Bank, Business Pulse and Enterprise Surveys data.

Note: "No shocks suffered" refers to firms that did not experience business closure or a decrease in sales relative to before COVID-19.

Various liquidity programs have covered one-quarter of the surveyed nonfinancial firms, with larger firms being more likely to receive public support than small and medium-sized enterprises.

As the pandemic persists, governments need to tailor policies that prevent resource misallocation and limit the rise of low-productivity firms that depend on government assistance for survival. The size and type of support will also depend on available fiscal space, type of firm, and the ability of governments to manage programs involving a large number of firms (Box 1.2). Governments should also roll back blanket loans and guarantees, and public support should be limited to circumstances in which there is a clear market failure. Examples include when a high degree of uncertainty deters the flow of funds from banks and capital markets to nonfinancial firms in the absence of government assistance, or when private sector participants fail to internalize the cost to society of widespread bankruptcies and job losses, or when private and public sector mechanisms are not adequate to resolve insolvency problems in a timely and effective way. To tackle the risk of widespread insolvencies, (quasi) equity injections such as junior “profit participation” loans could be considered, if fiscal space permits and capacity to reach and monitor the intended firms exists (Díez and others 2021).

Budget needs are expected to remain sizable, including for widespread vaccinations; continued provision of targeted lifelines adapted to recurring waves of contagion; and broad-based demand support, depending on fiscal space and macroeconomic conditions as economies emerge from the pandemic. These challenges will pose formidable policy trade-offs for policymakers—especially in highly indebted emerging market and developing economies that face tight financing constraints and have limited capacity for social protection and domestic revenue mobilization. The situation is even more precarious in fragile states or countries that are at risk of debt distress, limiting the scope for near-term support. In addition to reprioritizing noncritical spending and seeking efficiency gains, several countries will need assistance from the international community, including grants, concessional and emergency loans, and, in some cases, debt restructuring of commercial and official debt. Quickly implementing the G20 Common Framework for Debt Treatments and widening its country coverage of eligible debtors is thus necessary.

Broader Policy Priorities: Anchor Fiscal Support, Transition to a New Post-COVID-19 Economy, and Address Crisis Legacies

The trade-off between continuing to support the economy in the near term and strengthening fiscal positions over time can be made more palatable within credible medium-term fiscal frameworks attuned to economic developments. For example, in countries where recovery is faster and more complete than expected, lifelines could be withdrawn faster and fiscal buffers built more quickly. Once the recovery is firmly in place, calibrated consolidation strategies—supported by pro-growth and inclusive measures—should be implemented. This is especially true in advanced economies that face elevated debt levels and structural pressures such as those related to aging. In highly indebted emerging market and developing economies, low-for-long interest rates are not assured and investor appetite may disappear quickly; large financing needs, foreign currency denomination, and short maturity can be amplifying factors. Early development and announcement of such strategies could create more near-term fiscal space for maneuver while anchoring fiscal sustainability. Commitment devices, such as strengthened rules-based or principles-based fiscal frameworks with increased transparency and accountability mechanisms and legislation such as “preapproval” of future tax reforms can also enhance policy credibility. The use of escape clauses or temporary suspension of fiscal rules has provided many countries with flexibility in accommodating fiscal support during the pandemic (Box 1.3). To avoid undermining the credibility of rules-based fiscal frameworks, countries should clearly communicate pathways for reinstating the rules (and, in some cases, recalibrate the rules’ limits or improve their design) and reducing deficits and debt below the required limits.

In low-income developing countries, achieving debt sustainability while addressing development needs requires raising domestic revenues, improving spending efficiency, and facilitating private sector activity through structural reforms and improvements in governance and the rule of law. The COVID-19 pandemic has set back countries’ progress toward achieving the SDGs. Financing needs for SDGs were already large before the pandemic and, based on an in-depth analysis of four low-income countries and emerging market economies, would likely rise further by 2.5 percentage points to 4 percentage points of

GDP in those countries, depending on the potential scarring effects of the pandemic (Benedek and others 2021). Revenue collection should be bolstered through a medium-term revenue strategy in which both tax policy and revenue administration efforts are well coordinated. Measures include implementing well-designed value-added taxes with timely refunds; building capacity for property taxation; gradually expanding the base for corporate and personal income taxes, including by eliminating costly tax exemptions; and efficiently taxing extractive industries (IMF 2019a). Adopting a comprehensive risk-based strategy (by focusing on large taxpayers) could improve compliance. Concerns that the value-added tax would affect low-income households disproportionately can be better addressed by strengthening social safety nets (Chapter 2).

