CHAPTER 1

POLICY IN AN UNCERTAIN RECOVERY

Introduction

Against the backdrop of the uncertain course of the pandemic and unequal access to vaccines across countries, nimble and forceful fiscal policies remain crucial to contain the impact of the pandemic waves on families and businesses and to facilitate economic recovery and transformation. The Delta variant has been associated with a resurgence of the virus, but supportive fiscal policies and, especially in advanced economies, vaccination have fostered the resumption of growth in output and employment, and saved countless lives. Vaccination has also helped to alleviate the pressure on public finances. With the number of vaccinated people increasing and economic activity becoming more resilient to the health crisis, global growth is projected to rebound in 2021 (October 2021 *World Economic Outlook*). Primary fiscal deficits in 2021 continue to be large by prepandemic standards, although they have begun to decline and are expected to contract more in 2022. Deficits are typically falling more markedly in countries where they had increased the most in 2020, as tax receipts in those economies recover rapidly on the back of a stronger GDP rebound and as pandemic-related support expires or is phased out. Most of the $16.9 trillion in fiscal measures announced to fight the pandemic are set to expire this year.[1] Global government debt has stabilized at just below 100 percent of GDP, a record level. However, underneath the aggregate figures there is significant variation in fiscal and economic developments across countries, both in recent months and in terms of what is expected over the next few years (Table 1.1). This variation depends on local vaccination rates, the stage of the pandemic, and the ability of governments to access low-cost borrowing, all of which can exacerbate the unequal social and economic effects of the pandemic.

Despite some vaccine hesitancy by part of the population, most advanced economies have delivered a first full course of vaccination to the majority of adults, and the economic recovery is under way. Bold fiscal support continues in 2021, primarily in the form of spending and support programs, while tax revenues remain subdued, reflecting weaker economic activity than projected in 2019 (Figure 1.1). Spending is beginning to shift from measures to fight the pandemic toward supporting the recovery and transforming economies to make them more productive, equitable, and sustainable. Examples include the Next Generation EU (NGEU) recovery plan in the *European Union* and the Jobs and Families Plans in the *United States.* In parallel with the ongoing recovery, primary deficits have begun to decrease in 2021 and will shrink even more next year.[2]

In emerging markets and low-income developing countries, by contrast, the recovery is held back by low availability of vaccines and smaller space for fiscal support, and a key focus of policies has been to reorient expenditure priorities toward pandemic-related emergencies. In emerging markets, the rebound in GDP and its associated tax revenues has helped improve primary balances in 2021, but fiscal policy measures to cope with the crisis, which have been smaller than in advanced economies (Figure 1.2), appear to be waning further. In some countries, borrowing costs are rising, as central banks have begun increasing short-term reference rates on concerns about inflation or currency depreciation (October 2021 *Global Financial Stability Report* and the October 2021 *World Economic Outlook*). In low-income developing countries, policy support remains limited, with borrowing constraints

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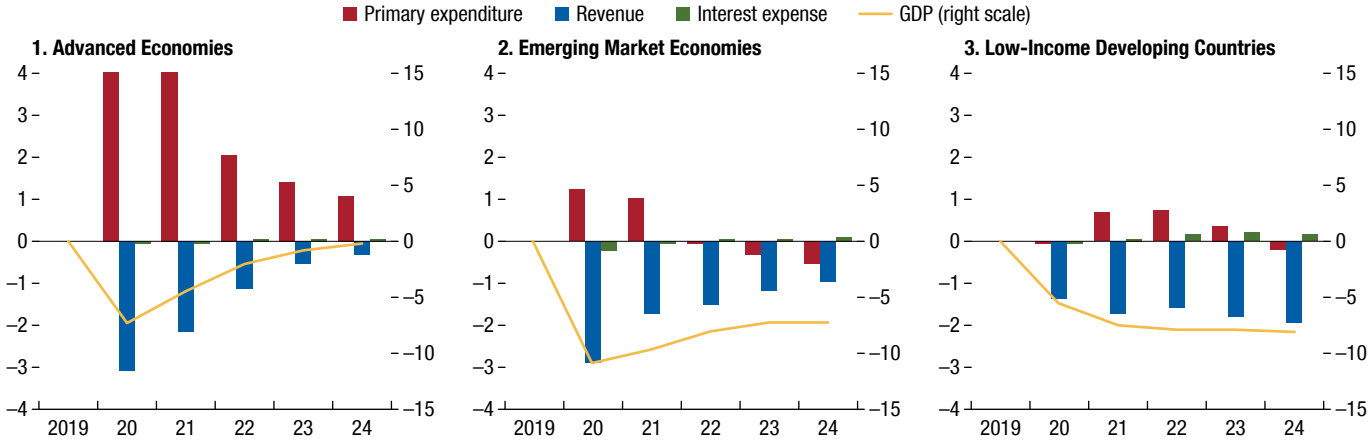
[1]It is becoming increasingly difficult to differentiate between fiscal measures strictly related to the COVID-19 crisis and measures with a broader goal of supporting the recovery. For details, see the Fiscal Monitor Database of Country Fiscal Measures in Response to COVID-19 at https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19.

[2]Discussions of the evolution of fiscal policy on an annual basis usually rely on measures that adjust the primary balance to account for the deviation of GDP from its potential output. However, given how difficult it is to estimate potential output during the pandemic, the change of the unadjusted primary balance, in terms of levels or percent of prepandemic GDP, provides a more reliable starting point when assessing the evolution of fiscal policy..

Figure 1.1. The Effect of the COVID-19 Pandemic on Fiscal and GDP Forecasts
(Deviation from prepandemic projections as a percentage of 2019 GDP; simple average)

Although GDP is expected to largely recover in advanced economies, it will remain much lower than expected in emerging market economies and low-income developing countries before the pandemic, and revenues will also suffer.



Sources: IMF, World Economic Outlook database; and IMF staff estimates.
Note: All quantities are converted into 2019 prices using the projected evolution of the GDP deflator.

increasingly binding as countries strive to curtail debt increases and retain access to market financing.

The pandemic will leave a lasting mark on government finances, inequality, poverty, and the level of GDP in many countries. The ratio of global public debt to GDP, which increased sharply in 2020 because of the crisis, has stabilized in 2021. Following this one-time jump, debt in the coming years is expected to remain persistently higher than the levels projected before the pandemic—in advanced economies it is projected to be almost 20 percentage points higher through 2026 (Figure 1.3). This will likely lead to a significant increase in government gross financing needs to cover both new and maturing debt. Large purchases of government debt by central banks (especially in advanced economies) and by the domestic banking sector (in emerging markets) have helped contain the cost of the new borrowing (Chapter 1 of the April 2021 *Global Financial Stability Report*). By 2026, ratios of gross government debt to GDP are projected to begin to fall only marginally (Table 1.2), relying almost entirely on economic growth. Growth is resuming across all income groups, but in emerging markets and low-income developing countries the GDP trajectory would remain at long-lastingly lower levels than prepandemic projections (Figure 1.1), leading to correspondingly reduced fiscal revenues. The outlook is particularly dire in low-income developing countries, where revenues are expected to be on average 2 percentage points lower than projected in 2019.

The stark difference across countries in the projected scarring from the pandemic is likely to affect income inequality and poverty, making it more difficult for countries to achieve their UN Sustainable Development Goals. Income inequality is likely to rise persistently in emerging markets and low-income developing countries, whereas in most advanced economies the increase is expected to be pared back, albeit not fully.[3] Overall, poverty is expected to decline in 2021, partly offsetting the large increase in 2020, but the number of people in poverty is still projected to be 65–75 million higher than prepandemic trends.[4]

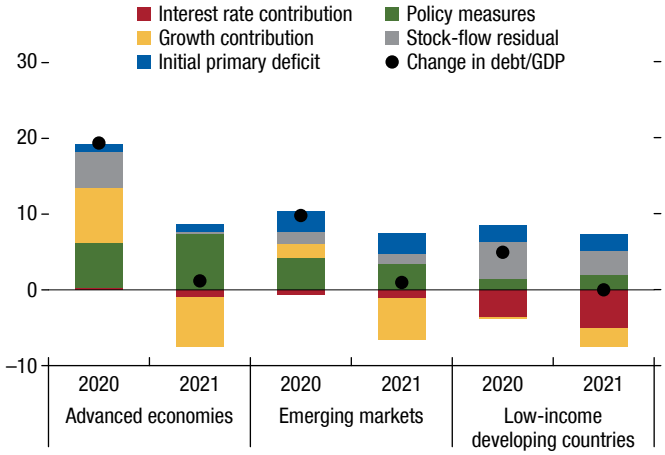
The fiscal outlook is subject to major risks. The interplay between vaccines and the virus and its variants is among the factors contributing to elevated

[3]These results are derived from Gini forecasts for 2021 onward; they are constructed using the parameters of regressions of Gini changes in income and labor losses during the period surrounding the global financial crisis, interacted with income and labor losses for 2021 and beyond coming from the *World Economic Outlook* projections.

