3. Fiscal Challenges from the Pandemic

The coronavirus disease (COVID-19) pandemic has required a substantial fiscal response from all countries, resulting in the largest synchronous fiscal easing in oil importers and a significant one in oil exporters. Nonetheless, the size of fiscal measures is slightly below that of other emerging market and developing economies, reflecting already-strong health and welfare systems in some economies and limited fiscal space in others. While the emergency measures have been critically important, these, along with significant declines in revenues, will increase financing needs for the region. Higher debt and deficits will erode fiscal space, leaving the region vulnerable to a resurgence of the virus and, for some countries, resulting in unsustainable debt dynamics. These adverse impacts are somewhat mitigated by lower borrowing costs, reflecting the large monetary easing in major advanced economies and increased official financing. Nevertheless, even with ambitious baseline fiscal adjustments, albeit not unprecedented, countries are not expected to revert to their pre-pandemic debt levels. In response to the increased fiscal vulnerabilities, governments should mitigate fiscal risks by developing medium-term fiscal frameworks, adopting fiscal rules, and strengthening debt management. At the same time, they must seek to expand fiscal space by, for example, enhancing tax compliance, increasing the progressivity of tax systems, and raising expenditure efficiency, including through improving governance and gradually eliminating fuel subsidies. Meanwhile, policymakers must also seek to support an inclusive recovery by enhancing social safety nets and prioritizing spending on health, education, and job retraining.

Jeta Menkulasi, Sergejs Saksonovs, and Ling Zhu prepared this chapter, and Tucker Stone provided research assistance.

COVID-19 Created Unprecedented Recessions and Deficits

The economic fallout of the pandemic, as outlined in Chapter 1, is expected to result in the largest output contraction in the past 20 years for most countries in the Middle East, North Africa, Afghanistan, and Pakistan (MENAP) and the Caucasus and Central Asia (CCA) regions.[1] The costs of dealing with the crisis and the loss of revenues, especially in oil-exporting countries where oil receipts have plummeted, are expected to result in the highest primary deficits in 10 of the 29 countries, with 8 more having their second-highest deficits in the past 20 years.

In this context, this chapter takes stock of fiscal policy responses to the crisis so far and their expected impact on government debt and fiscal buffers. It then seeks to answer three questions:

1. How much fiscal space is left to support the recovery?
2. What would it take to rebuild fiscal buffers over the medium term?
3. What measures could expand fiscal space while spurring an inclusive recovery?

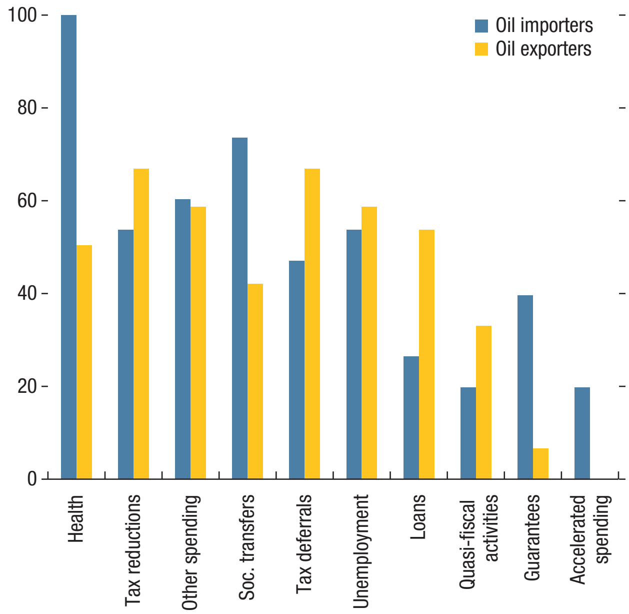
The Crisis Prompted Diverse Policy Responses across the Region

The region's governments have used a variety of tools to deal with the pandemic's consequences, broadly in line with IMF policy advice and responses outside the region.[2] Most oil importers focused on increasing health spending and

[1]This chapter excludes Libya, Somalia, and Syria from the analysis because of lack of relevant data.

[2]Calculations concerning frequency of country policies and their fiscal impact reflect information available as of August 7, 2020.

Figure 3.1. Share of Countries Adopting Policies in Response to COVID-19[1]
(Percent of total number of MENAP and CCA OEs and OIs)



Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.
[1]Oil exporters comprise 12 countries, excluding Yemen and Turkmenistan. Oil importers comprise 15 countries.

targeted social transfers, and most oil exporters centered their efforts on temporarily reducing taxes, extending tax payment deadlines, increasing other spending (for example, on partial payment of salaries to preserve employment), and providing loans (Figure 3.1).

The median size of revenue and expenditure measures in 2020 was 2 percent of GDP in the region's oil importers, which is equal to the median of emerging market and developing economies and double the median of the region's oil exporters (1 percent of GDP). Taking into account measures that do not have a direct impact on the deficit, such as extending tax collection deadlines and providing loans and guarantees to firms and households, increases the median cost to 2.7 percent of GDP in oil importers and 1.9 percent of GDP in oil exporters.

Spending increases caused by COVID-19 have been broadly offset by cuts in other categories.[3] For example, 24 countries are expected to cut capital spending this year. In fact, total government spending, in nominal terms, is projected to increase in only eight countries (out of 29), while non-interest current expense is expected to increase in 18 countries.

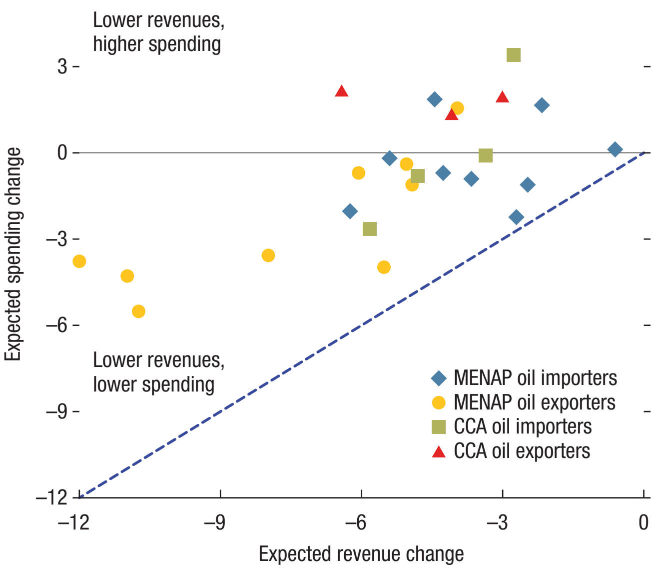
However, the unprecedented contraction in economic activity is projected to increase non-interest spending as a share of GDP in 22 countries. The median increase is expected to be at its second highest for oil exporters (at 2.2 percent of GDP compared with 2.3 in 2009) and at its highest for oil importers (2 percent of GDP compared with 1.1 in 2007).

