



MACROECONOMICS,  
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## EQUITABLE GROWTH, FINANCE & INSTITUTIONS INSIGHT

# The Fiscal Impact and Policy Response to COVID-19

Fiscal Policy and Sustainable  
Development Unit (MTI)

 WORLD BANK GROUP



## ABSTRACT

The spread and severity of the COVID-19 pandemic continues to accelerate.

*The outbreak was declared a pandemic by the WHO on March 11 and the epicenter of the crisis has moved from China and Korea to the US and Western Europe. Infections are also increasing at a rapid pace in WBG client countries, with large uncertainty about the extent to which many countries are affected due to the lack of testing. IDA countries, in particular, have limited resources and capacity to keep infections low and provide proper care for those with serious health problems due to COVID-19 infection as well as to address related socio-economic distress.*



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# MTI INSIGHT





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# The Fiscal Impact and Policy Response to COVID-19

## >> INTRODUCTION

The spread and severity of the COVID-19 pandemic continues to accelerate. The outbreak was declared a pandemic by the WHO on March 11 and the epicenter of the crisis has moved from China and Korea to the US and Western Europe. Infections are also increasing at a rapid pace in WBG client countries, with large uncertainty about the extent to which many countries are affected due to the lack of testing. IDA countries, in particular, have limited resources and capacity to keep infections low and provide proper care for those with serious health problems due to COVID-19 infection as well as to address related socio-economic distress.

Fiscal policy in countries around the world needs to respond to be able to combat the health and economic impacts of COVID-19. As countries are ramping up efforts to slow the spread of COVID-19 and raise the capacity of health care systems to treat affected patients, the global economy is slowing down. Most countries will face an economic recession and increased fiscal deficits. Countries are implementing their initial policy responses to the on-going health and economic crisis. In advanced countries, monetary and fiscal measures taken so far have been far-reaching and costly. Client countries often operate in a different context, with less fiscal space for costly fiscal measure and lower implementation capacity.

This note provides guidance to country economists and teams for assessing fiscal policy measures that fit country circumstances. Following a brief summary of the economic fallout of the COVID-19 pandemic (section 2), this note provides an overview of fiscal impacts (section 3) and the menu of fiscal responses for softening the economic downturn and protecting businesses, jobs and citizens more broadly from extreme economic hardship (section 4). This is followed by a brief discussion of longer-term aspects related to ensuring fiscal sustainability and supporting economic recovery (section 5) and an overview of MTI's contributions to the World Bank's support to client countries in addressing the COVID-19 crisis through fiscal instruments (section 6). Appendix 1 looks at the fiscal impact of the Global Financial Crisis and draws lessons for COVID-19 shocks by region.

## >> ECONOMIC IMPACT

The outlook on the evolution of the pandemic and related economic impacts is highly uncertain. An aggressive health, social, and economic response has been effective in controlling the spread of the pandemic at the country level. But policies and their effectiveness vary across countries, in part due to differences in the capacity for an effective response between more and less developed nations. Epidemiological experience and projections also raise the specter of several waves of the pandemic, which underlines the importance of a global approach to the pandemic, enhancing testing for the virus, the search for a vaccine, and preparedness for eventual subsequent waves.

Production and supply chains are disrupted as measures to contain the pandemic lead to a slowdown in production and require changes in work practices.<sup>1</sup> On the demand side, restrictions on movement and activities result in a general decline in demand as cashflow and income of businesses and households drop, in many cases dramatically. Demand and supply shocks spill over to other sectors and economies via trade and production linkages. These actions affect all countries and all sectors of the economy, with an immediate global economic slowdown that could persist in the medium term.

The economic impact of the COVID-19 is most pronounced in countries where infections and health measures are most disruptive: Western Europe, Iran, and the United States presently, and China and South Korea earlier. But effects are increasingly felt across emerging markets and developing economies (EMDEs). Health measures to contain the spread of COVID-19, such as social distancing and lockdowns, are implemented in an increasing number of EMDEs. The economic impact of these local measures compounds global COVID-19 effects. Service sectors that require direct contact between producer and consumers are especially hard hit by health measures, which trickles down to the wider economy as many businesses suspend operations and employment declines. Many countries also see an impact on trade and trade-related businesses, as global value chains are disrupted.<sup>2</sup>

Authorities in advanced economies have responded with measures aimed at protecting affected economic sectors and households, as well as strengthening their health systems to respond to the crisis. In Europe and North America, this includes travel restrictions, lockdowns, efforts to speed up test-

ing for the virus and treatment of affected patients, and public health measures to slow down transmission of the virus. To counteract the economic fallout from the health-related measures, advanced economies have enacted fiscal policy measures combined with quantitative easing. These have included lowering of interest rates and scaling up open market operations, combined with a mix of revenue, expenditure, equity and credit measures. Governments of less developed economies will be faced with multiple challenges and more limited choices between fiscal policy instruments.

In EMDEs, the impact of the pandemic and policy response to the COVID-19 crisis is evolving rapidly. Countries are looking at the experience in countries where the impact of the COVID-19 has been greatest (China and Korea initially and Western Europe and the US currently) for guidance on policy options for health and economic policy. Translating these examples into policies that fit the context of specific EMDEs is not straightforward. Health impact and options for combating COVID-19 vary for countries with difference levels of income, health care systems, institutional capacity, and overall governance models. Economic impact varies further with countries' positions in global value chains and the effect of commodity price shocks, as well as the risk of debt distress or availability of fiscal buffers and specific fiscal policy features such as the presence of social safety nets that can be scaled up to protect individuals and households during the crisis. The next section focuses on the fiscal impact of the COVID-19 pandemic.

1. This reflects two inter-related dimensions of the pandemic's economic impact. The first arises from the direct impact on human capital though people not being able to work due to increased morbidity and mortality and the diversion of labor and other resources needed to take care of those falling sick. The second dimension arises from measures to contain the pandemic, especially social (or physical) distancing and lockdown (isolation) measures—which concurrently severely restrict demand and supply in an economy.

2. Many African countries were affected in the initial stages of the crisis by a sudden stop in certain imports from China as companies there were temporarily shut down to deal with the wave of infections in Wuhan.

## >> FISCAL IMPACT

This section discusses the fiscal consequences of the COVID-19 pandemic and related economic slowdown in EMDEs in terms of recent and likely impact on government revenues and expenditures.

### >>> REVENUE COLLECTION IS EXPECTED TO DECLINE

The COVID-19 crisis presents unprecedented challenges to domestic revenue mobilization (DRM) in EMDEs. From past crises we know that the effect on taxes (especially direct taxes) exceeds the economic impact in scale and duration.<sup>3</sup> The unprecedented hit on cashflow and incomes of businesses and individuals puts a spotlight on the dual challenge of revenue systems to provide relief for affected taxpayers and manage a sudden large drop in collections.

The COVID-19 pandemic and related economic slowdown will lower government revenues as a share of GDP as: (1) some tax bases are disproportionately affected by a growth slowdown, including profits, capital gains, items with excises, and imports; (2) commodity prices and related revenues decline; and (3) countries take steps to lower the tax burden, for example by lowering of tax rates or scaling up incentives, in response to the crisis. Revenue performance may be further harmed by operational restrictions in revenue administrations due to health measures and related risk of worsened taxpayer compliance.

It is still too early to assess the impact on revenues in the current situation, although insight can be gained from looking at specific aspects of the revenue system that are likely to affect collections in EMDEs:

- **Customs and trade taxes.** In open economies, the interruption in global value chains has a direct and immediate negative impact on the revenue collected by customs (excises, import duties, and VAT). In African countries and other EMDEs, the slowdown in economic activity in China starting in January has already translated into a drop of manufacturing imports. These problems are deepening as advanced economies have entered crisis mode and COVID-19 has spread across the

globe.

- **Consumption taxes (inland).** Most of the goods consumed in Africa and EMDEs are imported, or include parts, from China and other countries where production has been affected. As supply chains have been interrupted, local traders selling imported items such as textiles, electronics or household goods are not supplied. As COVID-19 continues to spread more widely, the situation is likely to deteriorate further and would be compounded as demand responds to supply shocks.
- **Direct taxes.** Over the next year, revenues from Corporate Income Tax (CIT) and Personal Income Tax (PIT) are likely to decrease as income generating activities slow down. The most immediate effects may be felt in the collection of payroll and wage taxes, which have a shorter lag.
- **Revenue from natural resources.** The COVID-19 pandemic coincides with a major drop in the prices of oil and other commodities as the world economy is slowing down. In the case of oil, this was reinforced by the disagreement between Russia and Saudi Arabia about cutting back oil production in response to declining world demand. Commodity importing nations generally benefit from the drop of oil prices, but revenue could be adversely affected to the extent that taxes are based on the value of oil products (i.e., ad valorem instead of specific rates for fuel and other products).
- **Tax administration and compliance.**<sup>4</sup> As noted above, health measures disrupt operations of revenue administrations, including enforcement and taxpayer service activities (some tax administrations have already suspended audit and collection activities, see Appendix Table 2). Reduced enforcement activity would likely increase taxpayers' risk tolerance for tax avoidance and evasion and thereby reduce tax compliance. Moreover, tax arrears may increase as taxpayers divert constrained cash flows to their business operations. Businesses may also protect their cashflows by suspending or delaying payment of salaries, supplies, loans and other obligations, which could further reduce taxes collected.

3. During the global financial crisis of 2008-09, the average tax-to-GDP ratio dropped by 1.3 percentage point. Sub-Saharan Africa was the region that returned most quickly to tax-to-GDP levels from before the global financial crisis of 2008-09: 3 years. This took South Asia 7 years, while tax revenues in Eastern Europe and Central Asia and the Middle East and North Africa did not recover fully. See Appendix 1 for more detail.

4. Revenue administration aspects are only touched on in this note. A detailed assessment can be found in a companion note on Tax Administration Complications from COVID-19.

## >>> PUBLIC EXPENDITURE WILL RISE RAPIDLY

The COVID-19 pandemic and related economic slowdown has an immediate impact on the expenditure side through multiple channels:

- Activation of automatic stabilizers in response to economic effects of the crisis on household incomes and job losses. Automatic stabilizers are mechanisms built in government systems that act as counter-cyclical measures to mitigate economic impact of crisis, including unemployment benefits and various pro-poor programs. The principal benefit of these programs is the ability to respond quickly and effectively to crisis through social protection measures for the most vulnerable and affected households. Unfortunately, the presence of these stabilizers is much less advanced and institutionalized among developing countries, acting as a major amplifier of their vulnerability to economic shocks. This is particularly true for lowest income countries whose social protection total expenditure budgets are several times lower than in higher income countries.

- Discretionary changes in expenditure policy in response to the crisis will push up spending further. This includes increased budget allocations to health systems, additional cash transfers, introduction of wage compensation schemes, and various support mechanisms for targeted business and industries (see also Section 4.2).

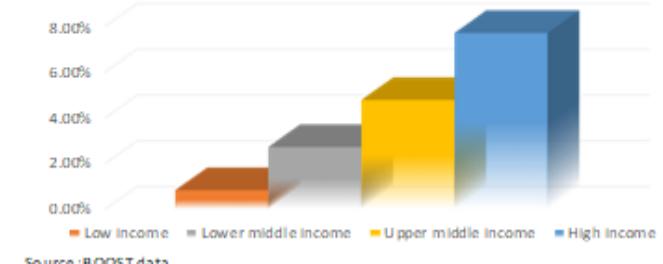
- On the other hand, some budget allocations would be underspent due to interruptions in implementation of programs and activities. The drastic behavioral changes produced by the pandemic will likely lead to significant under-execution of public investment programs. A lack of personnel induced by social distancing and governments' immediate focus on health crisis would slow down civil engineering works. The effect on government investment is likely most pronounced in countries that fail to spend their budgeted capital allocations in regular times. Underspending may also occur in certain per capita/formula/rule-based spending items because of social distancing and lockdowns, for example school meals (which many countries have counteracted with appropriate measures), utilities, and operational maintenance. Unavailability of supplies due to supply chain disruptions may further hamper government operations and spending. At the same time, arrears and contingent liabilities in the public sector would pile up when public entities start running out of

cash because of lower revenues.

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**FIGURE 1 - Social Protection by Income Categories, % GDP**

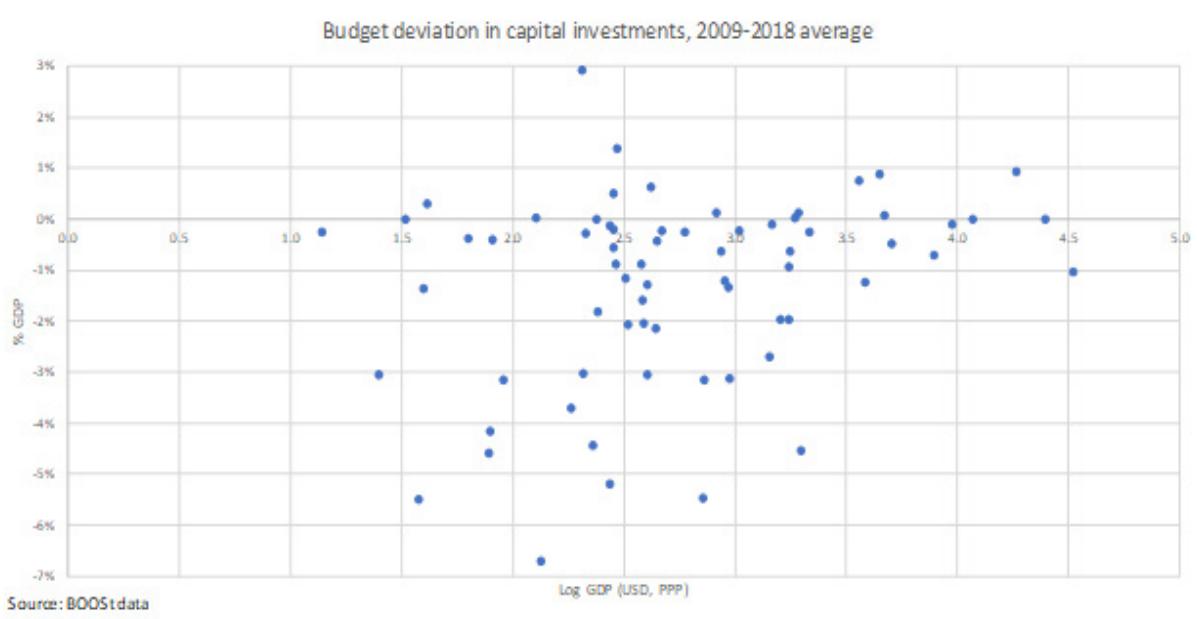
### SOCIAL PROTECTION BY INCOME CATEGORIES, % GDP



Source: BOOST Data

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## FIGURE 2 - Budget Deviation in Capital Investments, 2009-2018 Average



Source: BOOST Data

## >> IMMEDIATE FISCAL RESPONSE

The overall response to the COVID-19 crisis will go through phases as attention shifts from dealing with the immediate crisis to getting back to a sustainable situation, which would need to be more resilient than in the past:

- **Phase 1:** *Immediate crisis response* with an emphasis on providing adequate support for health care and supporting businesses and households that are immediately affected by health measures and the economic slowdown (see also below).
- **Phase 2:** *Recovery* as the health situation stabilizes but the economy is yet to regain its footing. During this phase rolling back temporary measures in the initial response phase, stepping up efforts to control cost and enforcement revenue compliance, and implementing tax policy and expenditure rationalization measures to restore revenue performance will be key.
- **Phase 3:** *Resilience and sustainability*—as the economic situation stabilizes, attention can turn to applying lessons from the crisis and the need for sustainability.

The design of the fiscal responses to the COVID-19 pandemic can be assessed by considering specific aspects of individual fiscal instruments which help to understand the efficacy and efficiency of the responses in achieving their

goals, both short term and long term. These aspects include the efficiency of a specific instrument to achieve targeted objectives; cost and fiscal sustainability; flexibility to adjust to changing circumstances; and administrative feasibility (Box 1).

The relative weight of these aspects in countries' choices will depend on circumstances. For example, countries with solid fiscal buffers will be less constrained by costs. Similarly, countries with strong administrative capacity will be able to deploy more complex instruments than countries with limited capacity.

This section focuses on fiscal responses in the first phases of the crisis—immediate response. Section 5 adds thoughts on second and third phases of the recovery. In the remainder of this Section, we will discuss the various fiscal instruments that are available for addressing the COVID-19 crisis, organized by revenue, expenditure, and credit and equity measures. These instruments are assessed, based on the classification of aspects set out above. An overview of fiscal measures planned and implemented across countries can be found in Appendix Table 2. The assessment of specific measures within the framework is presented in Appendix Table 3.

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## >>> BOX 1 - FRAMEWORK FOR ASSESSING FISCAL POLICY MEASURES IN RESPONSE TO COVID-19

Fiscal policy measures in this note are assessed in a framework that drives from the traditional timely-targeted-temporary model for assessing responses to crisis situations, with a focus on the following aspects:

**Efficiency.** The efficiency of a specific fiscal instrument to achieve particular objectives in a cost-effective way will be influenced by:

- *Targetability* – the extent to which the instrument allows to directly target specific business or population groups or activities
- *Speed* – the time elapsed between the adoption of the instrument and the desired impact
- *Abuse resistance* – the ease with which abuse by eligible beneficiaries and other parties involved with the measure can be controlled

**Cost and fiscal sustainability.** Containing the cost of fiscal measures is another important aspect of the fiscal response. This will also involve consideration of costs and benefits of specific instruments and their interactions. For example, measures that aim at reducing lay-offs may generate benefits in terms of reduced unemployment and social security payments.

- *Affordability* – the extent to which the use of the instrument impacts on fiscal stability. For example, instruments that provide support in the form of credits or through the deferral of payments will have lower cost implications than instruments in the form of outright grants and expenditure.
- *Predictability and control of cost* – the extent to which upper limits for the cost of a program can be established and the actual cost reasonably well predicted.

**Flexibility.** The high uncertainty regarding the duration of the pandemic and the intensity with which individual countries will be affected puts a premium on the flexibility with which an instrument can be deployed, including the ability to scale up the instrument or to stop its use as needed.

- *Scalability* – the extent to which the instrument can be expanded or replicated for additional groups of beneficiaries in accordance with needs

- *Reversibility* – the ease with which the response can be withdrawn, without causing economic and behavioral distortions

**Feasibility.** Measures may not have their intended effect if they are difficult to implement because of administrative constraints or impact is blunted by health measures, such as social distancing and lockdowns.

- *Administrative ease* – the extent to which the instrument can be implemented within existing administrative capabilities
  - *Impacts of the pandemic and containment measures* – the COVID-19 pandemic has direct impacts on the deployment of fiscal instruments. For example, scaling up of health expenditure may be constrained by a lack of qualified personal; measures that involve human contact (especially) in groups will be less desirable than instruments that limit such exposure; and scaling up of consumption and investment may face supply side constraints as suppliers and contractors may be in lockdown mode
-

## >>> REVENUE INSTRUMENTS

Governments are implementing a range of tax measures to address the short-term impact of the COVID-19 pandemic. Measures under consideration aim to: (i) protect businesses that see their cashflow and income jeopardized; (ii) provide support to households and communities that are affected by measures to stem the spread of the COVID-19 virus and the associated slowdown in economic activities, and to shore up aggregate demand and consumption to moderate the feedback loop between supply shocks and demand shocks. Short-term relief measures packages are designed in terms of tax rebates, exemptions, holidays or similar features with a direct impact on businesses and households and boost consumption. Measures also aim to manage longer-term effects, including on taxpayer compliance, business continuity, and fiscal sustainability.