[4]The estimate has a high degree of uncertainty and will depend, among other factors, on the strength of the recovery and the effectiveness of safety nets. It is especially sensitive to developments in countries that are home to many of the world's poor people (such as *Bangladesh*, *Democratic Republic of the Congo*, *India*, and *Nigeria*).

Figure 1.2. Drivers of Change in Government Debt, 2019–21
(Percent of GDP)

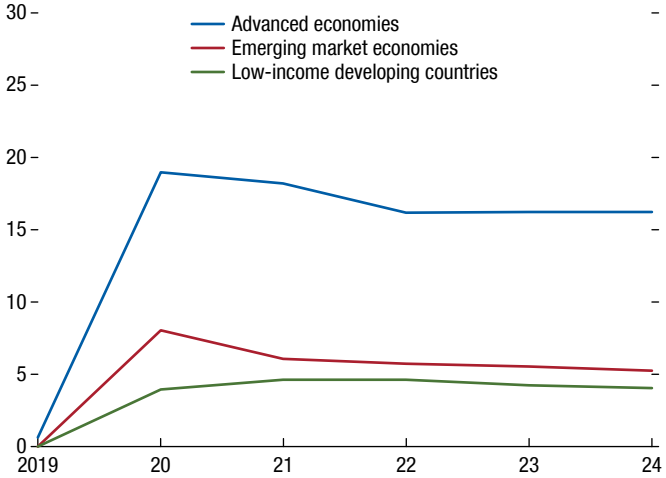
Fiscal policy support remains much higher in advanced economies compared with emerging markets and low-income developing countries.



Sources: IMF, World Economic Outlook database; and IMF staff estimates based on Mauro and Zilinsky (2016).
Note: The stock-flow residual is the change in the debt ratio resulting from factors such as bailouts or changes in exchange rates.

Figure 1.3. The Effect of the COVID-19 Pandemic on General Government Debt, 2019–24
(Change relative to prepandemic projections, percent of GDP)

Government debt as a share of GDP is expected to remain high compared with levels before the pandemic.



Sources: IMF, World Economic Outlook database; and IMF staff estimates.
Note: Prepandemic projections refer to projections in the October 2019 *World Economic Outlook*.

uncertainty in the short term. The evolution of public finances will also depend on how deeply the pandemic affects economic growth. On the upside, the structural transformation triggered by the crisis—accompanied by the investment packages currently under consideration—may help reduce future debt ratios by unlocking broad-based growth in productivity (October 2021 *World Economic Outlook*). On the downside, with debt at record-high levels, countries are exposed to changes in global interest rates, refinancing risks, and reduced fiscal space to respond to future shocks. This is especially relevant for emerging and developing economies, where the maturity of public debt is shorter and persistently low tax revenues risk straining governments' capacity to service debt. Borrowing costs could also rise faster than expected once central banks start to remove the exceptional monetary support, including by scaling down their purchases of government debt.

As the pandemic continues to take a toll, fiscal policy needs to remain nimble and support lives and livelihoods where vaccination coverage is limited and infections are resurgent. At the same time, emergency spending needs to be accompanied by measures that ensure transparency and accountability, so that public money is well targeted to the most needy (IMF 2020a).[5] The ability of governments to provide additional fiscal support in the short term can be enhanced if they credibly commit to rebuilding fiscal buffers in the medium term and to maintaining fiscal sustainability with a transparent set of rules and institutions that guide fiscal policy for the coming years (see Chapter 2). International cooperation, including financial support, is also crucial to ensure that vaccines, treatments, and medical supplies are distributed quickly and fairly across all countries (Agarwal and Gopinath 2021). Likewise, the adverse impact of the pandemic on economic development underlines the importance of domestic reforms and international aid, including through debt relief and concessional finance, to foster sustainable and inclusive growth (Benedek and others 2021).

[5]Governments have faced significant challenges in maintaining a satisfactory level of accountability in response to the COVID-19 crisis, though some positive innovative practices have emerged in countries across all income groups. For example, *Bangladesh* has provided extensive information on the effect of policy measures on disadvantaged groups. *Sierra Leone* undertook a real-time audit of its COVID-19 spending. *Chile* has relied on a consultative body that was established before the crisis. See International Budget Partnership (2021) for a study on the accountability, design, and implementation of government responses to COVID-19 in 120 countries based on a survey undertaken from March through September 2020. See also El Khoury and others (2021).

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

						Projections					
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
World	**–3.5**	**–3.0**	**–3.0**	**–3.6**	**–10.2**	**–7.9**	**–5.2**	**–4.2**	**–3.8**	**–3.6**	**–3.5**
Advanced Economies	**–2.7**	**–2.4**	**–2.5**	**–3.0**	**–10.8**	**–8.8**	**–4.8**	**–3.6**	**–3.2**	**–3.1**	**–3.0**
Canada	–0.5	–0.1	0.3	0.5	–10.9	–7.5	–2.2	–0.5	–0.1	0.2	0.4
Euro Area	–1.5	–0.9	–0.5	–0.6	–7.2	–7.7	–3.4	–2.4	–2.0	–1.7	–1.6
France	–3.6	–3.0	–2.3	–3.1	–9.2	–8.9	–4.7	–3.9	–3.6	–3.4	–3.4
Germany	1.2	1.3	1.9	1.5	–4.3	–6.8	–1.8	–0.4	0.0	0.5	0.5
Italy	–2.4	–2.4	–2.2	–1.6	–9.5	–10.2	–4.7	–3.5	–2.9	–2.6	–2.4
Spain[1]	–4.3	–3.0	–2.5	–2.9	–11.0	–8.6	–5.0	–4.4	–4.2	–4.2	–4.3
Japan	–3.8	–3.3	–2.7	–3.1	–10.3	–9.0	–3.9	–2.1	–2.1	–2.1	–2.2
United Kingdom	–3.3	–2.4	–2.2	–2.3	–12.5	–11.9	–5.6	–3.6	–3.2	–3.1	–2.9
United States[2]	–4.3	–4.6	–5.4	–5.7	–14.9	–10.8	–6.9	–5.7	–5.2	–5.3	–5.3
Others	0.5	1.2	1.2	–0.2	–5.2	–4.2	–2.3	–1.4	–1.0	–0.7	–0.6
Emerging Market Economies	**–4.8**	**–4.1**	**–3.7**	**–4.7**	**–9.6**	**–6.6**	**–5.8**	**–5.2**	**–4.8**	**–4.4**	**–4.1**
Excluding MENA Oil Producers	–4.4	–4.0	–3.9	–4.9	–9.7	–6.9	–6.0	–5.3	–4.9	–4.5	–4.2
Asia	–4.0	–4.0	–4.5	–5.9	–10.8	–7.9	–7.0	–6.2	–5.7	–5.2	–4.8
China	–3.7	–3.8	–4.7	–6.3	–11.2	–7.5	–6.8	–6.2	–5.6	–5.0	–4.5
India	–7.1	–6.2	–6.4	–7.4	–12.8	–11.3	–9.7	–8.8	–8.3	–8.1	–7.8
Europe	–2.8	–1.8	0.3	–0.7	–5.6	–3.2	–2.4	–2.1	–2.2	–2.3	–2.5
Russian Federation	–3.7	–1.5	2.9	1.9	–4.0	–0.6	0.0	0.2	0.1	–0.2	–0.5
Latin America	–6.0	–5.4	–5.0	–4.1	–8.8	–5.7	–4.9	–4.2	–3.5	–3.1	–2.9
Brazil	–9.0	–7.9	–7.1	–5.9	–13.4	–6.2	–7.4	–6.4	–5.4	–4.8	–4.4
Mexico	–2.8	–1.1	–2.2	–2.3	–4.5	–4.2	–3.5	–3.2	–2.9	–2.8	–2.8
MENA	–10.1	–5.3	–1.8	–2.9	–8.2	–4.3	–3.7	–3.7	–3.7	–3.7	–3.4
Saudi Arabia	–17.2	–9.2	–5.9	–4.5	–11.3	–3.1	–1.8	–1.4	–1.1	–0.6	0.1
South Africa	–3.7	–4.0	–3.7	–4.8	–10.8	–8.4	–7.0	–6.4	–6.2	–6.5	–6.8
Low-Income Developing Countries	**–3.8**	**–3.6**	**–3.4**	**–3.9**	**–5.2**	**–5.4**	**–5.0**	**–4.5**	**–4.3**	**–4.1**	**–3.9**
Kenya	–7.8	–7.5	–7.0	–7.3	–8.1	–8.0	–6.7	–4.9	–4.0	–3.2	–2.5
Nigeria	–4.6	–5.4	–4.3	–4.7	–5.8	–6.1	–6.0	–5.5	–5.6	–5.9	–6.1
Vietnam	–3.2	–2.0	–1.0	–3.3	–3.9	–4.7	–4.7	–4.5	–4.2	–3.9	–3.6
Oil Producers	**–5.2**	**–2.8**	**0.4**	**–0.2**	**–7.5**	**–4.2**	**–2.2**	**–1.6**	**–1.6**	**–1.6**	**–1.6**
Memorandum											
World Output (percent)	**3.3**	**3.8**	**3.6**	**2.8**	**–3.1**	**5.9**	**4.9**	**3.6**	**3.4**	**3.3**	**3.3**

