3 Way forward

This Chapter offers some guidance as to how tax policy responses could be adapted in the future. It identifies guiding principles on how countries can improve the targeting of emergency relief and carefully withdraw it as they emerge from the grip of the pandemic and loosen mobility and other restrictions. It also provides some guidance on how to design and implement effective stimulus-oriented tax measures. It concludes by providing a brief overview of the work that the OECD will be undertaking to help countries reassess their tax and spending policies in the longer run.

Today, the priority for countries is to continue adapting their fiscal response to the evolving health and economic developments. Governments should continue to use fiscal tools to provide relief to severely affected businesses and households where recovery remains hampered by containment measures, mobility restrictions or slow vaccinations. As economies reopen and economic activity rebounds, where possible, fiscal policy should remain supportive of the recovery.

Once the recovery is firmly in place, countries should re-examine their tax and spending policies to ensure that they address the structural economic challenges they face. These assessments will need to account for both the difficulties accentuated by the crisis, including increased debt levels, as well as those related to ongoing structural challenges including climate change, population ageing, rising inequalities, and digitalisation. This assessment process will then enable countries to determine the combination of fiscal policies needed to deliver inclusive, resilient and sustainable economic growth as they move beyond the pandemic.

Governments' responses to the ongoing crisis will naturally be tailored to country-specific circumstances, but there are some general guiding principles that countries can follow. The severity of the crisis, risks of longer-term scarring effects and countries' fiscal positions will all be determining factors in governments' responses to the pandemic and its aftermath. Nevertheless, this chapter offers some broad guiding principles to address two significant tax policy challenges faced by almost all countries in the short run, namely the withdrawal of relief where it is no longer needed and the provision of well-designed recovery-oriented stimulus measures. It also gives a brief overview of the work that the OECD will be undertaking in the future to help countries reassess their tax and spending priorities and policies in the longer run.

3.1. In the short run, a careful approach to tax relief and stimulus is needed

Emergency tax relief: increased targeting and careful withdrawal

Government approaches to tax relief will require a delicate balancing act. It will require ensuring that businesses and households severely affected by the crisis continue to receive sufficient support, while limiting the pressure on public budgets and ensuring a sustainable recovery by removing relief where it is no longer needed. However, the blunt and poorly timed withdrawal of relief could pose serious risks. As fiscal support is withdrawn and deferred tax payments come due, corporate cash flow might be put under severe pressure, creating a drag on economic recovery and possibly leading to an increase in corporate financial distress and business failures. Thus, relief withdrawal should be undertaken carefully.

Avoiding the premature withdrawal of relief and extending cash flow and income support measures where needed

The costs of removing support too early are likely to be greater than the costs of removing support later. Given the protracted nature of the crisis, with containment measures still significantly constraining supply and demand in many countries and the high level of uncertainty, governments should avoid prematurely withdrawing support. Support should be maintained where it is needed to keep businesses and households afloat. Withdrawing support too soon to businesses and households in need poses serious risks, including mass bankruptcies and job losses. Countries need to take heed of their experiences from the 2007-2009 crisis. After the financial crisis, policymakers were “flying blind” in that they had little research to guide them at that time, which had an impact on the way they designed and later withdrew stimulus packages (Ramey, 2019[1]). Overall, evidence shows that stimulus was withdrawn too early, which resulted in a prolonged period of slow sub-par growth. Nevertheless, every crisis is different and the speed of improvements in the health situation and the relaxation of containment measures will be the key determinant of whether, and the pace at which, emergency relief measures can be reduced and ultimately withdrawn.

Some measures play an important role in supporting liquidity and cash flow and are less costly to extend than others. For instance, tax payment deferrals and waivers of late payment interest and fines might be important for businesses and households still facing hardship, but may not be all that costly in terms of tax revenue foregone (as long as businesses survive the crisis). These measures could be extended, although in a more targeted way, until economic activity returns to normal. Loss carry-back measures could also be introduced or extended to enhance cash flow and target lossmaking firms (which were previously profitable) that will typically not benefit from other tax measures such as rate reductions or exemptions. While these measures involve an immediate revenue cost for governments, it is likely to be relatively low as it merely changes the timing of when losses are used to offset taxable income. This is particularly the case if these provisions are used by businesses that will be viable after the crisis. Additional tax measures that countries could consider introducing or extending to provide relief to businesses include accelerated tax refunds, revisions to income tax prepayment calculations to reflect anticipated drops in revenue, or recurrent business property tax waivers for struggling businesses. Increasing the limits to the deductibility of interest payments from taxable business income could also be considered on a temporary basis but should avoid creating opportunities for tax planning and windfall gains.