The COVID-19 crisis will also increase deficits because of significant projected declines in revenues, which in nominal terms, compared with their precrisis baseline, are projected to decline by 4.8 percent of 2019 GDP—5.9 in oil exporters and 3.7 in oil importers (Figure 3.2).

Accordingly, the median expected decline in primary balances in 2020 for oil importers is 4 percent of GDP, in line with other emerging market and developing economies (3.6 percent) and the highest in the past 20 years, although three-quarters of oil importers have previously experienced greater fiscal easing.[4] For oil exporters, the median non-oil primary balance as a share of non-oil GDP is expected to decline by 1.4 percentage points from its level in 2019, representing the fourth largest annual decline in the past 20 years. The crisis has thus resulted in the largest synchronous fiscal easing in oil importers and a significant one in oil exporters. The easing at the individual country level, however, is not unprecedented.

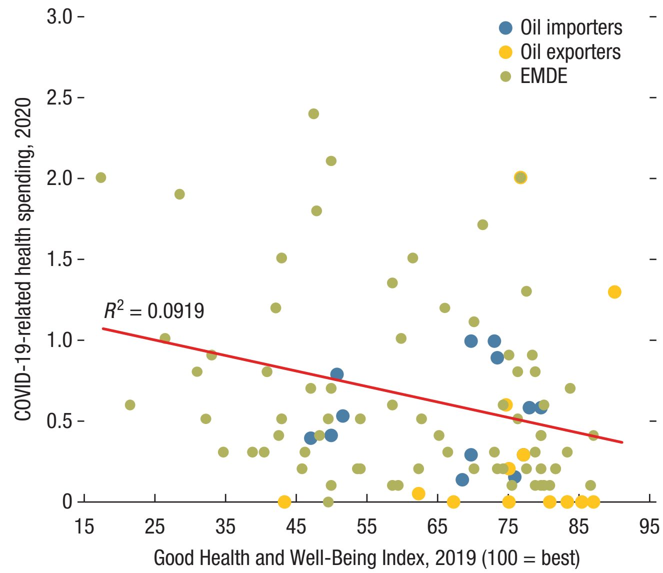
[3]The comparison is to a precrisis baseline defined as October 2019 *World Economic Outlook* projections.
[4]This chapter uses the change in the headline (non-oil) primary balance in percent of (non-oil) GDP as a measure of the fiscal policy stance. This may overstate the underlying adjustment given the unprecedented recessions. However, cyclically adjusted balances are unavailable in most countries and subject to high uncertainty and inaccuracy from the estimation of output gaps with structural breaks, particularly at the current juncture.

Figure 3.2. Change in Expected Revenues and Spending, 2020[1]
(Percent of 2019 GDP)



Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers;
[1]Most recent projections compared with precrisis. Iraq and Sudan are excluded.

Figure 3.3. COVID-19-Related Health Spending Measures
(Percent of GDP)



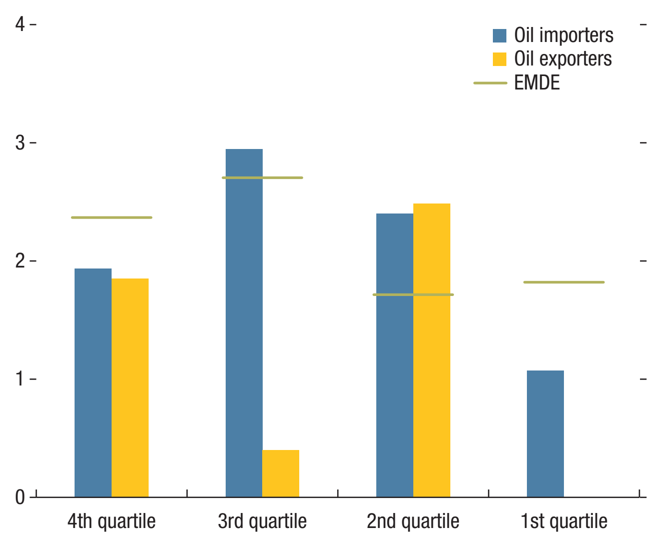
Sources: National authorities; Haver Analytics; Bertelsman Stiftung and the Sustainable Development Solutions Network; and IMF staff calculations.
Note: EMDE = emerging market and developing economies.

Several considerations may drive the fiscal response at the individual country level: direct impact of the pandemic, existing health infrastructure (Figure 3.3), and available fiscal space and the desire to preserve some of it to guard against considerable downside risks (for example, a second wave of the virus).

Revenue and expenditure measures in oil exporters were smaller than in emerging market and developing economies, even when comparing countries with similar incidence of COVID-19, which in oil exporters was relatively higher (Figure 3.4).[5] For some countries (for example, the Gulf Cooperation Council [GCC]), this is because of already-strong health and welfare systems and the ability to absorb additional health care costs within existing budget envelopes. For other oil

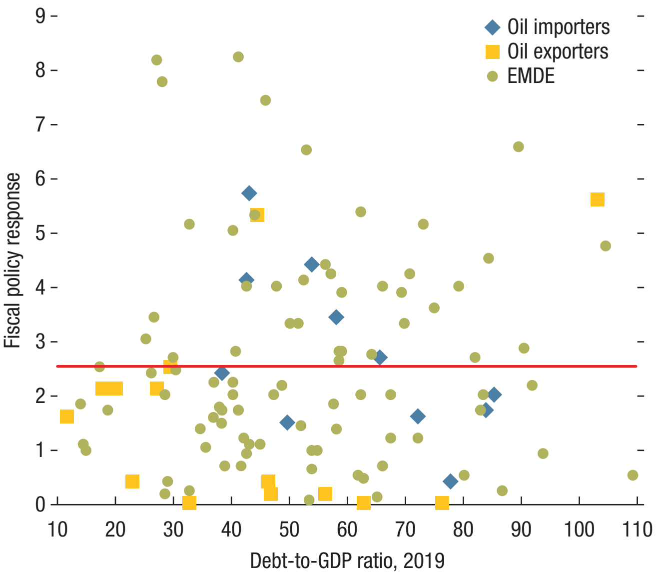
[5]COVID-19 incidence is measured as the number of COVID-19 cases per million people as of July 16, 2020. Most oil exporters in the region are in the fourth quartile of COVID-19 incidence (10 out of 14). Six out of 14 oil importers are in the third quartile, and 4 are in the second quartile, with 2 each in the fourth and first quartiles.

