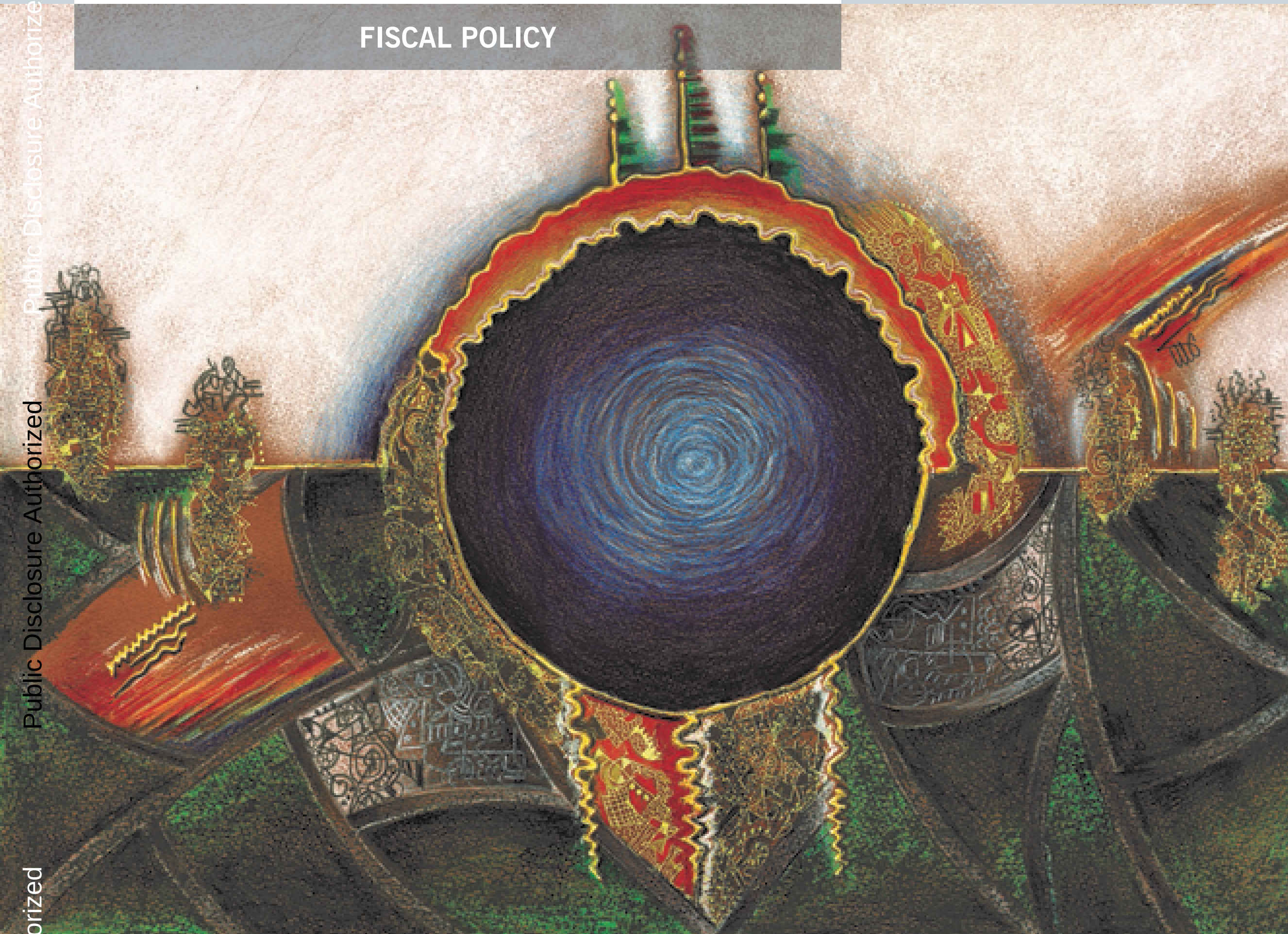
Public Disclosure Authorized
Public Disclosure Authorized
Public Disclosure Authorized

WORLD BANK GROUP

WESTERN BALKANS REGULAR ECONOMIC REPORT
No.17 | Spring 2020

The Economic and Social Impact of COVID-19

FISCAL POLICY



"You and me" by Tanja Burzanovic (Montenegro)

The RER No. 17 is a collection of notes on the Economic and Social Impact of COVID-19 that has been published in three parts. The first part was launched on April 29 and focused on the macroeconomic impact of COVID-19. The second part, launched on May 29, shows how the macroeconomic impact affects the people in the region. This third part focuses on specific economic policy response areas—fiscal, external, and financial sector—and the crisis impact on the private sector as reported by firms.