Governments should also prioritise removing tax hurdles to the production and deployment of vital equipment and vaccines. Rolling out the vaccine strategy remains the key priority both from a health and economic perspective. The tax system should not create any hurdles for the production or importation of vaccines. The European Union, for instance, has given EU Member States the authority to diverge from the EU VAT Directive in applying a zero VAT rate for vaccines and testing kits (European Commission, 2020[2]). Countries should ensure that their VAT and customs duty rules are adjusted and that they communicate the new rules to the business sector so that the importation of vital equipment and vaccines can be facilitated in an orderly and swift manner.

Progressively replacing blanket measures with more targeted support

Targeted tax relief can help strike a balance between ensuring that support is delivered to those who need it most, while limiting the fiscal cost of such measures. Increased targeting also implies that the amount of support that can be provided to those in need can be larger. This is particularly necessary given the highly uneven impact of the crisis across different sectors, businesses and households and the forecast that the recovery is likely to be highly uneven too (see Chapter 1).

Countries have increasingly moved away from broad-based containment measures to more targeted ones, and more information has become available on the economic and distributional impacts of the crisis as it has progressed. At the start of the crisis, when support was critically needed across the economy given broad-based lockdowns and when relatively little information was available on the types of businesses and households that were most affected, targeting would have almost certainly resulted in an under-provision of support and less timely relief. However, as the crisis has unfolded and countries have increasingly moved away from broad-based lockdowns, governments have more accurate information regarding the sectors, types of businesses, households or regions that may require continued emergency relief.

Relief should increasingly be targeted at taxpayers who need it the most. Support should be targeted at the most vulnerable households. The crisis has exacerbated existing inequalities (OECD, 2020[3]). In particular, those sectors affected by confinement measures, comprising large shares of low-skilled workers, have suffered extreme income losses, while labour markets for many higher-income workers have hardly deteriorated at all (OECD, 2020[4]; Palomino, Rodriguez and Sebastian, 2020[5]). Continued emergency relief should also be targeted to businesses that remain severely affected by containment measures and other constraints, such as travel restrictions. It can be targeted at particular types of businesses such as SMEs or economic sectors, or at companies that have experienced a significant and persistent drop in revenue relative to pre-crisis years. In sectors that are still subject to significant restrictions, access to relief measures should remain automatic for most companies, while in sectors that have been able to resume activities, relief could be granted on a more selective or even case-by-case basis, following a specific request from businesses, with reference to additional eligibility requirements. These eligibility requirements should be clearly and transparently communicated to businesses so they can verify whether and how they can apply.

Targeting prolonged relief only at firms that are likely to be viable post-pandemic may be desirable, but difficult to implement in practice. In many cases, measures aimed at providing relief to viable firms have also allowed unviable firms to survive. Support to unviable firms implies that part of the relief could have been better allocated to more productive businesses with a better prognosis of future success, which could ultimately slow the recovery, and potentially result in significant tax revenue losses for governments if businesses that have received tax support go bankrupt. However, this crisis makes it particularly difficult to distinguish viable from non-viable firms. For instance, a July 2020 study in France showed that highly productive firms accounted for a disproportionate share of companies facing insolvency (Guerini et al., 2020[6]). Care should be taken not to withdraw support prematurely for firms that are viable yet facing liquidity constraints, which could jeopardise their existence. More generally, applying traditional criteria to identify “viable” businesses – such as balance sheet data or recent credit history – may be more difficult given the scale and uniqueness of the shock countries have experienced (OECD, 2020[7]). Assessing firm viability is also particularly challenging where sectors remain severely constrained by containment measures. A further element of uncertainty hampering efforts to assess firm viability is the fact that the current pandemic has evinced a whole range of dramatic shifts in consumption and production behaviours and the permanence of some of these changes will only be known over time. However, targeting firms based on assessment of future viability may become easier over time and as sectors resume their activities under near (or ‘new’) normal conditions.

Avoiding “cliff edge” effects

The removal of short-term relief measures should avoid sudden spikes in tax liabilities. The removal of measures such as tax deferrals should not generate sudden increases in tax liabilities, or “cliff edge” effects that could result in solvency problems for recovering businesses. This can be achieved by progressively phasing out relief measures or by replacing initial relief measures with new ones.