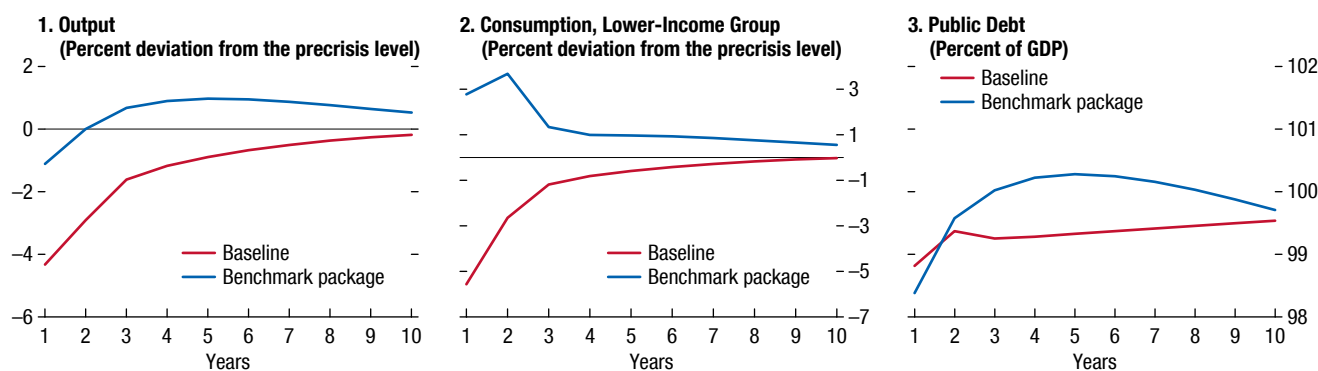
The effect of the crisis on countries’ public finances also reinforces the need to improve debt management and transparency. Advanced economies and some emerging markets could lock in historically low borrowing costs and extend average debt maturities. Low-income countries should close gaps in their debt operations, including weak legal frameworks, lack of operational risk management, insufficient audits, and incomplete coverage of debt statistics (particularly debt contracted through autonomous public entities, extrabudgetary funds, and state-owned enterprises that remains off budget). Further efforts are needed to manage risks and keep up with the evolving complexity of public debt structures. Measures include publishing

regular debt reports, broadening the coverage of debt statistics, and limiting risks from contingent liabilities. All governments need to monitor and manage fiscal risks associated with pandemic-related support (which, if realized, would further add to public debt) and disclose contingent liabilities comprehensively.

A well-designed and timely fiscal package can support an inclusive economic recovery while reducing public debt over time. Model simulations for a typical advanced economy or an emerging market with manageable financing costs—calibrated to roughly match the deep contraction of global GDP in 2020—could help inform the design of such a package (Online Annex 1.1). The simulations consist of temporary transfers to lower-income households, frontloaded public investment, and higher labor income taxes in the medium term. The model offers two distinctive insights. First, timing is critical. It is beneficial to provide greater short-term fiscal support when interest rates are low and economic slack is high and to strengthen fiscal positions once a recovery is under way. Second, the composition of measures matters. Reliance on high-multiplier expenditure measures and progressive personal income taxation can raise growth and mitigate income inequality while containing the increase in public debt over time. Transfers boost income and consumption for low-income households, and increased taxes are borne by high-income households over the medium term (Figure 1.15).

Figure 1.15. Balancing Greater Short-Term Support and Medium-Term Fiscal Discipline

Simulations show that a well-designed fiscal package can raise growth and mitigate income inequality while containing the increase in public debt over time.



Source: IMF staff estimates.

Note: The baseline has no additional fiscal actions relative to what was deployed in 2020. The benchmark package consists of targeted transfers to low-income households (2 percent and 1.5 percent of GDP for years one and two, respectively), public investment (0.5 percent of GDP for the first two years and declining gradually), and a delayed increase in labor income tax rates for high-income households by 0.5 percentage points at the peak (Online Annex 1.1).