The focus of revenue policy will shift over the phases of the crisis. During phase 1, the emphasis will be on ensuring that health care is available for those in need, providing relief to those affected most (e.g., through deferment of tax obligations and cash transfers to vulnerable households) lowering advance payments), and keeping core government agencies operational, including revenue administrations. In phase 2, rolling back the initial crisis measures, stepping up compliance enforcement, and implementing tax policy measures to restore revenue performance will be key. There may be windows of opportunity for strengthening taxes that benefit the environment (e.g., fuel taxes) and health (e.g., taxes on tobacco, alcohol, and sugary drinks and food) or that reduce tax avoidance by multinational corporations (such as through a diverted profit rule). During stage 3, countries need to turn to lessons from the crisis—how to be better prepared for a next adverse event and how to deepen the commitment to sustainability. A holistic and cross-country approach to green taxes, a successful reform of the international tax system, and a further reform of weaknesses in countries' revenue systems would be the focus during this stage.

## >>> PROTECTING BUSINESSES

### • Deferral of tax obligations.

**Examples:** A growing number of countries are deferring tax payments, including social contributions and even penalties, for businesses (e.g., Austria, Australia, Canada, Colombia, Ireland, Korea, Peru, Poland and Vietnam). In

some cases (Colombia, Korea, and Vietnam), the focus is on deferments for affected sectors (e.g., hospitality and aviation in Colombia). Korea has extended the due date for income tax and VAT (both tax filing and payment) for up to 9 months for affected businesses (tourism, restaurants, medical clinics, art performance, wholesale and retailers in the area where confirmed COVID-19 cases are present). Korea also suspended tax audit and any activities by tax authority to reduce outstanding tax arrears, by up to 1 year for affected business. Some countries (e.g., Austria and Costa Rica) have introduced temporary adjustments of advance payment rules that allow businesses to make advance payments for the CIT based on (downward adjusted) income expectations. And Canada has suspended client contacts for conducting audits. Finally, speeding up of payments by revenue administrations to taxpayers, such as VAT refunds, has the same effect as a tax deferral by enhancing taxpayers cashflow (e.g., in Australia, Bosnia and Herzegovina, China, Indonesia, Malta, and Thailand).

**Assessment:** Extended payment periods, payments in installments provisions, and accelerated VAT refunds represent useful temporary relief measures to keep taxpayers afloat during low profitable periods and cashflow constraints. To be effective those need to be enacted using clear eligibility criteria under risk management. The fiscal cost of these measures can be contained by targeting affected businesses—which may not be feasible in all cases, especially if the economic effect of the COVID-19 crisis becomes more widespread in EMDEs.

An alternative approach focuses on advance CIT payments. Typically, such advance payments are based on income for the previous year. During a downturn, advance payments would be too high and cause a cashflow crunch because of the mismatch between (high) advance tax payments and (lower) final liability. The fiscal impact of this measure is short lived; firms will be paying the full amount due for their CIT at the end of the fiscal year.

Caution should be exercised with measures that may allow taxpayers to escape the tax net, such as suspension of audits and tax amnesties. Such measures risk hampering recovery of revenues in the aftermath of the crisis and would drive up the fiscal cost in the short term.

- **Lower taxes for vulnerable businesses**

**Examples:** Vietnam is considering lowering the CIT rate for SMEs from 20 to 15 percent for five years (2020-24). This tax rate reduction would help this group of taxpayers to have more financial resources to recover from the crisis. Korea has already implemented tax relief measures for small businesses. For instance, if landlords reduce rent for small businesses, 50% of reduced rents during the first semester of this year will be credited against income tax of landlords (tax credit measure). A two-year VAT cut is granted for individual entrepreneurs with low annual turnover (VAT will be reduced to the level of the simplified VAT regime for micro enterprises). Countries are also allowing firms to accelerate depreciation of new investment (e.g., Australia, China, New Zealand, and Singapore).

**Assessment:** The impact on revenue of lowering the CIT rate for SMEs in Vietnam would be small. About 80 percent of incorporated businesses fall below the threshold in Vietnam, and they contributed only about 4 percent of the CIT revenue. The reduction of CIT rate would reduce the CIT revenue by about 1 percentage point. This reduction could be offset by phasing out the tax incentives for some sectors (in the aftermath of the crisis). But the measure risks creating some strategic sorting around the threshold and in general a reduction of rates is difficult to target and reverse after the crisis.

Reduction of compliance costs through simplification of tax obligations, especially for SMEs, has widely proven to be an effective way to increase compliance levels. During periods of economic distress and increased non-compliance risks, tax simplification becomes particularly relevant, opening opportunities for tax authorities to embark on serious efforts to identify complete set of regulations imposing higher compliance costs to taxpayers, and to prepare ad-hoc reforms aimed to tackle simplification objectives to be implemented during distressed times.

Accelerated or immediate expense of fixed assets is an appropriate policy tool for providing tax relief to adversely affected taxpayers. It can also provide an incentive for bringing forward investments needed in critical economic sectors – such as health providers or pharmaceutical firms (China allows accelerated depreciation for medical firms). To be used as temporary mitigation measures those need to be designed within well-defined tax periods; using simple eligibility criteria; and closely monitored by a special task group within the tax

administration. Extending loss carry forward rules will support businesses in future years, when the tax relief becomes operable. This may not provide immediate relief but may provide businesses with certainty that their losses during the crisis can be expensed against future tax payments.

In order to support exporters, particularly SME exporters, to stay resilient through tough economic times, it is important that administrations aid in the reduction of trading costs affected by taxes and customs duties. This can be tackled in a short-term period by granting: (i) a temporary zero rate policy to specific tariff codes, (ii) limited or provisional tax/tariff exemptions to relevant sectors; or (iii) by offering a more flexible deferral or installment agreements for customs duties, etc. These mechanisms can help them to increase their international competitiveness, face trade costs during global recession and to secure their participation within global value chains.

Tax incentives and holidays should be avoided to the extent those tend to decrease tax compliance levels in the mid/long terms.

### >>> PROTECTING VULNERABLE HOUSEHOLDS

**Examples:** Payments for Personal Income Tax (PIT) are deferred in Indonesia (for low-income earners) and Iran. Also, in mostly OECD countries, government are introducing cuts in social security contributions (e.g., Germany, Italy, Malaysia, Portugal, and Slovak Republic). These cuts may bring substantial relief and disposable income to workers. This is expected to help companies retain workers and support consumption and economic growth.

**Assessment:** Well-targeted tax credits and lower taxes for specific vulnerable groups can provide cost-effective relief quickly. But targeting tax relief measures to affected and vulnerable households is often challenging in EMDE contexts.

### >>> BOOSTING CONSUMPTION

**Examples:** Temporary reductions in VAT rates and other indirect taxes have been implemented in a number of countries, often focused on affected sectors such as aviation and tourism (e.g., China, Cyprus, Korea, and Norway). Korea introduced a suspension of the 70% excise tax for car purchases during Mar-Jun 2020 to promote consumption of (in the case of Korea) largely domestically produced cars. In addition, Korea reduced the VAT payable by small businesses with turnover below KRW 60 million until the end of 2021.

**Assessment:** Reversing the lowering of tax rates may be difficult, especially if recovery after the crisis is slow, which would drive up the fiscal cost. The effect on consumption of such measures is also in doubt. Even with more money available, people may not be spending it during the COVID-19 for precautionary reasons or because businesses are shut down and movement of people restricted.

### >>> EXPENDITURES INSTRUMENTS

The COVID-19 pandemic constitutes a serious challenge for WBG client countries, particularly those with weak health and social protection systems and feeble response capacities overall. Governments will have to reprioritize development, service delivery and administrative activities, while creating fiscal space in an environment of tight constraints and global supply shocks.

During the first phase of the crisis, the fiscal policy response aims at: (i) funding of the health sector response, including increases in staffing, facilities, and supplies and materials such as test kits and ventilators, as well as complementary public health measures such as public information campaigns; (ii) protecting people from the economic fall-out of measures to contain the pandemic (such as social distancing and lockdowns), which lead to a slowdown in economic activity, employment, and income; (iii) supporting the survival of businesses that face severe drops in activity and prevent lay-off through measures such as subsidies; and (iv) containing recessionary pressures through countercyclical spending.

### >>> EXPANSIONARY FISCAL POLICY IN A TIGHT FISCAL ENVIRONMENT

Expenditure reprioritization and new resource mobilization towards affected sectors across the developing world will be challenging. A key challenge is national readiness

for scaling up funding, in light of fiscal space constraints, existing budget rigidities and implementation capacity. A large number of developing countries simply lack the fiscal space to accommodate a meaningful policy response, either because of the effect of decreasing commodity prices and depleted fiscal buffers (Nigeria, Angola, Gabon), for being on a fiscal consolidation path with little room for increased spending (Panama) or constrained by adherence to fiscal and/or constitutional rules (Azerbaijan, Brazil). Scaling up funding might also prove challenging in countries with low absorptive capacity and historical under-execution of budgets, as well as in those with low systems' ability to quickly disburse funds where needed, requiring a tailored, approach based on countries' initial conditions and PFM systems quality.

There is an important lesson to be learned from current and past crisis around the long-term benefit of helping promote better fiscal preparedness in light of recurrent nature of these events (pandemic or natural disasters). Most low-income countries lack the appropriate financing instruments to cope with emergencies of this magnitude - such as contingent credit lines and emergency insurance schemes<sup>2</sup>, that could help create immediate fiscal space as opposed to relying mostly on limited supplementary budgets or foreign assistance. As recent medical emergencies (cholera outburst) in Zambia<sup>3</sup> demonstrated, budget rigidities might slow the process of extra funding allocation, undermining the pace and operational efficiency of health providers' response, while placing the entire burden on foreign assistance to fill the financing gap.

**Assessment:** It will be important to leverage the current crisis as a catalyst for developing countries to develop adequate financing strategies to enhance their preparedness vis-a-vis the recurrent nature of disaster or pandemic-related contingent liabilities. In this respect, wider applications in DPOs of Catastrophe Deferred Drawdown Options (Cat-DDO) or projects' Contingent Emergency Response Component (CERC) offer convenient avenues to developing countries for quick and inexpensive access to funding, as currently taking place in Romania and Kenya (CAT-DDO) and Angola (CERC) among others.

### >>> INCREASED FUNDING OF THE HEALTH SECTOR

Countries around the world are designing or already implementing expansionary fiscal policies to counter the economic and social impact of the COVID-19 pandemic. Significant resources are allocated to strengthen health systems in terms of both containment and mitigation preparedness, beyond existing basic prevention measures. In Italy alone, over 3.5 billion euros have already been allocated to fund extraordinary hires (including bringing back retirees) along with allowances and overtime, replenish the Health Emergency Fund, purchase medical devices and products - including by subsidizing loans or via direct contributions to companies producing surgical masks- and increase hospital beds and intensive therapy spaces, including the possibility of requisitioning movable property or hotels to face the emergency. In anticipation of similar manifestations across the developing world, various contingency plans are currently being developed in collaboration with development partners to enhance preparedness for a full-scale epidemic beyond existing prevention measures. In Nigeria for example, the government is considering a supplementary budget that reflects funding needed for the health sector in case of a severe epidemic scenario. In some countries such as Gabon and Cameroon, the governments have already created a fund to help and assist its citizens living abroad in case of emergency. In Myanmar, Tajikistan and other countries, contingency plans have been fully elaborated, incorporating funding needs towards procurement of medical supplies and equipment, training, surge capacity for service delivery and outreach activities.

**Assessment:** While increasing allocations to strengthen health systems is a necessary and most needed measure in the short term to help mitigate the crisis, it is important that due considerations be applied to ensure these measures are efficient, equitable, evidence-based, cost effective and minimize disruptions. This includes paying close attention to the following aspects, tailored to each country's needs, dynamics and initial conditions:

*Target resources towards most under-funded areas.* Limited fiscal resources require efficient priority setting processes to maximize their cost-effectiveness. For instance, in countries like Namibia where the majority of funding is devoted to finance hospital care and relatively little for prevention (PER 2019), fiscal policy measures should prioritize investment in primary care centers and related preventative measures. Similarly, countries with chronic under-funding in medical supplies

should prioritize their procurement in order to enhance value for money considerations of total sector spending, ensuring proper protocols and rules are in place and followed, while maximizing efficiency (for instance through joint procurement contracts). Good targeting also requires that a full costing strategy has been put in place, using available instruments such as recent guidelines issued by WHO.<sup>5</sup>

*Ensure equitable access to facilities and medical services.* Governments should to the extent possible subsidize full provision of basic prevention tools and testing which “must be the backbone of the response in every country” (WHO) as well as unrestrained access to medical facilities. In countries with high degree of private health spending, this would imply enhanced targeting of public financing to cover the costs of COVID-19 related healthcare for the needy to ensure universal access to medical services. Focused investments in mobile testing facilities may be desirable from both efficiency (not overloading the already strained health system) and equity perspectives, particularly to assist poorer or rural communities where medical facilities are typically ill equipped to attend even to basic necessities.

*Mitigate undue diversion of resources.* Re-allocation of health resources should not come at the expense of important treatments in other medical areas. Early evidence from China – where 42,000 doctors and nurses were sent to Wuhan to combat the outbreak – pointed to a sudden deterioration and de-prioritization of access to other ongoing health services such as maternal and child care, HIV and TB treatments. Recognizing the likelihood of such disruption, backup plans should be elaborated, including incentivizing (through tax or expenditure subsidies) private care givers to absorb influx of non-urgent patients during the crisis.

*Encourage investments in country capacity and systems for long term preparedness.* Historically, insufficient expenditure mobilization efforts have been devoted towards building adequate capacity and resilience in developing countries' health systems to cope with pandemics as these measures are systematically penalized in budget allocations in favor of more direct and ‘visible’ interventions. Past health crises such as Ebola, SARS and MERS witnessed a sudden upsurge of donor funding to neutralize the problem as opposed to investing in long term preparedness to build permanent capacity against such risks. Proper incentives can be embedded in fiscal policy measures to incentivize countries to make needed capital investments to close preparedness gaps, establish/strengthen regional health institutions (such as Africa CDC) for effective

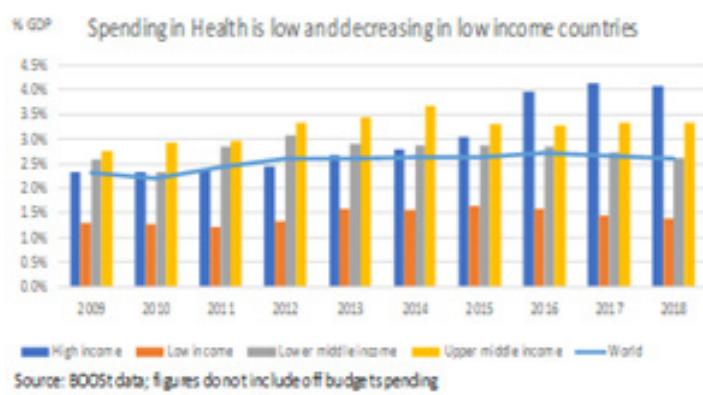
5. <https://www.who.int/docs/default-source/coronavirus/covid-19-sprp-unct-guidelines.pdf>

coordination and support diversification of appropriate financing instruments that could help create immediate fiscal space in case of emergencies.

*Reversibility vs. permanent investments.* While the absolute priority in the short term is to reinforce the health care system with more human resources, equipment and hospital beds, due considerations should be given to the term structure of

> > >

**FIGURE 3 - Spending in Health is Low and Decreasing in Low-Income Countries**



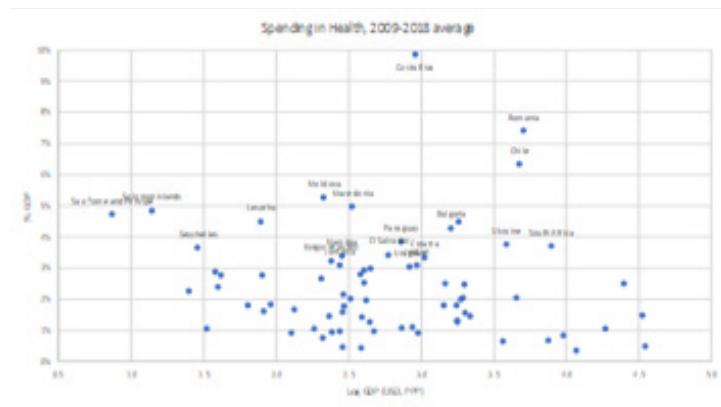
*Understand the inter-connectedness of health investments with other interventions.* Mitigation of the health crisis by “flattening the curve” goes beyond direct spending in health systems. A critical component hinges on the success in promoting desired behavioral change of global population via social distancing, which needs to be properly incentivized. While many countries have implemented measures – such as direct cash transfers, employment and wage compensation subsidies, and deferrals (loan payments and in some cases utilities) - to provide short term relief to economic hardships, further ‘creative’ measures should be considered to incentivize desired behavioral change of people staying home. In this respect, some countries have already introduced measures such as subsidized/free entertainment-related streaming services which carry limited fiscal implications given their time bound nature.<sup>6</sup>

*Account for quality of PFM systems.* Public financial management challenges can significantly affect the effectiveness of emergency funds during implementation. Historically, the health sector has exhibited some of the largest under-execution rates for low and lower middle-income countries – equivalent on average to over 0.2% of GDP or 5% of original allocations over the past decade (BOOST data) - questioning the absorptive capacity of the sector vis-a-vis

these interventions. While part of these interventions should be considered temporary with subsequent reduction of hiring surge after the epidemic wanes, it would be suitable for some structural interventions to become permanent particularly in low income countries where on budget health spending has been historically low before the crisis, accounting on average for less than 1.5% of GDP.

> > >

**FIGURE 4 - Spending in Health, 2009-2018 Average**



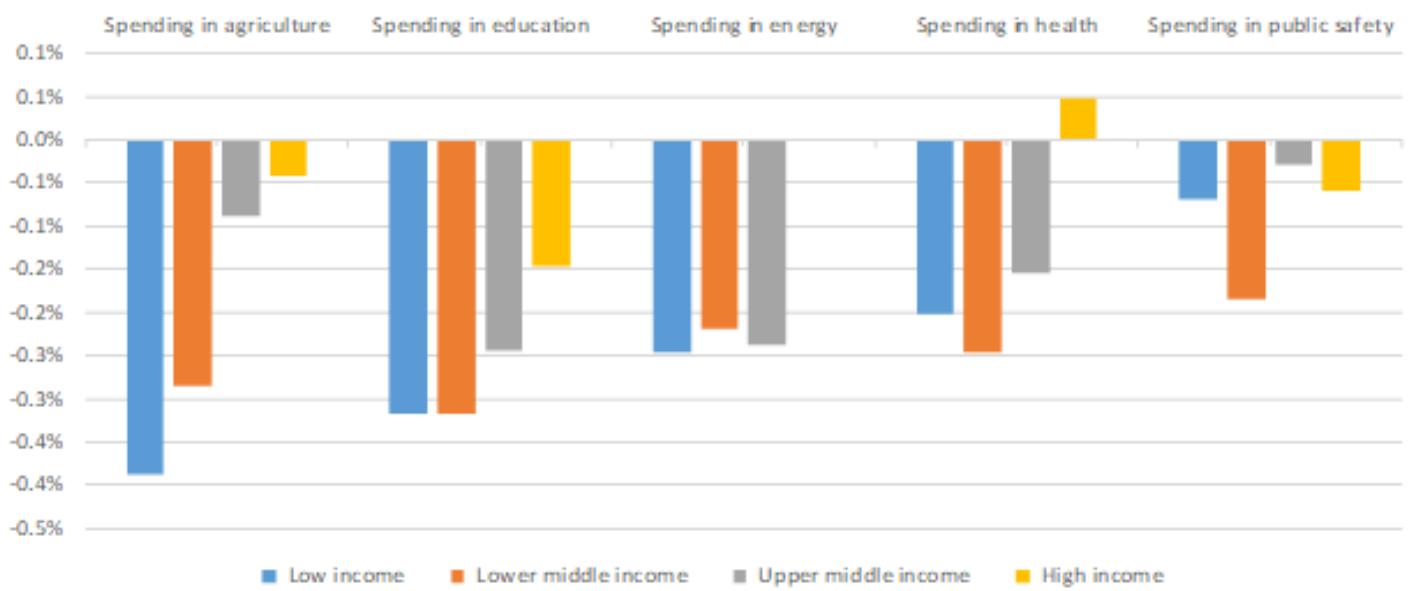
a significant influx of funds. Similarly, multiple administrative layers between the central government and health facilities might slow down the provision of additional funds in addition to being vulnerable to leakages without proper procurement rules and protocols and in absence of robust monitoring and commitment controls. Furthermore, countries with strict line item monitoring might lack the flexibility needed to adapt to changing circumstances effectively reducing overall operational efficiency of service providers. In short, it will be important for domestic and international constituencies to pay close attention to existing PFM arrangements to maximize accountability and value for money considerations for the expected inflow of funds, particularly in countries with poor quality of their financial management systems.