More generally, extending cash flow support measures should avoid storing up problems for the future, making it more difficult for taxpayers to return to normal if, for example, debts build up to unsustainable levels or deferred payments lead to severe cash flow problems at a later date. For instance, the longer tax deferrals are extended, the higher the risks that deferred tax payments reach unsustainable levels later. Such problems could be minimised by turning tax payment deferrals into interest-free tax payment plans (e.g. fixed monthly or quarterly payments of the tax due spread over several months or years). Tax payment plans could possibly be made sector or firm-specific to tailor them to the specific challenges faced by sectors or individual businesses. Additional difficulties may arise where governments have provided loan guarantees allowing firms to take out additional loans to survive the crisis. The additional debt taken on by businesses will increase interest payments that are due, which could increase solvency risks in particular if the economic recovery is slow. Governments may therefore have to extend support into the recovery phase to ensure that viable firms survive the crisis once the pandemic is under control.

Carefully enforcing and monitoring relief measures

Careful enforcement of relief measures and preventing potential abuse is critical. For instance, measures to accelerate refunds of VAT credits and other taxes, and payment of direct financial support more generally, can be vulnerable to abuse during times of crisis as cash-strapped businesses may be tempted to file fraudulent claims. This may be particularly true for countries with weaker tax auditing tools and capabilities. Where this is the case, tax administrations may consider restricting the availability of certain measures, such as the accelerated payment of VAT refunds, to businesses with a good compliance record or capping the amounts of accelerated refunds. This could be complemented with temporary measures to focus tax administration capacity on issues specific to the crisis, such as assessing and monitoring taxpayers and tax issues that present particular compliance risks as a result of the crisis through basic compliance indicators such as late filings and the evolution of tax arrears, and proactively contacting selected taxpayers to provide targeted assistance. Cases of abuse should also be sanctioned through clearly communicated fines and clawback measures.

Monitoring and regular data analysis is also essential to ensure that measures achieve their objectives. Regular monitoring and data collection are critical to determining whether fiscal provisions should be extended, reduced, removed or recalibrated to ensure that relief reaches the right sectors, firms and households. Monitoring and data analysis are also key to ensuring that tax relief does not lead to unintended effects (e.g. property tax waiver in the United Kingdom driving an increase in housing prices). The availability of high-frequency data (e.g. from credit cards) and forecasts based on quasi real-time data may help governments to determine the best policy strategies and actions.

Care should be taken around engagement with taxpayers, clear communication and providing some degree of stability. Anecdotal evidence suggests that in many countries there has been a strong positive reaction by taxpayers to the actions taken by tax administrations in helping to address cash flow concerns and reducing burdens on taxpayers, as well as to the role played by some tax administrations in the provision of government support. As is the case for fiscal support, care should be taken to avoid a "cliff edge" in terms of changes in messaging or a return to pre-crisis compliance activities by tax administrations where they have been suspended or reduced. Consideration should be given as to how to best communicate the rationale and timing of resumption of more normal operations to avoid adversely impacting taxpayer attitudes which might in turn adversely affect compliance behaviours. Providing a reasonable level of stability is also key. The proliferation of short-term measures and frequent changes to existing measures should be carefully assessed to avoid creating additional complexities for taxpayers.

Pursuing well-designed stimulus

As economies reopen, recovery-oriented stimulus measures could play a significant role if demand and investment remain persistently low. Stimulus policies should be considered if, once the pandemic is under control and activities are largely allowed to resume, consumption and investment remain persistently low.

Evidence suggests that fiscal stimulus may be particularly effective in the current context. Fiscal multipliers tend to be higher when monetary policy is very accommodative and interest rates remain low (Christiano, Eichenbaum and Rebelo, 2011[8]; Woodford, 2011[9]; Coenen et al., 2012[10]; Erceg and Lindé, 2014[11]) as is currently the case (see Chapter 1). In addition, fiscal policy has the advantage of being deployed through a variety of tools and channels, which allows it to have more direct and selective effects than monetary policy (Bartsch, Bénassy-Quéré and Corset, 2020[12]).

