

Part 2. Fiscal Policy for an Inclusive Recovery

Part 1 of this report presented both new and updated evidence on the barriers to global progress on poverty and inequality in all of their dimensions. The impact of the COVID-19 pandemic on poverty was deep and widespread, and it will have long-run effects on the ability of children to live lives free of poverty and vulnerability. The Russian invasion of Ukraine is yet another shock for households that have not fully recovered lost income from the pandemic and were already facing the long-term challenges of the climate crisis. These compounding crises have the potential to alter the long-term development trajectory in many countries. Meanwhile, the ongoing trade disruptions, worsening macroeconomic imbalances, and record high debt are rendering efforts to return to reducing poverty even more challenging. Rising interest rates and a medium-term outlook of poor growth and high inflation are also constraining the policy options in low- and middle-income countries.

Policy plays a key role in altering welfare trajectories in times of crisis and recovery. During the COVID-19 crisis, various public health policies, such as stay-at-home directives, as well as new and existing monetary, financial, and fiscal policies, affected the dynamics of disease transmission and altered growth, poverty, and learning outcomes. The use of policy to affect critical outcomes in times of crisis is again on view during the unfolding food and energy price crisis. Governments are engaging in large food purchases and implementing export restrictions (USDA 2022) to try to manage food price impacts, and they are offering subsidies (or energy tax reductions) to deal with rising food prices. Food export bans risk exacerbating food price volatility, as in the 2006–08 food price crisis (Martin and Anderson 2011). Monetary, trade, and fiscal policies (such as lower food tariffs or cash transfers) tailored to specific country conditions could mitigate the impact, but some policies will be more effective than others (Benson et al. 2013).

Part 2 of this report focuses on fiscal policy—the decisions governments make on revenue raising and spending—and how it affects poverty and inequality. Indeed, many of the policy choices made during crisis and noncrisis times affect growth and welfare outcomes, and these choices span a range of monetary, financial, regulatory, and trade dimensions.

Although the second part of the report concentrates on the role of fiscal policy, it starts from the recognition that the same policy can have very different effects in different countries. Higher-income economies are more resilient in the face of shocks because their households and firms are better endowed with wealth, health, and education and thus are able to adapt to changing circumstances (World Bank 2013). By contrast, governments in low- and middle-income countries face policy options with more limited effectiveness during a crisis because of the structure of their economies (Loayza 2020). A stay-at-home order does little if people are too poor to stay at home. Financial sector policy is less effective when it cannot reach a large informal sector. Fiscal policy cannot achieve much if fiscal options are restricted. And the structure of an economy can limit the reach of standard fiscal policy instruments. Finally, various features of an economy can amplify the impact of any shock or limit the impact of policies to address the crisis.

Why focus on fiscal policy?

This report concentrates on fiscal policy for three reasons. First, fiscal policies have wide-ranging impacts on poverty and inequality. They affect growth, employment, and wages, as well as the services available, the prices people pay, and the income people have left after taxes are paid and transfers are received. Governments use fiscal policy to pursue a variety of policy goals, including promoting economic growth and providing access to basic services. Public investment in infrastructure, basic services, and research and development (R&D) is a key driver of inclusive growth. Fiscal policy is also one of the main vehicles for implementing the prevailing social contract and so has the potential to significantly influence the current and future distribution of income and opportunity. Furthermore, fiscal policy is a critical tool when it comes to fighting economic crises, protecting households and firms from the worst impacts of downturns, and reigniting growth.

Second, in many countries fiscal policy is currently under considerable pressure. The fiscal policy choices that governments make in these moments of crisis can act as a lifeline for poor and vulnerable households, or they can further impoverish the poor and increase inequality. Even as governments decide which fiscal policies are the most suitable for achieving an inclusive recovery and long-run growth, they must deal with rising fiscal deficits and debt burdens (a problem before the pandemic and one exacerbated by it), with little space for fiscal policy to support the recovery and prepare for ongoing and future crises. Low- and middle-income countries are significantly more in debt today than two years ago. In fact, in 2020 more emerging economies experienced country credit rating downgrades than over the entire 2010–19 period. Countries have simultaneously faced lower revenue stemming from the crisis and the need to pursue expansionary fiscal policy to mitigate the worst impacts of the downturn. As a result, many countries now need to raise revenue, reduce spending, or both to escape debt distress. Historically, fiscal policy decisions in moments of tight fiscal space and debt crises have often hurt the poor, both in the immediate term and in later years, limiting their opportunities. It is essential to navigate the current challenge in ways that do not further impoverish the poor today or reduce the opportunities they might enjoy tomorrow.

