INFOCUS

MACRO COMMENT

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Vaccination is key to fiscal sustainability

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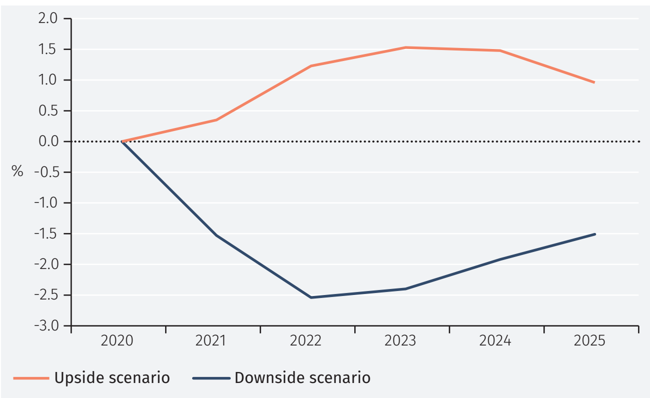
With the pandemic still ravaging the global economy, public finances remain under stress. The recently released IMF *Fiscal Monitor* provides a timely update on the outlook for public accounts in this context. In this edition of *Infocus*, GianLuigi Mandruzzato and Joaquin Thul highlight the key takeaways from the IMF's analysis. The main conclusion is that the success of the vaccination campaign will be crucial in determining economic performance and the sustainability of public debts.

The IMF's April 2021 *Fiscal Monitor* update has three important messages. The first is that the vaccination campaign is potentially the most profitable public project ever – the fate of the global economy and public finances depends on it. The second is that governments that best managed the health care emergency and deployed the most financial resources saw their economies outperform. The third is low interest rates make high public debts sustainable in the short-term but long-term financial stability will only be improved by the adoption of credible fiscal plans, which should prioritise frontloaded public investment and raise tax collection efficiency.

Short-term focus on vaccination and fiscal support

The IMF's *Fiscal Monitor* relies on growth projections from the IMF's *World Economic Outlook* to forecast the impact on public finances. The latter sets out three scenarios: a baseline, an upside, and a downside. In the upside scenario, an accelerated vaccination campaign raises the level of global GDP by USD9 trillion over the next five years and leads to a faster decline in unemployment than in the baseline (see Figure 1). The downside scenario considers the effects of bottlenecks in the vaccine supply chain leading to delayed herd immunity.

1. Global real GDP deviation from baseline

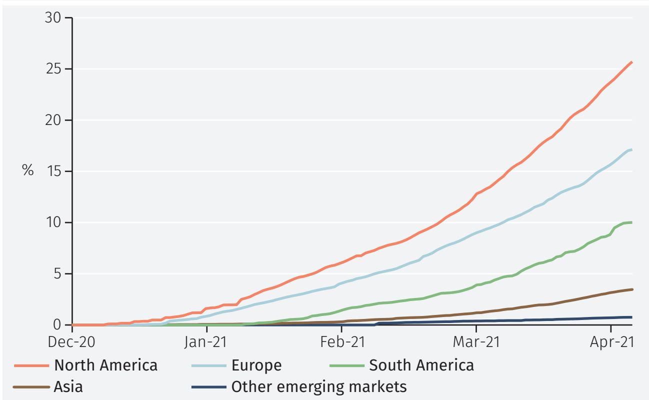


Source: IMF *World Economic Outlook*, April 2021.

The IMF *Fiscal Monitor* estimates that in the upside scenario tax revenues would be USD1 trillion higher than baseline through 2025 in developed countries alone, while expenditures would also be much lower. After the expected peak in 2021, debt/GDP ratios would consequently fall faster than in the baseline scenario. A virtuous cycle results in which improved public finances free up resources for the benefit of economic growth with favourable feedback effects on public debt. Vaccines should be seen as a global public good and, according to the IMF, the vaccination campaign could be "the public project with the highest return ever identified".

As of 17 April, over a quarter of the North American population and one-sixth of the European population had received at least one dose of a Covid-19 vaccine (see Figure 2). The share of the population vaccinated against the virus is lower elsewhere, with only 10% in South America and less than 4% and 1% of the populations in Asia and Africa respectively receiving at least one dose. Advanced economies therefore have an edge over emerging markets in recovering from the pandemic.