Nevertheless, fiscal stimulus should be carefully designed and adapted to country circumstances to ensure that it is effective. In particular, stimulus should be carefully timed and introduced when the health situation improves and economies reopen. The size of the stimulus package is also going to depend on the speed at which economies rebound: larger and more prolonged stimulus measures might be needed where recovery is anaemic, but where economies rebound strongly, the size and length of stimulus packages can be curtailed. Under certain circumstances, large stimulus packages could also increase risks of rising inflation, especially as there will likely be pent-up demand in many countries, which was one of the reasons why the rebound in the second half of 2020 was so strong (see Chapter 1). While rising inflation could lead to an increase in interest rates and affect debt sustainability, some inflation may be welcome in the current context. Stimulus measures should also be aligned with countries' longer term environmental, health and social challenges. More generally, policy flexibility will be key: this crisis is making conventional stimulus policies somewhat less effective under continued restrictions and the adequate timing of policies more difficult, so flexibly adapting policies to changing health and economic circumstances will be critical.

Getting the timing right

The introduction of recovery-oriented stimulus measures should be timely. In particular, introducing stimulus measures while lockdowns or severe restrictions are still in place will largely be ineffective and can even go against the objective of containing the spread of the virus. There is evidence that some of the tax stimulus measures introduced after the first wave of the pandemic have had less of an impact than anticipated because they were introduced when restrictions were still in place (OECD, 2021[13]). An additional challenge is potential time lags between the design of policies, their enactment, their implementation, take-up by taxpayers and the receipt of benefits by taxpayers.

In many cases, relief and stimulus measures are likely to coexist. This combination of measures is unusual when compared to previous economic crises, but will be necessary given the unique nature of the ongoing crisis**.** Many countries have introduced partial lockdowns, allowing some businesses to resume activities, while others, such as tourism and hospitality, remain severely constrained. Many countries have also adopted intermittent approaches where containment measures are relaxed and then tightened again as renewed outbreak risks arise. This has increased heterogeneous effects across businesses and households, which should be taken into consideration in countries' policy responses. The mix of relief and recovery-oriented stimulus measures should therefore be closely aligned with the nature of the containment and mitigation measures in place. For instance, where containment measures are partially lifted, businesses that are still subject to restrictions may need continued liquidity and solvency support, while sectors that can resume their activities could benefit from stimulus measures.

Ensuring that stimulus is temporary

Recovery-oriented tax measures should be temporary. Temporary stimulus encourages businesses and households to bring their spending and investments forward. Without an end date to the measures, there is less incentive to do so. There is also evidence that the timing of investment decisions tends to react strongly to taxation (US Treasury, 2010[14]). In addition, temporary stimulus has the advantage of limiting the impact of measures on public budgets. Stimulus measures could also have pro-cyclical effects if they are maintained once economic recovery is on a solid footing.

Measures could have clear end dates but allow for possible temporary extensions, or be tied to the achievement of certain outcomes. Measures could have clearly specified expiry dates or sunset clauses. This would induce government to evaluate the effectiveness of measures. However, given the uncertainty of the pandemic, some flexibility may be needed. If there is a strong case for extending measures once their expiry date is reached to continue supporting supply or demand, these could be temporarily extended. For instance, debt overhangs built up by businesses, households or the financial sector may lead to longer than anticipated weakness in consumption and investment while debts are being paid down. In these cases, the temporary extension of measures beyond their initially anticipated end-dates may be warranted. An alternative to sunset clauses may be to link the duration of stimulus measures to the attainment of certain outcomes. For instance, unemployment benefits could be maintained if unemployment rates exceed a certain threshold (Schnabel, 2021[15]; OECD, 2021[13]). Tying the duration of stimulus measures to the attainment of certain outcomes (e.g. recovery in certain sectors, employment levels) may reduce risks of discontinued or delayed support where discretionary extensions may need to be approved through long legislative processes.

Targeting stimulus to areas where equity needs and fiscal multipliers are highest

Targeting support at less affluent households, in addition to being fairer, is likely to have a greater impact on output. As mentioned above, the crisis has had a highly uneven impact across households and the recovery is expected to be unequal too. Therefore, targeting income support at lower income households is key from an inclusiveness perspective. Targeted income support to lower income households is also expected to have higher multiplier effects as research suggests that lower income households are more likely to spend as opposed to save additional disposable income received through fiscal stimulus packages relative to other households (Sahm, Shapiro and Slemrod, 2010[16]; Parker et al., 2013[17]; Broda and Parker, 2014[18]). A limiting factor, however, may be that households may use some portion of support as precautionary savings, or to repay debt, if they face prolonged uncertainty over unemployment prospects, dampening the multiplier effect on output (Mody, Ohnsorge and Sandri, 2012[19]; Baiardi, Magnani and Menegatti, 2019[20]; BNP Paribas, 2021[21]). This highlights the importance of ensuring that income support goes hand-in-hand with employment support measures and other measures aimed at enhancing consumer and business confidence (see Chapter 1).