6. The private sector has also contributed towards this outcome by subsidizing home deliveries of groceries and food.

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## FIGURE 5 - Under-Execution Across Main Sectors, 2009-18, % GDP

Under-execution across main sectors, 2009-18, % GDP



### >>> SAFETY NETS, EMPLOYMENT SUBSIDY AND BUSINESS SUPPORT SCHEMES

The unprecedented, multi-faceted, disruptive nature of the pandemic undermines the feasibility of implementing traditional fiscal policy measures when introduced in isolation. Instead this requires comprehensive packages that complement resources allocated to health systems with proper enablers to mitigate the economic impact in terms of income and productivity losses while encouraging desired behavioral change. With effects of demand-side fiscal policies in the form of credits, transfers or allowances likely constrained by the current environment of 'social distancing' and restrictions, more effective measures require a combination of basic social safety nets strengthening along with support mechanisms aimed at mitigating further economic disruption by incentivizing private sector in retaining employees and enduring the financial impact caused by the pandemic through a variety of wage compensation, loan subsidies and deferrals and advance payment schemes, as introduced in most developed countries.

In this context, social safety nets will need to be strengthened in order to mitigate the impact of the crisis on the most vulnerable. Some countries have already introduced a vast array of fiscal policy measures to counter the income effect of the crisis, in the form of credits for businesses affected by the pandemic, wage compensation measures and direct transfers. For instance, China and South Korea have expanded and extended both cash and in-kind transfers,

especially for vulnerable groups. In Austria and Denmark, temporary wage compensation measures were introduced to benefit employers who grant special leave or otherwise pledge to retain their workers despite experiencing financial losses due to decreased demand, covering up to 75% of full salary. In Italy, a comprehensive 25 billion Euro package of fiscal policy measures has been introduced targeting wage compensation schemes, cash transfers and allowances, employment benefits, one off firm subsidy for sanitation, alongside various tax relief measures and regulatory measures (special leaves, suspension of dismissals, etc.). In this respect, some developing countries have already designed contingency plans along similar lines. For instance, Cambodia recently introduced a \$2 billion package to support tourism businesses while pledging to pay wages of workers affected by factory suspension.

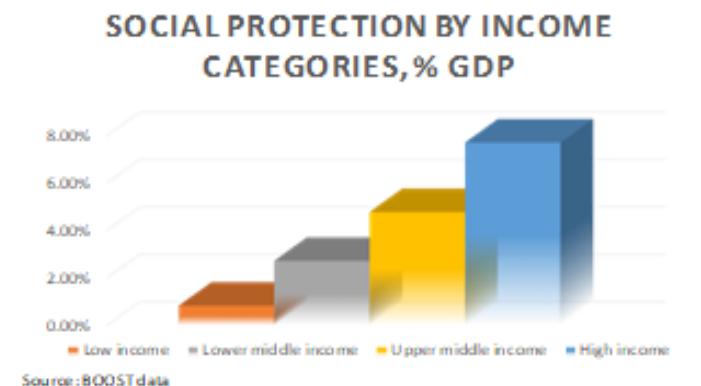
Similarly, much like during the global financial crisis, an important role for fiscal policy is to prevent loss of productive capacity due to potential bankruptcy of firms that would have been financially viable without the pandemic, particularly SMEs. This is particularly compelling in some of the sectors that have been most affected by the crisis, including transportation and hospitality, but also include cascading effects from trade disruption affecting supply chains globally. While the full extent of the economic pain will largely be dictated by the future trajectory of the pandemic, it is reasonable to expect a wave of request for bailouts from most affected industries – potentially even leading to temporary government ownership

of critical industries as witnessed during the global financial crisis – including from SOEs operating in affected sectors such as airlines. In this context, it is important for governments to undertake proper fiscal risk analysis and scenario planning while designing fiscal policies aimed at mitigating the economically disruptive impact of current restrictions. A good example is the set of measures implemented in China to support SMEs in affected areas via a combination of deferrals of loan payments and reduction of social security contributions.

**Assessment:** These measures are important not only to provide temporary economic relief to firms and individuals hit by the crisis to mitigate long term financial impact of the pandemic but also to encourage the behavioral change required to mitigate spread of the virus, i.e. incentivizing individuals in staying home without risking losing their jobs/income. Proper implementation of these relief schemes should incorporate at a minimum the following considerations:

> > >

**FIGURE 6 - Social Protection by Income Categories, % GDP**



Targeting and vulnerability to abuse - Effective implementation of these policies requires strong administrative capacity in targeting proper beneficiaries – particularly when equity considerations are built into these transfers - which in turn depends on the quality of existing social protection systems, business registration, and tax administration systems, which are typically weak in most low-income countries. Balancing beneficiary validation with the need for timely disbursements and fraud prevention will likely imply a certain degree of risk to be borne, particularly in countries with weak PFM systems, low quality of governance, and low transparency and accountability arrangements. Furthermore, in case of corporate support schemes, in addition to identify industries to be supported on the basis of their criticality, governments should take clear actions to ensure that most of the subsidies trickle down to their employees as opposed to funding buybacks and other corporate needs.

Reversibility vs permanent changes – The risk of public expectation and political pressure to keep measures in place for longer than needed is non-trivial as often witnessed with introduction of new tax incentive schemes in the developing world. While the priority in the short term is to mitigate at all cost the economic impact of the pandemic, the majority of these interventions should be considered temporary with clear and transparent rules - including sunset clauses where applicable - established for their removal once pre-crisis economic levels are restored. Countries however might want to leverage the current drive for reform to introduce permanent structural interventions to improve prospects of long-term growth such as for instance regulatory simplifications to ease the cost of doing business and investing in robust and resilient social safety nets to become more effective automatic stabilizers to help reduce procyclicality in fiscal policy of many developing countries.

Equity and efficiency – When compared to bailout packages and broader corporate support schemes, unconditional direct cash transfers to households provide the most equitable and efficient channel to support distressed families and restart the economy. Bailout packages on the other hand not only raise the issue of discretion of identifying which industry or segment to be rescued but also carries widespread perception of not sufficiently benefiting ordinary people, as historically these benefits have not typically trickled down to employees and/or consumers.

#### >>> PURSUING OTHER EXPANSIONARY EXPENDITURE POLICIES WITH HIGH FISCAL MULTIPLIERS

A growing literature recognizes that fiscal multipliers are much higher during economic downturns than during normal times (Auerbach & Gorodnichenko, 2013; Blanchard & Leigh, 2013b). The persistence of stimuli furthermore depends on the type of spending: government consumption may only help buffer current distress whereas government investment may also raise the longer-term growth potential (Alichi et al., 2019; Coenen et al., 2012).

Economic crises often create a window of opportunity for economic reforms. In addition to encouraging investments in country capacity and health systems for long term preparedness, one such opportunity revolves around green public investments in renewables, climate adaptation, clean water systems or public green transport as these would not only serve as catalyst for restarting the economy but also tilt it towards green growth. A related opportunity would envision removing fossil fuel subsidies, as the effect of their removal

– and particularly the elimination of ceilings – would not be felt in the current low-price environment. These mechanisms are widely used in developing countries to buffer the domestic economy against hikes in global fuel prices but also discourage investments in energy efficiency and tend to turn into a significant drag on public finances during price booms. Their removal would help improve future fiscal space along with a large built-in source of procyclicality in the fiscal policy of many developing countries. Section 5.4 further elaborates likely pathways for tilting the economic recovery green.

### >>> CREDIT AND EQUITY INSTRUMENTS

Given the temporary nature of crises impact, countries may use credit instruments to help businesses. For example, Germany has announced that businesses will receive credit (through KfW). An initially Euro 20 billion has been allocated with guarantees up to Euro 500 billion (in comparison, during the global financial crisis,<sup>7</sup> about Euro 200 billion were used). In addition to direct credit, countries are also working with their financial sectors on measures to defer debt service payments.

In past crises, countries have also deployed equity instruments to prevent the closing or foreign takeover of businesses that are considered of strategic importance or national interest. During the global financial crisis, the automotive and financial sectors of several countries were supported by governments taking equity positions during the crisis, which were sold to investors once the businesses had stabilized and the economy recovered. In many cases, these equity interventions actually had high financial returns for governments, as their stakes in these enterprises could be sold at higher prices than what they were bought for during the crisis.

### >>> ASSESSING THE FISCAL POLICY RESPONSES

Table 1 provides a summary classification of fiscal policy instruments described in the previous sections, related to expenditure, revenue, and credit/equity, by the key characteristics identified at the start of Section 4: efficiency, cost and fiscal sustainability, flexibility, and feasibility. This table is detailed by fiscal policy measure in Appendix Table 3.

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7. Compared to the global financial crisis, lower perception of moral hazard may reduce political resistance to support of the financial sector and large companies.

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**TABLE 1 - Classification of Fiscal Policy Instruments**

		REVENUE INSTRUMENTS	EXPENDITURE INSTRUMENTS	CREDIT/EQUITY INSTRUMENTS
<b>TARGETABILITY</b>		Automatic targeting of corporate and income taxes. Tax incentives can be targeted to specific sectors and industries. For indirect taxes targeting is more difficult. Loss making entities with no income tax liabilities will also not benefit from revenue measures.	In principle most expenditure instruments are amenable to targeting by location, sector etc. In practice, targetability will depend on quality of existing social protection systems, business registration, etc.	Similar to expenditure instrument with the added advantage that beneficiaries will self-select.
<b>EFFICIENCY SPEED</b>		Temporary reductions in tax rates for indirect taxes can have immediate effect, though potential problems with pass through, especially for more complex taxes. Direct taxes will have impacts based on tax calendars.	Subsidies, cash transfers, and scale up of recurrent spending will have immediate effect. Capital investments will have longer gestation and implementation periods.	Funds can be made available relatively quickly but will depend on administrative capacity to correctly target the spending.
<b>ABUSE RESISTANCE</b>		Will depend on governance environment and strength of tax administration. Risk that tax incentives and exemptions are used fraudulently. Indirect tax measures less prone to abuse, but risk of erosion of tax morale.	Depends on quality of governance environment, risks of abuse of subsidies and transfers, inefficiencies in the use of increases in operations and maintenance spending, and corruption in investment spending.	Scope for abuse more limited as assessment creditworthiness and repayment will be required. However, in weak governance environments credit instruments will also be open to abuse.
<b>COST AND FISCAL SUS-TAINABILITY</b>	<b>AFFORDABILITY</b>	Full cost.	Full cost.	Potential to recover credits and equity participations after crisis.
	<b>PREDICTABILITY AND CONTROL OF TOTAL COST</b>	Less predictably, given that a range of factors will affect revenue impact.	Upper limits of expenditure can be established to reduce risk of overspending. Use of increases in spending on operations and maintenance and investment will be subject to absorptive capacity constraints.	Upper limits can be established, though actual usage more uncertain than for expenditure instruments as access depends on business and household decisions.
<b>FLEXIBILITY</b>	<b>SCALABILITY</b>	Limited by level of tax liability.	Most expenditure instruments easily scalable as government can choose the level of support and investment, but implementation/PFM weaknesses can be a critical obstacle.	Similar to expenditure instruments.
	<b>REVERSIBILITY</b>	Tax measures can have explicit time limits, but risk of undermining tax moral and political pressure to keep measures in place.	Recurrent expenditure increases more easily reversible than investment expenditure, which will also have recurrent cost implications. Risk of public expectation and political pressure to keep measures in place for longer than needed.	Credit programs are relatively easy to stop when no longer needed, but also risk of political pressure to keep them in place.
<b>FEASIBILITY</b>	<b>ADMINISTRATIVE COMPLEXITY</b>	Broad based adjustments to rates and tax schedules that are within the regular work of a tax administration may be feasible in many countries. New tax measures or specifically targeted tax measures will be more complex and require higher capacity.	The use of targeted transfers will require that adequate systems are in place. Quality of public expenditure and investment systems will impact on quality of spending.	Will require significant capacity to assess needs, creditworthiness, and repayment capacity.
	<b>RESILIENCE TO HEALTH MEASURES</b>	Efforts to control the health effect of COVID-19 would mute the impact of revenue measures to the extent that they depend on face-to-face interaction between taxpayers and revenue officials and revenue administrations struggle with business continuity. Revenue measures aimed at protecting livelihoods and supporting demand in affected sectors would be ineffective to the extent health measures constrain behavior.	Expenditure measures would be hampered to the extent that health measures impede the functioning of government agencies and implementation depends on face-to-face interaction. Spending measures aimed at protecting livelihoods and supporting demand in affected sectors would be ineffective to the extent health measures constrain behavior.	Unlikely to be strongly affected by health measures.

## >>> ASSESSING COUNTRY CIRCUMSTANCES: FISCAL SPACE AND CAPABILITY

Following the earlier discussion of fiscal impact of and response to the COVID-19 pandemic, this sub-section adds granularity by discussing country characteristics and how these map to the choice of instruments. The most fundamental determinants for the choice of instruments will be the available fiscal space and the capability of the state to design and implement specific fiscal interventions. In addition, the economic and fiscal structure of a country will also influence the specific economic and fiscal impact of the COVID-19 pandemic and also shape the set of appropriate and feasible responses. This sub-section discusses how these factors impact on the efficacy of fiscal instruments to respond to the pandemic and its economic impacts. It also shows the variation across countries with respect to these factors, which can serve to group countries into categories to facilitate the choice of fiscal instruments that is well aligned with specific country circumstances.

An effective use of fiscal measures in response to the impacts of the COVID-19 pandemic requires that governments have the capability to design and implement quickly appropriate fiscal policies and that they have sufficient fiscal space to adopt measures on the needed scale. While countries with high capability and fiscal space will be able to choose from the whole menu of reforms, for countries which have lower capability or lower fiscal space the set of available options will be much more limited and specific measures to deal with capability or fiscal space constraints may be needed.

Fiscal space has already been narrowing prior to the onset of the COVID-19 pandemic. Kose et al (2019) define fiscal space as “the availability of budgetary resources for a government to service its financial obligations.” They discuss various concepts of fiscal sustainability and related indicators, which they group into four clusters, namely debt sustainability, balance sheet vulnerability, external and private sector debt related risks as potential causes of contingent liabilities, and market access. They also show that most countries had expanded their fiscal space prior to the global financial crisis in 2007/08, which facilitated the adoption of strong countercyclical measures. By 2019, fiscal space of many countries had eroded, leaving countries in a much weaker position to deal with an external shock before the outbreak of the Covid-19 pandemic. The massive build-up of private and public debt that took place during the last decade played an important role in narrowing fiscal space (Kose et al 2020). In the context of dealing with an external shock, fiscal space relates the ability to deal with

increased expenditure requirements or reduced revenue. Available fiscal reserves, capacity to adjust expenditures, and access to loanable funds would be key elements of fiscal space.

Aside from fiscal space, countries’ and governments’ capability to design and implement fiscal responses to an external shock will also affect the choice of instruments. In a broad sense, capability includes both the technical capacity to implement particular fiscal measures and the institutional and political arrangements which may either facilitate or hinder an adequate fiscal response. Capabilities of particular subsystems will be of particular importance when specific measures are being considered, including capabilities of a country’s Ministry of Finance, revenue administration, and social protection systems. Broader capabilities relating to the quality of policy coordination and government decision processes will also be important.

These two broad sets of characteristics are key parameters for countries’ choices of fiscal strategies and instruments to confront the COVID-19 pandemic and its economic impacts. Dividing countries into those with lower or higher fiscal space and lower or higher government capability gives us four types of countries. Table 2 shows the key elements of feasible fiscal strategies, which maps to the discussion and assessment of fiscal instruments in the previous section.

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**TABLE 2 - Fiscal Strategies to Address COVID-19 Impacts Aligned with Country Capability and Fiscal Space**

	LOWER CAPABILITY	HIGHER CAPABILITY
MORE FISCAL SPACE	<ul style="list-style-type: none"> <li>Focus on less complex fiscal measures</li> </ul>	<ul style="list-style-type: none"> <li>Seek fiscal instruments that are most suitable to the specific country circumstances, including economic and fiscal structure</li> </ul>
LESS FISCAL SPACE	<ul style="list-style-type: none"> <li>Focus on interventions where cost control is manageable and that are easily reversible with limited capability</li> <li>Focus on less complex fiscal interventions</li> <li>Clear prioritization of objectives</li> <li>Seek to expand fiscal space</li> </ul>	<ul style="list-style-type: none"> <li>Focus on cost control and reversible measures</li> <li>Clear prioritization of objectives</li> <li>Seek to expand fiscal space</li> </ul>

For countries with limited space, focusing on interventions with more limited cost implications that are easily reversible will be particularly important. Credit instruments such as tax deferrals and short-term loans may be particularly appropriate. Less fiscal space will also force countries to set clear priorities. In most cases, health interventions will clearly have the highest priority, followed by interventions to protect people and businesses.

Expanding fiscal space will also be important for countries with limited fiscal space. Limited access to funding from reserves or from borrowing will force countries to seek to reallocate funds towards COVID-19 priorities. However, the disruption of programs from which resources are allocated away can have significant economic cost in terms of delayed development. For developing countries, development partners will also have an important role in expanding fiscal space, be it through increased development assistance, debt forgiveness or deferral of debt service payments, or reprioritization within existing programs of support.

Limited state capability imposes a different set of constraints on the implementation of fiscal measures. The scope for increasing such capacity in the short term will be very limited. However, using non-state actors in the response, especially CSOs, faith-based organizations, or the private sector may help to broaden capabilities and the set of interventions that can be used. Otherwise, the focus will need to be on the selection of instruments that are administratively less complex and that are within the capability of countries.

To illustrate which IDA countries might fall into which category, we use two specific measures of fiscal space and state capability. Given the massive impact of the Covid-19

pandemic, for most countries higher health expenditure and disrupted economic activity will result in higher fiscal deficits. We thus use a country's risk of debt distress as the primary indicator of fiscal space, where higher risk of debt distress will typically imply more limited access to and higher cost of loanable funds. We group countries into three categories – those with high risk of or in debt distress, those at medium risk, and those at low risk. To categorize countries according to state capability, we use a country's overall policy and institutional assessment (CPIA) rating.<sup>8</sup> We divide countries into two groups – those with better capabilities which have a CPIA above the median and those with weaker capabilities – with a CPIA below the median.

Using these two categories simultaneously allows us to classify countries into six categories ranging from countries with very little fiscal space and lower capacity to those with wider fiscal space and higher capabilities (Table 3). Table 3 categorizes all IDA countries according to their fiscal space and their capability for policy design and implementation. The two categories are not independent. Unsurprisingly, countries with higher capabilities tend to have more fiscal space while countries with lower capabilities have less fiscal space, putting them into a particularly precarious situation in confronting the COVID-19 pandemic.

The categorization in Table 3 is illustrative. Country teams will be best placed to assess into which quadrant their country falls, using additional information on fiscal space and state capability. Appendix 1 provides further guidance on the types of contextual factors, such as public financial management, revenue structure and performance, and economic structure could be taken into account when assessing the fit of fiscal policy instruments for country circumstances.

8. Using the rating of CPIA Cluster D - Public sector management and institutions – yields broadly similar groups, but we thought that the broader assessment, which also includes the assessment of social protection systems, provides a better assessment of broad state capability.