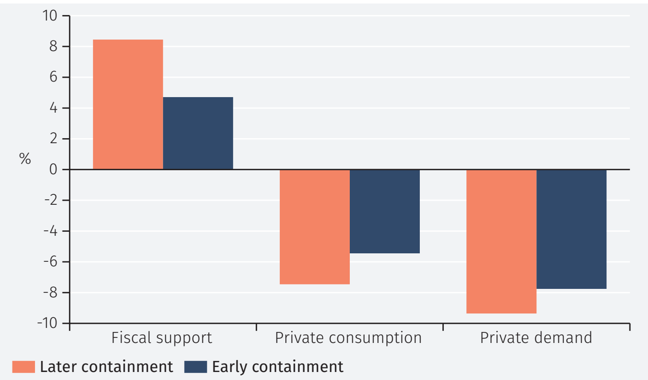
2. Percentage of people receiving at least one dose of vaccine



Source: OURWorldInData.com and EFGAM calculations. Data as at 21 April 2021.

In addition, the *Fiscal Monitor* stresses that countries need to be decisive in taking potentially unpopular but necessary decisions to defeat the pandemic, safeguard the economy and improve fiscal stability. Considering the experience of last year, the IMF shows that economies where measures to contain the pandemic were adopted most rapidly required lower public deficits than late adopters and saw less pronounced contractions in private consumption and investment (see Figure 3). More generally, the IMF notes the importance of strengthening health systems and social safety nets to increase economic resilience to future pandemic risks.

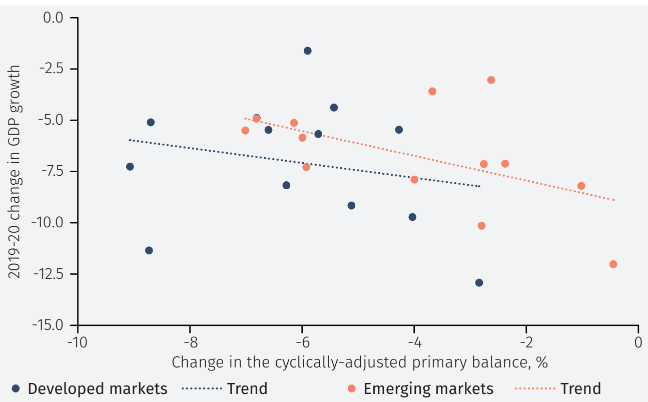
3. 2021 forecast revisions



Note: Early containment is achieved if the aggregate stringency index is above the cross-sectional median after the country has reached 100 cases of infections. Source: IMF staff calculations. Data as at 21 April 2021.

Beyond effectively managing the health care emergency, countries that mobilised the most financial resources to counter its economic effects experienced a less pronounced decline in economic activity (Figure 4). The larger the increase in the cyclically adjusted primary deficit, the smaller the decline in GDP growth in 2020 compared to 2019. The IMF's recommendation to governments is therefore to maintain stimulative policies in place until the crisis is resolved and economies have fully recovered.

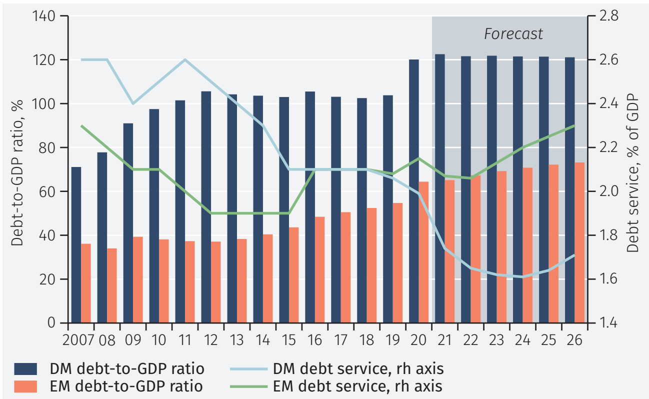
4.Fiscal response and GDP growth



Source: IMF *Fiscal Monitor*, April 2021 and EFGAM calculations.

As a result of the large fiscal responses to fight the pandemic public debts are much higher (see Figure 5). Debt-GDP ratios have risen by tens of percentage points in developed and emerging countries, raising concerns about governments' short-term funding of large-scale needs and debt sustainability in the medium to long term. Thankfully short-term financing is made easier due to low interest rates resulting from expansive monetary policies. According to IMF forecasts, interest expenditure on public debt as a percentage of GDP will continue to fall in coming years in advanced economies and will remain low in emerging market economies. This will free up precious public resources.

5. Government debt and debt service



Source: IMF *World Economic Outlook*, April 2021, IMF staff calculations and EFGAM calculations as at 21 April.

A credible fiscal strategy improves debt sustainability

According to the *Fiscal Monitor*, in the near term, governments should continue to provide emergency financing to the healthcare and education sectors to support inclusive growth and prevent long-term inequalities in income and employment.