Source: IMF staff estimates and projections.

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

[1] Including financial sector support.

[2] For cross-economy comparability, expenditure and fiscal balances of the United States are adjusted to exclude the imputed interest on unfunded pension liabilities and the imputed compensation of employees, which are counted as expenditures under the 2008 System of National Accounts (2008 SNA) adopted by the United States but not in countries that have not yet adopted the 2008 SNA. Data for the United States in this table may thus differ from data published by the US Bureau of Economic Analysis.

Recent Developments and Outlook

Many factors explain the differentiated evolution of fiscal policy at the global level. In the short term, these include variation across countries in the intensity of the health crisis, the low availability of vaccine in many emerging markets and low-income developing countries, and uneven availability of fiscal space to further increase spending or reduce taxes. In the medium term, the composition and size of the fiscal policy response, both at the peak of the crisis and during the recovery, will likely contribute to the uneven economic damage inflicted by the pandemic across countries (April 2021 *World Economic Outlook*).

Advanced Economies

Fiscal policy in advanced economies is moving boldly on two fronts. First, governments are continuing to provide ample support as their economies grapple with the pandemic and its uneven effect within society.

Table 1.2. General Government Debt, 2016–26

(Percent of GDP)

						Projections					
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Gross Debt											
World	**83.2**	**82.0**	**82.3**	**83.6**	**98.6**	**97.8**	**96.9**	**97.0**	**96.9**	**96.8**	**96.5**
Advanced Economies	**105.6**	**103.2**	**102.7**	**103.8**	**122.7**	**121.6**	**119.3**	**119.3**	**119.1**	**118.8**	**118.6**
Canada[1]	91.7	88.8	88.8	86.8	117.5	109.9	103.9	100.2	96.9	93.4	89.7
Euro Area	90.1	87.7	85.7	83.7	97.5	98.9	96.3	95.4	94.5	93.4	92.2
France	98.0	98.3	98.0	97.6	115.1	115.8	113.5	114.6	115.4	116.2	116.9
Germany	69.3	65.0	61.6	59.2	69.1	72.5	69.8	68.0	65.9	63.4	60.9
Italy	134.8	134.1	134.4	134.6	155.8	154.8	150.4	149.4	148.6	147.5	146.5
Spain	99.2	98.6	97.5	95.5	119.9	120.2	116.4	116.2	116.3	116.8	117.5
Japan	232.5	231.4	232.5	235.4	254.1	256.9	252.3	250.8	251.0	251.3	251.9
United Kingdom	86.8	86.3	85.8	85.2	104.5	108.5	107.1	109.4	110.5	111.2	111.6
United States[1]	106.9	106.0	107.1	108.5	133.9	133.3	130.7	131.1	131.7	132.5	133.5
Emerging Market Economies	**48.4**	**50.5**	**52.4**	**54.7**	**64.0**	**64.3**	**65.8**	**67.1**	**68.2**	**69.0**	**69.8**
Excluding MENA Oil Producers	50.1	52.2	54.2	56.2	65.9	66.8	68.3	69.6	70.6	71.4	72.0
Asia	50.0	52.8	54.5	57.3	67.3	70.1	72.4	74.2	75.7	77.0	78.1
China	48.2	51.7	53.8	57.1	66.3	68.9	72.1	74.5	76.6	78.5	80.1
India	68.9	69.7	70.4	74.1	89.6	90.6	88.8	88.1	87.3	86.3	85.2
Europe	31.9	30.1	29.7	29.2	38.0	36.6	36.7	36.8	37.1	37.2	37.4
Russian Federation	14.8	14.3	13.6	13.8	19.3	17.9	17.9	17.7	17.8	17.5	17.5
Latin America	56.4	61.1	67.4	68.3	78.1	73.0	73.6	74.2	74.2	73.8	73.2
Brazil[2]	78.3	83.6	85.6	87.7	98.9	90.6	90.2	91.7	92.4	92.6	92.4
Mexico	56.7	54.0	53.6	53.3	61.0	59.8	60.1	60.5	60.9	61.2	61.5
MENA	42.5	41.9	41.1	45.7	52.6	48.4	47.1	47.5	47.9	48.2	48.3
Saudi Arabia	13.1	17.2	19.0	22.8	32.5	29.7	30.8	30.4	29.5	28.4	27.2
South Africa	47.1	48.6	51.6	56.3	69.4	68.8	72.3	74.9	77.4	80.2	83.0
Low-Income Developing Countries	**39.5**	**42.1**	**42.7**	**44.2**	**49.9**	**50.2**	**49.8**	**49.0**	**48.5**	**48.0**	**47.3**
Kenya	46.7	54.8	57.3	59.0	67.6	69.7	70.2	69.6	68.3	70.9	69.6
Nigeria	23.4	25.3	27.7	29.2	35.0	35.7	36.9	37.7	39.1	40.6	42.0
Vietnam	47.6	46.3	43.7	43.6	46.3	47.9	47.8	47.8	47.0	46.1	45.3
Oil Producers	**41.4**	**41.8**	**44.0**	**45.5**	**58.0**	**54.1**	**52.9**	**52.2**	**51.7**	**51.1**	**50.4**
Net Debt											
World	**69.3**	**67.8**	**67.9**	**68.4**	**80.6**	**81.9**	**81.1**	**81.6**	**81.8**	**82.3**	**82.7**
Advanced Economies	**76.9**	**75.1**	**74.8**	**75.1**	**88.1**	**89.8**	**88.7**	**89.2**	**89.5**	**90.3**	**91.0**
Canada[1]	28.7	26.0	25.6	23.4	34.7	34.9	32.5	30.1	27.7	25.1	22.2
Euro Area	74.6	72.4	70.6	69.3	80.7	82.8	80.9	80.5	80.0	79.2	78.4
France	89.2	89.4	89.2	88.9	102.6	103.3	100.9	102.0	102.9	103.7	104.4
Germany	49.6	45.7	42.9	40.8	50.1	54.4	52.9	51.6	50.0	48.0	46.0
Italy	121.6	121.3	121.8	122.1	142.3	142.2	138.5	137.9	137.3	136.5	135.7
Spain	86.1	85.1	83.7	82.2	103.0	104.5	101.9	102.3	102.8	103.8	104.8
Japan	149.6	148.1	151.2	150.8	167.0	171.5	169.2	168.3	168.4	168.7	169.4
United Kingdom	77.8	76.8	75.9	75.3	91.8	97.2	95.2	97.8	98.7	99.5	99.9
United States[1]	81.9	81.6	82.1	83.0	98.7	101.9	100.8	101.9	103.3	106.0	108.9
Emerging Market Economies	**34.7**	**35.8**	**36.7**	**38.4**	**44.7**	**45.3**	**46.3**	**47.5**	**48.2**	**48.5**	**48.6**
Asia	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Europe	31.4	30.2	30.4	29.4	36.9	37.4	37.8	38.1	38.4	38.6	38.8
Latin America	40.3	42.5	42.9	44.1	52.0	51.4	53.2	55.2	56.6	57.1	57.9
MENA	26.9	26.5	28.5	34.5	39.1	39.8	39.0	41.0	41.8	42.3	41.6

Source: IMF staff estimates and projections.