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**TABLE 3 - State Capability and Fiscal Space**

		RISK OF DEBT DISTRESS		
		HIGH OR IN DEBT DISTRESS	MODERATE	LOW
CPIA	ABOVE MEDIAN	Mauritania, Samoa, Tonga, Grenada, St. Vincent & the Grenadines	Benin, Ethiopia, Kenya, Madagascar, Mali, Niger, Togo, Burkina Faso, Vanuatu, Kyrgyz Republic, Fiji, St. Lucia	Honduras, Nicaragua, Dominica, Guyana, Bhutan, Cambodia, Nepal, Cameroon, Cabo Verde, Ghana, Cote d'Ivoire, Lesotho, Rwanda, Senegal, Tanzania, Uganda, Zambia, Moldova, Uzbekistan, Kosovo
	BELOW MEDIAN	Haiti, Yemen, Afghanistan, Burundi, Central African Republic, Chad, The Gambia, Mozambique, Sierra Leone, South Sudan, Zimbabwe, Kiribati, Marshall Islands, Micronesia, Tuvalu, Tajikistan	Maldives, Comoros, DRC, Guinea-Bissau, Guinea, Liberia, Malawi, Solomon Islands, Papua New Guinea	Bangladesh, Myanmar, Lao PDR, Djibouti, Congo

## >> ENSURING FISCAL SUSTAINABILITY AND SUPPORTING ECONOMIC RECOVERY

While the immediate focus of the response to the COVID-19 pandemic is to manage the health impacts and soften the economic impact on households and businesses, it is also important to look beyond the immediate impacts of the crisis with a view towards long-term fiscal sustainability and economic recovery. Given that the COVID-19 pandemic has triggered sharp drops in stock markets around the world and parallel developments in the oil markets, attention to these issues is even more important. In the following we discuss such broader elements which include preventing structural damages to the economy, ensuring long-term fiscal sustainability, and taking action to foster economic recovery and sustained economic growth. At the same time, the current crisis may also be a window of opportunity to embrace reforms that would not only support fiscal sustainability and economic recovery, but also accelerate the transition toward lower carbon emissions and enhanced resilience as well as effective taxation of the digital economy.

### >>> PREVENTING STRUCTURAL DAMAGE TO THE ECONOMY

Temporary measures to contain the COVID-19 pandemic are resulting in significantly reduced demand for many sectors and reduced demand for labor. If this results in significant business closures and unemployment, this may be difficult to reverse once the temporary impacts of the COVID-19 pandemic pass. Measures to prevent unemployment and business closures are thus high on the agenda of many countries. With regard to preventing lay-offs and unemployment this includes measures

where government covers part of the salaries of temporarily underemployed workers and reduces or postpones social security payments. For businesses, interventions include the establishment of credit facilities to help overcome liquidity shortages, sector specific subsidies to offset significant losses of revenue, and also government's equity participation in businesses that are considered to be of systemic importance to the economy (during the global financial crisis, several countries took equity stakes in their automotive and financial sectors to prevent long term damages to their economies.) Broader countercyclical measures to stimulate demand will also be of importance to accelerate economic recovery and ensure that impacts on households and businesses remain temporary.

### >>> FISCAL SUSTAINABILITY

Fiscal policy measures to deal with the COVID-19 pandemic and its economic fallout need to be taken with the importance of long-term fiscal sustainability in mind. This will impact on the type and scale of feasible response, but also the need for external support. Countries which have adequate fiscal buffers before the crisis are of course in a much stronger position than those that entered the crisis with higher fiscal deficits or higher levels of public debt. Cost, long-term fiscal implications, and reversibility of measures will directly impact on long-term fiscal sustainability.

From this perspective, measures that are in the form of credits and guarantees rather than in the form of outright grants and subsidies are attractive. They hold the prospect of repayment once businesses and households recover. On the revenue side, tax deferrals may be preferable to outright tax exemptions. Similarly, temporary equity participation instead of subsidies may also be appropriate, requiring, however, a credible commitment to disinvest once the economic situation has improved and adequate governance arrangements to protect businesses from excessive government interference.

Measures that have limited long-term fiscal implications and that are easily reversible also help to reduce risks to fiscal sustainability. For example, infrastructure investment projects typically have long gestation and construction periods, which may well exceed the time when economies will have recovered. In addition, they also have recurrent cost implications that would add to the fiscal burden. Other measures such as targeted subsidies that are clearly identified as being temporary will be easier to reverse. However, measures may also differ with regard to the political feasibility of reversing them, as there will often be strong pressure to keep temporary measures in place indefinitely.

Sustaining fiscal sustainability in the context of (temporary) reduced fiscal balances should also include reviewing the scope for medium to long-term measures to enhance revenue and rationalize expenditure. Not only will this be important for fiscal stabilization after the crisis, but also to support the strengthening of buffers to be able to confront the next crisis. Debt sustainability analysis will continue to play a central role in the assessment of the scope of debt financing, including a focus on debt transparency.

For low-income countries with limited fiscal buffers, external support will often be critical. Such support would allow the adoption of a minimum set of measures without jeopardizing fiscal and macro-economic sustainability.

### >>> STRUCTURAL REFORM FOR RESUMPTION OF SUSTAINED ECONOMIC GROWTH

Fiscal sustainability will also depend on the trajectory of the recovery and economic growth beyond the crisis period. Policy reforms that enhance countries' international competitiveness should thus be an integral part of efforts to stem the crisis impacts. Reforms will need to be country specific, but "stroke of the pen reforms" that can be implemented quickly may be of particular importance, especially in the areas of streamlining regulation to reduce the burden on businesses, strengthening

the regime for resolving insolvency, facilitating employment, and access to credit.

### >>> PATHWAYS TO TILTING THE ECONOMIC RECOVERY GREEN

As policymakers design and implement large stimulus packages and policy measures aimed at economic stabilization and recovery, pathways to green and lower carbon economic growth need to be considered. The scale of stimulus programs being unveiled, \$5 trillion in pledges by the G20, will have long lasting impacts on the economic structure of the world economy, and this is a critical moment to shift to low carbon, sustainable growth. In a context of limited fiscal space in many countries, key policy measures can be supported by environmental tax reforms.

Stimulus measures are helped by fiscal multipliers that are much higher during economic downturns than during normal times (Auerbach & Gorodnichenko, 2013; Blanchard & Leigh, 2013b). The effectiveness of stimuli furthermore depends on the type of spending: government consumption may only help buffer current distress, whereas government investment may also raise the longer-term growth potential (Alichi et al., 2019; Coenen et al., 2012).

Providing a stimulus to the economy and taking action on climate change do not stand in opposition to each other. Large stimulus packages will inevitably influence the trajectory of economic activity, and instead of reproducing the same type of growth and economic structure as in the past, well-designed stimulus packages that give priority to 'green spending' can help to stabilize aggregate demand in the short- and medium-term and yield large positive economic returns in the long run (see Box 2 for an assessment of green stimulus packages in response to the 2008/9 financial crisis). Green investment spending has the following desirable characteristics:

- Triggers additional spending from the private sector, with a large associated multiplier effect.
- Results in long-term climate benefits, such as a reduction in future energy consumption, lower pollution and low-carbon development.
- Boosts resilience, with investments that are climate smart.
- Avoids lock-in effects that make it excessively costly to switch to more efficient or cleaner technology pathways or development patterns in the medium and long term.
- Compensates tax-payers implicitly in the form of decreased expenses on energy and lower costs of abating GHG emissions in the future.

## >>> BOX 2 - ASSESSING GREEN STIMULUS PROGRAMS IMPLEMENTED DURING THE 2008/9 FINANCIAL CRISIS

The 2008–2009 global financial crisis led to numerous attempts to move economies towards a ‘green path’. Recovery packages were implemented in several countries to stimulate green growth, create jobs and support low-carbon economies (see below table). By mid-2009, governments around the world had allocated more than USD430bn in fiscal stimulus to key climate change investment themes. China and the US led the way. Key beneficiaries include rail transportation, water infrastructure, grid expansion and improved building efficiency. Renewable energy received limited support, except in the USA. In the United States, the American Recovery and Reinvestment Act (ARRA) included three spending objectives: it cut taxes, it extended unemployment benefits, education, and health care; and it created jobs by allocating about one third of the US\$ 840 billion package in federal contracts, grants, and loans, to investments in clean energy, education, and health care. This amount included more than \$90 billion for strategic clean energy investments, which – in turn – leveraged more than \$100 billion in private capital for investments in manufacturing, power generation, and renewables.

While the ‘clean energy’ stimulus was the subject of much attention there have been few evaluations of the performance of the policies that were promoted or introduced as a result. A recent paper<sup>9</sup> provides a comprehensive ex-post assessment of stimulus policies on renewable energy technologies in the U.S. Overall, the authors find that the stimulus programs had a positive effect on the renewable energy sector. The stimulus programs helped to boost manufacturing capacity and the supply chain, particularly in the wind sector. Emissions from energy decreased significantly in the early 2010’s but other factors may have played a role, notably the economic slowdown. Estimates indicated positive employment effects and increased revenue in the renewable energy sector. On the negative side, the proliferation of many different programs, pointed to misalignment and missed opportunities for them to work together. The stimulus could have had even more significant effects if it had been accompanied - as originally intended - by a greenhouse gas ‘Cap-and-Trade’ program, which would have increased renewable investment, even after short-term incentives had expired. While the program had positive green impacts overall, the renewable energy stimulus was not sufficient to generate a large-scale transformation to green growth.

> > >

**FIGURE 7 - A Climate of Recovery? The Climate Change Investment Dimension of Economic Stimulus Plans**

A Climate of Recovery? The climate change investment dimension of economic stimulus plans												
Country	Fund USDbn	Period Years	Green Fund USDbn	% Green Fund	Low-Carbon Power			Energy Efficiency (EE)			Water/Waste	
					Renewable	CCS/Other	Building	EE	Lo C Vech+	Rail	Grid	
<b>Asia Pacific</b>												
Australia	26.7	2009-12	2.5	9.3%	-	-	-	2.48	-	-	-	-
China	586.1	2009-10	221.3	37.8%	-	-	-	-	1.50	98.65	70.00	51.15
India	13.7	2009	0.0	0.0%	-	-	-	-	-	-	-	-
Japan	485.9	2009 onwards	12.4	2.6%	-	-	-	12.43	-	-	-	-
South Korea	38.1	2009-12	30.7	80.5%	1.80	-	-	6.19	1.80	7.01	-	13.89
Thailand	3.3	2009	0.0	0.0%	-	-	-	-	-	-	-	-
<b>Sub-total Asia Pacific</b>	<b>1,153.8</b>	<b>0.0</b>	<b>266.9</b>	<b>23.1%</b>	<b>1.8</b>	<b>0.0</b>	<b>21.1</b>	<b>3.3</b>	<b>105.7</b>	<b>70.0</b>	<b>65.0</b>	
<b>Europe</b>												
European Union	38.8*	2009-10	22.8	58.7%	0.65	12.49	2.85	1.94	-	4.85	-	-
Germany	104.8	2009-10	13.8	13.2%	-	-	10.39	0.69	2.75	-	-	-
France	33.7	2009-10	7.1	21.2%	0.87	-	0.83	-	1.31	4.13	-	-
Italy	103.5	2009 onwards	1.3	1.3%	-	-	-	-	1.32	-	-	-
Spain	14.2	2009	0.8	5.8%	-	-	-	-	-	-	-	0.83
United Kingdom	30.4	2009-12	2.1	6.9%	-	-	0.29	1.38	0.41	-	-	0.03
Other EU states	308.7	2009	6.2	2.0%	1.9	-	0.4	3.9	-	-	-	-
<b>Sub-total Europe</b>	<b>325.5</b>	<b>0</b>	<b>54.2</b>	<b>16.7%</b>	<b>3.5</b>	<b>12.5</b>	<b>14.7</b>	<b>7.9</b>	<b>5.8</b>	<b>9.0</b>	<b>0.9</b>	
<b>Americas</b>												
Canada	31.8	2009-13	2.6	8.3%	-	1.08	0.24	-	0.39	0.79	-	0.13
Chile	4.0	2009	0.0	0.0%	-	-	-	-	-	-	-	-
US EESA	185.0**	10 Years	18.2	9.8%	10.25	2.60	3.34	0.76	0.33	0.92	-	-
US ARRA	787.0	10 Years	94.1	12.0%	22.53	3.95	27.40	4.00	9.59	11.00	-	15.58
<b>Sub-total Americas</b>	<b>1,007.8</b>		<b>114.9</b>	<b>11.4%</b>	<b>32.8</b>	<b>7.6</b>	<b>31.0</b>	<b>4.8</b>	<b>10.3</b>	<b>12.7</b>	<b>15.7</b>	
<b>Total</b>	<b>2,796</b>		<b>436</b>	<b>15.6%</b>	<b>38.0</b>	<b>20.1</b>	<b>66.8</b>	<b>15.9</b>	<b>121.8</b>	<b>91.7</b>	<b>81.6</b>	

(\*Only EUR30bn from direct EU contribution considered for calculation as the rest (EUR170bn) is contributed by member states; \*\*USD700bn under TARP not considered for calculation as the fund is mainly for bank bailouts not for fiscal stimulus) + Low Carbon Vehicles

Source: HSBC estimates

9. Mundaca Luis, Jessika Luth Richter. 'Assessing 'green energy economy' stimulus packages: Evidence from the U.S. programs targeting renewable energy', [Renewable and Sustainable Energy Reviews Volume 42](#), February 2015, Pages 1174-1186.

The positive effects of stimulus measures are more persistent if they combine short-term stabilization of demand with long-term expansion of potential output. Hence, government spending should go to investments into durable assets such as resilient infrastructure. The World Bank's work on cost-effective interventions on resilience suggests that for infrastructure, the benefit-cost ratio is estimated around \$4 per \$1 invested. In early warning system it's even higher. There are also cost-effective investments in energy efficiency or improving the grid to benefit from low-cost renewable energy. Governments can maximize the impact of a fiscal stimulus by: (i) increasing their spending on public procurement, that is on items that show up directly on their balance sheets (green measures would include retrofitting buildings to make them more energy efficient, or investing in public transport and renewable energy); and (ii) mobilizing private sector investment and engaging in public-private partnerships, including government loan guarantees or refundable tax credits targeted at private sector investments in green recovery measures.

Lock-in to higher carbon needs to be avoided. Green investments provide a durable expansion of output potential whereas brown investment will temporarily expand output, which in a future carbon constrained world may become stranded assets, leading to significant adjustment costs when high-carbon assets need to be retired before their physical wear-out, cutting short their operational lifetimes.

Given that many countries seek to implement stimulus measures in a context of limited fiscal space and elevated debt burdens, environmental tax reforms can play an important role. If the stimulus needs to be fiscally neutral, one approach is to reduce taxes which have a high fiscal multiplier during recessions (such as direct taxes), while seeking to raise revenues on tax bases that have a low fiscal multiplier (such as consumption taxes). This is exactly what an environmental fiscal reform does.

Policymakers could also seek to capture the fall in oil prices for all by revisiting fossil fuel subsidies and taxes, and recycling any additional funds to priority spending needs. The current low fuel prices provide a selective stimulus to high-carbon, capital-intensive industries. The absolute benefit of the reduced prices accrues to more affluent households, especially in low- and middle-income countries. Taxing those fuels and recycling the revenues through spending or reduction in labor taxes improves equity and jobs (because low-carbon industries are on average more labor-intensive). Alternatively – but with similar effects – countries could phase out fossil

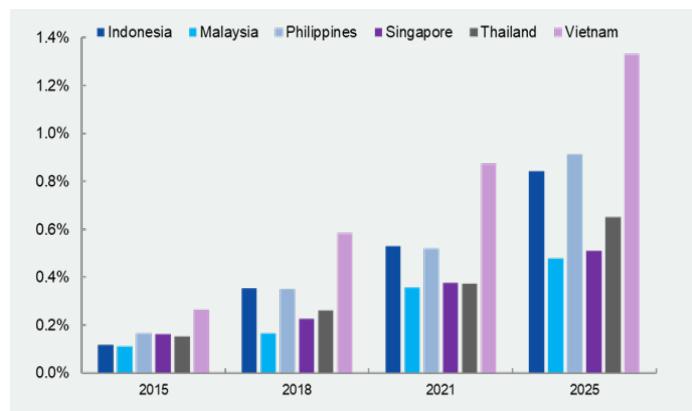
fuel subsidies, which are used in many developing countries to buffer the domestic economy against hikes in global fuel prices but also discourage investments in energy efficiency and tend to turn into a significant drag on public finances during price booms. Their removal would help improve future fiscal space along with a large built-in source of procyclicality in the fiscal policy of many developing countries.

### >>> EFFECTIVE TAXATION OF THE DIGITAL ECONOMY

The COVID-19 crisis is likely going to accelerate the relative importance of effectively taxing e-commerce and the digital economy more generally. In many economies, the digital economy is already a significant source of tax revenues and its growth suggests it will become even more so in the future (see below figure). While there is a clear international consensus on how to capture revenue from indirect taxes, with taxing rights allocated to the jurisdiction where the final consumption occurs, many developing economies have not yet put adequate policies and put the administrative structures in place to impose VAT on the direct supply to consumers of services and intangibles by foreign suppliers. Social distancing is accelerating the growth of most digital delivery models (thus boosting online sale of goods and online trade in services such as education and banking). Incorporating these dynamics of expanding market shares in a contracting global economy, suggests that as opposed to most other revenue sources, the tax base of the sector is going to continue expanding in times of a global recession. Implementing rules to tax the sector is hence one potential avenue to protect government revenues and should also contribute to a level playing field for less non-digital providers.

>>>

**FIGURE 8 - Tax Potential 2020-2025 (% GDP)<sup>10</sup>**



10. Al-Rikabi and Loepnick (forthcoming, 2020), provide estimates using a combination of macro and micro data sources for East Asian Economies. When looking at current collections and revenue potential, their findings suggest revenue in range of 0.15-0.25 of GDP is at stake now. But this was expected to increase alongside the dramatic growth of e-commerce to around 0.8% - 1.4% of GDP by 2025. With COVID-19 accelerating the transition of commerce, this share is likely to increase further.

## >> AREAS FOR MTI SUPPORT

In line with the importance of a well-designed fiscal response and in response to country requests, MTI has already started to scale up lending preparation and technical assistance. In addition to helping countries with the design and funding of adequate fiscal responses, work on ensuring the resumption of economic growth and fiscal sustainability will be important. The following provides a brief overview of MTI areas of support to contribute to the Bank's overall engagement on the COVID-19 pandemic.

### >>> ADVICE AND ANALYTICS

- Supporting the country response to the COVID-19 pandemic**

The immediate priority will be for country economists to proactively engage with Ministries of Finance on assessing the economic and fiscal impact and designing the fiscal response to the COVID-19 pandemic. This would include providing information on the global experience, options for response (which this note aims to support), and assessment of fiscal sustainability implications.

In many countries, such engagement will be able to draw on existing analytical work, especially public expenditure reviews, TADAT and DIAMOND revenue assessments, debt sustainability assessments, and economic updates. Close coordination with the health and social protection teams, the IMF, and other developments will be essential.

- Supporting the post-pandemic recovery**

MTI support will also assist countries in considering options for economic recovery after the health crisis has passed. For this work, the emphasis would shift to countercyclical policies and institutional and structural reforms needed for a strong recovery. MTI work on the drivers of economic growth such as country economic memoranda, economic growth studies, and country economic updates will provide important background for such engagement.

- Supporting fiscal sustainability and the building of buffers**

This would build on MTI's expertise in the areas of public expenditure and debt management and domestic revenue mobilization. In light of already high debt levels of many countries which are likely to increase further as a result of the pandemic, measures to strengthen domestic revenue collection and

rationalize expenditure will gain in importance. This will also assist countries in strengthening fiscal buffers in enhancing resilience to future external shocks.

As countries readjust their fiscal policies, this may also be an opportunity to engage on environmental tax reform which would bring together improved revenue mobilization with the pursuit of climate objectives and fiscal policy reforms that would support the transition towards a low carbon economy.

### >>> FUNDING SUPPORT AND DONOR COORDINATION

- DPO and Cat/DDO support to help prioritize and fund country responses**

Many countries will require external financing support to cope with the fiscal impacts of the COVID-19 pandemic. The Bank, in close coordination with the Fund, can support these efforts through DPOs.