Figure 3.4. Median Revenue and Expenditure Measures by COVID-19 Incidence, 2020
(Percent of GDP)



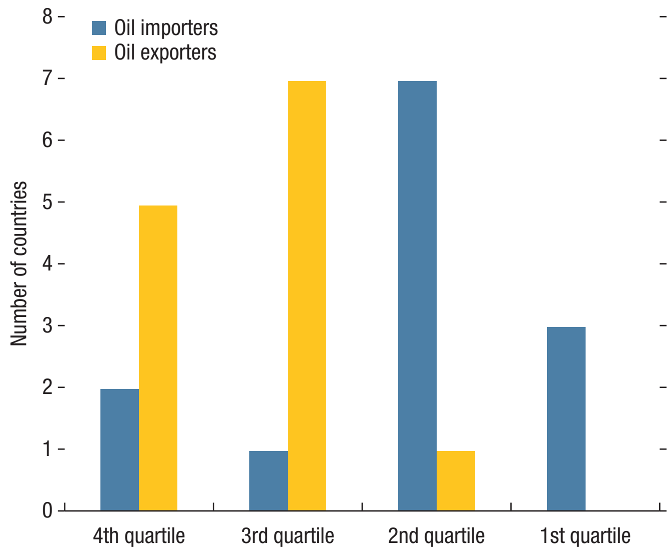
Sources: National authorities; and IMF staff calculations.
Note: EMDE = emerging market and developing economies.

Figure 3.5. Fiscal Responses to COVID-19 and 2019 Debt Levels
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: EMDE = emerging market and developing economies. Fiscal responses are above-the-line expenditure and revenue measures.

Figure 3.6. Number of Countries by Quartiles of COVID-19 Pressure Index



Sources: COVID-19 Pressure Index; and IMF staff calculations.
Note: Excludes Armenia, Turkmenistan, and West Bank and Gaza.

exporters, however, this reflects their fragility and limited fiscal space (*Iraq*, *Yemen*).

Oil importers, however, have generally spent more than emerging market and developing economies with similar COVID-19 incidence, except for those in the highest quartile (*Armenia, Djibouti*).[6] This reflects generally strong responses in the CCA. Median health spending associated with COVID-19 was 0.6 percent of GDP in oil importers compared with 0.5 percent of GDP in other emerging market and developing economies.

Although initial levels of indebtedness will have a major impact on the medium-term implications of the pandemic, there does not seem to be any relationship between the size of the measures taken so far in the emerging markets as a whole and their 2019 debt levels (Figure 3.5). There is, however, a slightly negative relationship between the two for oil importers, suggesting their responses were constrained by their pre-pandemic fiscal space.

The measures taken so far are unlikely to be the last policy responses to COVID-19 in all countries in the region, particularly in oil exporters. A broader measure of policy pressures caused by COVID-19—that combines epidemiological data and countries' capacity to deal with the pandemic—shows that certain oil exporters (*Algeria, Iraq, Uzbekistan, Yemen*) are facing higher pressures than those faced by median emerging market and developing economies, reflecting higher incidence of the disease and greater vulnerability to intensified pressures from the virus (Figure 3.6).[7]

[6]Armenia had a substantial below-the-line component in its fiscal package.

[7]The pressure index is based on a principal component analysis of epidemiological data (new cases, new deaths, and respective trends) and indicators of capacity to deal with the pandemic that include health care infrastructure and spending and the fiscal response to the pandemic.

Table 3.1. 2020 Public Financing Needs and Sources in the Region
(Percent of region GDP)

	Oil Importers		Oil Exporters	
	MENAP	**CCA**	**MENAP**	**CCA**
Financing Needs				
Overall Balance	7.9	7.0	11.2	6.1
Debt Amortization	20.6	3.8	2.8	1.5
External	2.2	2.0	0.7	1.3
Domestic	18.4	1.8	2.1	0.2
Total	**28.5**	**10.8**	**14.0**	**7.6**
Financing Sources	**28.5**	**10.8**	**14.0**	**7.6**
Domestic	**23.7**	**1.5**	**11.1**	**4.6**
Government and SWF Resources	0.8	−1.4	3.8	3.2
Central Banks	0.0	0.3	0.4	0.0
Commercial Banks	22.9	2.6	6.9	1.4
External	**4.8**	**9.3**	**2.9**	**3.0**
Bond Issuance	1.2	0.0	2.6	0.5
Commercial Loans	0.3	0.0	0.2	1.1
IFI, Official Bilateral	3.2	9.3	0.1	1.4

Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; IFI = international financial institution; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; SWF = sovereign wealth fund.

Higher Deficits Imply Higher Financing Needs and Debt

Higher fiscal deficits will increase financing needs in the region, with a median increase of 4.3 percent of GDP. A few patterns emerge regarding near-term financing needs across the region (Table 3.1).

First, financing needs are higher in MENAP and oil importers compared with CCA and oil exporters, respectively. CCA oil exporters, which are projected to increase nominal spending, have the lowest financing needs because of their relatively low stocks of debt.

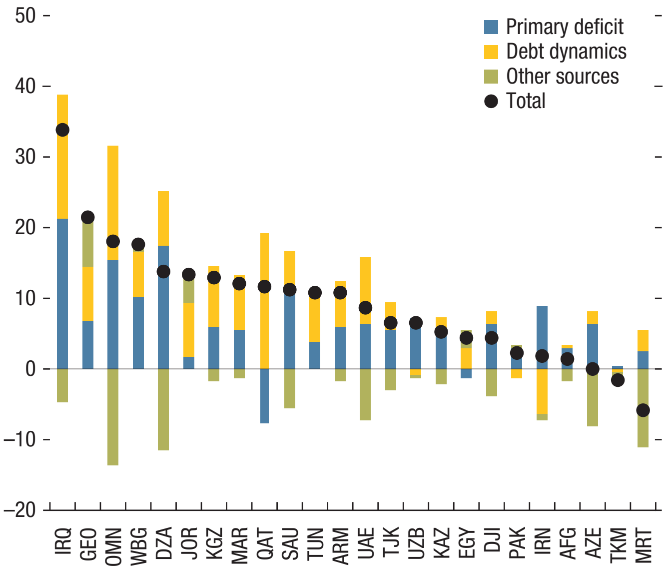
Second, MENAP countries are expected to rely primarily on domestic financing sources to cover their 2020 financing needs, notably commercial banks (for example, *Egypt and Morocco*).[8] This reliance on domestic financing sources reflects more-developed banking systems in the region, but it may lead to an intensification of elevated linkages between the solvency of banks and sovereigns over the medium term (Chapter 4).

By contrast, CCA economies rely more on external financing sources. This is especially the case for CCA oil importers, which expect significant borrowing from international financial institutions, while CCA oil exporters rely mostly on government and sovereign wealth fund resources.

The crisis is also expected to markedly increase government debt and attendant vulnerabilities in the region. In 2020, the highest increases in government-debt-to-GDP ratios are expected in MENAP oil exporters and CCA oil importers (median at about 11 and 12 percentage points, respectively). In the former group, the increase in the government-debt-to-GDP ratio is driven by higher primary deficits, mostly because of lower revenues, while in the latter, it is driven by automatic debt dynamics, especially contributions from negative real GDP growth and exchange rate depreciation (Figure 3.7). The share of foreign-currency-denominated debt is expected to increase in 10 out of 29 countries in the region, although it is often due to an increase in official financing, which would mitigate the resulting vulnerabilities somewhat.