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

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

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

The crisis has increased the inequality of labor earnings in *Canada, Israel*, and the *United States.* Data covering the early stage of the recovery in the *United States* and member countries of the Organisation for Economic Co-operation and Development (OECD) show that employment rates have rebounded beyond prepandemic levels for high-wage workers but remain significantly lower for low-wage workers.[6] Second, policymakers in many countries have recognized the need to "build back better" in the aftermath of the pandemic. This has led to the announcement of multiyear plans to increase public investment, strengthen social safety nets, address climate change, and improve resilience to future health crises.

The cyclically adjusted primary deficit for advanced economies as a group is expected to decrease in 2021 by 0.5 percentage points of GDP (to 6.3 percent). This average figure includes a decrease of 1½ percentage points in the *United States* (on the back of a strong revenue outturn) and an increase of 1½ percentage points in the *euro area*. The cyclically adjusted primary deficit is projected to shrink by almost 2 percentage points on average in 2022 and fall further to 2.1 percent of GDP by 2026 (0.8 percent in the *euro area* and 3.5 percent in the *United States*), a level somewhat higher than in 2019. Favorable interest rates and economic growth, along with projected fiscal adjustments (including a decline in COVID-19–related spending), imply that the ratio of gross government debt to GDP for advanced economies is expected to decline marginally to about 120 percent in 2026 (Table 1.2). However, in some countries the debt ratio is expected to remain broadly stable (*United Kingdom*) or continue rising (*Republic of Korea*). These baseline projections include the domestic and international fiscal and growth impact of the multiyear plans that have been announced or approved in advanced economies. The key features of the largest among these packages are described next.

In the *European Union*, the NGEU recovery plan issued its first 10-year bonds in June.[7] The issuance will contribute to expanding the availability of credit issued at the EU level. The package (€750 billion, of which €390 billion is in grants and €360 billion in loans) will be mainly directed to countries that suffered a large negative effect from the crisis and that have limited fiscal space.[8] It aims to support a sustainable recovery and reduce crisis-driven divergence in economic prospects across EU states. This is reflected in the much lower degree of economic scarring from the pandemic currently projected for emerging markets in the *European Union* compared to the average emerging market economy. Climate and digitalization investments are priorities: the Recovery and Resilience Facility, which will allocate most of the financing, requires that at least 37 percent of each plan's allocation must support the green transition and at least 20 percent be directed to digital transformation. Climate policy and digitalization investment projects accounted for more than half of planned grant spending as of June 3.[9] Several governments intend to frontload these investments (*Austria*, *Denmark*, *Finland*, *Spain*).

In the *United States,* the new administration has proposed a significant increase in spending through the American Families Plan (AFP) ($2 trillion) and the American Jobs Plan (AJP) ($2.3 trillion). The primary aim is to redistribute resources toward vulnerable households, invest in infrastructure, encourage human capital accumulation, boost labor force participation, and improve productivity (see Box 1.1 on the

[6]See Opportunity Insights (https://www.tracktherecovery.org/) and OECD (2021). Evidence from past recessions also suggests that the poorest are hardest hit. Those at the bottom of the income distribution do not attain significant increases in income until the recovery is well under way, while those at the top of the distribution see their incomes soar sooner (Heathcote, Perri, and Violante 2020).

[7]As of August 2021, the EU had concluded three issuances of NGEU bonds with maturities from 5 to 30 years, for a total of €45 billion. The issuances have attracted strong interest from investors, with large oversubscriptions. The bonds have been trading with a yield between that of yields on the corresponding German and French bonds.

[8]These design features for the Recovery and Resilience Facility intend to promote solidarity among EU member countries and are guided by the principle of providing targeted fiscal support to promote a faster recovery: A country's allocation will be proportional to its population size and inversely proportional to its per capita income level. In addition, during 2021–22, the allocation of 70 percent of the funds will also consider the unemployment rate in the period immediately before the pandemic (2015–19), and during 2023 the allocation of 30 percent of the funds will reflect the economic effect of the crisis. Under these guidelines, eastern and southern European countries will be the largest recipients of the grants, with *Bulgaria, Croatia*, and *Greece* each receiving more than 8 percent of their 2019 GDP, and *Spain* and *Italy* receiving 4.8 percent and 3.7 percent of their 2019 GDP, respectively.

[9]The distribution of NGEU funds will include, for example, €1.4 billion to the *Czech Republic* to renovate buildings and improve its energy efficiency and €500 million to boost digital skills through investments in upskilling and reskilling programs for the entire workforce; €155 million to *Ireland* to renovate residential and public buildings and to support businesses that improve their energy efficiency, with the aim of reducing the country's greenhouse emissions; and €40 million to *Cyprus* to promote energy-efficient investments in small and medium enterprises, municipalities, and the wider public sector, and €35 million for the expansion of high-capacity digital networks in underserved areas.

distributional impact). The costs of the additional federal spending, and therefore the impact on government debt, are expected to be partially offset by raising revenues through increases in the personal and capital income tax rates, an increase in the corporate tax rate, and a global minimum tax on corporate profits.[10]

Figure 1.4 presents a simulation of the potential cumulative global economic effect of the AFP, the AJP, and the NGEU. Note that the fiscal packages examined here represent only part of the fiscal policies advanced economies need to recover from the pandemic—especially in the *European Union,* where national fiscal policies account for the bulk of the fiscal response and where additional national measures are expected later in the year. By 2026, the programs considered could add $4.6 trillion to global GDP. About 16 percent of this increase, or roughly 0.6 percent of global GDP, would correspond to international spillovers.[11] The effects are especially strong on exports (Figure 1.4, panel 1). Global investment would also increase, but more gradually. Panel 2 of Figure 1.4 shows the joint effect of the packages on international prices. The increases are expected to take place quickly and gradually diminish, with the exception of the impact on global interest rates (and monetary policy rates), which occurs with a lag. These increases in international prices are also expected to be modest, except for oil prices, which could rise by more than 6 percent. Most of the cumulative spillovers on GDP, consumption, investment, and employment are expected to accrue to advanced economies and to commodity-exporting economies (see Annex 1.1 for more details). For all economies other than the *European Union* and the *United States*, fiscal deficits and net debt as a share of GDP would fall relative to a baseline that does not include the packages. In most countries, this will reflect the positive effects of higher growth and fiscal revenues, but in some it would be the consequence of fiscal policy adjustment to tighter financing conditions.

Indeed, despite the overall positive global effect of the packages, some countries may face adverse spillovers, especially if global interest rates were to rise sharply. For example, real consumption in G20 emerging market economies is expected to contract slightly. The extent of the potentially negative spillovers will depend crucially on the response of domestic inflation and, correspondingly, of monetary policy in the two source countries/regions (*European Union, United States*). Commodity exporters and close trading partners of the two source countries/regions would benefit the most, whereas highly leveraged countries that are susceptible to changes in financing costs would be harmed by higher interest rates.