For countries that have approved DPOs, supplemental financing will be the quickest way to provide support while ensuring that program implementation and macro-economic stability remain on track.

For countries, without current DPO engagement which require quick budget support, prior actions will need to be focused and achievable within a short-time period. Prior actions that support the sound design of fiscal measures in response to the pandemic may be particularly attractive, while actions that are not closely related to the crisis response risk diverting government attention at this critical juncture.

Demand for CAT/DDOs is also likely to increase. While to date the focus of many CAT/DDOs is on natural disasters, the Covid-19 pandemic highlights the urgency of including the strengthening of countries' response capacity to pandemics in CAT/DDOs, requiring close collaboration with the Bank's health teams.

The Bank, typically around a DPO engagement, has also an important role to play in coordinating budget support by other development partners. While this will be easier where ongoing DPO engagements are in place, it will also be important to support governments in donor coordination – including avoiding uncoordinated assessments and conditionality by multiple development partners.

- TA/IPF operations to strengthen fiscal systems for increased resilience and preparedness are important funding support.
- Strengthening fiscal systems for increased crisis resilience and preparedness will require scaled up and re-prioritized technical assistance for many countries. Substantive support for the overhaul of countries' domestic revenue systems can be provided in the form of technical assistance projects. Such strengthening of revenue systems would also be well aligned with IDA-18 commitments to assist countries in this area.

## >> APPENDIX 1: FISCAL IMPACT OF THE GLOBAL FINANCIAL CRISIS - LESSONS FOR THE COVID-19 CRISIS

The impact of the COVID-19 on the fiscal situation of governments is difficult to predict. The closest recent parallel to a major global crisis has been the 2008-09 global financial crisis (GFC). While the global financial crisis started in the US financial sector, resulting in a sharp drop in liquidity and quickly spread globally, its effects varied by region. COVID-19 is expected to have different impact pathways across the globe, but the impact on liquidity is likely to be of a similar nature. In a baseline scenario, the effects of COVID-19 would last until May-June of 2020 in the United States and Europe even while China recovers, which is a massive shock to the global economy.

Globally, revenues recovered to their pre-GFC level only after eight years while spending spiked during the recession years and stabilized at higher than pre-crisis levels. Globally, the shock to revenue was an average of 1.3 percent of the GDP while government spending jumped a full percentage point of GDP.

> > >

**APPENDIX TABLE 1 - Revenue Shock in the 2008-09 Financial Crisis and Years to Full Recovery**

REGION	PRE-CRISIS REVENUE (% OF GDP)	REVENUE SHOCK (% OF GDP)	REVENUE SHOCK (% OF REVENUE)	YEARS TO RECOVER
SOUTH ASIA	15.8	0.81	5.1%	7
SUB-SAHARAN AFRICA	19.45	0.86	4.4%	3
LATIN AMERICA AND THE CARIBBEAN	21.91	0.95	4.3%	6
EAST ASIA AND THE PACIFIC	25.9	1.52	5.9%	4
EASTERN EUROPE AND CENTRAL ASIA	28.35	1.54	5.4%	Did Not Recover
NORTH AMERICA	31.83	2.24	7.0%	Did Not Recover
MIDDLE EAST & NORTH AFRICA	34.62	4.28	12.4%	Did Not Recover
WESTERN EUROPE	35.1	1.00	2.8%	4

Regionally, the largest shock of 4.28% of GDP was for the countries in the Middle-East and in North America. The economic shock in these countries was compounded by the lower oil revenue as oil prices declined causing a sharp reduction in fiscal revenues. In the case of Sub-Saharan Africa, the revenue shock was 0.86% of GDP nearly 4.4% of the pre-crisis level, though these countries recovered the quickest among all the regions. South Asia recovered its revenues to pre-crisis levels in 7 years. Even ten years after the financial crises, revenues for countries in the regions of North America, the Middle-East and North Africa and Eastern Europe and Central Asia have not fully recovered.

levels while Income tax revenues and VAT recovered in 6 years with revenue shocks of 0.56 and 0.53% of GDP. Trade taxes suffered a shock of 0.44% of GDP and did not recover to its pre-crisis levels.

In South Asia, income taxes were not affected by the crisis and continued to show an increasing trend through the crisis. The most significant shock was felt in non-tax revenue which dropped by 2.57% of GDP. Apart from non-tax revenues, trade taxes suffered a negative shock of 0.2% of GDP. Other taxes suffered only marginal losses.

Sub-Saharan Africa too showed similar rising trend for income taxes right through the crisis. Here too, the non-tax revenue suffered the biggest negative shock of 1.5% of GDP. Trade taxes that were falling pre-crisis continued its downward trend though the fall was accelerated due to the crisis. The other negative shocks were to VAT and excises.

### Tax types most affected

Globally, non-tax revenues, income tax and VAT were most affected by the financial crisis. Non-tax revenue which suffered a negative shock of 0.77% did not recover to pre-crisis

Among Latin American and Caribbean countries, the biggest negative shock of 0.65% of GDP was in trade taxes followed by 0.49% for the VAT. Income tax suffered a small negative shock of 0.34% of GDP. Non-tax revenue suffered a small negative shock while excise taxes was unaffected.

Income tax suffered the biggest negative shock (1.96% of GDP) among East Asian and Pacific countries. Trade taxes had the second biggest shock among these countries (0.51% of GDP). VAT and excise suffered smaller negative shocks. Among Eastern European and Central Asian countries, income tax revenues suffered their biggest shock (1.09% of GDP) with VAT and trade taxes following closely (0.43% of GDP and 0.40 % of GDP respectively).

North American countries (United States and Canada) suffered their biggest shock of 2.22% of GDP for the income tax which did not recover to pre-crisis levels. The impact on other revenue items was small.

Among Middle-Eastern and North African countries, non-tax revenues suffered a shock of 4.31% of GDP due to lower oil revenues. The next largest fall was in the VAT (0.69% of GDP) followed by income tax revenues, which fell by 0.39% of GDP. Excises and trade taxes were relatively unaffected.

Lastly among the countries of Western Europe, the negative shock to the income tax revenues was about 1% of GDP followed by 0.34% of GDP for the VAT. Income Tax revenue did not recover to its pre-crisis levels.

## Government spending

In South Asia, government spending 5% of GDP after the crisis from nearly 19% of GDP to 24% of GDP. By 2015, these levels dropped to nearly to its pre-crisis levels to 20% of GDP. In Sub-Saharan Africa, government spending increased by 1% of GDP after the crisis dropping back to the pre-crisis levels by 2012.

In Latin America and the Caribbean, government spending jumped 3% of GDP after the crisis to 23% of GDP and remained elevated rising further to 24% of GDP. In the East Asia and the Pacific, after the crisis, government spending jumped nearly 6% of GDP from 17% of GDP to 23% of GDP. by 2011 its levels further increased and settled at 26% of GDP nearly 8% higher than its pre-crisis levels.

In Eastern European and Central Asia, jumped 2% of GDP immediately after the crisis from 35% of GDP to 37% of GDP. However, these levels have since dropped to 32% of GDP.

In North America (USA and Canada), immediately after the crisis, government spending rose 4% of GDP from 19% to 23% of GDP. By 2014, it settled at 20% of GDP, 1% above its pre-crisis levels.

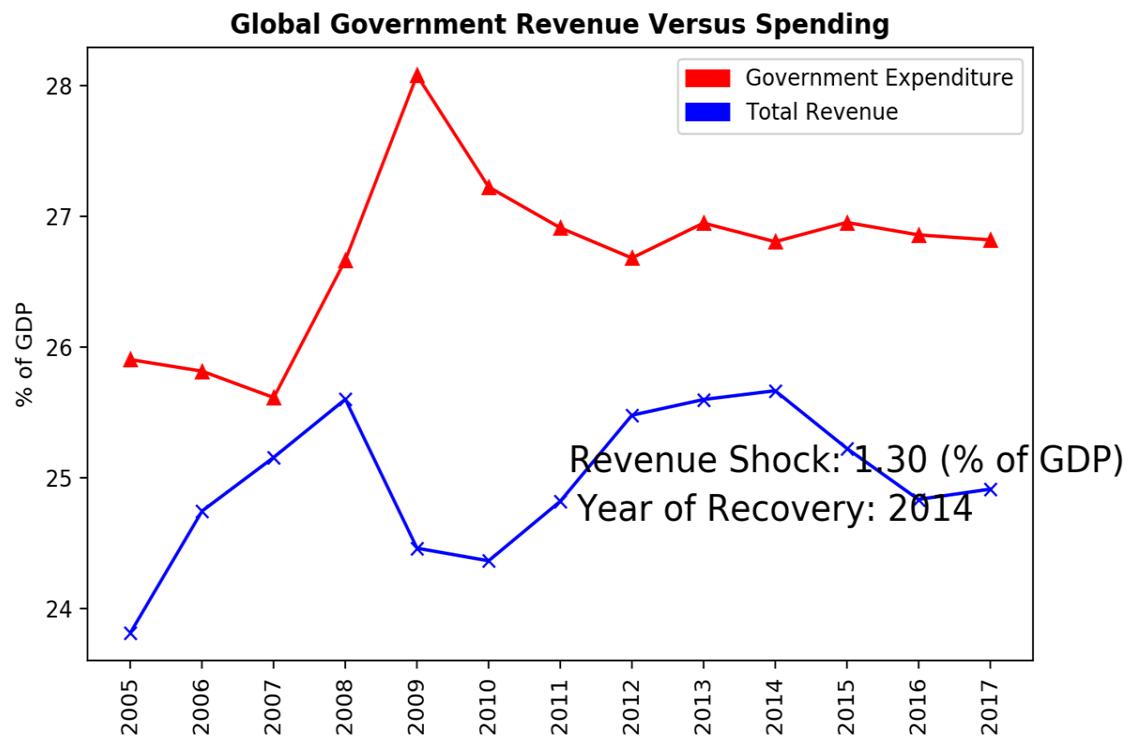
In MENA, government spending jumped 2% of GDP immediately after the crisis from 29% to 31% of GDP. By 2011 the levels were 28% of GDP and have fallen to lower levels since. Western European countries increased government spending from 33% of GDP to 39% of GDP a 6% of GDP jump. By 2017, its levels have dropped to 35% of GDP 2% above the pre-crisis levels.

## Conclusion

A study of the impact of the financial crisis on government spending and revenues would provide a perspective and some estimates of the magnitude of the effects of the COVID-19 crisis. During the financial crisis, globally, there was a 2% points government spending shock and a 1% of GDP negative revenue shock, implying a fiscal shock of nearly 3% of global GDP. In our opinion, we should be prepared for an effect of at least the same magnitude for the COVID-19 crisis. Transmission through tax systems suggests that in some regions, non-tax revenues may be in for a negative shock while in other regions income tax revenues might be the most adversely affected.

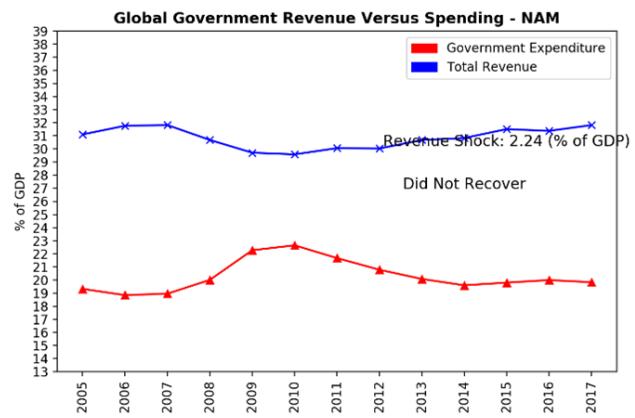
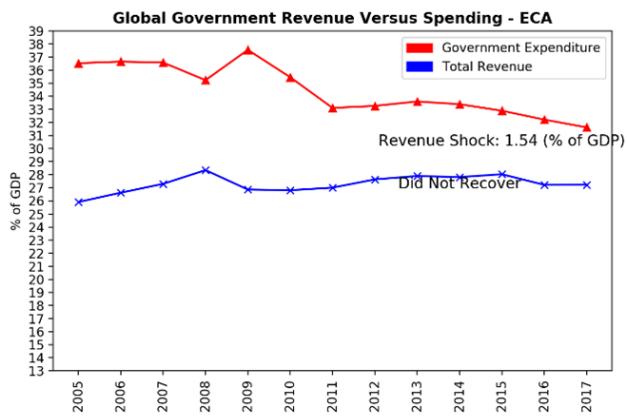
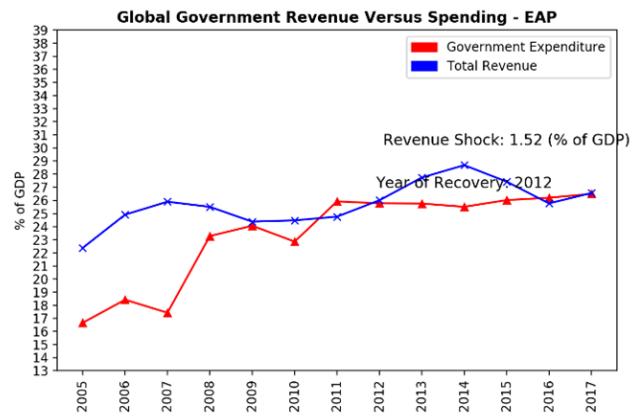
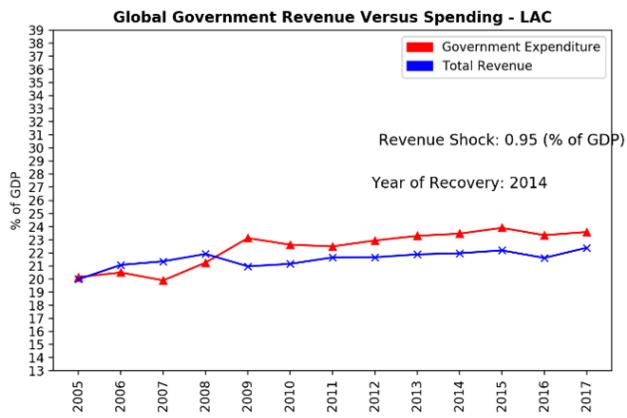
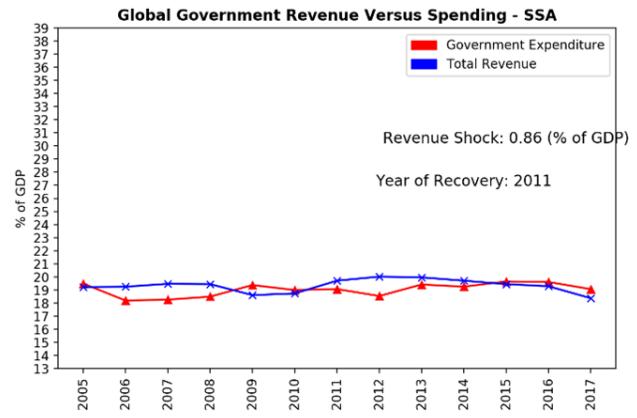
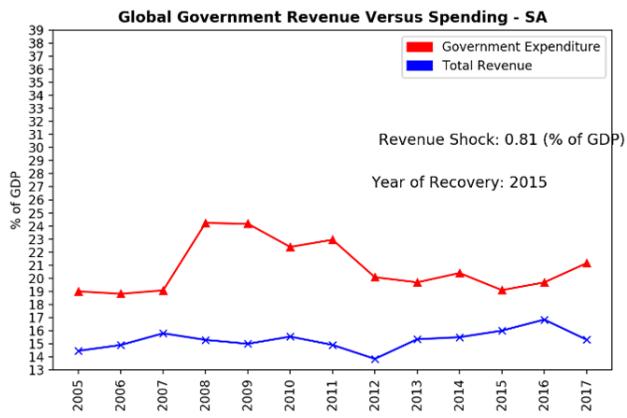
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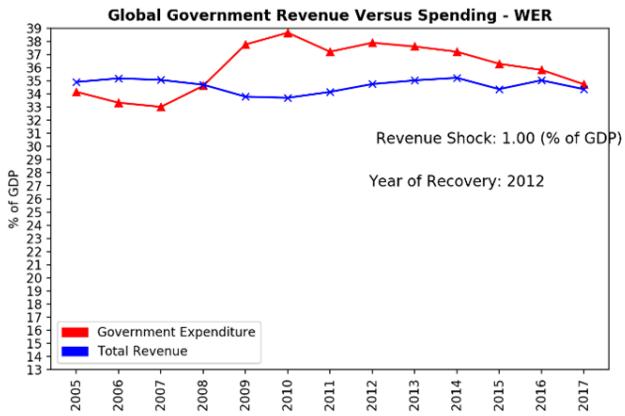
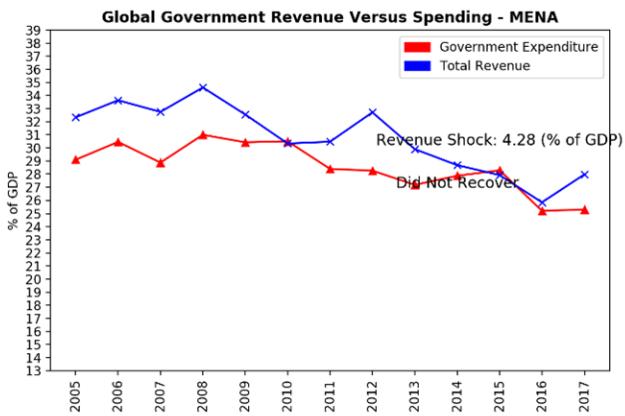
## APPENDIX FIGURE 1 - Global Government Revenue Versus Spending



