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Authors
Clausing, Kimberly
Bhorat, H.
Boushey, Heather
et al.

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# 1 Rethinking fiscal and monetary policy for the new economy





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The pandemic-induced lockdowns and the global recession of 2020 that followed have created a highly uncertain global outlook. Globalization is stalling, social cohesion is being eroded by unrest and political polarization, and the still-unfolding economic crisis is threatening the livelihoods of those at the lower end of the income spectrum. As existing temporary support measures begin to expire in several countries, it will be of paramount importance to put in place the structural reforms that will help to build back not only better but also broader.

Economies were already facing several major global challenges before the pandemic: global inequalities (within and across countries), deflationary pressures, as well as climate change and environmental degradation. There is nothing inevitable about these developments: they are the by-product of decades of focus on maximization of profit and the pursuit of economic growth without a commensurate focus on equity, inclusion and the environment.

The depth of the economic shock triggered by the pandemic has exacerbated the need for effective, proportionate and timely fiscal and monetary support to pave the way towards more inclusive and greener socioeconomic systems while ensuring fiscal sustainability. The current conditions have prompted policy innovations and experiments around the world. Now is the time to prepare for the next phase of the post-pandemic world. Policy-makers are challenged to recalibrate their priorities and restructure the ways in which they support the economy, creating the right environment to shape fairer, more inclusive and sustainable economies and societies.

This brief represents the latest thinking on pathways to achieve those goals, based on consultations with leaders from government, business, academia and civil society in the World Economic Forum's Global Future Council on the New Agenda for Fiscal and Monetary Policy.

## 1.1 Laying the foundations of a new inclusive economy

### 1.1.1 Reinforce the use of automatic stabilizers and safety nets

Rising inequality was already a major social and economic challenge before the pandemic. One of the defining features of the transformation that economies are experiencing is its asymmetric nature, disproportionately affecting already disadvantaged populations. Some of the countries hardest hit by the pandemic were already facing the greatest inequalities. People in lower-income work and in precarious jobs have borne the brunt of pandemic-related slowdowns, and racial, gender and intergenerational inequalities have been exacerbated in many countries. Most households with limited resources are not equipped to respond to economic shocks, thus amplifying the adverse effects of the crisis.

Providing adequate support to vulnerable households and workers to absorb shocks will be an essential step towards creating an economy that is more inclusive and will help to restore demand. Unemployment insurance can play a crucial role in facilitating a more efficient job search and smoothing consumption declines during unemployment spells. It may not be a viable solution in countries with large informal sectors, however, so lessons need to be learned from the experience of rapid deployment of cash support, thus creating an institutional design that would be able to deploy an income support programme quickly and safely in the face of systemic shocks. Non-contributory social safety nets such as cash transfers can provide income support for the most vulnerable and the unemployed who do not have access to unemployment benefits.

From a macro perspective, social insurance and automatic stabilizers that affect inequality can have a substantial effect on aggregate consumption volatility. The automaticity of benefits partly determines how swiftly they can be deployed without discretionary government action to respond to shocks and stabilize the economy.[1]

Countries around the world have adopted a range of measures to support the economy, and to top up existing social protection measures, extend benefits and increase their reach to broader swathes of the population than ever before. But the approaches have been necessarily ad hoc, and attention now needs to be directed to what to keep and how to change. In many countries, low coverage of existing social insurance systems has prevented the provision of lifelines to households in a timely manner. Targeted cash transfer programmes tend to have the largest effect of all social assistance programmes in reducing poverty and can improve human capital accumulation and help households to smooth income shocks, reducing future inequality.[2]

Enhancing the responsiveness and timeliness of a fiscal response through automatic stabilizers, at the same time as ensuring that support programmes are tailored to target the companies and households most in need, will be crucial to bolster the recovery and build resilience against future shocks.



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### 1.1.2 Invest in inclusive growth multipliers within and across countries

Social safety nets and automatic stabilizers have a crucial role to play in buffering the initial impact of shocks but will have to be complemented with more far-reaching structural reforms that improve equality of opportunity. Importantly, such reforms will need to include widening participation in labour markets on fairer terms and access to education and training for the skills emerging as core in the new economy; subsequent chapters of this paper propose a concrete set of avenues on these two dimensions.[3] Enhancing universal healthcare coverage and broadening technology access are equally important in this respect. While relief efforts were critical in the initial stages of the pandemic and may need to be continued for some time, it will be important for governments to guard sufficient fiscal space for these deeper types of transformation.