Emerging Markets

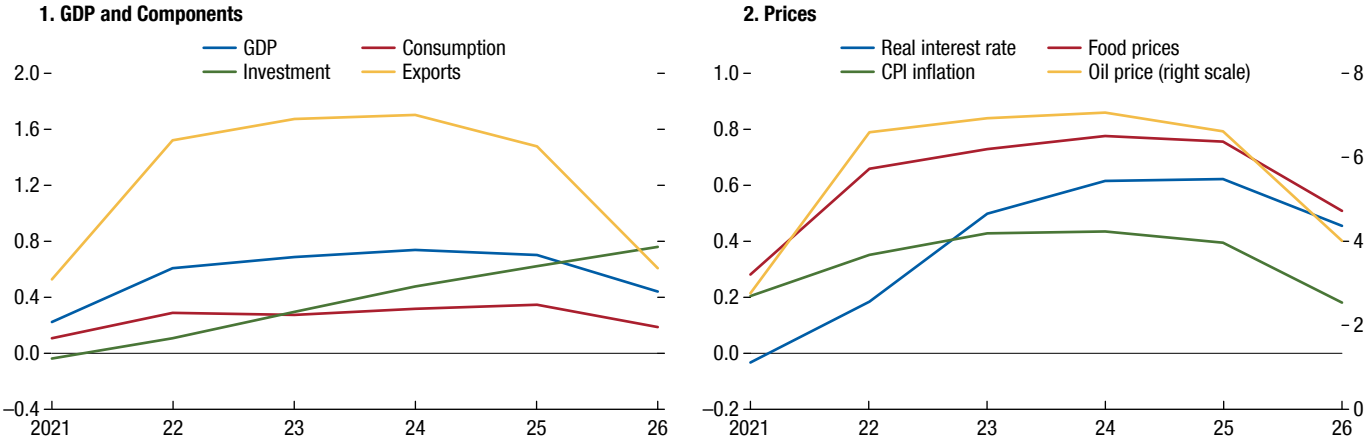
In emerging market economies, fiscal policy is still supportive on average amid limited vaccine coverage and resurgent waves of infection. Many countries have approved new spending to cope with the virus in 2021. However, tight borrowing constraints are increasingly leading to some fiscal retrenchment in several countries and are limiting the ability of fiscal policy to support people and firms during the crisis. The average fiscal deficit is projected at 6.6 percent of GDP in 2021, down by 3 percentage points from 2020 (Table 1.1). The decrease can be split about equally between a recovery in tax revenues as economic conditions improve and a reduction in discretionary spending measures. In two-thirds of emerging markets, real primary spending in 2021 will be above its 2019 level. In half of the countries, despite still-challenging economic conditions, real primary spending will have fallen from its 2020 peak as a result of contractions in both current and capital spending. In 2022, the deficit is expected to fall by an additional 1 percentage point.

[10]On August 10, the US Senate passed a bipartisan infrastructure bill that includes about $550 billion in new spending. The bill is under discussion in the US House of Representatives and a final vote on the package by September 27 has been agreed upon. The Administration remains committed to the remaining components of the Jobs and Families Plans that are not included in the bipartisan proposal. On August 24, the House passed a budget blueprint that paves the way for a reconciliation bill that authorizes $3.5 trillion in new spending covering most of the components of the AJP and AFP not included in the bipartisan infrastructure bill.

[11]"Spillovers" are defined here as the effects that a change in fiscal policy in one source country/region imposes on all other countries in the world, and therefore include the spillovers that the two source countries/regions impose on one another. This latter component accounts for about one-tenth of the total value of spillovers or 0.6 percent of global GDP. Considering the joint effect of their domestic packages and the spillovers from other countries, GDP, consumption, investment, and employment increase in the *European Union* and the *United States*. Consumption would grow more markedly in the *United States*, reflecting the effect of the redistributive policies on overall aggregate demand. On the other hand, despite the large investment component of the US packages, investment growth would be higher in the *European Union* due the focus of their packages on expanding the productive capacity of the economies. Inflation in these three economies/regions is also expected to increase, but only moderately.

Figure 1.4. Global Effect of Three Large Recovery Packages on Macroeconomic Variables and Prices
(Percent change relative to baseline)

Global GDP and gross exports would see a sizable increase, the rise in prices would be transitory and moderate, and the increase in global interest rates would be long-lasting.



Sources: IMF World Economic Outlook database; and IMF staff calculations.
Note: The figure focuses on three large recovery packages announced since April 2021 by the European Union (NextGenerationEU) and the United States (American Families Plan and American Jobs Plan). Simulations use the G20 module of the Flexible System of Global Models. CPI = consumer price index.

Underneath the narrowing average deficit lie large differences across countries. In *China,* with strong pandemic control and a consequent swift economic rebound, the cyclically adjusted primary deficit is projected to fall by 2½ percentage points in 2021 compared with 2020 because most pandemic-related fiscal measures are expiring and public investment is being reduced. In *Brazil* and *Russia,* the 2021 fiscal retrenchment is even more marked. In contrast, the narrowing fiscal deficit among oil exporters (Table 1.1) is explained by significant revenue improvements as oil prices increase. In *Chile*, the cyclically adjusted primary balance is instead expected to deteriorate in 2021, on the back of new stimulus measures to buffer the effects of the crisis.

Average gross government debt in emerging markets is predicted to reach 64 percent of GDP in 2021, up by almost 10 percentage points from 2019 (Table 1.2), with the level rising by more than 20 percentage points in one-fifth of the countries. To counter these trends, some governments are raising revenues (*Indonesia*). However, social and political tensions in several countries amid the challenges from the pandemic limit the ability of governments to plan medium-term fiscal consolidations (*Colombia*). In the medium term, public debt for the emerging market group is projected to reach 70 percent of GDP in 2026 (but remain stable at 60 percent of GDP excluding China). Asia would surpass Latin America as the region with the highest public debt as a share of GDP, with debt in *China* increasing despite fiscal tightening and a renewed effort to restrict debt in state-owned enterprises and local governments.

Low-Income Developing Countries

The average overall fiscal deficit in 2021 in low-income developing countries remains at just above 5 percent of GDP, little changed from 2020, and 1.5 percentage points of GDP above its prepandemic value (Table 1.1). This pattern can be explained by the limited fiscal support that these countries have expended to cope with the virus compared with the other income groups (Figure 1.2). In real terms, overall expenditure in 2021 is expected to increase in about 70 percent of the countries. In the vast majority, current expenditure in 2021 will be above its 2019 level in real terms, whereas this will be the case for capital spending in only 60 percent of countries. Real revenues are projected to increase in 2021 in three-quarters of the countries but are likely to remain subdued in countries that are reliant on tourism. In almost half of them, real revenues will exceed their 2019 level. However, in almost half of the countries, grants are expected to be below their 2019 level in dollar terms.

Fiscal deficits as a share of GDP are expected to fall in half of the countries in 2021, especially in those that had elevated debt levels before the pandemic (*Liberia, South Sudan, Zambia*); those with large fiscal deficits in 2020 (*Ghana, Guinea-Bissau*); and in certain commodity exporters (*Sudan*). The average overall fiscal deficit is projected to return to its prepandemic level by 2025, as countries implement medium-term fiscal consolidation measures to rein in debt. Over the medium term, average revenue is expected to increase and stabilize at 14½ percent of GDP but would still remain 0.5 percentage points of GDP below the 2019 level because of lower tax revenues (*Republic of Congo, Vietnam*) and lower external grants (*Afghanistan, Djibouti, Liberia*). Expenditure is projected to decline to 18 percent of GDP by 2026, ½ percentage point of GDP below the 2019 value, with current levels of spending gradually scaling down and capital expenditures holding steady as a share of GDP.

Average gross debt in 2021 is projected to remain stable at almost 50 percent in 2020, still 5 percentage points above its 2019 value (Table 1.2). In the medium term, debt vulnerabilities are expected to remain high and the room for further borrowing is likely to get smaller, with the debt service relative to taxes trending upward. Half of low-income developing countries are experiencing debt distress or are at risk of it, and are counting on international support to fight the pandemic. As of the end of May 2021, 47 out of 73 eligible countries had joined the Debt Service Suspension Initiative (DSSI). The initiative has helped countries increase COVID-19 spending but has not been enough to prevent a reduction in other priority spending (Box 1.2).[12] A few countries have recently sought debt relief under the G20 Common Framework (*Chad*, *Ethiopia, Zambia*).[13] In parallel, the IMF has extended $117 billion in new financing and debt service relief to 85 countries. This includes financial assistance to 53 low-income developing countries and grant-based debt service relief to 29 of the IMF's poorest and most vulnerable members. Compared to its level before the pandemic, the IMF's support to low-income developing countries has almost tripled and has increased by about 1 percent of GDP for emerging market economies (Box 1.2). The new Special Drawing Right (SDR) allocation will further help vulnerable countries struggling to cope with the impact of the crisis.[14]

Risks to the Outlook: Uncertain Room to Maneuver

The evolution of the pandemic and its social and economic implications continue to represent the most significant source of risks to the global outlook in the short term. A rapid scaling up of vaccine production and delivery, especially to emerging markets and low-income developing countries, would accelerate the pace of resolving the health crisis, limit further damage to the global economy, and improve fiscal prospects. Conversely, the spread of the Delta variant has added new uncertainties, and vaccine hesitancy in some countries and low vaccine coverage in others could inflict new damage to the world economy and increase pressures on public budgets, with many governments facing tight borrowing constraints.