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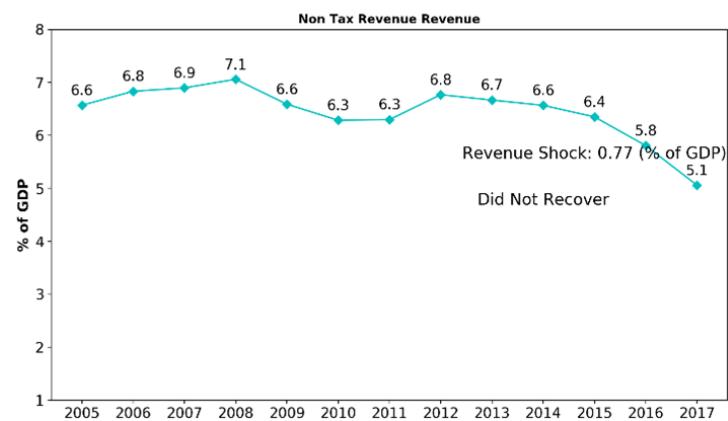
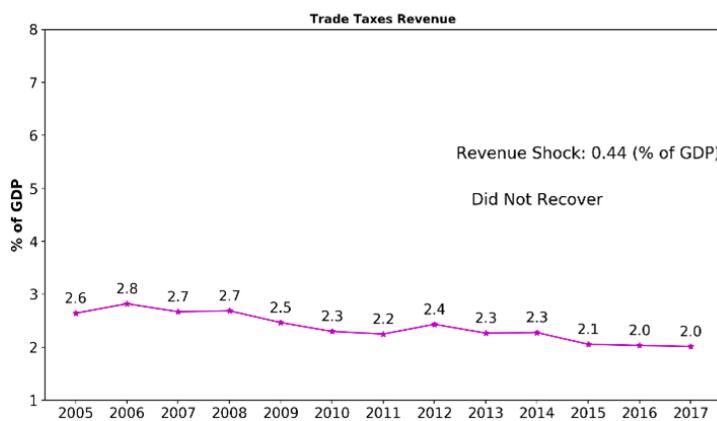
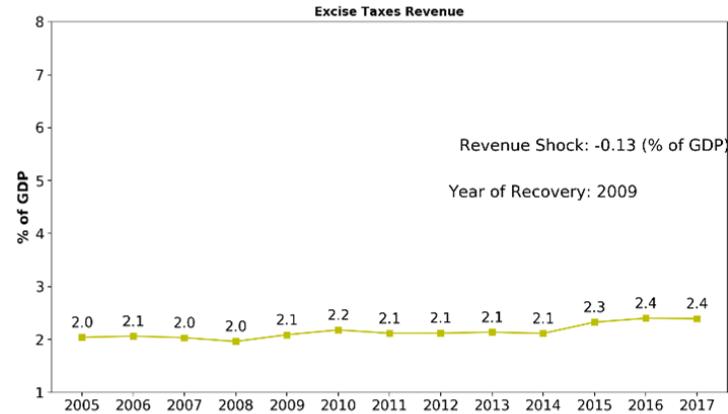
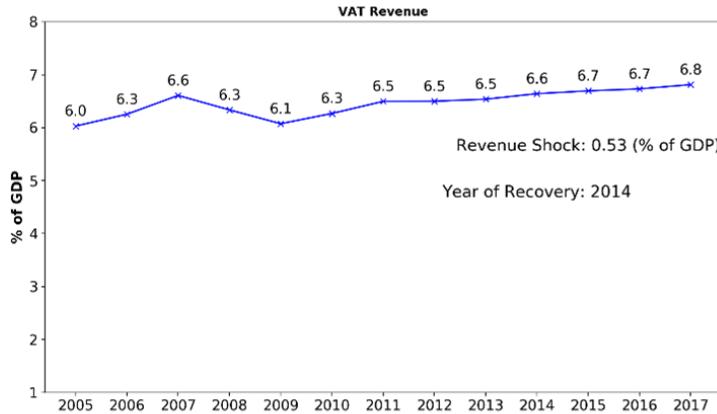
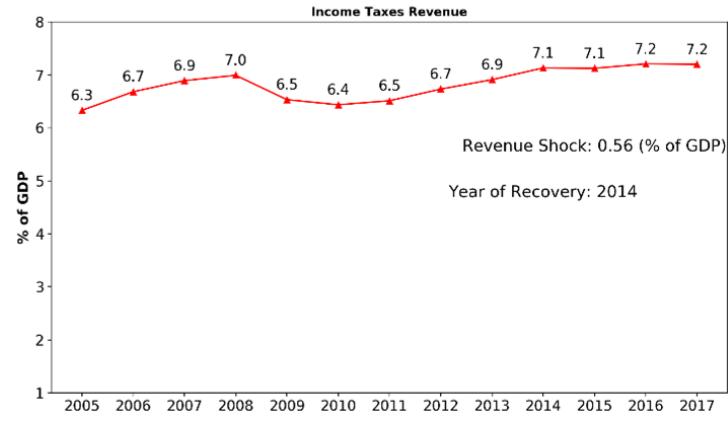
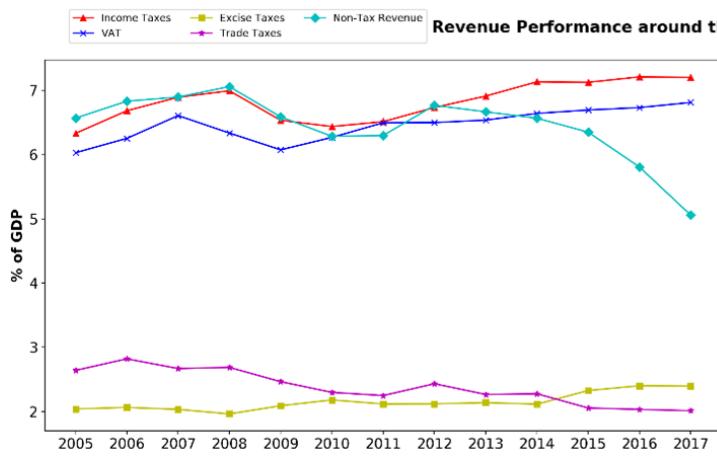
## APPENDIX FIGURE 2 - Government Revenue Versus Spending Around the Financial Crisis - Regions





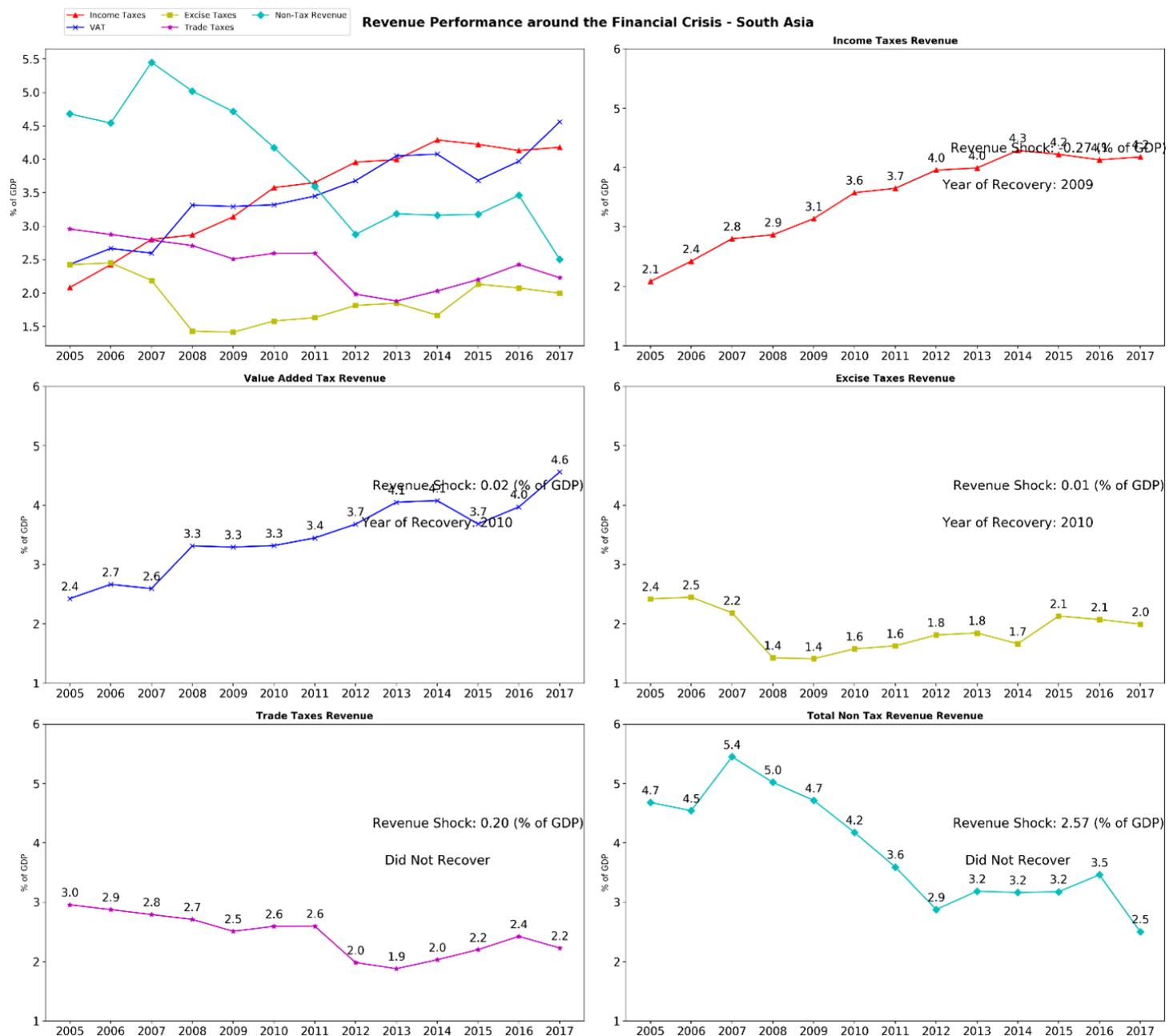
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**APPENDIX FIGURE 3 - Revenue Performance Around the Financial Crisis - World Average**



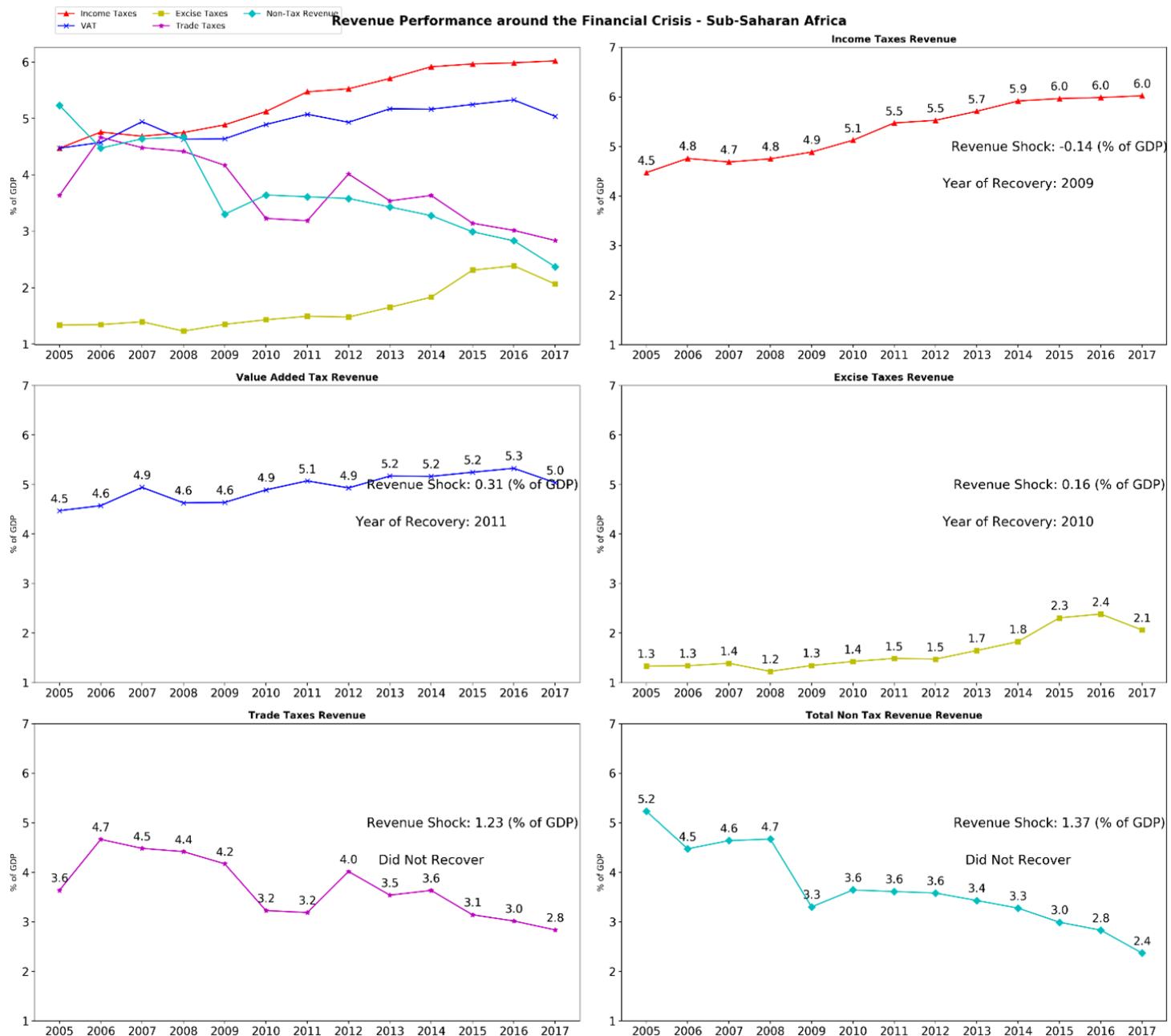
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## APPENDIX FIGURE 4 - Revenue Performance Around the Financial Crisis - South Asia



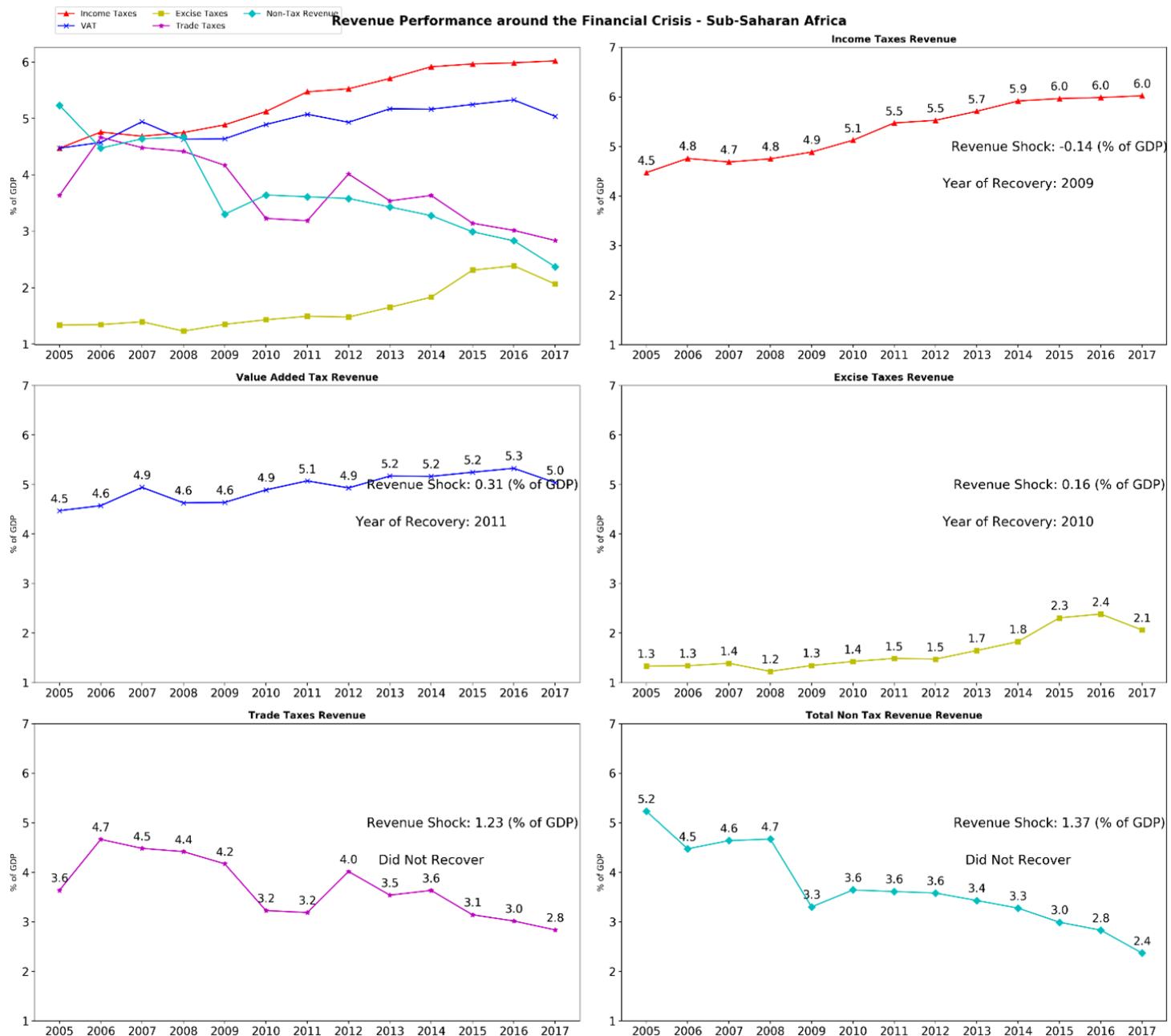
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## APPENDIX FIGURE 5 - Revenue Performance Around the Financial Crisis - Sub-Saharan Africa



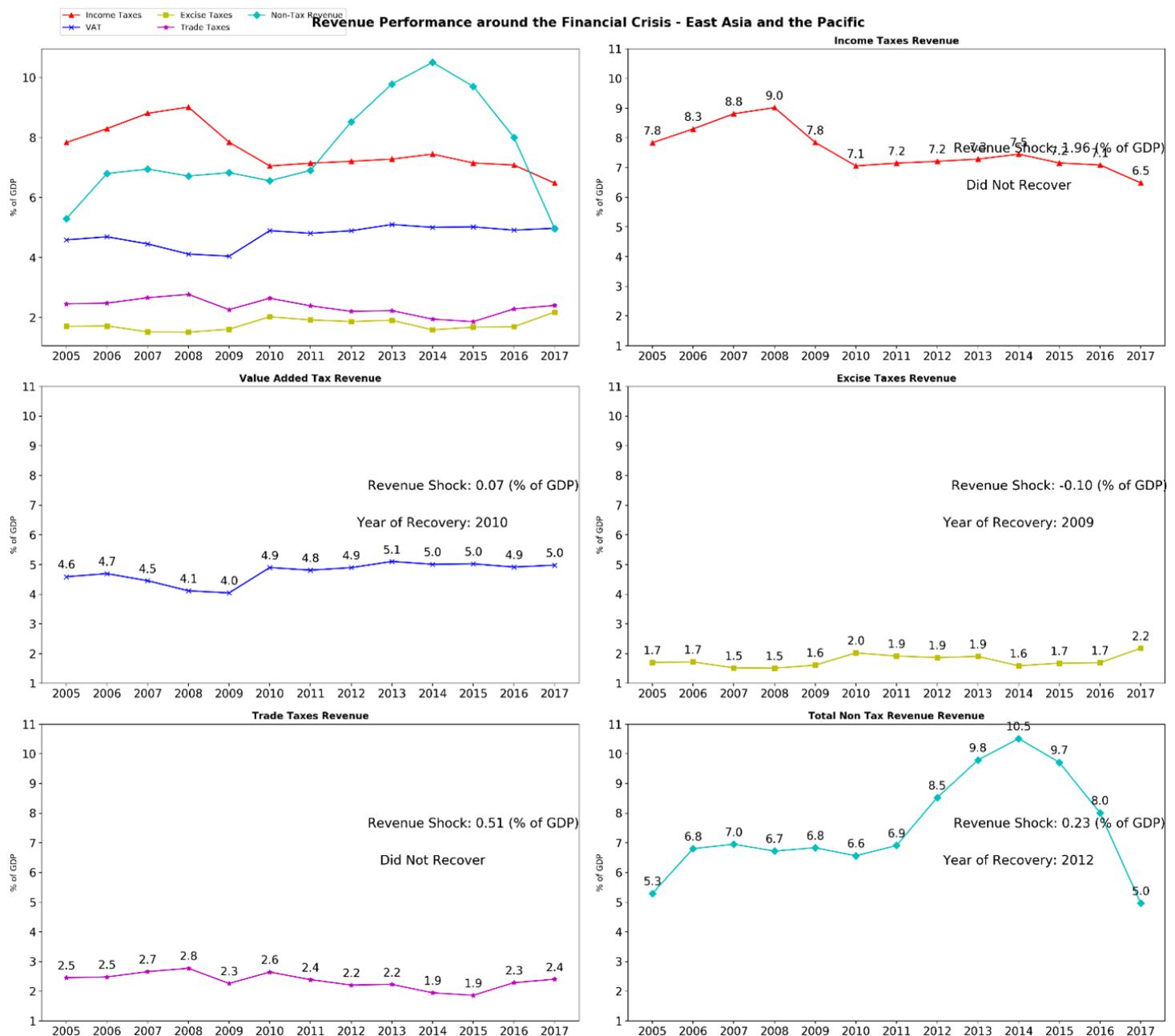
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## APPENDIX FIGURE 6 - Revenue Performance Around the Financial Crisis - Sub-Saharan Africa