Countries can provide income support to low-income households in various ways, including through cash transfers, expanded access to social benefits as well as targeted tax measures. Enhanced cash transfers or social benefits can provide cash more quickly to the ones in need, but targeted tax measures can mimic that effect for instance through advanced payments of refundable child or other types of tax credits. The effectiveness of PIT reductions in delivering support to low-income households, as well as their multiplier effects, will depend on whether significant shares of low-income households are subject to the PIT. Where most low-income households are not subject to the PIT, as is the case in many developing and emerging economies, and in some OECD countries, enhanced transfers and access to social benefits will generally be more effective in delivering support to low-income households.

On the other hand, measures to stimulate consumption, particularly broad-based and untargeted ones, might not generate much additional consumption and should be carefully considered depending on country context. Many households, and particularly those with higher-incomes who have accumulated more savings during the pandemic, will be eager to consume once restrictions are lifted. This does not apply to all households as those at the lower end of the income spectrum have often experienced an increase in spending on essential consumption during lockdowns. Providing targeted income support to lower income households would therefore be more cost-effective than broad-based measures to stimulate consumption, such as VAT rate reductions, which are very costly, might not be needed to boost consumption, and would end up partly subsidising the consumption of high-income households. Targeted income support may be more difficult, however, in countries with less well developed tax and transfer systems. Tax measures favouring consumption may also have unintended consequences, such as contributing to a large increase in demand, which could drive prices up. Therefore, measures aimed at boosting consumption should be carefully considered and designed in ways that avoid providing windfall gains to higher income households.

In the area of corporate taxation, expenditure-based corporate tax incentives lead to greater additionality, in terms of new investment and job creation, than profit-based ones. Expenditure-based tax incentives, including for instance investment tax credits, accelerated depreciation allowances or immediate expensing may be effective stimulus measures, in particular if they are time-bound. They reduce the cost of capital and encourage frontloading private investment (Edge and Rudd, 2011[22]; Zwick and Mahon, 2017[23]). Such incentives should be preferred to profit-based tax incentives, which typically lead to little additionality and generate windfall gains. For instance, corporate income tax holidays can disproportionately benefit larger and more profitable firms whose investment plans would likely occur irrespective of tax holidays. Expenditure-based tax incentives also have a more immediate effect as corporations can benefit from such incentives as soon as they make an investment.

Governments could consider more generous expenditure-based tax incentives targeted at severely affected sectors. The impact of the crisis has hit a number of services sectors particularly hard, and tax support to return to normal business activities might be very welcome once the health crisis is under control and the economy recovers. In addition, expenditure-based tax incentives should be accompanied by adequate loss carry-forward provisions to ensure that tax incentives also benefit investments with delayed returns.

Prioritising measures that support employment

The crisis has led to unprecedented job losses and could have longer term scarring effects on labour markets. While labour market conditions are improving slowly, across the OECD economies, almost 10 million more people are unemployed than prior to the crisis, inactivity rates have risen and employment rates have declined (see Chapter 1). In addition, unemployment levels may rise in a number of countries when government support is withdrawn, particularly where unviable businesses are currently being propped up. In developing countries, substantial job losses have increased poverty and deprivation of millions of workers. The COVID-19 crisis is also having a greater impact on some workers than others. Young people and women are among those at greatest risk of joblessness and poverty. They generally have less secure, lower-skilled jobs and are overrepresented among workers in industries most affected by the crisis, such as tourism and restaurants. Supporting labour market recovery is therefore not only essential to ensure an economic rebound, but also to prevent intergenerational, socio-economic and gender inequalities from being further exacerbated.

Tax measures can be used to encourage businesses to retain their workers and hire new employees. Temporary and targeted reductions in employer social security contributions, either through lower contribution rates or tax credits that can be claimed against employer SSCs, may be among the measures that countries could consider. Such measures were implemented in the aftermath of the 2008/9 crisis in many countries. In addition to creating an incentive for employers to hire new workers, they reduce the cost of employing current workers, which would support business cash flow. Depending on country-specific circumstances, countries may prefer to target measures at specific categories of employers or workers (e.g. low-income or younger workers). Countries may also consider adapting support measures over time. For instance, tax support could initially be widely available to all low-income workers and then gradually recalibrated to target workers employed on indefinite contracts and/or to target specific sectors if recovery proves slower in certain sectors.