At present, a deep recession and accommodative monetary policy would increase the size of multipliers (Auerbach and Gorodnichenko 2012; Erceg and Lindé 2014), but high public debt and pandemic-induced supply constraints tend to lower it (Bi, Shen, and Yang 2016). The fiscal package discussed previously and in Online Annex 1.1 would increase output with a two-year cumulative output multiplier of slightly more than 1, considering the low-interest-rate environment and accommodative monetary stance, spike in unemployment and its partial recovery, firm-level excess capacity, and composition of fiscal measures—including targeted transfers to those who are more likely to spend rather than save them. The long-term multiplier could be close to 2, assuming a persistent increase in productive public investment. However, many other factors could affect the size of fiscal multipliers, including mobility restrictions, the productivity of public capital, the efficiency of public investment, the size of economic slack, and government indebtedness (October 2020 *Fiscal Monitor*).

Another factor is the timing and quality of the spending mix, including frontloaded public investment. Postponing quality public investment will likely limit the expansionary effect of targeted transfers because of its knock-on effects on private firms' incentives to invest (given that public capital is complementary to private investment in a low-interest-rate environment). In addition, delaying the push for high-return public investment would increase aggregate demand when the recovery is more advanced and interest rates are likely higher. This would make the same public investment less expansionary. Thus, for countries with fiscal space, an early push for quality public investment maximizes its growth effects. Refining the pipeline of appraised projects and resolving bottlenecks can help with scale-up. As a priority, pandemic-related investments in health care and vaccination should be maintained.

When the recovery is under way, policy should increasingly change focus to rebuilding buffers and reducing debt vulnerabilities. Model simulations illustrate several factors related to the quality and timing of short-term support, long-term adjustment needs for debt stabilization, and instrument choices. Medium-term adjustment needs, in particular, would be smaller if short-term support is based on high-quality and frontloaded measures (as outlined previously and detailed in Online Annex 1.1). Fiscal positions

strengthened through more progressive personal income taxation over the medium term tend to be more equitable. In contrast, fiscal adjustments through higher capital income tax rates (if not on rents) generate a fiscal multiplier below 1 in the long term. Although raising capital income tax rates can mitigate income inequality (as can more progressive labor income taxes in the benchmark package), it has a stronger negative effect on private investment and, hence, long-term growth.

As part of recovery efforts, expenditures could be prioritized toward measures that bolster inclusive and robust growth, such as an investment push by economies with fiscal space. Investment projects—ideally with the participation of the private sector—should aim at mitigating climate change and facilitating digitalization, and can be partly financed with higher carbon taxes (October 2019 and October 2020 *Fiscal Monitor*). In low-income countries, green investment can be facilitated through official support, especially if combined with domestic and international private finance and improved public investment management frameworks. Strengthening social safety nets and addressing the weaknesses in tax systems—including by improving progressivity in domestic taxes and reforming international tax systems—could support inclusive growth. Progressivity and revenue performance could be improved through broader tax bases; more progressive personal income taxation; more neutral capital taxation; improvements in the design of value-added taxes; more and better use of carbon, property, and inheritance taxes; digital enhancements; and institutional strengthening to enable revenue administrations to implement and manage these tax reforms (de Mooij and others 2020; IMF 2019b; October 2019 *Fiscal Monitor*; October 2020 *World Economic Outlook*). The appropriate mix of measures would depend on individual countries' tax systems, the size of informal sector, and other economic structures. On international tax, reaching a political agreement under the Organisation of Economic Co-operation and Development's "Inclusive Framework" will help prevent unfettered tax competition that undermines revenue mobilization efforts and a proliferation of unilateral measures that could catalyze tax or trade wars with large economic costs (Box 1.4).