How much extra room do governments have to increase their borrowing without triggering negative market reactions? Market access to further borrowing, debt sustainability, and fiscal space are all intertwined concepts that can be assessed using a variety of indicators.[15] The debt-to-GDP ratio (Table 1.2) and the debt-to-revenue ratio (Figure 1.5, panel 1) provide complementary perspectives on the ability of a country to muster enough resources to service its debt. Both indicators show a large increase in 2021 relative to 2019, signaling a deterioration in fiscal space. The already sizable interest rate spread paid by emerging markets and low-income developing countries on their debt denominated in foreign currency has remained broadly stable for the median countries but has increased in several cases (Figure 1.5, panel 2). This is a sign that financing

[12]Preliminary evidence suggests that the DSSI may also have helped lower sovereign bond spreads for participating frontier economies in sub-Saharan Africa compared to nonparticipating African countries.

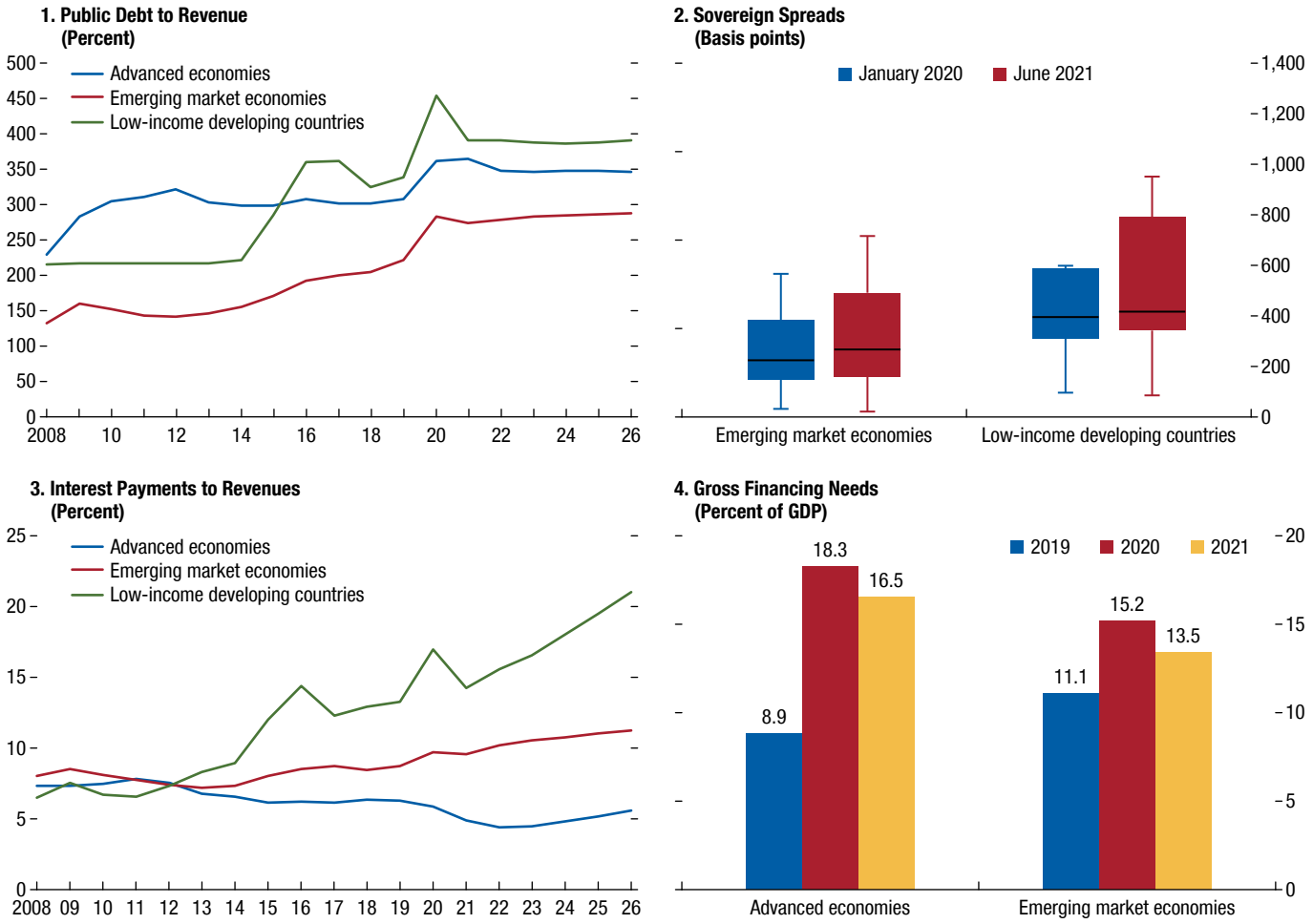
[13]The Common Framework for Debt Treatments beyond the DSSI is an agreement among the G20 and Paris Club countries to coordinate and cooperate on debt treatment for up to 73 low-income developing countries that are eligible for the DSSI.

[14]In August 2021 the IMF approved the largest general SDR allocation to date, worth $456.5 billion SDR ($650 billion), effective as of August 23, 2021, to help boost buffers and economic resilience while supporting the IMF's more vulnerable members. For more details about SDRs and their role in IMF financing, see https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/14/51/Special-Drawing-Right-SDR.

[15]Fiscal space is defined as the room to increase spending or lower taxes relative to a preexisting baseline without endangering market access and debt sustainability (IMF 2018). However, measuring the amount of "fiscal space" is a difficult task (Chapter 2).

Figure 1.5. The Evolution of and Outlook for Fiscal Space for Advanced Economies, Emerging Market Economies, and Low-Income Developing Countries

Financing constraints have become tighter or prohibitive in several emerging market economies and low-income and developing countries.



Sources: Panels 1, 3, and 4: IMF, World Economic Outlook database; and IMF staff calculations. Panel 2: Refinitiv Datastream.
Note: Panel 2 uses JP Morgan Emerging Market Bond Index (EMBI) spreads.

constraints are tightening for those countries, which are perceived as increasingly risky and have as a consequence experienced credit rating downgrades over the past two years.[16] Higher borrowing rates make debt more onerous. The combination of higher interest rates and lower government revenues has progressively strained the capacity of low-income developing countries to service their debt, a trend that has been exacerbated by the current crisis (Figure 1.5, panel 3).

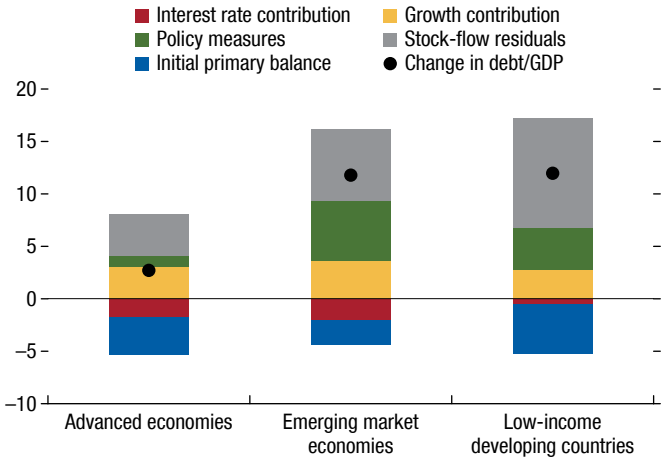
A counterbalancing force, especially for advanced economies, has been the reduction in the gap between the interest rate they pay on their public debt and their average growth rate projected over the next decade. Higher debt levels have nonetheless increased gross financing needs significantly in many countries (Figure 1.5, panel 4), posing challenges for debt management (IMF 2020b) and making public finances more vulnerable to rising borrowing costs when central banks reduce the exceptional large scale asset purchases. Even in advanced economies that face no material refinancing risk and still have some fiscal space, fiscal policy would have to withdraw more quickly than in the baseline should private demand recover faster than anticipated.

[16]Credit spreads tend to move sharply just at the time when a debt crisis breaks out and thus provide a limited indication of future debt distress.

Figure 1.6. Cumulative Contributions to Debt Deviation Over 2009–14

(Relative to 2009 projections; percent of GDP)

After the global financial crisis, a combination of factors drove debt much higher than expected for emerging market economies and low-income developing countries.