Tax measures could also be used to encourage workers to return to the labour market and, where appropriate, support re-skilling. The crisis will very likely have long-lasting effects and may have increased the speed of the structural economic changes that were set to happen as a result of, for instance, the digitalisation of the economy. Workers that have lost their jobs in less viable economic sectors or firms might be encouraged to find jobs in other sectors through, for instance, enhanced earned income tax credits. Targeted tax support for workers to re-skill might also be considered, in addition to standard active labour market policies and improved access to flexible, modular training for lower-skilled workers. It should be mentioned as well that in some cases there may be trade-offs between measures supporting productivity-enhancing investments and support for employment, especially in the short run.

Considering measures to encourage business recapitalisation

The capital structure and solvency of companies have been severely affected by the current crisis. Many firms have survived the crisis by tapping into their available cash reserves and capital stock and by taking on additional debt, weakening their capital structure and jeopardising their survival. Low levels of retained earnings could also put a drag on investment in the coming years. Policy responses have largely focused on providing liquidity support, and these policies might put the solvency of businesses under pressure if they are abruptly withdrawn. Evidence shows that in some cases support to address liquidity shortages has increased concerns over future solvency risks (IMF, 2020[24]; OECD, 2020[7]). Moreover, many firms entered the crisis with a high degree of leverage. Governments may therefore have to start turning their attention to measures that can mitigate these insolvency risks for businesses that are otherwise viable. Solvency risks might be particularly high for SMEs, which have been hit harder by the crisis than large companies (see Chapter 1) and have fewer financing options.

In light of these financing challenges, governments could consider tax measures to encourage business recapitalisation. Measures could include allowing companies to exempt part of their profits by recording them under a capital reserve aimed at rebuilding their equity. Such schemes would have to be temporary and could be capped or targeted at SMEs. Strict rules would also be needed to prevent any abuse. Temporary tax measures taken exceptionally during this period to support business recapitalisation would need to be coordinated with other policy tools, including for instance efforts to privilege grants, and equity-type support over debt for SMEs.

Aligning stimulus with longer term environmental, health and social objectives

Supporting innovation efforts through targeted support for promising clean technologies can encourage recovery and help accelerate the transition to a carbon-neutral economy. The need for low-carbon innovation and the potential for spill-overs justify targeted support for R&D and technology transfer towards specific applications, including through corporate tax incentives. If well designed, they can encourage investment in specific technologies (Maffini, Xing and Devereux, 2019[25]). Targeted technology support that generates low-carbon investment can reduce the cost of complying with carbon pricing in the future, and can become a powerful tool in building support for stronger carbon pricing. Targeted low-carbon innovation support has increasingly become a practicable option given international advances in the classification of clean technologies and standards. Where such standards for clean products and processes exist, they could be used to direct targeted support.

Such tools are even more effective when combined with carbon pricing efforts. Carbon pricing reinforces green stimulus measures and helps align traditional stimulus with climate objectives, even when it is not explicitly targeted towards decarbonisation. Carbon taxes or emissions trading systems encourage cleaner investment and consumption choices for all public and private spending, limiting CO_2 emissions and local pollution. Tax and spending policies can be implemented in tandem to deliver an equitable reform package that boosts the purchasing power of vulnerable groups (OECD, 2020[26]).

Where raising carbon prices is not an immediate policy option, governments could usefully commit to future price increases (Van Dender and Teusch, 2020[27]). Expectations about higher future carbon prices can create strong incentives, particularly for investments in long-lived assets and infrastructure. Households and businesses will embrace low carbon on their own if they believe that carbon prices will rise over time, without the need for the government to identify the most promising technologies and spending choices in advance. This reduces the risk of stranded assets and stranded jobs in the future.

Investment incentives could also be used to steer businesses towards investments that minimise health-related risks or strengthen the collective ability to respond to such risks in the future. For instance, special tax incentives could be granted to support businesses adapting their workplaces or facilities to strengthened sanitary protocols.

Tax stimulus should be aligned with inclusive growth objectives and regressive tax stimulus should be avoided. As mentioned, this may be achieved by targeting tax relief (or other forms of income support) at lower income households. It may also involve providing additional relief to families with children. Tax stimulus aligned with inclusiveness objectives also implies avoiding providing tax relief that will predominantly benefit higher-income households, for instance through regressive personal income tax expenditures. This is particularly the case given that some high-income earners have benefited from the crisis and that this crisis has increased income polarisation (Stewart, McCarty and Bryson, 2020[28]; Stiglitz, 2020[29]; Bottan, Hoffmann and Vera-Cossio, 2020[30]). Governments should also favour tax support in the form of tax credits rather than tax allowances whose value increases with an individual's income level.