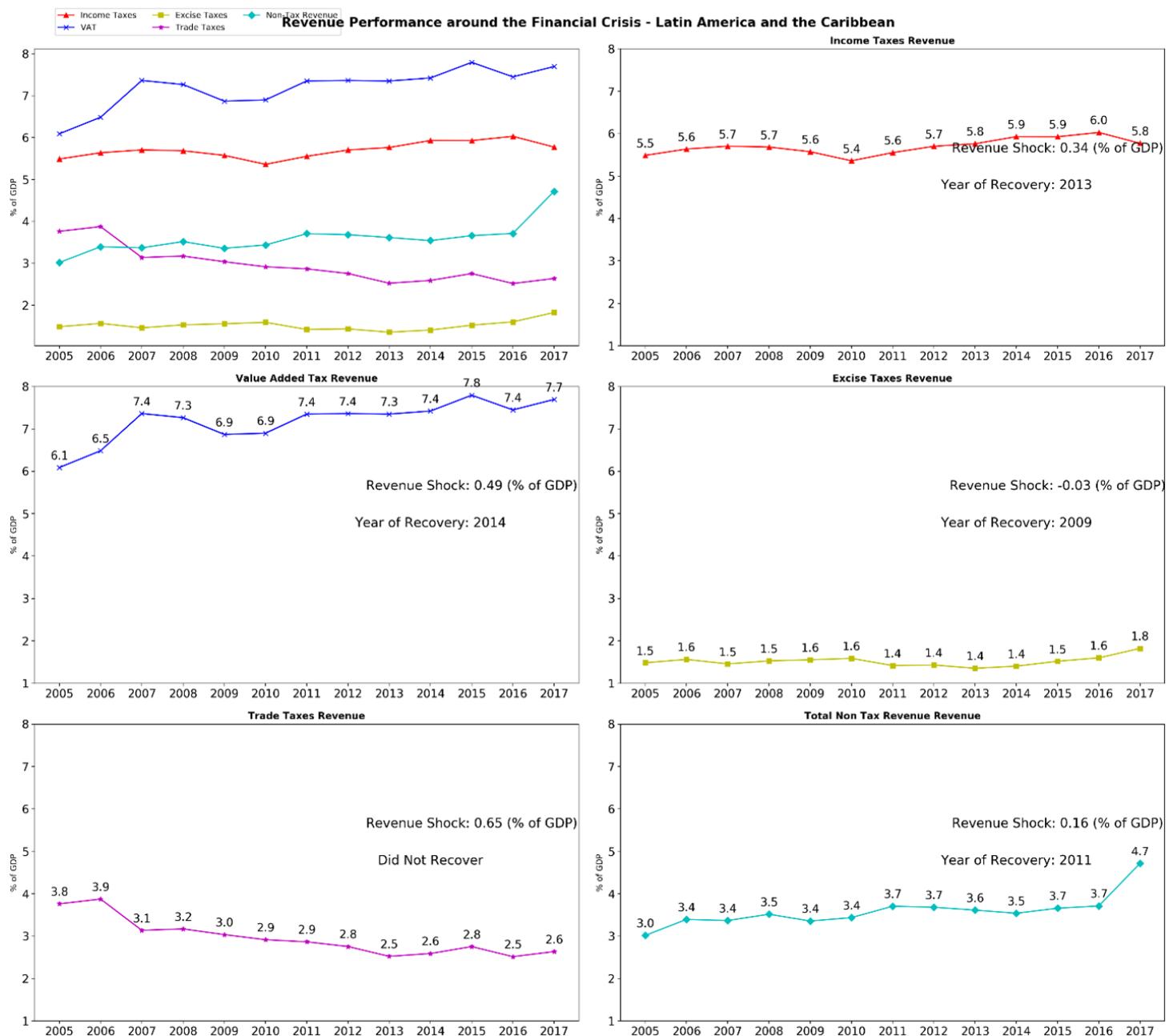
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## APPENDIX FIGURE 5 - Revenue Performance Around the Financial Crisis - East Asia and the Pacific



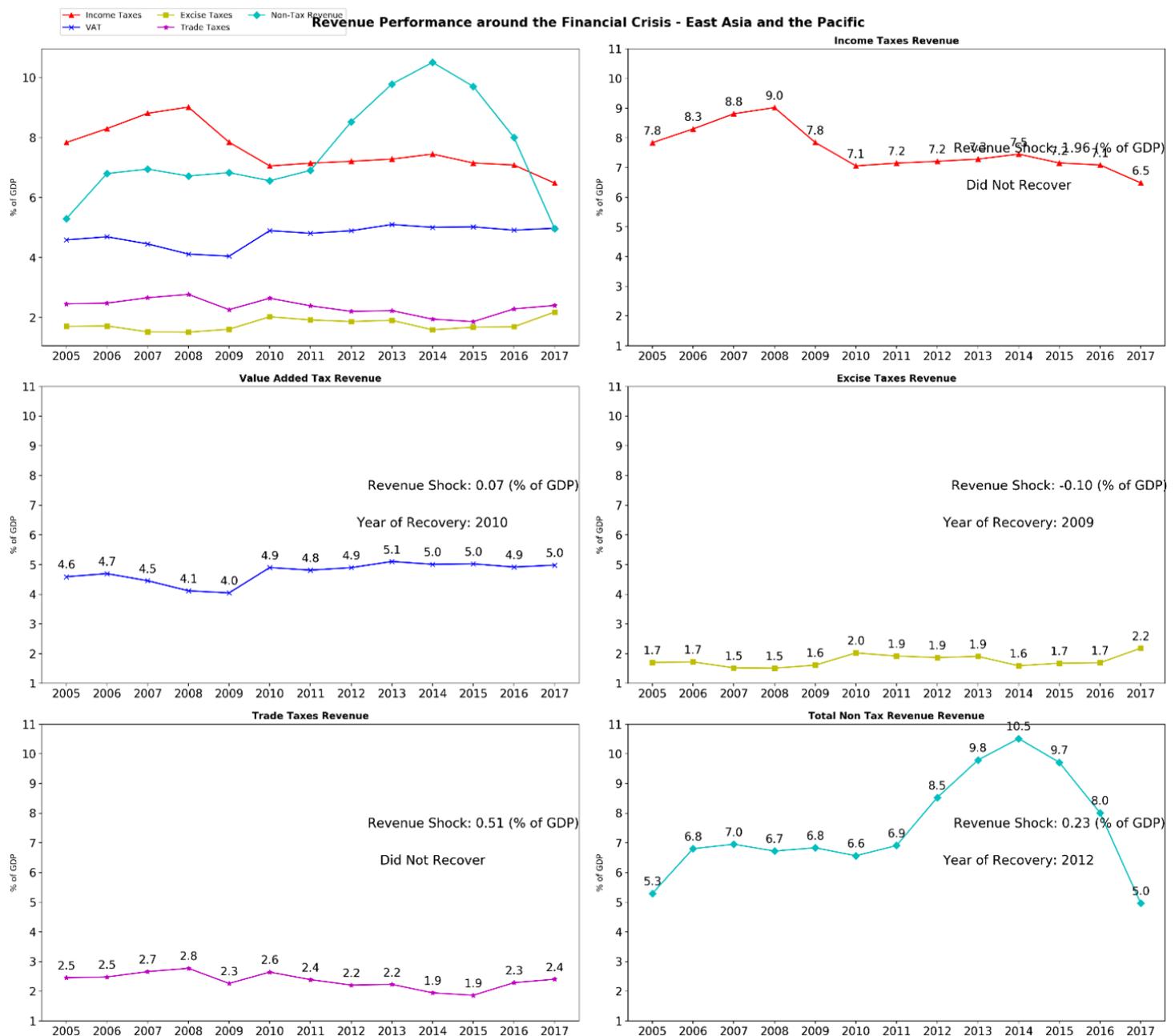
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## APPENDIX FIGURE 7 - Revenue Performance Around the Financial Crisis - Latin America & Caribbean



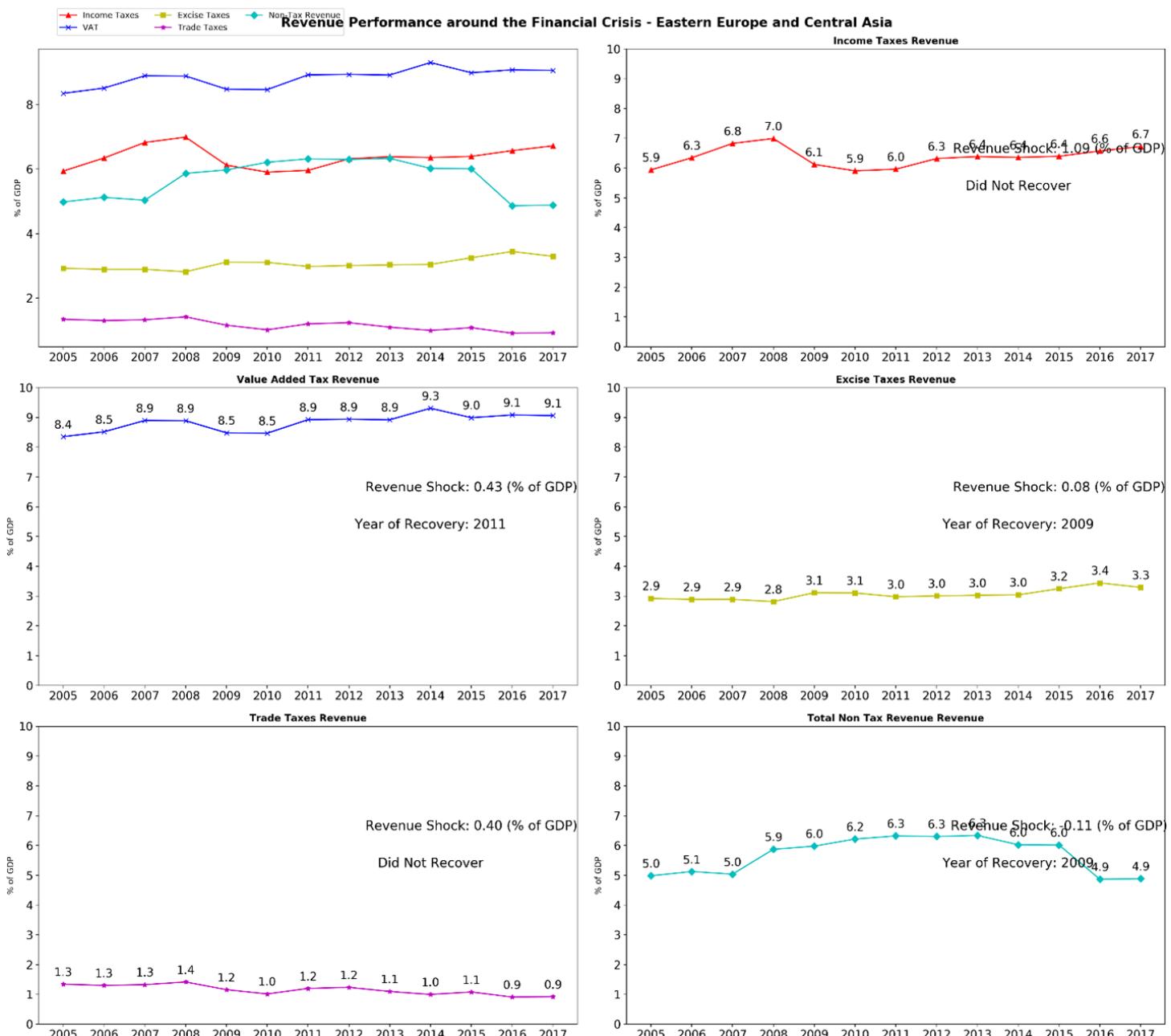
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## APPENDIX FIGURE 5 - Revenue Performance Around the Financial Crisis - East Asia & Pacific



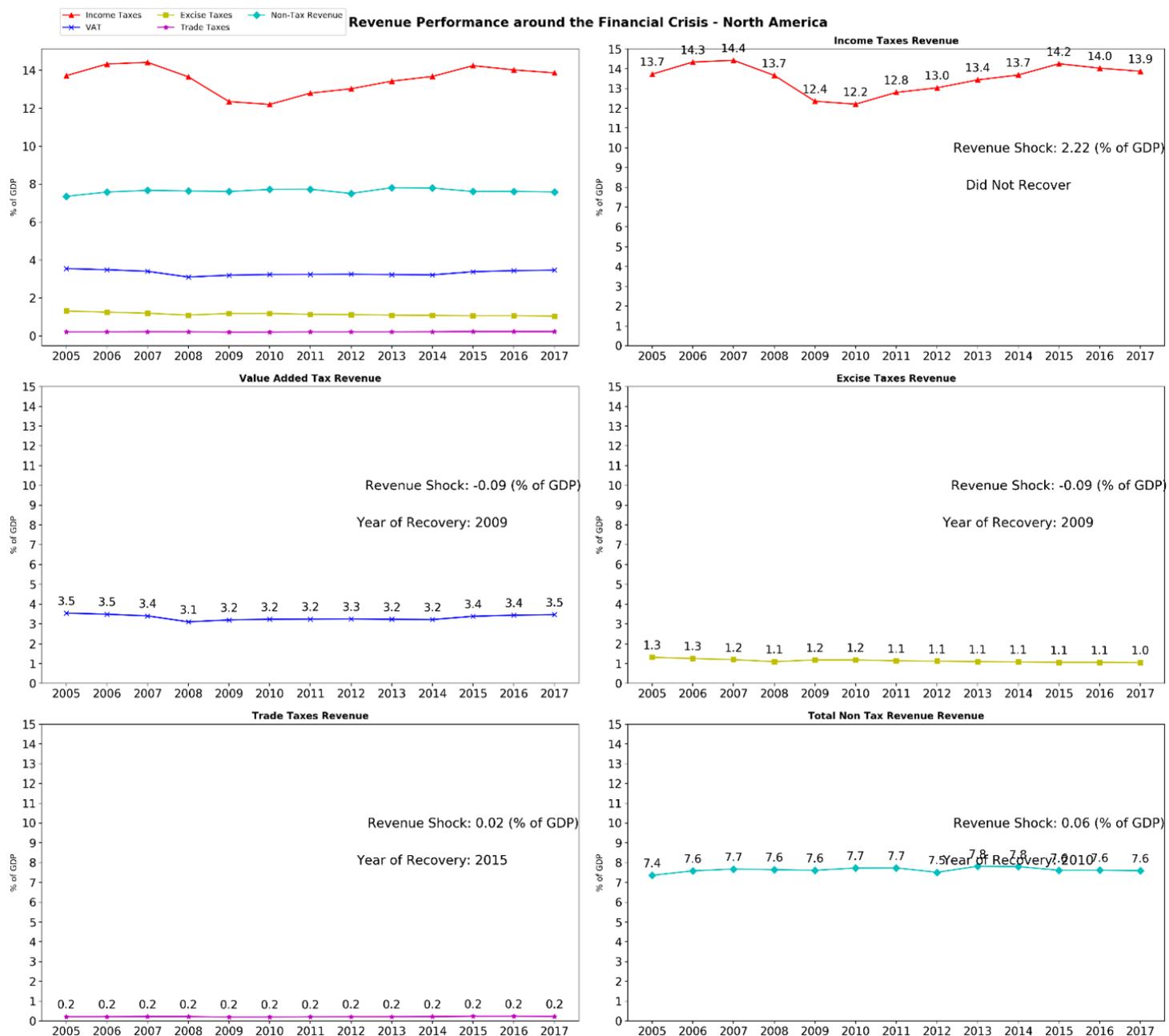
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## APPENDIX FIGURE 8 - Revenue Performance Around the Financial Crisis - Eastern Europe & Central Asia



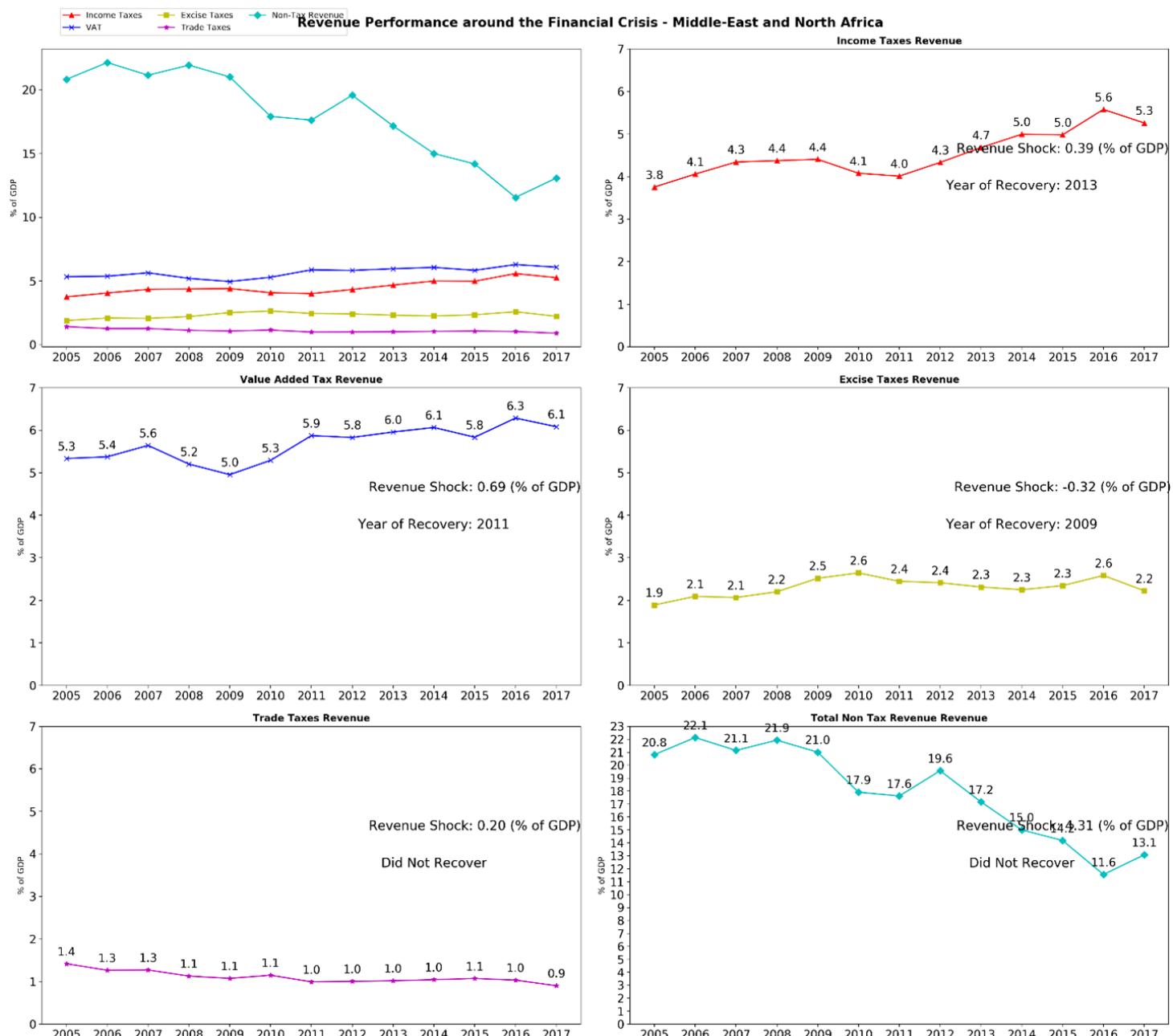
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## APPENDIX FIGURE 9 - Revenue Performance Around the Financial Crisis - North America