Significant additional and longer-term financial support will be needed for low- and middle-income countries to overcome the economic and social effects of the pandemic. Beyond the immediate impact on GDP, the pandemic has had dire consequences for labour market participation and educational achievement across economies. A recent analysis performed in Latin American countries suggests the likelihood of today's students completing secondary education in the region may drop from 61% to 46%, a low level of educational attainment not seen since the 1960s.[4] Setting a new education and skills agenda will be critical to improving people's livelihoods in addition to overall economic development.[5]

Many developing economies were already facing financing constraints and elevated debt levels before the pandemic. Having had to prioritize their spending on the immediate health crisis, governments were left with limited resources for adequate direct transfers to the most vulnerable households and support to the most affected industries. Even fewer resources are now available for investing in the new markets that will serve as their future sources of growth. The potential tightening of financial conditions and the uncertain nature of the recovery puts these economies at risk of worsening debt overhangs, increasing debt servicing costs and deterioration of their credit ratings. Emerging and developing economies will need continued support through international grants and concessional financing, as well as the creation of an enhanced multilateral framework for potential sovereign debt restructuring for the most vulnerable economies.

It is not only possible to make economies and societies more equitable and resilient without compromising on economic performance, but the future of growth is dependent on adequate investments in human capital and broadening market access. Improving digital access, enhancing high-quality education and building lifelong learning markets will be three fundamental investments to reverse the damage induced by the pandemic and to lay the foundations of a new economy in advanced and developing countries.[6]

### 1.1.3 Embed environmental sustainability in fiscal and monetary support

Despite a temporary reduction in global carbon emissions by 4% to 7% in 2020 compared to 2019,[7] resulting from lockdown measures and reduced international travel and trade, much remains to be done to reverse the global trend. According to recent IMF estimates, even in the scenario of a prolonged recession resulting from the pandemic, greenhouse gas (GHG) emissions are still projected to rise by about 20% by 2030.[8] When looking at existing fiscal support packages[9] announced globally since the beginning of the pandemic, only a limited share of these measures was allocated to climate-positive measures. The "net climate impact" of these measures remains negative in both advanced and developing economies.[10]

Stimulus programmes should not only encourage green growth but also reduce long-term support to carbon-intensive industries by promoting green growth and accelerating the decarbonization process through market-based incentives. However, the long-term use of monetary policies labelled as unconventional before the pandemic could also be used to accelerate the transition of our economies towards more sustainable growth. Despite significant efforts made in a number of economies, the net contribution to environmental sustainability of existing fiscal support measures remains negative in an overwhelming majority of countries, often due to the support for carbon-heavy industries during the lockdown phase of the pandemic.

Greening the recovery must become a central dimension of both fiscal and monetary policy if operational targets on climate change are to be reached by 2030. Measures such as tax incentives and investments in low-carbon infrastructure, for instance, building and energy efficiency but also support for green R&D, should be encouraged to promote innovation and investment in climate-smart technologies.[11] Furthermore, supporting the growth of



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the green economy can act as a catalyst to support job creation, as these industries are typically more labour-intensive than fossil fuel energy, transportation or heavy manufacturing.[12] Several economies have already implemented or are scheduled to implement carbon pricing initiatives; however, according to the latest estimates, these initiatives would represent only 22.3% of global GHGs.[13] It will be crucial to create new multilateral frameworks that support the adoption of proactive tools such as notional emissions trading systems (ETS) and carbon taxes to accelerate the adoption of low-carbon initiatives, raise funds and provide the right incentives for green growth.

Businesses, workers and households will need to be supported through this transition to a low-carbon future by ensuring just transition mechanisms are put in place. These measures should be crafted through social dialogue and consultation with all relevant stakeholders. The current change in fiscal and monetary policy must be perceived as an opportunity to embrace and accelerate the pace of transition towards a more environmentally sustainable economic future.

## 1.2 Creating progressive, efficient and fairer taxation mechanisms

### 1.2.1 Expand the tax base and shift the tax burden

Progressive taxation will be an essential mechanism to compensate for the uneven recovery already under way, but also to provide higher revenue mobilization (especially in countries with lower tax capacity) and contribute to financing social spending and structural reform.[14]

There is a need to redesign tax systems to achieve more efficient taxation of capital and multinationals while also improving global transparency. Designing more progressive taxation mechanisms that shift the tax burden from the bottom to the top will also be crucial in the foreseeable future.