Fiscal Policy to Flatten the Curves: Crisis Containment and Mitigation[1]

- After the immediate crisis containment period, fiscal policy needs to strike a fine balance between supporting an economic recovery and ensuring fiscal sustainability.
- Some Western Balkan countries have improved their fiscal stance in recent years creating fiscal buffers which allowed them to finance larger support programs; still, all Western Balkan countries entered the COVID-19 crisis with more debt than before the 2009 global financial crisis.
- Fiscal policy is leading the response to COVID-19: all Western Balkans introduced measures necessary to mitigate the immediate crisis impact but how effective they are also depends on how well they are adapted to the specific context of each country.
- Borrowing needs surge raising future interest payments throughout the Western Balkans as fiscal deficits and public debt rise and financial markets tighten.

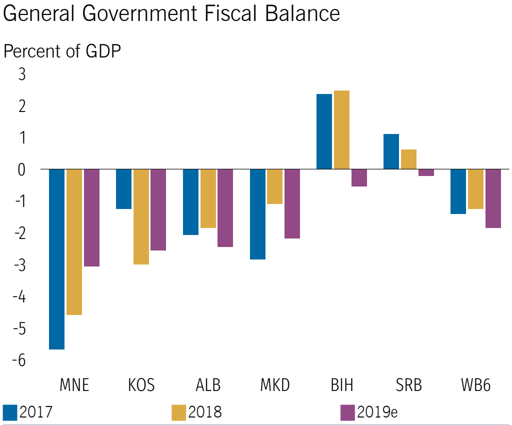
Fiscal policy is central to the package of responses to the COVID-19 crisis. Restrictions on movement and social distancing affect labor supply, transport, and travel in unprecedented ways. Whole sectors of national economies have been shut down—including restaurants, hotels, nonessential retail trade, tourism, transport, and a significant share of manufacturing. As in 2008−09, governments have used both monetary and fiscal policy to counter the economic erosion and support households and businesses. Yet the COVID-19 pandemic has struck in a context of extremely low nominal interest rates in the Western Balkans as well as advanced economies, with few monetary policy levers to ease the economic effects of the outbreak. Moreover, two of the six Western Balkan countries have unilaterally euroized, one has a currency board, and another a pegged regime against the euro. Fiscal policy thus had to lead the response to COVID-19 and authorities have jumped to activate an array of fiscal measures to save lives, protect the individuals and firms most affected by income losses, unemployment, and bankruptcies, to reduce the likelihood that the pandemic results in a deep, long-lasting slump.

1 This note was prepared by Milan Lakićević, Sanja Madžarević-Šujster, and Besart Myderrizi, and benefited from the comments of Marc Schiffbauer, Edith Kikoni, and Enrique Blanco Armas, Jasmin Chakeri, and Gallina Vincelette.

The starting position of Western Balkan countries limits fiscal response options and makes them more vulnerable

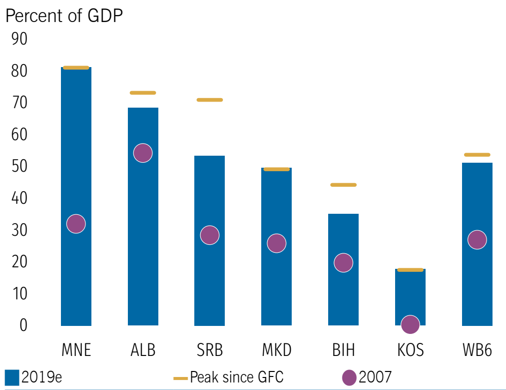
In recent years economic growth and fiscal consolidation have helped improve Western Balkan fiscal positions—but headline figures mask underlying vulnerabilities. Since their 2013–14 peaks of more than 4 percent of GDP, deficits have remained below 2 percent since 2016 as countries in the region undertook fiscal consolidation. Still, changes to expenditure composition have been slow, and the countries with rigid spending patterns have little fiscal room for maneuver. Some countries, notably Bosnia and Herzegovina (BiH) and North Macedonia, consolidated by compressing capital spending; and in all the countries, despite fiscal consolidation mandatory spending, especially

Figure 1. Fiscal deficits widened in 2019…



Source: Ministry of Finance.

Figure 2. …though debt is still below the 2015 peak.



Source: Ministry of Finance.
Note: GFC = Global financial crisis.

on public wage bills and pensions, is still high. BiH and Montenegro spend relatively more on public wages than the EU28 or EU small member states. Social benefits in BiH, North Macedonia, and Serbia are also higher than in small EU states. Thus, countries in the region have far less budget flexibility or room for maneuver in times of crisis.