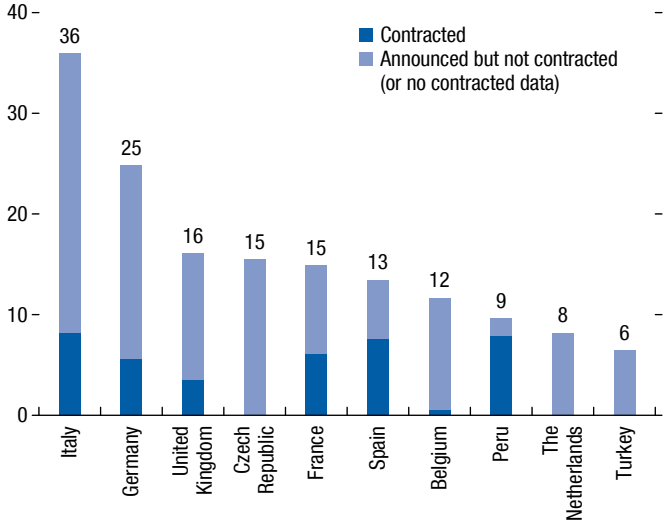


Sources: IMF World Economic Outlook database; and IMF staff estimates.

Figure 1.7. Government Exposure to Contingent Liabilities, Selected Countries

(Percent of GDP)

In most of the sample countries, take-up of blanket COVID-19 support programs has been limited to date, reducing potential contingent liabilities.



Sources: IMF Fiscal Response Database; and IMF staff estimates.
Note: For the Czech Republic, The Netherlands, and Turkey, data on contracted amounts are not available. COVID-19 = coronavirus disease 2019.

Overall, these indicators paint a picture wherein financing constraints have become tighter or outright prohibitive in several emerging markets and low-income developing countries. This represents a likely source of significant vulnerability for the medium-term trajectory of debt ratios. Many countries will increasingly face a difficult balancing act between supporting the recovery and containing the burden on future generations. The pace of withdrawing fiscal support and rebuilding fiscal buffers will depend on country-specific economic conditions and fiscal vulnerabilities (Chapter 2). These challenges highlight the importance of developing sound fiscal frameworks that include upgraded fiscal risks analysis over the medium and long term to help inform policy choices.

The recovery from the global financial crisis illustrates the important role played by interest rates, growth, and fiscal policy shocks in causing unexpected deviations of debt ratios from their projected path. In the years after the crisis, a disappointing growth performance, along with a larger-than-expected contribution of fiscal policies to creating debt in emerging markets and low-income developing countries, pushed up the debt ratio to higher-than-expected levels. This was only partly offset by a lower contribution of the interest rate bill and downward revisions to the initial 2009 primary deficit (Figure 1.6). In the end, the average debt ratio in 2014 turned out larger than projected by about 3 percentage points in advanced economies and by about 12 percentage points in emerging markets and low-income developing countries (Chapter 2).

Figure 1.6 also highlights that changes in government debt not accounted for by fiscal deficits (stock-flow adjustments) can cause major debt surprises, especially in emerging markets and low-income developing countries, where accounting transparency is typically lower. In these countries, financial risks stemming from the operation of state-owned enterprises (SOEs) are often a concern (Chapter 3 of the April 2020 *Fiscal Monitor*). For instance, a large proportion of local government financing vehicles and local SOE debt is likely unserviceable in China (October 2020 *Global Financial Stability Report*), where stock-flow adjustments are projected to increase from 1.6 percent of GDP in 2021 to 3 percent in 2026. In other emerging market and low-income developing countries, contingent liabilities could materialize because of government guarantees and loans extended during the crisis to SOEs operating in the tourism sector.

In advanced economies, the bold fiscal measures undertaken may cause debt surprises, including from the realization of contingent liabilities from blanket support to firms. Though these measures were appropriate given the crisis, they also carry risks. In most

cases, the take-up of the programs has been much lower than the committed resources (Figure 1.7) and expected annual fiscal costs seem manageable (Hong and Lucas, forthcoming). However, the outstanding guarantees are nonetheless large in various countries. Some of them have started estimating potential losses. The Office of Budget Responsibility in the *United Kingdom* estimates that up to 40 percent of participants in one of its most popular guarantee programs, the Bounce Back Loans Scheme, might default (Browning 2021). On the other hand, the Banque de France (2020) projects a default rate of only up to 6 percent of guaranteed loans in *France*.

Policy Conclusions

As the landscape of the COVID-19 pandemic continues to evolve, fiscal policy needs to remain nimble and adapt to rapidly changing conditions. Economic prospects continue to be highly uncertain and varied across countries, with the spread of the Delta variant adding new risks and with vaccination rates remaining low in many countries. In this context, fiscal policy can reduce the amount of short-term damage and medium-term scarring from the crisis. The size and composition of the fiscal measures will depend on the different stages of the economic recovery as well as on country-specific characteristics. Measures need to be centered on addressing the economic and social fallout from the pandemic where the virus is still spreading rapidly and vaccination rates are low, and on sustaining the recovery where widespread vaccination has been achieved. In all countries, strengthening medium-term fiscal frameworks can help buy time to provide further fiscal support in the short term while ensuring that fiscal space is rebuilt in the medium term (Chapter 2). Strong frameworks that ensure that fiscal sustainability is not at risk, including by improving revenue mobilization, can help central banks in both advanced economies and emerging markets credibly operate their asset purchase programs (Box 1.3 in the October 2021 *World Economic Outlook*).

In countries that face tight borrowing constraints, fiscal policy will need to balance difficult trade-offs. This is the case for many emerging markets and low-income developing countries, where the crisis is likely to lead to a permanent downward revision in the GDP trajectory, a permanent loss in fiscal revenues, and a setback in poverty reduction. In these countries, fiscal policy is called on to act on many fronts: saving lives, supporting the economy until vaccinations become widespread, funding development needs, containing the buildup of public debt, and managing social tensions. In some cases, relying on sustained and large fiscal deficits is not an option given already-elevated risk premiums and narrow and illiquid financial markets. In such instances, fiscal policy needs to be selective, giving priority to protecting lives and the poor, strengthening the efficiency of public spending, and enhancing growth prospects. In low-income developing countries, reversing some of the damage from the pandemic and moving closer to achieving Sustainable Development Goals will require significantly scaling up spending on human and physical capital in the years ahead while ensuring debt sustainability. Mustering the needed resources would, in turn, necessitate reversing the decline in revenues as a share of GDP—which are currently expected to remain below their prepandemic levels. This can be achieved through a well-designed menu of value-added and property taxes, progressive income, corporate and capital taxation, and expansion of the base for corporate and personal income taxes. Concerns about the distributional impact of these measures can be addressed by strengthening social safety nets.

In advanced economies, calibrating fiscal policy to the economic cycle (and the speed of the recovery) while achieving the right mix between fiscal and monetary policy should be at the forefront of policy design. Protracted low interest rates help strengthen the effectiveness of fiscal policy in reducing the amount of scarring from the pandemic, closing output gaps (both domestically and globally), and, where relevant, bringing inflation back to target. At the same time, fiscal policy would need to be retuned if private demand were to recover more quickly than expected, including to avoid contributing to inflationary pressures in case these are excessive and prolonged.

Fiscal policy should likewise support the transformation of economies to increase productivity and economic growth. In several countries, reaching this goal calls for increasing high-quality investments in physical capital and education and better targeting fiscal transfers toward policies that support the retraining and reallocation of workers across firms and sectors. Together with strengthening social safety nets, this would make growth more inclusive, reduce the economic scarring from the pandemic,

and smooth out the pandemic's uneven effects within societies. Fiscal policy should also contribute to building economies that are more resilient to future shocks. This requires plotting a medium-term course to rebuild fiscal buffers, tackle the risks from climate change, and improve preparedness to deal with future pandemics, including by investing in the health care sector and funding vaccine research, development, and manufacturing.