A number of policies could be considered to improve progressivity. These include increasing top marginal income tax rates that have seen a decline in recent decades,[15] and reforming tax deductions that predominantly benefit higher incomes (e.g. mortgage interest deductions). Increasing progressivity at the top of the income distribution could entail raising tax rates on higher income and addressing loopholes in the taxation of capital income (such as interest, dividends and capital gains). Increasing reliance on inheritance/gift taxes and property taxation could also be considered. Both the International Monetary Fund (IMF) and the United Nations (UN) Secretary-General have recommended a focus on a "solidarity tax",[16] in which revenue-raising is targeted on elements such as wealth taxes on the most affluent and excess profits taxes on those that have prospered during the pandemic. Where low- and middle-income economies are also considering the introduction of value-added taxes (VAT) to raise revenues from domestic consumption, it is important to recognize the likely distributional consequences and to ensure that progressive VAT systems are implemented. Despite the critical importance of broadening the national tax base, economies must also ensure that public services are effective enough to counterbalance the potential regressive distributional impact.[17] Where public spending may be too limited to have an impact, any introduction or expansion of VAT should be treated with caution.

Furthermore, accelerating digital transformation creates opportunities for revenue mobilization as well as challenges; multinationals with limited or no physical presence in the markets in which they operate, as well as automation and rising capital income share, affect income distribution. It has also become increasingly evident that the digital economy will require more agile taxation tools. However, the consequences of implementing a "digital only" tax have to be carefully assessed. Looking more closely at existing proposals, the implementation of such taxes can be complex if the delimiting criterion is for a company to derive profits from sales on digital platforms. Furthermore, policy-makers should be wary of using taxation to solve a market concentration issue, and it may be detrimental to solving profit-shifting initiatives in other industries.



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## 1.2.2 Transform the global corporate tax architecture

Taxation systems must be redesigned efficiently to tax capital and multinationals. In an era of rising inequality and pandemic-induced disruption, there is increased need to reform international taxation by adopting new tax regimes that involve taxing excess profits of multinationals at higher rates. Taxing such profits at excess rates could help mitigate some of the spending demands currently placed on governments, and also contribute to restoring a fairer and more progressive global tax system.

There is increased potential for an international agreement on a globally enforced minimum tax rate. According to the latest estimates from Tax Justice Network, an estimated $427 billion in tax is lost every year to international corporate tax fraud and private tax evasion.[18] When it comes to corporate taxation, solutions need to consider the increasing complexity of the international financial and tax architecture, the growth in intangible assets and the digital economy's rise providing increased flexibility for multinational companies to allocate their profits to low-tax jurisdictions.

The historical lack of multilateral cooperation and international tax agreements is among the issues that the Organisation for Economic Co-operation and Development (OECD)'s base erosion and profit shifting (BEPS) initiative aims to tackle, making profit-shifting harder to achieve and less attractive to multinational enterprises (MNEs). The current OECD proposal is split into two pillars: Pillar 1 would assess the profits of MNEs at a global level and compute the share of global activities in terms of sales and/or employment in each country. Pillar 2, on the other hand, looks at introducing a global minimum corporate tax rate in order to disincentivise tax arbitrage between different jurisdictions. It remains to be seen to what extent tax revenue gains from this ambitious proposal would be shared with low- and middle-income countries.

A recently published alternative proposal to the current OECD BEPS initiative aims to enforce a minimum effective tax rate (METR).[19] This follows a similar approach in design to the OECD proposals, but with a different implementation mechanism. Where the OECD proposal distinguishes between the taxing rights of the multinational's headquarters country and the host countries, the METR would reallocate undertaxed profits proportionally to countries according to their share of the multinational's real economic activity, based on sales and employment in each country. This proposal would result in a sizable shift of tax revenues, from tax havens to countries where the underlying economic activity takes place.

At the 21% rate proposed by the Biden administration, modelling suggests that the OECD approach would raise some $540 billion in additional revenues annually, while the METR approach is projected to raise $640 billion.[20] OECD countries would gain somewhat under the METR, but lower-income countries would gain significantly more, with the result that their corporate income tax revenues would typically grow by at least 30%, similar to what OECD countries would obtain.