As vaccinations advance and economies recover, fiscal policy needs to focus on enabling a green, digital, and inclusive transformation of the economy, while managing fiscal and financing risks. Priority areas

include (1) investing for the future and improving health care and education outcomes; (2) facilitating the reallocation of labor and capital; (3) improving the coverage and adequacy of social protections in a cost-effective way—thereby countering the rise of inequality and poverty (Chapter 2); (4) reforming tax systems, including at the international level; and

(5) reducing debt vulnerabilities and enhancing debt transparency. Once the recovery is firmly in place, long-standing weaknesses in public finances must be tackled by rebuilding fiscal buffers, addressing crisis legacies, and in low-income developing countries, renewing efforts to achieve the SDGs that have suffered a setback during the pandemic.

Box 1.1. Keeping the Receipts: One Year On, Some Innovative Practices

Since the onset of the COVID-19 pandemic, governments have been advised to “Do what it takes, but keep the receipts” to protect lives and livelihoods (April 2020 *Fiscal Monitor*). Many countries have demonstrated a commitment to tracking and transparently reporting on emergency COVID-19 spending¹ and the IMF has provided advice on how to keep (and verify) the receipts (IMF 2020a). This box highlights innovative practices implemented by various countries in the following areas: (1) tracking COVID-19 spending; (2) ensuring transparency of COVID-19 responses, including for procurement contracts; and (3) auditing COVID-19 spending.

Tracking COVID-19 spending: Where possible, countries have built on recent reforms of their public financial management systems to implement ad hoc measures and track, report, control, and oversee their COVID-19 response:

- Some countries have implemented their measures through normal budget channels while adapting their budget nomenclature and programs and their financial management information systems to better track the budgeting and execution of these measures (IMF 2020b). *Burkina Faso* and *France* have used their programmatic budget frameworks to introduce specific COVID-19 programs or actions that cut across ministries and agencies. Countries with modern charts of accounts and financial management information systems, such as *Honduras* and *Rwanda*, have tagged COVID-19 spending in their information systems. Because some implementing agencies are off budget (for example, national development banks), other countries—such as *Benin*—have achieved more comprehensive monitoring with innovative tracking mechanisms beyond the perimeter covered by their financial management information systems.
- More than 40 countries have established dedicated COVID-19 funds to centralize their emergency response and keep an audit trail (IMF 2020c). Some countries—such as *Botswana*—have also made use of such funds to combine and track public and private support. A COVID-19 fund, backed by strong safeguards, can be a pragmatic approach

¹In addition, countries have committed to publish information on COVID-19–related procurement contracts, including on the true owner (“beneficial ownership”) of the contracted companies, and to audit the COVID-19 response. The IMF has kept track of these commitments.

when public financial management systems are weak (for example, where key processes and controls are not automated). These safeguards include strong legal backing, a clear “sunset clause,” well-defined public financial management processes, and robust accounting and reporting standards. Learning from the Ebola crisis, *Sierra Leone* has set up such a fund, which contributed to the rapid deployment of emergency operations, and facilitated a recent real-time audit on the use of emergency funds by the country’s supreme audit institution (Audit Services of Sierra Leone 2020).

Ensuring transparency of COVID-19 measures:

In addition to tracking and monitoring, it is equally important to demonstrate that funds have been effectively allocated and used for their intended purposes, particularly given the exceptional nature—in size, composition, and speed—of the fiscal response to COVID-19. Many countries across income groups have done so:

- COVID-19–related information is typically included in regular budget execution reports. For example, *Austria* includes COVID-19 spending and guarantees in its monthly budget report and provides information on COVID-19 response in its report on state-owned enterprises. But some countries, such as the *Maldives*, have prepared dedicated reports, sometimes on a weekly basis. Others—such as *Colombia*, *France*, *Honduras*, and *Peru*—have published spending information on dedicated transparency portals, providing a comprehensive picture of support expenditure that is updated promptly. Emerging good practice on transparency portals suggests that they provide an overview of the COVID-19 response (including off-budget measures), such as in the *Philippines*; show cross-sectional information on spending, such as in *Brazil* (for example, by administrative, economic, and functional groups; by beneficiary; and by region); and allow open access to microdata, such as in *Paraguay* and the *United States*.
- Countries such as *Jordan* and *Papua New Guinea* also publish information on procurement contracts, including their beneficial ownership, in line with their commitment when accessing IMF emergency funding. Countries such as *Ecuador*, *Kenya*, *Kyrgyz Republic*, and *Nicaragua* went further to amend their procurement legal framework to require the collection of beneficial ownership information for

Box 1.1 (continued)

all contracts on a permanent basis. Countries such as *Colombia*, *Honduras*, and *Ukraine* have added a module in their e-procurement platforms that presents detailed information on all emergency procurement related to COVID-19.