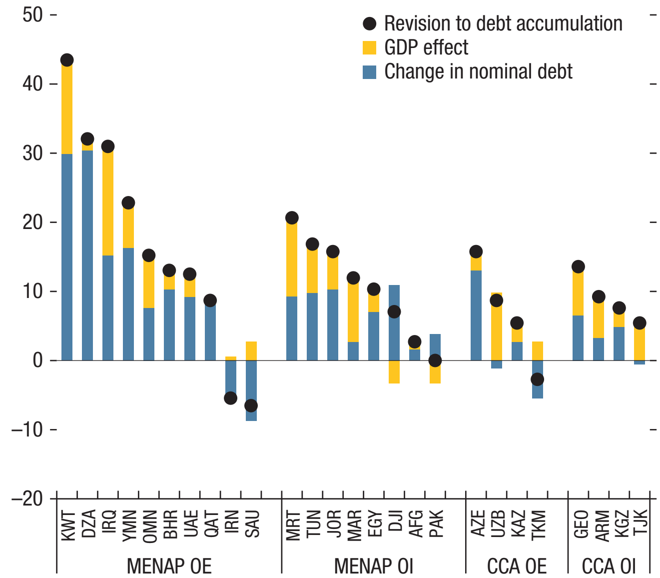
[8]Algeria, Armenia, Bahrain, and Yemen are expected to rely on monetary financing to varying degrees. The central bank has financed most debt in Algeria.

Figure 3.7. Contribution to Projected Annual Change in Debt-to-GDP Ratio, 2020
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 3.8. Revisions to Debt Accumulation Projection from Pre-COVID-19 WEO, 2020–24
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: Pre-COVID-19 refers to October 2019 *World Economic Outlook* (WEO) projections. Country abbreviations are International Organization for Standardization (ISO) country codes. CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers.

Rising Debt Erodes Fiscal Space and Increases Fiscal Risks

The near-term revisions to the government debt outlook carry over to the medium term. Since the onset of the pandemic, medium-term projections of government-debt-to-GDP ratios have been significantly revised for most countries up to 44 percentage points of GDP, with the largest revisions in MENAP oil exporters—reflecting the combined impact from the pandemic and the oil shock (Figure 3.8).[9] Lower projected GDP growth rates account for about half of these revisions in many countries.

These expected dynamics will increase government debt to elevated levels over the medium term in some countries (for example, *Algeria, Iraq, Kuwait, Morocco*) and heighten debt sustainability concerns in those with large initial debt stocks (for example, *Bahrain* and *Oman*). Combined with the 2020 level shift in debt, debt does not stabilize under baseline projections for *Algeria, Bahrain, Kuwait,* and *Oman*. Large fiscal buffers for *Kuwait* and sizable central bank holdings of government debt in *Algeria* are mitigating factors to their debt sustainability concerns.

Within MENAP, median government debt is projected to rise above 70 percent of GDP over the medium term, reflecting high precrisis debt stock in oil importers and expected rapid debt accumulation in oil exporters, including *Algeria, Bahrain, Iraq,* and *Oman*.

Although sovereign spreads remain elevated in some countries (including *Bahrain, Georgia, Oman,* and most MENAP oil importers), overall borrowing costs, as measured by effective interest rates, are projected to decline over the medium term from their precrisis levels for MENAP oil exporters and CCA oil importers (Figure 3.9). This development is mainly due to the large

[9]Iran, Saudi Arabia, and Turkmenistan are the only exceptions.

monetary easing in advanced economies and the increased provision of official financing to many countries in the region.

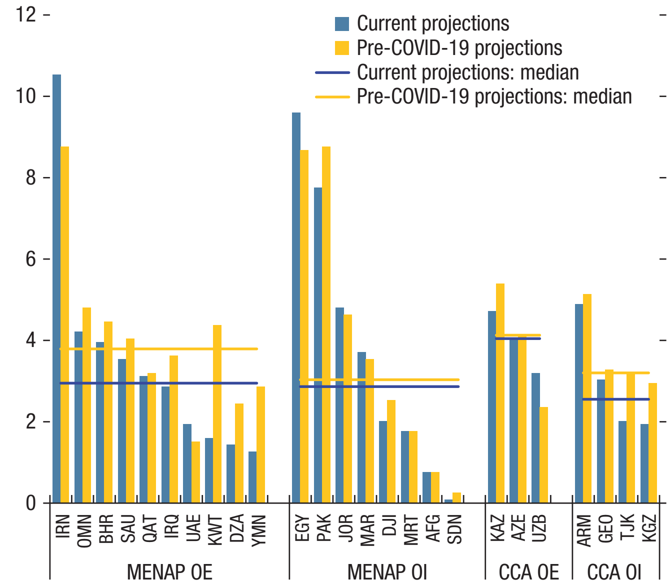
Despite the decline in expected borrowing costs, risks have risen, particularly those associated with increased reliance on domestic financing—including fiscal dominance and closer sovereign-bank linkages.

Moreover, international capital markets remain fickle. Although *Jordan* and several GCC countries have been able to tap international capital markets at reasonable rates since April, *Egypt* paid a higher premium when it issued bonds in May.[10]

The mix of higher debt, larger financing needs, and the challenges of implementing the projected ambitious fiscal adjustments is expected to erode fiscal space across the region. Figure 3.10 shows a range of fiscal sustainability indicators across countries, including ease of obtaining financing, strength of fiscal positions, size of financing needs, and realism of projected fiscal adjustments. These indicators, computed using data before and after the onset of the pandemic, are then used to assess each country's fiscal space (see Box 3.1 for the methodology).[11]

Several countries entered the pandemic with essentially no fiscal space assessed, such as *Egypt, Jordan, Lebanon, Pakistan, and Tunisia* among oil importers, and *Iran* and *Oman* among oil exporters.[12] The deterioration in access to market financing, along with the debt outlook and consolidation plans for *Lebanon* and *Oman,* underscore the unsustainability of debt for Lebanon and heightened fiscal risks for Oman.

Figure 3.9. Expected Effective Interest Rate: 2021–23
(Percent, simple average)



Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers. Effective interest rate is computed as the ratio of government interest expense and initial government debt stock. Pre-COVID-19 projections refer to October 2019 *World Economic Outlook* projections. Country abbreviations are International Organization for Standardization (ISO) country codes.

Other countries with fiscal space assessed as none or at risk because of the pandemic include *Iraq*, reflecting upward revisions in its medium-term debt outlook by about 20–30 percentage points of GDP, in turn raising debt sustainability concerns.

Countries with some fiscal space before the crisis, such as *Algeria* and *Morocco*, have eroded this space either because of more elevated debt levels (*Algeria, Morocco*) or higher medium-term adjustment needs (*Morocco*).