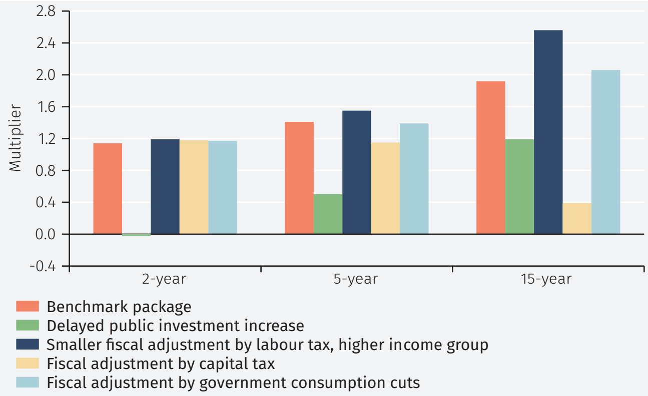
In the medium to long term, the IMF emphasises the importance of frontloading public investment as simulations show that it has the highest impact on medium-term economic growth (see Figure 6 overleaf).[1]

To finance these policies, countries will need to raise additional revenues and improve spending efficiency. Strengthening tax collection systems will be crucial as governments face large spending needs. Furthermore, limited fiscal space in emerging markets should encourage governments to prioritise expenditures towards the sectors most affected by the pandemic.

The IMF notes that countries can adopt different strategies to deal with the surge in debt, including raising taxes on

[1] The IMF calculates the cumulative output multipliers as the GDP increase in dollars for each dollar of combined stimulus of higher transfers and public investment as assumed in a fiscal package. Fiscal adjustments are modeled by fiscal reaction functions, in which various instruments react to the rising public debt-to-GDP ratio by the magnitudes sufficient to stabilise debt growth in the medium term.

6. Monetary policy rates



Source: IMF *Fiscal Monitor*, April 2021, Online Annex 1.

corporate and personal incomes, property, and consumption (see Figure 7). Governments should also consider imposing wealth taxes. In the past, these have been less frequently used because of the challenges stemming from difficult valuation of assets and collection of third-party information. According to IMF calculations, a recurrent one percent wealth tax on the top percentile of the population could reduce wealth inequality and increase revenues by up to 0.4% to 0.6% of GDP in advanced and emerging countries respectively.

Alternatively, countries could agree on an effective minimum corporate tax, thereby reducing international tax competition. The IMF suggests governments should earmark revenues from such taxation to finance healthcare, education and social assistance expenditures.

Given the potential distortions new taxes could create, the IMF acknowledges countries should initially rely on existing taxes before introducing new instruments. Implementing more progressive tax systems, including a temporary recovery levy on high incomes, and improving collection of property and inheritance taxes would be less distortionary and more effective at reducing inequality than increasing taxation on corporates.

To avoid social instability, raising taxes and redirecting government spending requires political consensus and improvements in people's perception of government functions. Reinforcing people's trust in their governments will be key to successful implementation of the policy changes required to support growth.

Conclusions

The IMF *Fiscal Monitor* highlights the importance of a successful vaccination campaign for improving long run debt sustainability. It would increase fiscal revenues and reduce public outlays compared to the baseline, improving the trajectory of public debts. The IMF also advises governments to maintain expansionary fiscal policies until economies fully recover, exploiting the favourable financing conditions resulting from low interest rates.

Long run debt sustainability will benefit from the adoption of credible consolidation strategies which, according to the IMF, should include frontloaded public investment, prioritising green economy projects, improved efficiency in tax collection and, if needed, higher taxes. The latter should target the highest percentiles of the income distribution to limit the distortionary effects of taxation on growth and to reduce social inequality.

7. Tax reform options to raise additional revenues

Personal income tax	Corporate income tax
• Set exemption thresholds below GDP per capita • Restrain generalised deductions • Raise top marginal rate, if feasible • Introduce temporary surcharge	• Rationalise profit-based tax incentives for foreign direct investment • Rationalise special incentives for SMEs • Use anti avoidance rules against profit shifting • Introduce excess profit taxes • Use special regimes for extractive industries
Property taxes	**Consumption taxes**
• Raise property tax rates • Update property values to current market prices • Strengthen property registries and administrative capacity • Strengthen inheritance and gift taxes	• Reduce VAT exempt and zero-rated goods and services • Strengthen excise taxation by better design, enforcement and higher rates • Introduce or raise carbon taxes

Source: IMF *Fiscal Monitor*, April 2021.

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