Tailoring stimulus to countries' specific circumstances

Stimulus policies should take into account country-specific needs. As mentioned in Chapter 1, countries have been unevenly affected by the crisis and the pace and scale of the recovery is also expected to vary widely across countries. Stimulus packages will need to be calibrated to the size of countries' output gaps. The timing of stimulus measures will also vary across countries, as some have already seen a pick-up in economic activity, while others are still imposing highly restrictive supply and demand constraints.

Stimulus should be aligned with countries' means. Countries entered the crisis with very different fiscal positions, including budget balances and government debt levels. In addition, their ability to rely on central bank support has varied. These financing constraints should be taken into consideration in designing stimulus policies. While limited stimulus may result in a slow economic recovery, disproportionate stimulus packages compared to countries' available fiscal space may undermine market confidence, which could result in lower investment and consumption, and weigh on the recovery. Evidence shows that fiscal multipliers tend to be smaller when fiscal positions are weaker (Huidrom et al., 2019[31]). It should be mentioned, however, that the near-term fiscal space has risen in many countries thanks to declining servicing costs.

Coordinating tax stimulus with other policies

Tax stimulus has to be designed in coordination with other crisis support measures, including wage subsidies, cash transfers, additional loans and debt guarantees. Tax stimulus – and fiscal policy more generally – also need to be carefully coordinated with monetary policy. Tax support will be the most effective if it is aligned with, and possibly reinforces the impact of, other support measures that countries have implemented.

Ideally, tax stimulus should be aligned with measures that will be taken over time to restore public finances and to address long-term challenges. Short term stimulus measures should be aligned with the direction that the tax system will need to take in the longer term. For instance, tax stimulus that would induce firms to invest in technology that is not environmentally friendly has to be avoided as it is not aligned with the optimal design of the tax system and the long-term objective of CO_2 neutrality.

Coordinating tax stimulus across countries

Fiscal policies have important output spill-over effects from one country to another. One lesson from the global financial crisis is that policy actions can have positive or negative externalities across countries. Economic support by some countries can create positive feedback loops through trade and investment links, providing a boost to the global economy (OECD, 2019[32]). Similarly, there could be negative feedback loops and negative externalities through integrated financial markets where countries in tight fiscal circumstances take limited expansionary fiscal action to help their economy to recover.

Therefore coordination of fiscal policies may valuable, particularly as openness increases. The benefits of internationally coordinated policy action can be seen from the experience of the global financial crisis, particularly in relation to monetary policy and financial market regulation. Fiscal policy would also benefit from a similarly coordinated approach.

3.2. In the medium run, tax and spending policies should be reassessed

The short-term priority is to continue navigating the pandemic and build a robust and inclusive recovery, but countries will need to start thinking about the medium and long-term challenges they face. Once the recovery is firmly in place, the post-crisis environment will provide an opportunity for countries to undertake a more fundamental reassessment of their tax and spending policies along with their overall fiscal framework. Such a reassessment should take into account both the challenges brought to the fore by the crisis as well as those related to ongoing structural trends. Such a reassessment should go beyond a focus on economic growth only, but integrate other key objectives of fiscal policy including inclusiveness, health, resilience and environmental sustainability.

Countries are facing a number of long-term structural challenges, including climate change, rising health risks, digitalisation, population ageing and increasing inequalities. Some of these challenges are interrelated, and some have been influenced by the COVID-19 crisis (e.g. accelerating digitalisation, inequalities). These trends can affect public finances in many ways: they can affect them directly (e.g. population ageing); they can influence the policy priorities of countries in the post-crisis environment; and they can have an effect on the different tax and spending policy instruments that are available (e.g. ageing populations and increases in automation or non-standard work may erode the personal income tax and social security contributions base over time).

Rethinking countries' public finance strategies will involve a combination of measures to support sustainable tax revenues and improve the quality of public spending, including through improved public finance governance. For some countries, increased domestic resource mobilisation will be needed to fund additional spending, whereas in countries with higher current levels of taxation and spending, there may be a need to contain spending growth, reprioritise spending and increase its efficiency. Tax revenues can be supported and enhanced with measures within the tax system (e.g. adjusting tax rates, broadening tax bases), but also with structural reforms (e.g. better education and training, reforms in the labour and product markets) that are not directly related to taxation but would support long-term economic growth and, in turn, growing tax bases.