- Civil society and the media have aided external oversight, making the data more easily available and, in some cases, complementing government efforts on transparency. In *South Africa*, where procurement data have been published by the government, volunteers disseminated the data by making it available on a platform called “Keep the Receipts.” The Latin American Journalists Network for Transparency and Anti-Corruption, Red PALTA, has used procurement data from seven Latin American countries to publish articles tracing overpricing and corruption in the purchase of medical equipment.

Adequately scrutinizing and auditing COVID-19 spending: Legislatures and the public must be confident that COVID-19 expenditures have been used as intended and that waste has been avoided.

- To mitigate the relaxation of ex ante controls done to respond swiftly to the pandemic (IMF 2020d), supreme audit institutions have stepped in to provide stronger and more timely ex post controls.

In *Honduras*, *Peru*, *Sierra Leone*, and *South Africa*, the respective supreme audit institutions have undertaken interim audits to uncover irregularities and tackle governance vulnerabilities as they happen. These audits are bearing results. In *South Africa*, more than one-third of the auditees have taken actions to address identified irregularities; the Unemployment Insurance Fund has recovered R3.4 billion (US\$220 million) of incorrect payments, and the president has set up a high-level task force to address allegations of corruption (Auditor General of South Africa 2020). In January 2021 the European Court of Auditors published a first review of the European Union’s emergency response until mid-2020 and announced that one-quarter of its audits in 2021 would focus on the European response to fighting the pandemic.

- Other independent watchdog institutions will ensure accountability of COVID-19 spending. In *Austria*, the Parliamentary Budget Office has spearheaded transparency efforts. In *Kenya*, the Ethics and Anti-Corruption Commission recently issued a report indicating that procurement laws were violated in the purchase of COVID-19–related supplies.

Box 1.2. Considerations When Supporting Firms

As the COVID-19 pandemic dramatically changes household behavior and business operations, a growing share of firms, particularly small and medium-sized enterprises, are incurring sustained losses. If the pandemic persists, widespread corporate insolvencies could follow, destroying millions of jobs and weakening the recovery (Díez and others 2021). This box highlights the key elements of support to firms:

Partnering with the private sector to assess the viability of firms: Where governments do not have the capacity to assess the financial health of each firm (especially small and medium-size enterprises), that function may be better served by the private banking sector, the capital markets, or even sovereign wealth funds or development banks. To avoid moral hazard among private lenders, loan guarantees should gradually be made partial.

Targeting support to viable firms (Figure 1.2.1): The April 2021 *Global Financial Stability Report* discusses how to identify illiquidity and solvency risks (applying to firms with access to capital markets or banks). Fiscal support to such firms (together with regulatory measures) would prevent a large increase of bankruptcies (Blanchard, Philippon, and Pisani-Ferry 2020; Gourinchas and others 2020). Governments could facilitate the restructuring of firms that have a viable business plan but are insolvent, for example, by making loan write-offs tax deductible for creditors. For firms that are difficult to reach, such as microenterprises or those operating in the informal sector, government support may need to be channeled through other means, including institutions that provide microcredit to households that own small businesses. Policymakers should allow a gradual process whereby nonviable firms shrink or close and new ones open, and some workers move between companies and sectors with help from targeted time-bound hiring subsidies, wage-loss insurance programs, and increased training. This could be facilitated by streamlined, standardized restructuring or bankruptcy procedures. Support could depend on objectives such as fostering digitalization and improving energy efficiency.