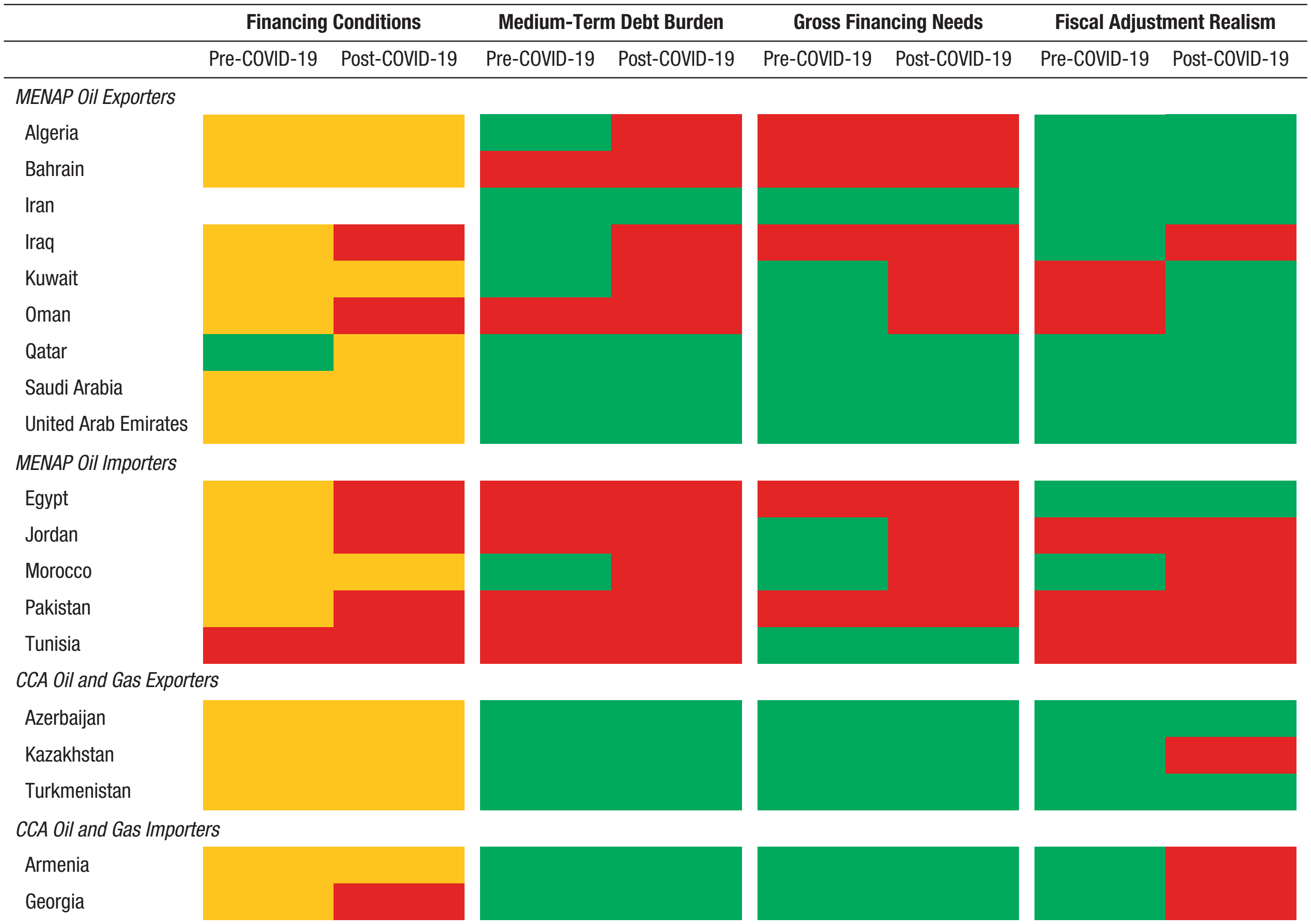
Generally, most countries in the region lack fiscal space to support the recovery. At the current juncture, the only countries with some or substantial fiscal space are *Armenia* and *Georgia* among oil importers, followed by *Azerbaijan, Kazakhstan, Kuwait, Qatar, Saudi Arabia,*

[10]In April, Qatar issued $10 billion, Abu Dhabi and Saudi Arabia both issued $7 billion, with spreads of 250–350 basis points (bps) above US treasuries. In May, Abu Dhabi issued another $3 billion with spreads at 135–180 bps, Egypt issued $5 billion with spreads above 550 bps. In June, Jordan issued $1.75 billion with spreads below 520 bps. Sharjah (United Arab Emirates) issued $1 billion in June followed by another $1 billion in July, with spreads below 300 bps for both.

[11]The analysis has benefited from comments and suggestions by staff from other IMF departments, including the interdepartmental working group on fiscal space, and builds on earlier work done by the Strategy, Policy, and Review Department on post-COVID-19 policy space. This interim update of fiscal space for countries with sustained market access will be reassessed in the context of debt sustainability analysis conducted under bilateral surveillance.

[12]Without recent reforms, which had significantly reduced debt (though still high) before the crisis, Egypt would have entered the crisis in a more vulnerable position.

Figure 3.10. Pre- and Post-COVID-19 Financing Conditions and Medium-Term Outlook



Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan. This figure reflects the second stage of IMF fiscal space assessment (Box 3.1.1). Green denotes low risk, orange denotes medium risk, and red denotes high risk (see Box 3.1 for detailed explanations).

Turkmenistan, and the *United Arab Emirates* among oil exporters.

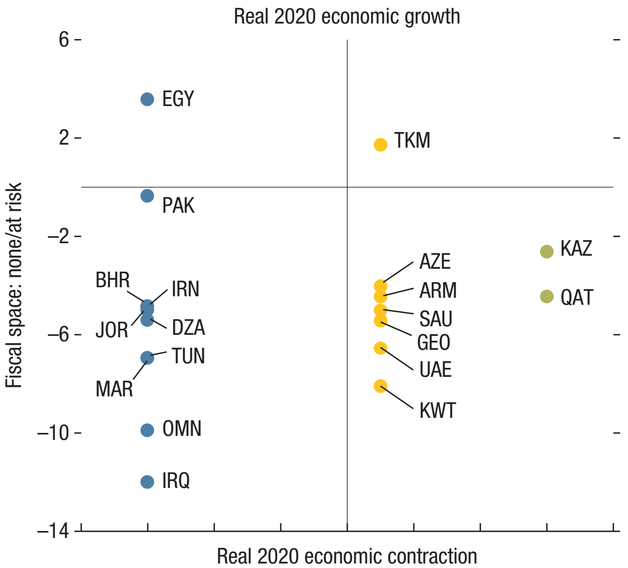
Most countries with no fiscal space are expected to see their real GDP contract by 5–13 percent this year (Figure 3.11), highlighting the debt sustainability constraints on supporting growth through additional fiscal stimulus.