Third, new analysis in three areas provides important insights into the poverty and inequality impacts of good fiscal policy making in crisis and noncrisis times. Chapter 4 analyzes the welfare impact of the COVID-19 fiscal response. Chapter 5 presents a harmonized analysis of how taxes, transfers, and subsidies have affected poverty and inequality in 94 countries. And chapter 6 looks at the emerging insights from a new approach to valuing the impact of fiscal policies on welfare. The final chapter discusses the policy implications that emerge from these areas and examines the degree to which better fiscal policy can put poverty and inequality reduction back on track in the coming years.¹

Fiscal policy is only part of the policy solution to addressing poverty and inequality. In fact, many other policy choices, such as labor market regulations, affect personal incomes and have a large impact on welfare. There is also a strong relationship between fiscal policy and instruments such as monetary policy. In the context of rising inflation across the world, governments may want to expand fiscal spending to support households. However, expansive fiscal policy may work at cross-purposes with monetary policy oriented to tame inflation. If inflation continues to rise and recovery continues to stall, this tension will increase.

What is in part 2?

Chapter 4 examines how fiscal policy was used during the pandemic and how it has been used to manage the 2022 food price crisis. The fiscal response to the pandemic matched its historic impact on poverty and inequality and protected many households from poverty. Countries in all income categories have used fiscal policy to effectively mitigate the impacts of the crisis.

Microsimulations in low- and middle-income countries suggest poverty would have been, on average, 2.4 percentage points higher without a fiscal response. Impact evaluations have consistently shown that, when received, transfers are highly effective in allaying food insecurity, increasing employment, and reducing poverty. However, the scale of the fiscal response was limited and less protective in low- and middle-income countries than in high-income countries. Microsimulations also suggest that nearly all losses were mitigated in high-income countries through fiscal policy, that about half of losses were reduced in upper-middle-income countries, and that just over a quarter of losses were mitigated in lower-middle-income and lower-income countries.

The chapter provides a first look at lessons learned from this global experience. It highlights not only the impressive achievements on the scale, speed, and targeting of the response but also what underpinned the vastly different abilities of fiscal policy to protect welfare in richer and poorer countries: access to finance, the structure of economies, and the existing reach of the tax and benefit system. These findings give insights into how to strengthen the protective role of fiscal policy during the continuing food price crisis and in an increasingly risky world (taken up in chapter 7).

Chapter 5 looks at the fiscal systems countries had going into the pandemic. It brings together fiscal incidence analysis for 94 countries to document where the tax burden falls across the income distribution and who benefits from spending on transfers and subsidies. This information highlights who will benefit and lose from the policy options governments currently face on how to raise taxes, reduce exemptions, and reorient spending to address fiscal constraints and provide continued support to poor and vulnerable households.

In bringing this work together, the chapter documents how taxes and transfers have an immediate impact on inequality and poverty across countries. All countries reduce inequality through taxation, subsidies, and transfers, but in each income category there are countries that successfully reduce poverty through these measures, whereas many other countries see poverty increase. The chapter considers how taxes and benefits contribute to this pattern and points to the types of policies that can raise revenue and reverse this trend to ensure that poor households are not out of pocket in a pandemic recovery.

Fiscal policy for poverty reduction requires not only considering who benefits from a given policy but also assessing the impact of a fiscal policy on growth. Historically, growth in the labor incomes of poor households has driven poverty reduction (Azevedo et al. 2013), and it is the low growth rates of recent years that make returning to a path of poverty reduction so challenging. Prioritizing fiscal policies that bring growth and revenue-raising strategies that have as little negative impact on growth as possible is essential.

One way of measuring the impact of fiscal policy on growth is by valuing a fiscal policy in terms of the long-run growth it brings intended beneficiaries and any growth impacts it has on nonbeneficiaries. Chapter 6 looks at how to assess the value of fiscal policies. It considers what a measure of value should include and provides examples of how fiscal policy has been valued in the recent literature.