*Encouraging greater reliance on equity financing:*¹ Government guarantees on bank loans should be reduced over time and linked to restrictions on dividends and share buybacks. Guarantees or insurance could be offered for portfolios of privately funded and managed distressed assets rather than individual loans, and involve better risk pricing such that viable firms could access credit at lower rates. If the social cost of mass bankruptcies exceeds the private cost to debtors and creditors, governments could consider targeted quasi equity injections, including into small and medium-sized enterprises, such as through profit participation loans (Díez and others 2021). Governments could also consider conversion of guaranteed debt into equity and quasi equity for highly indebted but viable firms, especially for large firms or cases with a strong economic and social rationale for intervention. For example, in *Germany*, the government has introduced a temporary “umbrella” program—authorized by the European Commission—that uses all classes of equity and hybrid instruments to support firms affected by the pandemic. Even so, government equity stakes come with potential costs for the firm (political interference), the government (oversight responsibilities and governance issues), and the economy (competitive neutrality concerns) (April 2020 *Fiscal Monitor*). Experience during the global financial crisis suggests that government’s direct involvement in private balance sheet restructurings (for instance, by injecting equity capital or subordinating its tax or debt claims on firms) could, in some cases, prevent tail-risk events (October 2009 *Global Financial Stability Report*; Group of Thirty 2020). However, it will be crucial to ensure that public support is done transparently at arm’s length for good governance, consistent with overall policy goals, and that there is a clear exit strategy (including to minimize fiscal risks).

¹Persistent corporate debt accumulation may lower productivity growth in the long term and raise vulnerabilities (Gopinath and others 2017; Lam and others 2017; Diamond, Hu, and Rajan 2020; Anderson and Raissi 2021).

Box 1.2 (continued)

Figure 1.2.1. Policy Support to Nonfinancial Firms

Differences in viability and leverage of firms call for varying types of policy interventions.

Firm financial condition	Systemic or network firms	Large	Medium and small	Micro and informal sector
General support	<ul style="list-style-type: none"> Targeted, temporary, and state-contingent tax and social security contribution deferrals or subsidies (for example, to cover wages) for firms in affected sectors, especially when containment restrictions curtail demand. As the economy reopens, focus should turn to fiscal measures to stimulate domestic demand. Infrastructure investment, temporary reduction in taxes (such as VAT or accelerated depreciation), cash transfers to individuals based on income. 			
Liquidity constrained	<ul style="list-style-type: none"> Partial guarantees. Direct loans with restrictions. Temporary debt repayment moratoriums or the temporary suspension of insolvency rules. 	<ul style="list-style-type: none"> Partial guarantees. Direct loans with restrictions. Temporary debt repayment moratoriums or the temporary suspension of insolvency rules. 	<ul style="list-style-type: none"> Standardized partial guarantee programs. Direct loans (such as using development banks). Temporary debt repayment moratoriums or the temporary suspension of insolvency rules. Temporary reduce utility tariffs. 	<ul style="list-style-type: none"> Micro-lending program through banks. Temporarily reduce utility tariffs and evictions.
Viable but insolvent without support	<ul style="list-style-type: none"> Foster debt restructuring by making debt forgiveness nontaxable, providing tax credits to creditors that grant haircuts to debtors, or applying larger haircuts on government claims. Fresh equity investment alongside private investors. 	<ul style="list-style-type: none"> Out-of-court financial restructuring. Hybrid restructurings/prepackaged reorganization. Foster debt restructuring (for example, make debt forgiveness nontaxable, provide tax credits to creditors that grant haircuts to debtors, larger haircuts on government claims). Seed a privately run special financing facility for distressed enterprises under reorganization. Equity-like funding. 	<ul style="list-style-type: none"> Out-of-court financial restructuring. Hybrid restructurings/prepackaged reorganization. Foster debt restructuring by making debt forgiveness nontaxable, providing tax credits to creditors that grant haircuts to debtors, or applying larger haircuts on government claims. Seed a privately run special financing facility for distressed enterprises under reorganization. 	<ul style="list-style-type: none"> Provide debt discharge through streamlined liquidation procedures. Enhance unemployment benefits. Sponsor innovation fund alongside private sector to support micro startups.
Nonviable	<ul style="list-style-type: none"> Infusion of equity with restrictions if closing firm would have negative effect on economic activity (such as by disrupting production or trade networks). Providing a business reorganization plan is an option rather than bailing out inefficient state enterprises. 	<ul style="list-style-type: none"> Bolster formal bankruptcy system resources. 	<ul style="list-style-type: none"> Develop streamlined or standardized liquidation procedures for these firms. 	<ul style="list-style-type: none"> Provide debt discharge through streamlined liquidation procedures. Enhance unemployment benefits. Sponsor innovation fund alongside private sector to support micro startups.