Baseline Fiscal Adjustments Sensitive to Growth Assumptions

Mitigating debt sustainability concerns would require many countries in the region to embark on strong and front-loaded fiscal consolidations. Such consolidations would require an ambitious effort and a timely economic recovery, both of which could be muted or delayed if a second wave of COVID-19 occurs.

The median projected fiscal adjustment over the next three years (measured as the cumulative

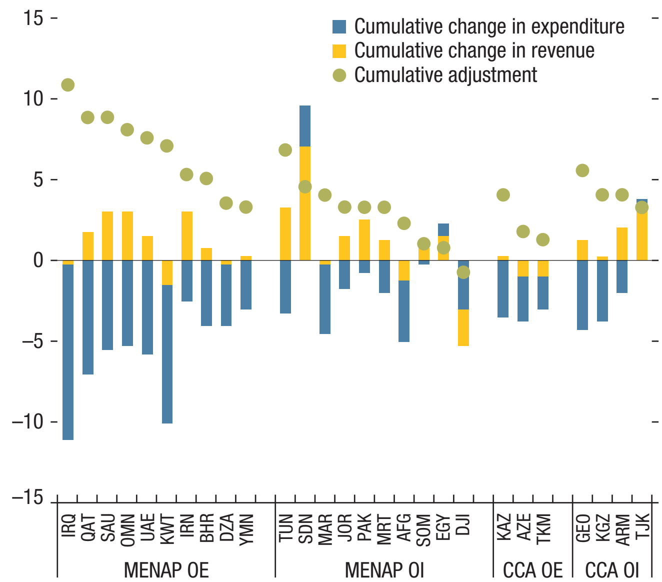
Figure 3.11. 2020 GDP Growth Projection and Fiscal Space Rating



Sources: National authorities; and IMF staff calculations.
Note: Fiscal space rating is based on the standard IMF methodology, combined with the interim update of the financing block up to late August 2020. Country abbreviations are International Organization for Standardization (ISO) country codes.

Figure 3.12. Decomposition of Cumulative Fiscal Adjustment, 2021–23

(Percent of GDP)



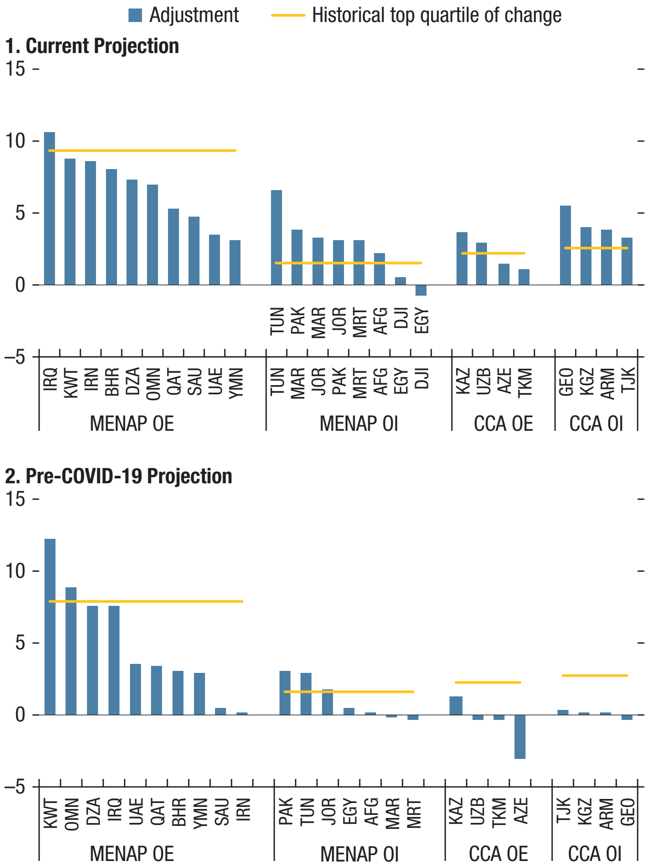
Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan; OE = oil exporters; OI = oil importers. Cumulative adjustments are computed as the sum of annual fiscal adjustment—measured as annual change in primary balance in percent of GDP for OIs and change in non-oil primary balance in percent of non-oil GDP for OEs. Non-oil revenue and non-interest expenditure, both in percent of non-oil GDP, are used for OEs. Total revenue and non-interest expenditure, both in percent of total GDP, are used for OIs. Country abbreviations are International Organization for Standardization (ISO) country codes.

change in primary balance for oil importers and the cumulative change in non-oil primary balance for oil exporters) is expected at 3.6 percent of GDP for MENAP oil importers (excluding *Sudan*) and 5.8 percent of non-oil GDP for MENAP oil exporters. For CCA oil importers and CCA oil exporters the median adjustment stands at 4.1 percent of GDP and 1.3 percent of non-oil GDP, respectively. These adjustments mostly reflect increases in projected revenue growth in oil importers, and declines in expenditure-to-GDP ratios in oil exporters (Figure 3.12)—the latter is driven by a projected strong recovery in non-oil GDP, which is subject to sizable uncertainties.

Looking at historical episodes of fiscal consolidations within each country group over the 2003–19 period, the projected three-year cumulative consolidations from 2021–23 appear optimistic for all oil importers and for Iraq (Figure 3.13), reflecting significant upward revisions compared with the pre-COVID-19 projections for oil importers.

However, the projected adjustment is not unprecedented. The assumed three-year adjustment for oil importers lies on the upper quartile of the distribution of past adjustments, implying that historically the expected consolidations are undertaken between 10 and 25 percent of the time. Among oil exporters, this appears to be the case for *Iraq* and *Kazakhstan*. These results should be interpreted with caution because the measure of fiscal adjustment does not account for the cyclical changes to the fiscal balance. Specifically, the sharp deteriorations in fiscal balances in 2020 tend to inflate the adjustments in the subsequent year. Moreover, the projected fiscal paths in part reflect improvements through automatic stabilizers because of the assumed strong rebound after the unprecedented

Figure 3.13. Projected Three-Year (2021–23) Cumulative Fiscal Adjustments and Historical Comparisons
(Percent of GDP)



Sources: National authorities; and IMF staff calculations.
Note: CCA = Caucasus and Central Asia; MENAP = Middle East, North Africa, Afghanistan, and Pakistan. Cumulative changes are computed as the sum of annual fiscal adjustment—measured as annual change in primary balance in percent of GDP for OIs and change in non-oil primary balance in percent of non-oil GDP for OEs. Due to data limitations, Uzbekistan is measured in percent of GDP. Pre-COVID-19 projections refer to October 2019 *World Economic Outlook* projections. Country abbreviations are International Organization for Standardization (ISO) country codes.

crisis. Finally, fiscal policies in oil exporters can be highly susceptible to volatile oil prices.