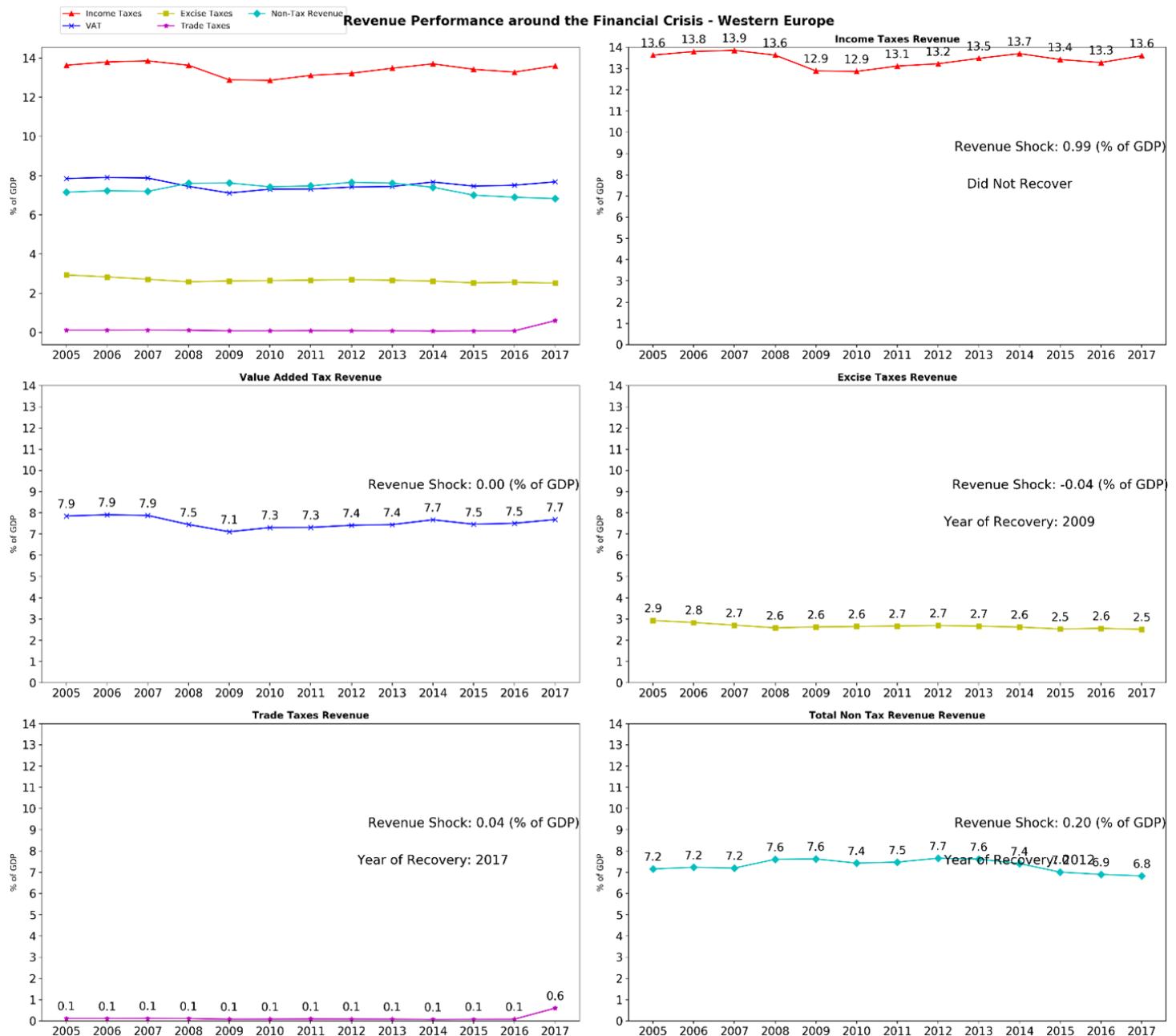
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## APPENDIX FIGURE 10 - Revenue Performance Around the Financial Crisis - Middle-East & North Africa



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## APPENDIX FIGURE 11 - Revenue Performance Around the Financial Crisis - Western Europe



## >> APPENDIX 2 - FURTHER ANALYSIS OF COUNTRY ASPECTS FOR FISCAL POLICY DECISION MAKING

This Appendix drills down on the categories identified in Section 4 for assessing country aspects that need to be considered in the choice of fiscal policy instrument: fiscal space and capability. Fiscal space is further examined by looking at economic structure and fiscal structure. Capability is looked at through the lens of public financial management.

### Economic structure

Specific aspects of countries' economic structure are of particular importance for the impact of the Covid-19 pandemic and the appropriate fiscal response. This includes: sectoral composition of GDP; economic complexity; informality; and export orientation.

Countries differ widely with respect to the sectoral composition of their economies. The tertiary sector includes many activities (such as tourism, restaurants, retail trade) that depend on direct interaction with customers and are thus particularly vulnerable to social distancing measures. Secondary, industrial sector activities are on the other hand more susceptible to supply chain disruptions and impacts of the pandemic on the work force. Primary sector activities, especially agriculture related activities tend to be more dispersed than secondary activities and with less concentrated producer-customer interaction than tertiary activities. As the share of agriculture in GDP tends to be particularly high in low income economies, this may provide some degree of economic resilience to these economies.

Two other structural characteristics of economies are the degree of economic complexity and informality. Higher economic complexity implies denser and more diversified economic networks among producers both domestically and with the rest of the world. As such, shocks such as COVID-19 are likely to be more disruptive in economically complex economies than in less complex economies. Another important economic characteristic is the size of the informal sector. A key characteristic of informal sector activities is there very limited integration into a country's tax system. So, for countries where the informal sector plays an important role, fiscal measures that seek to provide relief to persons and businesses will only have a very limited impact on actors in the informal sector. This will imply that in order to reach actors in the informal economy, targeted social protection measures will be more effective than revenue side measures.

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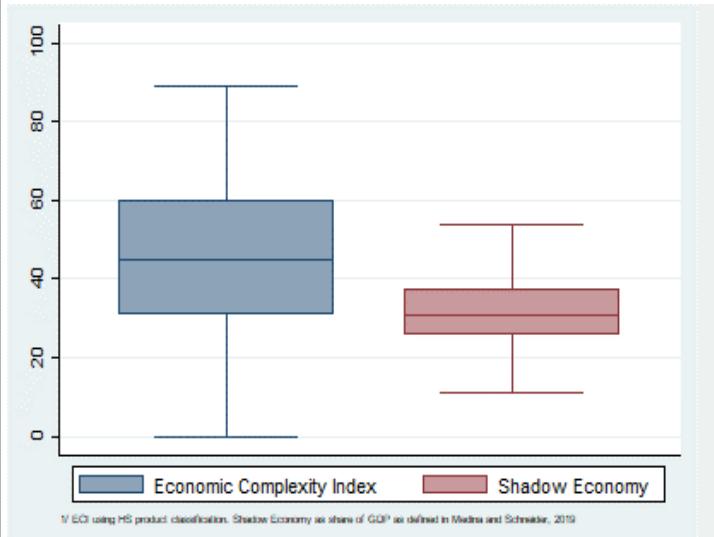
### APPENDIX FIGURE 12 - Sectoral Shares in GDP (2018 or latest available)



Note: Chart shows quartile distribution of selected indicators at the 25th, 50th, and 75th percentile as well as minimum and maximum value of indicator in sample. Colored area shows 25th-75th percentile.

>>>

### APPENDIX FIGURE 13 - Economic Complexity and Share of Informal Sector (2018 or latest available)



Note: see previous chart

The export and import intensity of an economy is an important indicator of its global integration, vulnerability to external shocks and disruptions to international trade. In addition, trade flows are also often an important source of government revenue.

Countries with a high trade share are particularly vulnerable to COVID-19 related distortions to global trade flows and supply chains. This can be through the reduced availability of imports as an import to domestic production and reduced demand for exports. Government revenue of countries with well targeted fiscal measures such as the suspension of taxes on all imported medical supplies, including medical equipment such as masks, respirators and protective suits as well as medicines, disinfectants and soaps can support countries' health response. More than 50 countries have already started to reduce tariffs and restrictions on the import of health-related goods to foster greater domestic availability. At the same time, countries have also started to impose restrictions on the export of health-related goods which, as happened during the global food crisis when countries restricted the export of grains and other food stuffs, can result in adverse impacts on domestic producers, increased smuggling, and the related loss of tax revenue.

A reduction of import and export taxes as part of a broader response to support household incomes (especially tariffs on food and other necessities) and business activity could also be an important aspect of fiscal measures, especially for economies that are highly import dependent and where such reductions could expect to have the broadest impacts. However, in many LDCs, while tariffs are higher, tariff exemptions are also high – and therefore revenue losses will be lower than anticipated on the basis of statutory tariffs.

### Fiscal structure

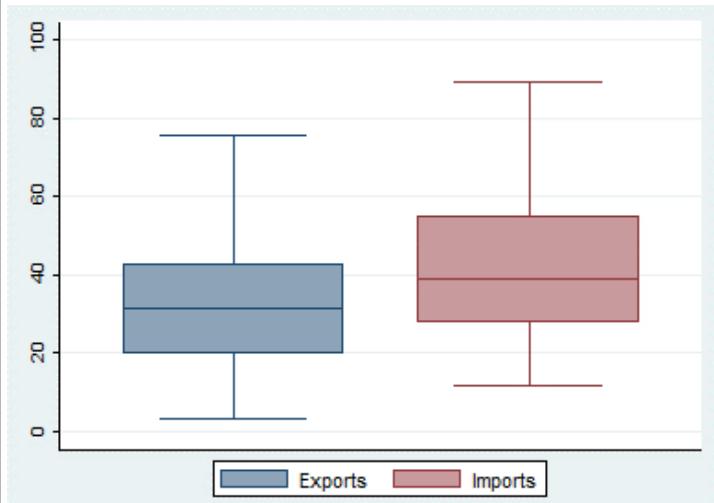
The composition of government revenue and expenditure also plays an important role in determining how the COVID-19 impacts fiscal aggregates and the choice of fiscal responses. As the below charts show, the structure of tax revenue sources differs significantly across countries, which will also lead to variations on how the COVID-19 impacts on revenue and which revenue side measures will be most effective.

For countries where the share of businesses and persons that pay income tax is small, use of these instruments may only reach a limited number of entities and their usefulness to achieve broader economic and social objectives may be limited. However, such measures may nonetheless be important to protect the tax base and ensure thus ensure

that revenue from income tax recovers after the pandemic has passed. For many developing countries most of the government revenue comes from trade and other indirect taxes. Temporary reductions in these taxes could have a far reach, but studies have also shown that reductions in indirect taxes may not be passed on to the consumer.

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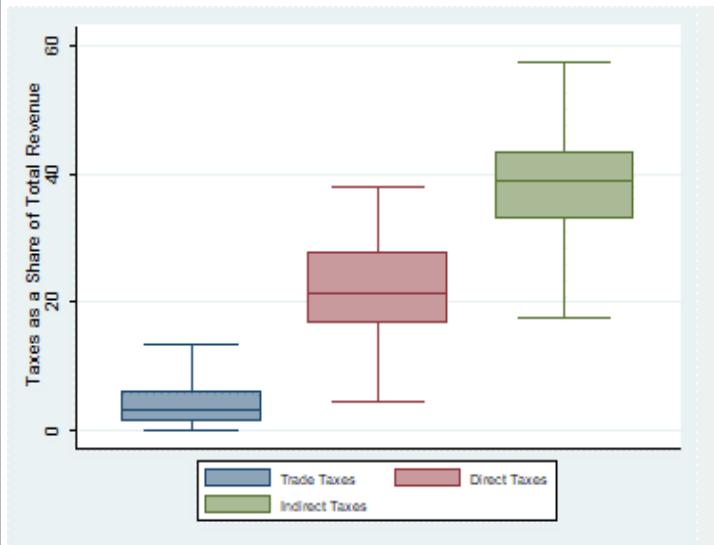
**APPENDIX FIGURE 14 - Exports and Imports as Share of GDP (2018 or latest available)**



Note: see previous chart

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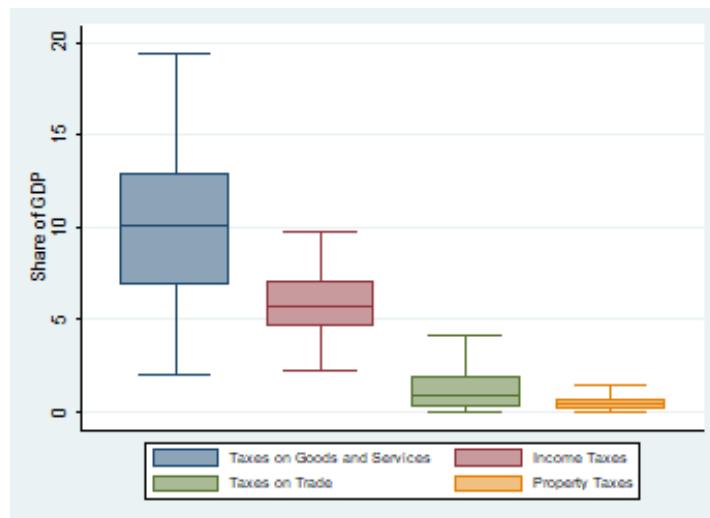
**APPENDIX FIGURE 15 - Share of Revenue Components in Overall Revenue (2018 or latest available)**



Note: see previous chart

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## APPENDIX FIGURE 16 - Share of Revenue Components in GDP (2018 or latest available)



Note: see previous chart

For countries where the share of businesses and persons that pay income tax is small, use of these instruments may only reach a limited number of entities and their usefulness to achieve broader economic and social objectives may be limited. However, such measures may nonetheless be important to protect the tax base and ensure thus ensure that revenue from income tax recovers after the pandemic has passed. For many developing countries most of the government revenue comes from trade and other indirect taxes. Temporary reductions in these taxes could have a far reach, but studies have also shown that reductions in indirect

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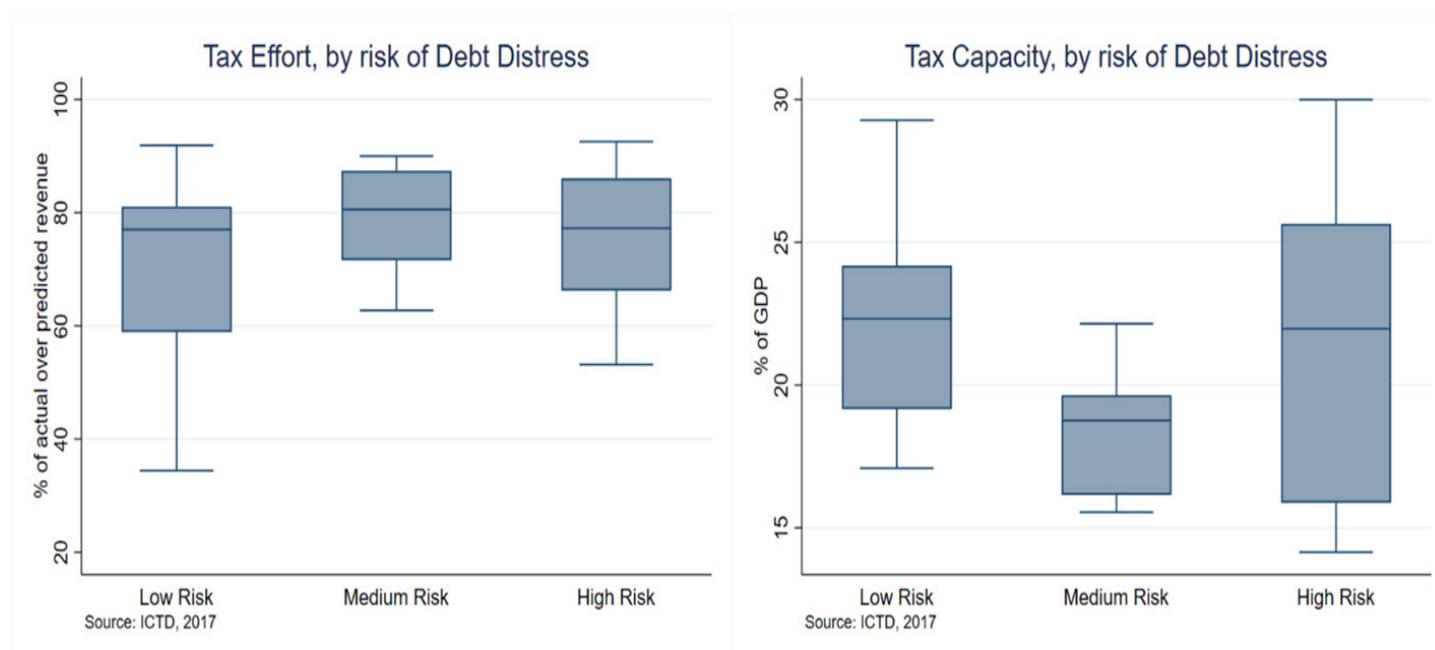
### Revenue performance

Regression analysis can help to determine if a tax system is productive, and what its tax capacity could be, given the performance of peers with similar levels of income and trade. Tax effort is then determined by the share of actual collection to potential collection (tax capacity). The below figures show tax effort and tax capacity by risk of debt distress for IDA countries.

Tax effort does not differ to a statistically significant degree among IDA groupings of low, medium, and high debt distress. However, medium-debt-distress IDAs appear to have a tax effort slightly higher than the other two categories (although this is only a point estimate). This could be a response to the onset of debt distress. Low-debt-distress IDAs have the most cases of low tax effort, with over 25% of countries in this category collecting less than 60% of their potential tax revenue. These countries understandably are not under great pressure to mobilize more revenues. However, more than 50% of high-debt-distress IDAs collect less than 80% of their potential tax revenue. This indicates substantial scope for tax reform to address the policy gaps (such as exemptions) and administration gaps (that lead to low tax compliance) in order to approach tax capacity and relieve debt distress.

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## APPENDIX FIGURE 17 - Tax Effort and Capacity by Level of Debt Distress



Tax capacity varies widely by category, most so for the high-debt-distress IDAs—debt distress appears to affect countries with large and small tax bases. Countries with high debt distress and high tax capacity must increase tax effort to meet their revenue potential. Countries with high debt distress and low tax capacity have no choice but to rationalize expenditures in order to improve fiscal space. Medium-debt-distress countries are much more concentrated, and over 75% of them have a potential tax-to-GDP below 20%. These countries must spend in accordance with their means. Expanding tax capacity is possible over time through economic growth. In the short run, countries must take their capacity as a given, strive to meet it, and spend within their means.

Country economists are encouraged to use the tax analysis tool that will circulate soon to learn the tax capacity and tax effort of their country.

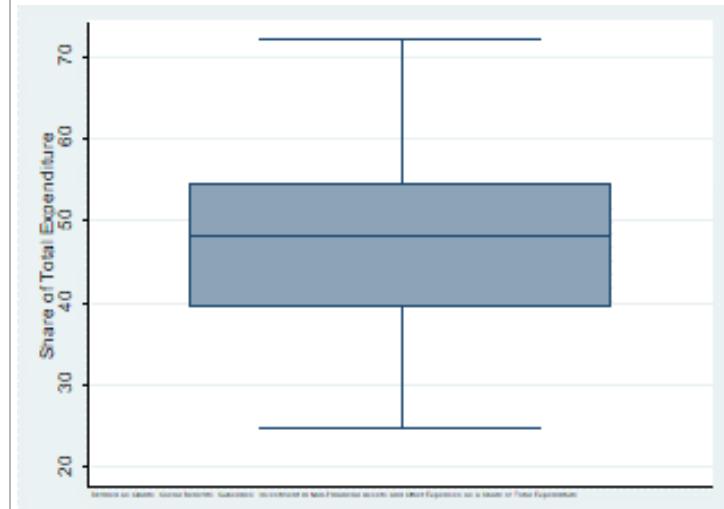
### Expenditure flexibility

For many countries, especially those with limited scope to mobilize additional resources quickly, the fiscal response will rely on countries' ability to reallocate resources from other expenditure programs towards the crisis response. This ability will depend on the flexibility of the structure of expenditures. Some expenditure categories such as expenditure on operations and maintenance, capital expenditure, or transfers and subsidies have some scope to be deferred or reduced to free resources for the crisis response, while others such as payments for wages and salaries or debt service have typically less flexibility. In the context of the COVID-19 pandemic, some expenditures will drop automatically such as operations and maintenance expenditure for services that are not provided, while others will increase, especially unemployment payments and social security benefits. Recent calls for debt service moratoriums would also enhance the scope for fiscal reallocations in an expenditure category that typically has limited flexibility.

As a simple measure of expenditure flexibility, we calculate the share of expenditure on operations and maintenance, transfers and subsidies, and capital spending as a share of total spending. A higher share of these expenditure types typically signals higher expenditure flexibility. The above chart shows how this indicator is distributed across countries by quartile. For the bottom quartile, flexible expenditure accounts for 25 to 37 percent of expenditure, for the two quartiles in the middle 37-56 percent, and for the upper quartile with the highest expenditure flexibility 57-77 percent.

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### APPENDIX FIGURE 18 - Expenditure Flexibility



Note: see previous chart