Global challenges require global solutions. The pandemic is one of the fronts where countries need to act together. The immediate priority continues to be the ongoing national and multilateral efforts to vaccinate as many individuals as soon as possible. The joint plan proposed by the IMF, World Bank, World Health Organization, and World Trade Organization provides a roadmap to address the health crisis and promote the economic recovery.[17] It will also help replenish fiscal accounts. An extraordinary effort from the international community to increase official lending and aid to low-income developing countries would contribute to covering their financing gaps and achieving their development goals. Countries with strong external positions are encouraged to take the opportunity of the new SDR allocation to channel resources toward those most in need. Even so, unsustainable debts and the limitations of the current international architecture to support orderly debt restructurings may continue to hobble some countries' responses to the pandemic. The G20 Common Framework is an important building block toward such an architecture. Steps to promptly make it fully operational, and further progress toward greater debt transparency, are critical. The recent extension of the Debt Service Suspension Initiative to the end of 2021 has bought additional time to move forward on this front. On the revenue side, multinational profit-shifting and mutually harmful tax competition have undermined tax receipts for years. In a welcome development, support is growing for a global minimum effective corporate tax and for the allocation of corporate taxes more closely with the jurisdiction where the consumers of major multinationals are located. Like the pandemic, addressing climate change and building climate resilience brings challenges that extend beyond national borders. Carbon taxes, supported by an international carbon price floor, can incentivize decarbonization. International cooperation in these crucial areas can alleviate the burden of the pandemic, foster the recovery, and facilitate transformation toward greater resilience and inclusive growth.

[17]For details, see the "Task Force on COVID-19 Vaccines, Therapeutics and Diagnostics" at https://www.covid19taskforce.com/en/programs/task-force-on-covid-19-vaccines.

Box 1.1. Long-Term Distributional Impact of the American Families Plan

The American Families Plan (AFP) consists of policies aimed at "building back better," as the fiscal measures included in it could significantly transform social policies and outcomes in the United States. The plan would extend changes in social programs set in motion by the American Rescue Plan (ARP), including the expanded health and insurance tax credits, the Earned Income Tax Credit, and the Child Tax Credit. In addition, the AFP would provide universal preschool, increased access to high-quality affordable childcare, support for tertiary education, increased nutrition support to disadvantaged families, and paid family leave. If legislated, the plan would be financed by higher income and capital taxes on households at the top of the income distribution. These policy changes are intended to address deficiencies in support to the low-income population, with emphasis on young workers, women, and lower- and middle-class families (see Online Annex 1.2 for details).

A model-based analysis gauges the potential long-term distributional impact of the policy changes over a decade or longer. The results suggest that the package could have a major impact on reducing inequality and poverty. The Gini coefficient for disposable income could fall by at least 4.3 points (from prepandemic levels) to values close to those in other member countries of the Organisation for Economic Co-operation and Development (such as the *Republic of Korea*, *Israel,* and *Romania*) and below those of others (such as the *United Kingdom*). The ratio of disposable income of the top 10 percent to the bottom 10 percent of the distribution could fall from 14 to 10. Poverty could fall by nearly one-third, from 10.5 percent (the prepandemic level) to 7.6 percent of the population.

Improving the targeting of the measures could further increase the impact of the package on inequality. For example, just improving the targeting of the Child Tax Credit by reducing income levels at which the program phases out (for example, 300–400 percent of the federal poverty level) could reduce the Gini by 0.7 points and decrease poverty by an additional 0.15 percentage points. It is notable that the overall progressivity of the policy measures in the plan does not appear to generate a substantial trade-off between equity and efficiency. The AFP's cumulative fiscal multiplier of approximately 1.0—that is, for every $1 spent, output would increase by $1.0—would leave the country with a higher level of GDP and a more equitable society.

What explains the dramatic changes in inequality and poverty while also allowing GDP to increase? Most of the positive distributional impact of the package can be attributed to the higher level of transfers targeted to the most vulnerable households in the economy. These transfers could potentially reduce labor force participation and lead to lower employment, investment, and production. However, the package includes policies that encourage labor force participation (expanded earned income tax credit, paid family leave, universal preschool, and high-quality affordable childcare) and more than offset the negative effect of the unconditional transfers on labor supply—thereby playing an important role in ensuring that prosperity would be shared across the entire spectrum of the income distribution. Consumption levels are expected to be higher for all households, although they would rise more for lower-income households.

At the same time, policies that facilitate the upgrading of individual workers' skills and raise the number of highly educated workers (tertiary education subsidies) would lift the productivity of the labor force, making it more profitable for firms to expand investment, especially in economic sectors that depend on a highly educated labor force. More productive workers, together with higher capital levels, would translate into higher levels of GDP, amplifying the positive effect of the transfers on the consumption levels of all households, even those whose main source of income is their capital income.

Box 1.2. Fiscal Developments in Countries Participating in the Debt Service Suspension Initiative

Large external grants and exceptional emergency and concessional financing, including the IMF's various lending facilities (Figure 1.2.1) and the Debt Service Suspension Initiative (DSSI), have helped combat the COVID-19 crisis. However, many low-income developing countries are still struggling in the face of financing constraints.[1] The DSSI has helped some low-income developing countries cope with the pandemic by contributing to increased government spending. However, the initiative has not been large enough to prevent a reduction in other priority spending (Figure 1.2.2; see also IMF and WBG 2021).

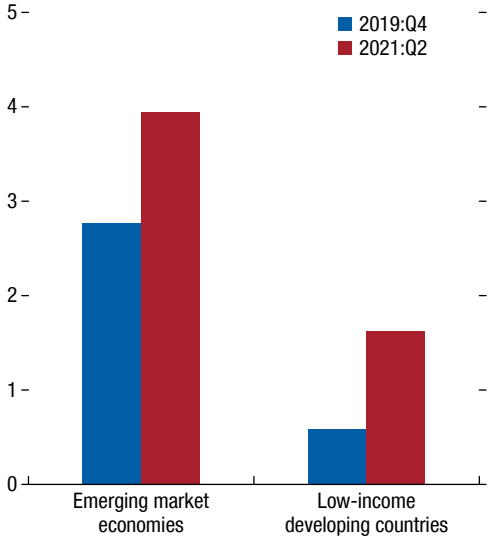
Among DSSI beneficiaries, the overall increase in fiscal deficits in 2020 was contained at 1.8 percentage points of GDP compared to projections before the pandemic. This is in line with the average increase among low-income developing countries, where governments have had to face difficult budget choices amid binding borrowing constraints. Grants and international financial support have allowed phase 1 DSSI beneficiaries to increase their COVID-19–related spending despite a fall in tax and other revenues.

However, non–COVID-19 expenditures have fallen. For example, 70 percent of DSSI beneficiaries have cut capital spending relative to prepandemic projections, with an average contraction for the group of 1.1 percentage points of GDP. Significant reallocations have taken place within spending categories. For instance, although overall priority spending has increased slightly relative to prepandemic projections, education spending has been cut in about 70 percent of the DSSI beneficiaries in favor of increases in social protection and health. In turn, in the health category, average COVID-19–related health spending (0.5 of a percentage point of GDP) has been larger than the average increase in health spending (0.2 of a percentage point of GDP), indicating that cuts in non–COVID-19 health spending have also taken place.

Figure 1.2.1. IMF Credit Outstanding in Emerging Market Economies and Low-Income Developing Countries

(Percent of 2019 GDP of the income group)

The IMF's various facilities have increased lending to help emerging market economies and low-income developing countries cope with the COVID-19 crisis.

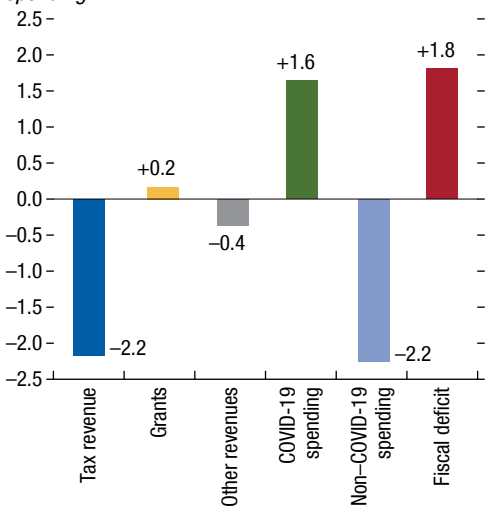


Source: IMF staff calculations.
Note: Credit is expressed as a ratio to the 2019 GDP of the income group, consisting of countries with IMF credit outstanding as of June 30, 2021.

Figure 1.2.2. Revenue and Spending among DSSI Beneficiaries

(Change from prepandemic projections, percentage points of GDP)

DSSI countries have had to cut non–COVID-19 spending.



Source: IMF and WBG 2021.
Note: COVID-19 = coronavirus disease 2019; DSSI = Debt Service Suspension Initiative.

[1]The DSSI provides the opportunity for eligible countries to temporarily suspend their debt service payments: 73 low-income developing countries are currently eligible to participate in the initiative, and of those, 43 counties participated in the first phase.

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