There are significant downside risks to the projected fiscal improvements, which remain vulnerable to a delayed or weaker-than-expected economic recovery. These risks raise the importance of measures to mitigate fiscal risks and additional growth-friendly and equitable policies to expand fiscal space through efficiency gains.

Mitigate Fiscal Risks and Improve Debt Management

Protecting public health and supporting the most vulnerable remain top policy priorities, but mitigating fiscal risks—particularly those stemming from the crisis—will help prevent a further deterioration of fiscal space in the region.

One way to manage fiscal risks during this crisis is to make transparent the extent and impact of COVID-19-related fiscal support by embedding it into a medium-term fiscal framework (MTFF). Anchoring the fiscal response to the crisis in an MTFF will help improve public financial management by accounting for the full cost of such support, including potential contingent liabilities. To enhance the monitoring and disclosure of contingent liabilities, governments could add fiscal risk statements into their budgets (as in *Georgia,* for example), including a stocktaking of new contingent liabilities stemming from the COVID-19 response, particularly on measures such as government loans or guarantees.

MTFFs can also help enhance the credibility of fiscal adjustment programs by including clear plans on how crisis support could be gradually unwound. Targeted support, however, should not be withdrawn prematurely because the costs of early withdrawal could outweigh those of continued support.

With an uncertain economic outlook and fickle capital markets, debt management offices will have a crucial role to play in ensuring that large financing needs are met at reasonable costs. In this regard, strengthening communication with external stakeholders and increasing outreach can help gauge changes in market sentiment and demand, and identify the best timing for issuances, while revising debt management strategies (for example, as in *Egypt*) can help prepare borrowing plans for sudden changes in market conditions.

The potential gains from these fiscal risk mitigating measures—through developing and improving MTFFs and strengthening debt management—can be particularly large in the region given its relatively weak fiscal institutions (October 2019 *Regional Economic Outlook: Middle East and Central Asia*).

Expand Fiscal Space and Spur Inclusive Recovery

The epidemiological consequences of the virus and their impact on the economic outlook will remain uncertain until a viable vaccine exists. In this context, fiscal support for vulnerable households and viable companies in sectors facing economic scarring will continue to be needed (Chapter 2). Therefore, all countries—especially those with limited policy space—should seek to expand their fiscal space.

To preserve fiscal revenues, plans should be in place to restore taxpayer compliance. Compliance likely has deteriorated because of extended deadlines, limited availability of staff, and taxpayers' weakened financial positions. In addition, revenue administrations may face a surge in workload from taxpayer requests for assistance and support. This may cause a substantial risk to the revenue stream if not managed adequately. Starting preparations now will allow operations to be scaled up gradually in a timely fashion.

A combination of growth-friendly expenditure and revenue measures, focusing on equity and efficiency gains, will be needed to expand fiscal space over the medium term. On the revenue side, strengthening the progressivity of the tax system, in addition to curbing broad-based tax and fee exemptions that disproportionately benefit those with the capacity to pay, could both expand tax bases and improve equity. If a longer provision of targeted support is needed, temporary social solidarity taxes could also be considered to partly offset the cost.

On the expenditure side, governments across the region should continue improving spending efficiency—including gradually lifting fuel subsidies, rationalizing public wage bills and, to the extent possible, further reorienting spending within existing budgets and reducing nonpriority spending—to provide space for priority spending, such as on social protection, education, and health. The exact mix of measures will involve trade-offs and should depend on country-specific circumstances.

These efforts could be supported by the adoption of fiscal rules and continued reforms to curb corruption and improve governance in the region.

Fiscal rules, an essential building block of MTFFs, could help rebuild fiscal buffers by reducing fiscal procyclicality. Only one-third of the countries in the region have enacted fiscal rules. At the same time, the region's fiscal policies have been found to be the most procyclical among emerging market and developing countries (Bova, Carcenac, and Guerguil 2014). Fiscal procyclicality is particularly severe among oil exporters, where government expenditure is usually linked closely to oil prices. Having well-designed fiscal rules that decouple expenditure from revenue (and for oil exporters, from oil prices) amid strengthened public financial management practices, including stronger budgeting processes, could credibly allow countries to rebuild buffers in the aftermath of the crisis, boosting their capacity for countercyclical policy during future economic downturns (Eyraud and others 2018).

More broadly, by improving governance in the public sector—an area where the region lags the average for emerging market and developing economies—and curbing corruption, governments could achieve the dual objectives of mitigating risks and expanding fiscal space. Fiscal risks could be mitigated by increasing transparency, revenues would be boosted from reducing tax evasion and avoidance, and government projects could become more cost-effective through better controls on waste (April 2019 *Fiscal Monitor*).

A protracted recession in the region (for example, because of a second wave of the virus) may require additional external support—including concessional loans and debt relief—for some countries, particularly among oil importers. Moreover, some governments, particularly those with already-elevated debt and no fiscal space, might face the need for debt operations as a last resort to create fiscal space without further deepening the recession. In this context, involving the private sector in the restructuring of government debt will be critical.

Because poverty and inequality are expected to rise across the region after this crisis (Chapter 2), ensuring an inclusive recovery should be a medium-term policy priority. In countries with available fiscal space and major economic scarring, a temporary stimulus can be considered to bolster growth once the health crisis recedes. In those where policy space is limited, the focus should be on protecting the vulnerable and improving efficiency (October 2020 *Fiscal Monitor*).

In addition to continuing targeted support as needed, fiscal measures could include spending aimed at providing universal access to healthcare and education. With unemployment likely rising, governments should also facilitate labor reallocation from less productive sectors to more productive ones through job retraining.

Governments could strengthen the efficiency and effectiveness of their social safety nets, by better targeting the most vulnerable and by advancing digitalization, including for the delivery of government services and transfers. For example, automatic transfers on digital platforms should be prioritized where bank and phone coverage are broad enough, with the latter also useful to scale up the coverage of existing official registries (as in *Azerbaijan, Jordan, Morocco*, and *Pakistan*). The experience with digital delivery during the crisis could be further expanded to reach informal workers, who so far have remained outside the reach of social safety nets in the region (as in *Morocco*; see Box 3.2).