The chapter highlights that some of the highest-value fiscal decisions made by governments support the long-run income growth of households. Examples include investments in health and the education of children, roads, electricity, and R&D, especially investments that the private sector cannot or would not make—that is, investments that address market failure or provide public goods. For example, spending that invests early in a child's life can be transformative and set the stage for a lifetime of higher earnings. When these policies benefit households at the bottom of the income distribution, the impact on poverty and inequality can be very large. However, beneficial policies can be hard to prioritize precisely because their benefits accrue over the long term and are not realized today. For politicians, this time frame does not align with political realities that require immediate results, and long-run benefits may also be less valuable to some households that find it difficult to look beyond the present. The chapter points to what

can help governments prioritize the long run in decision-making, noting the key role of improving governance and access to low-interest finance. The chapter concludes with a look at how to increase the efficiency of spending, which is particularly important in times of tightening fiscal budgets.

Chapter 7 concludes the report by taking a broad look at the policy options available to strengthen the ability of fiscal policy to support and protect poverty reduction and inequality, especially those options likely to be the most beneficial in the current climate of constrained fiscal space and continuing crises. It includes some back-of-the-envelope calculations to show how choosing good policies can help countries recover some of the losses of the past two years and get back on track in reducing poverty and inequality. Technical feasibility is a key lens through which policies are discussed in the report. However, the true feasibility of sustained and effective reform relies on ensuring political support. Although this report does not focus on what makes a reform politically feasible (something that has to be determined on a country-by-country basis), it highlights some of the key dimensions of political economy constraints in making these changes, and the analysis and tools discussed allow one to clearly identify the winners and losers from any reform. Chapter 7 ends by considering the degree to which better fiscal policy making can get countries back on track to reduce poverty and inequality. The need for global action is underscored.

Note

1. The focus is on above-the-line fiscal measures, which affect revenue and spending today rather than the acquisition of assets or promises to pay in the future. A recent International Monetary Fund publication discusses the distinction between above-the-line and below-the-line measures: “‘Above-the-line’ measures involve revenue raising and government expenditure, which affects the overall fiscal balance and government debt. . . . ‘Below-the-line’ measures generally involve the creation of assets or liabilities without affecting fiscal revenues and spending today. Examples include government provision of loans or equity injection in firms” (IMF 2020, 77). Below-the-line measures are discussed in *World Development Report 2022: Finance for an Equitable Recovery* (World Bank 2022).

References

- Azevedo, Joao Pedro, Gabriela Inchauste, Jaime Saavedra, and Hernan Winkler. 2013. “Is Labor Income Responsible for Poverty Reduction? A Decomposition Approach.” Policy Research Working Paper 6414, World Bank, Washington, DC.
- Benson, Todd, Nicholas Minot, John Pender, Miguel Robles, and Joachim von Braun. 2013. “Information to Guide Policy Responses to Higher Global Food Prices: The Data and Analyses Required.” *Food Policy* 38: 47–58.
- IMF (International Monetary Fund). 2020. *Fiscal Monitor*. April, IMF, Washington, DC.
- Loayza, Norman V. 2020. “Costs and Trade-Offs in the Fight against the COVID-19 Pandemic: A Developing Country Perspective.” Research and Policy Briefs 35, World Bank, Washington, DC.
- Martin, Will, and Kym Anderson. 2011. “Export Restrictions and Price Insulation during Commodity Price Booms.” Policy Research Working Paper 5645, World Bank, Washington, DC.
- USDA (United States Department of Agriculture). 2022. “The Ukraine Conflict and Other Factors Contributing to High Commodity Prices and Food Insecurity.” USDA, Washington, DC. <https://www.fas.usda.gov/data/ukraine-conflict-and-other-factors-contributing-high-commodity-prices-and-food-insecurity>.
- World Bank. 2013. *World Development Report 2014: Risk and Opportunity—Managing Risk for Development*. Washington, DC: World Bank.
- World Bank. 2022. *World Development Report 2022: Finance for an Equitable Recovery*. Washington, DC: World Bank.