The options to restore public finances will depend heavily on country-specific circumstances, including the country's starting point in terms of growth, development, inequalities and fiscal space; its current levels and structures of taxation and spending; as well as the nature of the specific long-term structural trends and challenges it faces. Those circumstances can vary widely across countries. For instance, countries at an earlier stage of economic development may have a lower tax-to-GDP ratio and have less developed social safety nets. Equally, countries may face different demographic challenges. For example, many OECD countries are facing considerable upward pressure on pension, health care and long-term care spending, whereas demography may have a more favourable effect on public finances in some emerging and developing economies.

Inclusive growth will also need to be at the heart of post-crisis tax policy. In addition to the benefits of growth for well-being and prosperity, robust growth rates support debt sustainability, by supporting tax revenues and eroding past debt. At the same time, policies will have to be inclusive and address inequalities. Recent studies have highlighted the negative impacts of the crisis on inequality (OECD, 2021[13]). Labour market outcomes have polarised, with those sectors affected by confinement measures having suffered sizeable income losses, while labour markets for some higher-income workers have hardly deteriorated at all (OECD, 2020[4]; Palomino, Rodriguez and Sebastian, 2020[5]). At the same time, asset prices have increased in many economies. In this context, the OECD will be undertaking work with a specific focus on personal capital taxation and the taxation of high income earners.

Countries will also need to address the challenges and seize the opportunities arising from digitalisation. Rising pressure on public finances as well as increased demands for fair burden sharing should provide new impetus for reaching an international agreement on how to address the tax challenges arising from the digitalisation of the economy. In the current context, international tax cooperation is even more important to ensure that tax disputes do not turn into trade wars, which would further harm recovery at a time when the global economy can least afford it. Work has continued to address the tax challenges arising from the digitalisation under the auspices of the OECD/G20 Inclusive Framework. In 2019, the Inclusive Framework agreed to a two-pillar Programme of Work that could form the basis for a multilateral consensus-based approach. Pillar One aims to expand the taxing rights of market jurisdictions where there is an active and sustained participation of a business in the economy of that jurisdiction. Pillar Two would introduce global anti-base erosion rules to ensure a minimum level of effective taxation. During the course of 2020, despite the COVID-19 pandemic, significant progress was made on the development of both Pillars. The Inclusive Framework approved Blueprint Reports on Pillar One and Pillar Two in October 2020 and released an Economic Impact Assessment of the proposals. At the same time, the Inclusive Framework also invited public comments on these Blueprint Reports in January 2021. The Inclusive Framework is building upon this input to further refine and simplify the Pillar One and Pillar Two proposals, with the objective of reaching a political agreement in mid-2021. In addition, broadening VAT bases by including all e-commerce, following the recommendations included in the OECD International VAT/GST Guidelines, is another priority to level the playing field between domestic and non-resident suppliers and has become even more important with the acceleration of digitalisation during the pandemic. Further, the increasing use of digital solutions can also play a key role in improving the functioning of tax administrations, as well as the design and implementation of tax policies.

Ensuring that the recovery is sustainable will be another major priority, which will involve, among other reforms, greater carbon pricing efforts. Today, taxes on polluting fuels are nowhere near the levels needed to encourage a shift towards clean energy. Around 70% of energy-related CO_2 emissions from advanced and emerging economies are entirely untaxed and some of the most polluting fuels remain among the least taxed (OECD, 2019[33]). This provides limited incentives for investors and citizens to favour clean over polluting energy sources. Adjusting taxes, along with state subsidies and investment, are therefore central elements of countries' strategies to curb carbon emissions. At the same time, policy packages should take account of the potential adverse impacts of carbon pricing on equity and affordability. The OECD will continue to build on its expertise to inform and support carbon pricing reform, adapted to countries' circumstances, in ways that strike a balance between creating incentives to reach carbon neutrality by the middle of the century, boosting inclusiveness and supporting sound public finances.

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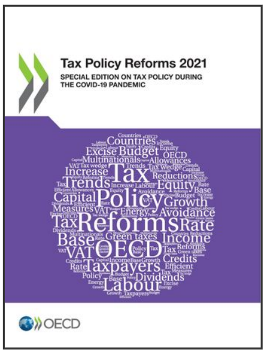

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