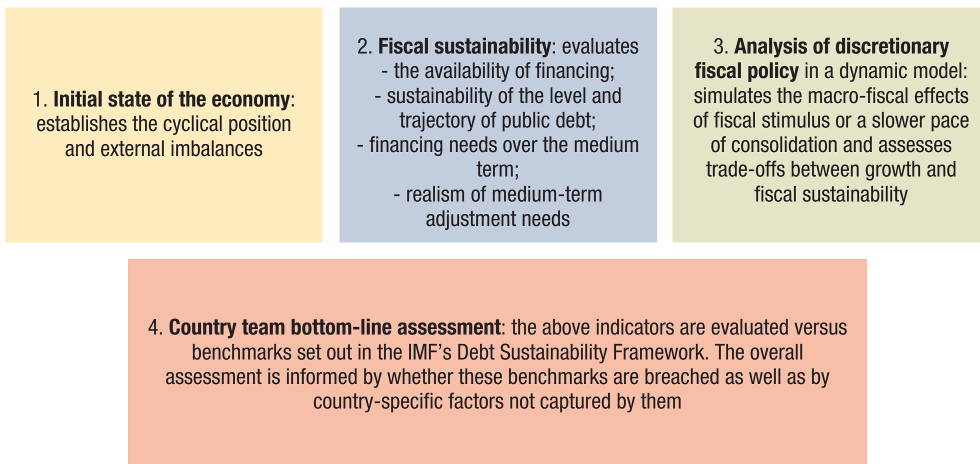
Some of these measures—for example, reorienting expenditure within current budgets and embedding COVID-19 support in a preexisting MTFF—can be implemented quickly. However, others, particularly those that will require pushing through reforms to tax and subsidy systems and budget rules, would take longer to carry out. For those medium- to long-term measures, authorities should act now to build up domestic support for necessary reforms by making a case for why they are important and communicating their potential benefits to domestic constituents.

Policymakers should also prepare a clear and feasible road map to guide actions and ensure that progress can be achieved over time. In countries that lack existing fiscal frameworks—for example, those that have not yet established an MTFF or a debt management office—seeking external expertise might be necessary. In this regard, the IMF can provide technical support, including through remote capacity development courses.

Box 3.1. Fiscal Space Assessment

The fiscal space assessment framework was first developed by the IMF in 2016 and later updated in 2018. Fiscal space is defined as the room for undertaking discretionary fiscal policy without endangering market access and debt sustainability. Discretionary fiscal policy can take the form of fiscal stimulus or a slower pace of consolidation versus existing plans. It allows for a systematic approach to assessing fiscal space over a three- to four-year horizon using a qualitative framework that facilitates consistency and comparability across countries. References to the fiscal space assessment in this chapter refer to the interim update of the second stage below (fiscal sustainablility).

Figure 3.1.1. Assessing Fiscal Space: A Four-Stage Framework



Source: IMF (2016, 2018).

Benchmarks used for the heatmap in Figure 3.10, which are indicative and correspond to those used in the Debt Sustainability Framework for Market Access Countries, include the following:

External financing conditions:

- Sovereign spreads: Below 200 (400) basis points (bps) for low risk (green); between 200 and 600 (400 and 600) bps for medium risk (orange); and above 600 (600) bps for high risk (red) for emerging markets (advanced economies). The values correspond to the latest three-month average spread and the average spread over the past five years.
- Share of public debt in foreign currency: For emerging markets only; below 20 bps for low risk (green); between 20 and 60 bps for medium risk (orange); and above 60 bps for high risk (red).
- External financing requirements as a share of GDP: Below 5 (17) bps for low risk (green); between 5 and 15 (17 and 25) bps for medium risk (orange); and above 15 (25) bps for high risk (red) for emerging markets (advanced economies).

Debt burden indicators:

- Does the debt level breach the benchmark during the projection period? No/green (yes/red) if below (above) 70 for emerging markets and 85 for advanced economies.

Box 3.1 *(continued)*

- Public gross financing needs over the projection period: Green (red) if below (above) 15 percent of GDP for emerging markets and 20 percent of GDP for advanced economies.

Realism of fiscal adjustment needs:

- Because of data limitation on cyclically adjusted balances, three-year adjustment in primary balance as a share of GDP is used, and the historic (2003–19) upper quartile is applied as the threshold for green and red.

Box 3.2. Recent Innovative Digital Solutions to Expand Social Protection

A major challenge in the implementation of coronavirus-related support for emerging market and developing economies has been reaching informal workers. In this regard, several innovative digital solutions have been introduced recently to tackle this challenge, thereby expanding the coverage and better targeting social safety nets.

Morocco is a sucess story. The government has been able to reach informal workers through a combination of mobile payments for those who qualify for noncontributory health insurance benefits (the RAMED medical insurance program) and online cash claims for those who do not qualify.[1] Households benefiting from RAMED received a mobile payment of 800–1,200 dirhams (US$80–$120), depending on household composition. As of April this year, the program had reached 85 percent of eligible households in the informal sector.

In Pakistan, the authorities are developing digital infrastructure to better identify households for targeted support. The National Socio-Economic Registry is underway to collect household data on socioeconomic conditions at the grassroots level. Once completed, new data about people's socioeconomic conditions will be used in the provision of all benefits.[2] In addition, the one-window registry Ehsaas-Emergency Cash Program for social protection and livelihoods has been developed to assist beneficiaries and reduce duplication and abuse.

Outside the region, Togo is another bright spot. A new mobile cash-transfer program, NOVISSI, aimed at supporting informal workers, was launched in April. Eligible applicants receive a state grant of at least 30 percent of the minimum wage, with payouts from 10,500 CFA francs (US$18) to 20,000 CFA francs (US$34). Based on the program data, 65 percent of the beneficiaries are women. In total, 1.4 million individuals have registered, and nearly 600,000 have received a NOVISSI payment.

When reaching out to the informal sector, government support could be designed to incentivize formalization, which will provide a boost to the tax base once recovery takes hold. The potential gain can be particularly large in Caucasus and Central Asia (CCA) countries, where the informal economy represents more than 40 percent of GDP on average. For example, in Armenia, the amount of government support channeled to small businesses during the pandemic would be higher if they adopted cash registers that help record transactions for tax administration purposes.

In addition to expanding targeted coverage, moving to digital solutions helps minimize the need for human interaction during a pandemic. In Eswatini during the crisis, for example, the government migrated monthly payments to citizens older than 60 from cash distribution through post offices to electronic funds transfers.

The benefits of digital solutions are not limited to fiscal responses, because they can also help implement donor support. For example, in The Gambia, many donors are expanding their social assistance support through cash transfers using mobile money and direct payments targeted to poor households, new mothers, and farmers by using existing databases of past recipients, village lists, and voter rolls.

[1]Direct cash transfers have also been extended to informal workers in Jordan and Tunisia.
[2]The National Socio-Economic Registry database completion is expected by June 2021.

References

Bova, Elva, Nathalie Carcenac, and Martine Guerguil. 2014. "Fiscal Rules and the Procyclicality of Fiscal Policy in the Developing World." IMF Working Paper 14/122, International Monetary Fund, Washington, DC.

Eyraud, Luc, Xavier Debrun, Andrew Hodge, Victor Lledó, and Catherine Pattillo. 2018. "Second-Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability." IMF Staff Discussion Note 18/04, International Monetary Fund, Washington, DC.

International Monetary Fund (IMF). 2016. "Assessing Fiscal Space—An Initial Consistent Set of Considerations." IMF Staff Paper, Washington, DC.

International Monetary Fund (IMF). 2018. "Assessing Fiscal Space: An Update and Stocktaking." IMF Policy Paper, Washington, DC.