The UN FACTI panel (the High Level Panel on International Financial Accountability, Transparency and Integrity for Achieving the 2030 Agenda) has recommended that negotiations begin on a UN tax convention to establish the basis for such arrangements. A UN tax convention could also set inclusive, ambitious standards for tax transparency and cooperation, which – coupled with a global minimum corporate tax rate – could potentially mark the end of the international race to the bottom.[21]





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## 1.3 Rethinking the division of labour between fiscal and monetary policy

### 1.3.1 Redefine the roles of and frontier between fiscal and monetary policy

The current economic downturn raises important questions about the division of labour between monetary and fiscal policies. A fundamental rethink of the scope and roles of fiscal and monetary policy might be required, enhancing the coordination between different tools and policies during recessions as well as recoveries. Although the current macroeconomic framework relies primarily on central banks and monetary policies for taming business cycles, the effective lower bound problem is eminent. This implies that, where fiscal space is available, fiscal policy will need to play a greater role in supporting the economy. Furthermore, while current monetary policy tools might be effective at maintaining liquidity, they might not encourage the structural transformation towards fairer, more equitable and sustainable economies.

The new conventional wisdom in these unconventional times seems to be that advanced economies can take advantage of today's favourable financing conditions to borrow and spend relatively freely in order to support their economy.[22] However, when economies have higher debt levels, small increases in interest rates can have a lasting impact on their fiscal sustainability, while also mechanically reducing the fiscal leeway to respond to future crises. Furthermore, the combined effect of asset purchases and low/negative interest rates could entail negative medium- to long-term externalities, potentially threatening global financial stability, fuelling asset bubbles and increasing market concentration in certain sectors.[23]

During the first phase of the pandemic it was necessary to act fast to provide liquidity, limit economic scarring and support the most vulnerable.[24] We must now ensure that any further spending is geared towards policies that have high fiscal multipliers. Economies should focus on programmes that increase their future growth potential, investing in improving the capabilities of its people through education, physical and digital infrastructure and innovation. Despite the crucial importance of swift fiscal and monetary policies, the recovery phase of the global pandemic must be a call to action for policy-makers to face the magnitude of the profound structural reforms required to build more resilient, inclusive and sustainable economies.



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Members of the Global Future Council on the New Agenda for Fiscal and Monetary Policy 2020–2021

**Haroon Bhorat**, Director, Development Policy Research Unit (DPRU), University of Cape Town

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**Kimberly Clausing**, Deputy Assistant Secretary for Tax Analysis, Office of Tax Policy, US Treasury.

**Alex Cobham**, Chief Executive, Tax Justice Network (TJN)

**Era Dabla-Norris**, Division Chief, Asia Pacific Department, International Monetary Fund

**Diana Farrell**, Board Trustee, National Economic Council (NEC) (Co-Chair)

**Alicia García-Herrero**, Senior Fellow, Brussels European and Global Economic Laboratory (BRUEGEL)

**Ugo Gentilini**, Global Lead, Social Assistance, The World Bank

**Vishal Gujadhur**, Deputy Director, Development Policy and Finance, Bill & Melinda Gates Foundation

**Karen Harris**, Managing Director, Macro Trends Group, Bain & Company

**Byoungchan Lee**, Assistant Professor, Hong Kong University of Science and Technology (Council Fellow)

**Nora Lustig**, Samuel Z. Stone Professor of Latin American Economics; Director, Commitment to Equity (CEQ) Institute, Tulane University

**Tan Min-Lan**, Head, Chief Investment Office, Asia-Pacific, UBS Group

**Rain Newton-Smith**, Chief Economist, Confederation of British Industry (CBI)

**Zhu Ning**, Deputy Dean and Professor of Finance, Shanghai Advanced Institute of Finance

**Raghuram G. Rajan**, Katherine Dusak Miller Distinguished Professor of Finance, University of Chicago Booth School of Business (Co-Chair)

**Bharat Ramamurti**, Deputy Director, National Economic Council for Financial Reform

**Paul Sheard**, Research Fellow, Mossavar-Rahmani Center for Business and Government, Harvard Kennedy School of Government

**Lutfey Siddiqi**, Visiting Professor-in-Practice, London School of Economics and Political Science

**From the World Economic Forum**
**Guillaume Hingel**, Insights Lead, Centre for the New Economy and Society



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