Source: IMF staff compilations.
 Note: Network firm refers to a firm that is part of a larger structure and operates under a common brand name or shares significant professional resources. VAT = value-added tax.

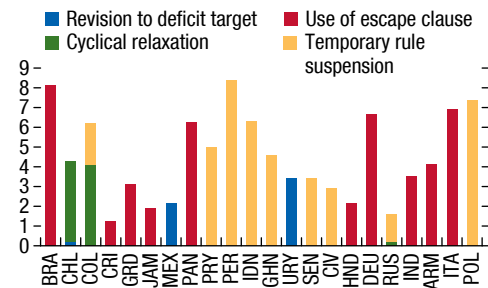
Box 1.3. The Flexibility of Fiscal Rules during the COVID-19 Pandemic

The COVID-19 pandemic continues to test the flexibility of rules-based fiscal frameworks and highlight the need for a return pathway to the rules (and, in some cases, a recalibration of the rules' limits). In 2020, many countries appropriately used escape clauses to deviate from or suspend the fiscal rules, on the basis of a pre-defined process that includes governments, parliaments, and, in some cases, fiscal councils (including to facilitate communications) (Figure 1.3.1). Commonly used provisions include the following:

- **Supranational escape clauses:** The activation of supranational escape clauses—such as those in the Central African Economic and Monetary Community, the Eastern Caribbean Currency Union, and the European Union—automatically triggered the national ones in some countries (*France, Italy, Portugal*). Others relied on separate national escape clauses (*Czech Republic, Germany*), including different sets of triggers and suspension periods.
- **National escape clauses:** Countries with escape clauses resorted to them (*Armenia, Austria, Azerbaijan, Brazil, Costa Rica, Croatia, Estonia, Grenada, Honduras*). In some countries, escape clauses include quantitative triggers, such as in *India*, where the fiscal rule allows for temporary deviations from the target fiscal deficit (not exceeding 0.5 percentage points in a year) if real output growth declines by at least 3 percentage points below the average for the previous four quarters. *Brazil* adopted a “war budget” that excluded COVID-19 spending from the constitutional expenditure ceiling and declared a state of public calamity that lifted the obligation to comply with a primary balance target in 2020.
- **Suspension of the fiscal rules or changes to numerical targets:** Several countries without escape clauses temporarily suspended their fiscal rules (*Colombia, Ghana, Poland, Russian Federation*). *Paraguay* and *Peru*, despite having escape clauses, suspended their fiscal rules entirely until the end of 2021 to offer more flexibility. In some cases, the suspension of the rule was verified by independent fiscal councils, adding credibility to government decisions. *Indonesia* suspended the balance budget target of 3 percent of GDP for three years. *Chile, Mexico, and Uruguay* have modified their fiscal targets within their existing fiscal frameworks to allow for greater spending.

Figure 1.3.1. Policy Relaxation Relative to Fiscal Rule Limits, 2020
(Percent of GDP)

Many countries have used the built-in adjustments of fiscal rules during the COVID-19 pandemic.



Sources: Country reports; national authorities; and IMF staff calculations.

Note: Data labels use International Organization for Standardization (ISO) country codes.

Countries are contemplating when and how to transition back to the rules (that is, to exit the escape clause or end the suspension). For example, *Canada* plans to gradually unwind support measures on the basis of data-driven triggers such as employment or total hours worked rather than a predetermined calendar. Policymakers need to balance the need for continued flexibility to counter the pandemic and support the recovery against the need to keep market confidence, especially when debt and gross financing needs are high. *Brazil* has prioritized debt stability by withdrawing most COVID-related fiscal support measures at the end of last year and aiming to meet the expenditure ceiling in 2021. This reinforces credibility, though it requires a large upfront adjustment. A constitutional amendment exempted the recently announced round of cash transfers from the rule but limited it to 0.6 percent of GDP. For all countries, preserving the credibility of the framework requires ensuring that flexibility is temporary and transparent—including by communicating the process of returning to the rule, announcing a realistic medium-term path, and, in some cases, improving the design of the rules or recalibrating its limits to fit postpandemic circumstances.

Box 1.4. Toward an Agreement on Reforming International Taxes

The taxation of multinational corporations has been under severe stress in recent decades.¹ The way in which profits are attributed among affiliates of a multinational group in different countries not only is challenging to implement but leaves considerable scope for cross-border profit shifting. Especially in developing countries, anti-tax avoidance measures often remain ineffective—owing to limited administrative capacity—and do not address structural weaknesses in international tax rules. Digitalization has exacerbated the shortcomings of the current framework, which assigns taxing rights primarily on the basis of physical presence and enables highly digitalized firms to earn significant profits in “market countries” without incurring any income tax liability there. A potentially even larger revenue risk for governments comes from unrestricted tax competition among countries, an issue that is yet to be addressed.

The G20/OECD Base Erosion and Profit Shifting project, which concluded in 2015, partly addressed issues of tax avoidance by multinationals. But it did not fundamentally reform the system, leaving deep-rooted problems unresolved. Recognizing that more needs to be done, the now 139 members of the OECD’s “Inclusive Framework” have since discussed reform proposals for a more fundamental departure from the current century-old norms. In October 2020, these were detailed in Blueprints on two pillars, which are currently being discussed.

- *Pillar One* aims to address the digitalization challenge through a new approach that assigns some taxing rights to market countries. It would use a formula based on the share of sales to reallocate a share of “residual” profits—those, roughly, in excess of a normal return—earned by large multinationals operating in some sectors (that is, automated digital services and consumer-facing businesses) to market countries. These new features are welcome to address some of the weaknesses of the current system (IMF 2019b). However, while offering a compromise, the proposal lacks a coherent economic rationale, is highly complex, and does not yet specify several issues of substance (such as the portion of profit to be reallocated). According to OECD (2020), it would increase global corporate tax revenues by $\frac{1}{4}$ to $\frac{1}{2}$ percent.
- *Pillar Two* targets tax competition and further limits profit shifting by ensuring that profits of large

multinationals are subject to at least some minimum level of taxation. It envisages an “outbound” tax rule (an “income inclusion rule”) charged by residence countries on low-taxed foreign earnings, and two “inbound” rules (a principal “undertaxed payment rule” denying deductions for payments not taxed at a sufficient rate elsewhere, and a separate “subject to tax rule” permitting source countries under tax treaties to impose withholding taxes). According to OECD estimates, with this proposal global corporate tax revenues would rise by between $1\frac{3}{4}$ and $2\frac{3}{4}$ percent (OECD 2020). The broad intent of this pillar is welcome, but it is also likely to benefit advanced economies more than developing countries. The proposed effective priority of the “outbound” rule over the principal “inbound” rule (given the likely limited impact of the narrow and optional “subject to tax” rule) means that the revenue collected by “topping up” taxes on lightly taxed income in source countries accrues not to those countries, often developing countries, but to residence countries, often advanced economies.

Overall, the Blueprints contemplate significant and welcome departures from long-standing standards and go some way to addressing the fractures in the international tax architecture—paving the way for a more robust and sustainable future system. Agreement by mid-2021 is an ambitious target, calling for renewed efforts to address many implementation issues and excessive complexities of the proposals. Key features to be agreed include (1) the rule order in Pillar Two, with developing countries seeking a greater role for the inbound rule; (2) the scope of Pillar One, with some European countries focusing on automated digital services, and the United States asserting a broader reform beyond digital companies; and (3) the level of the minimum effective tax rate—with the range between 9 percent and $12\frac{1}{2}$ percent being discussed seen as too low by some.

Reaching political agreement on the two pillars will be important to avoid both unfettered tax competition that undermines revenue mobilization efforts and a proliferation of unilateral measures—such as “digital service taxes” of various kinds now enhanced or proposed in many countries (Aslam and Shah 2020)—that could give rise to tax and trade wars with large economic costs for all. Even if agreement is reached, pressures for further reforms, likely expanding upon these newly adopted approaches, will continue given the relatively narrow scope and limited estimated effect of the proposals.

¹The issues are discussed in more depth in de Mooij, Klemm, and Perry (2021) and Devereux and others (2021).

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