Moreover, after two years of tightening, in 2019 several Western Balkan countries eased fiscal policy, depleting funds now desperately needed. The region's deficit grew to 1.8 percent in 2019—up by 0.6 pp of GDP from a year earlier. Albania's deficit has risen to 2.5 percent of GDP as higher revenues were not enough to compensate for subsidies to energy SOEs, higher refunds on VAT arrears, fiscal incentives for agriculture, tourism, and pharmaceuticals, and the emergency operations related to the earthquake. In BiH, the solid expansion in revenue was outpaced by higher spending on public wages, social transfers, and capital spending, so that the fiscal balance switched from a 2018 surplus of 2.5 percent of GDP[2] to a deficit of 0.5 percent.[3] After significant tightening in previous years Serbia also loosened fiscal policy slightly, bringing about a deficit of 0.2 percent of GDP. Despite increases in tax and social security contribution rates, in 2019 North Macedonia doubled its deficit to 2.1 percent of GDP (2.4 percent if the off-budget road company is added in) as the government scaled up firm and employment subsidies and capital spending. Although Kosovo and Montenegro tightened fiscal policy, that was mostly achieved by underspending their capital budgets; neither has controlled current spending.

In 2019 public debt in the Western Balkans averaged 51 percent of GDP, though with large variations among countries, limiting the available fiscal space for dealing with the COVID-19 crisis. Entering the crisis, Albania, BiH, and Serbia had been improving their fiscal positions, reducing their debt by 1–1.7 pp of GDP supported also by a robust

2 See Consolidated CBBiH data, available at the CBBiH Panorama web portal. 2019 consolidated data will be available in June 2020.
3 BiH Global Fiscal Framework for 2020–2022.

Table 1. Credit ratings improved in only two Western Balkan countries since 2014…

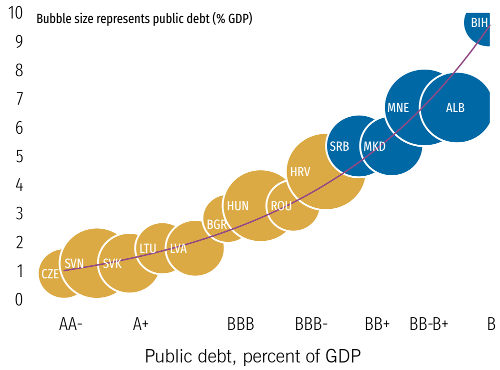
Sovereign Credit-Risk Ratings

	Dec 2014	Dec 2017	March 2020
ALB	B	B+	B+ (Stable)
BiH	B	B	B (Positive)
MKD	BB-	BB-	BB- (Stable)
MNE	B+	B+	B+ (Stable)
SRB	BB-	BB-	BB+ (Stable)

Source: Standard and Poor's.

Figure 3. …and lower credit ratings keep risk premiums in the region higher than those of peers.

Adjusted default spreads, percent



Source: S&P credit rating, Ministries of Finance, and New York University - Stern School of Business.

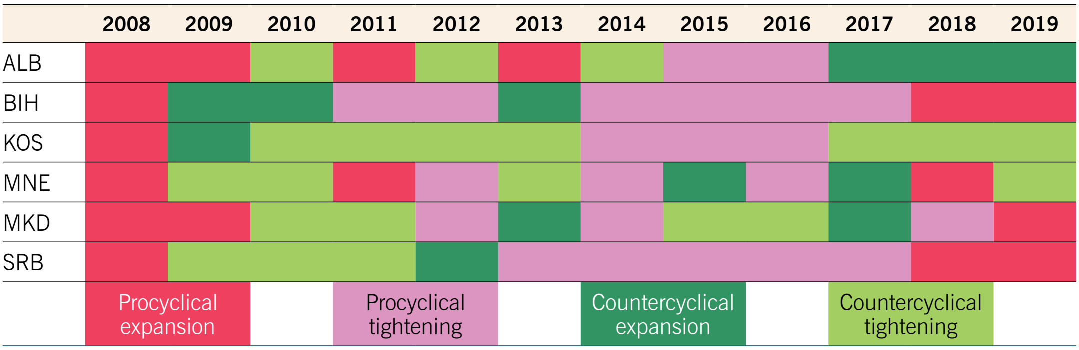
Note: Adjusted default spread taken from http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html.

growth. Kosovo and North Macedonia kept debt just above the 2018 level, by 0.2–0.5 pp of GDP. Montenegro faces the crisis with high levels of public and publicly guaranteed (PPG) debt that is above 81 percent of GDP, even though net debt had gone down in 2019 due to the receipts of €500 million in Eurobonds (10pp of GDP) that were deposited and used to service debt repayments due in 2020 (including €320 million of Eurobonds redeemed in March). In Albania, although public debt has been declining, contingent PPP liabilities are mounting. Yet, since their peaks in 2016 Albania has brought debt down by 4.5 pp of GDP, Bosnia and Herzegovina by 9 pp and Serbia by 17.8 pp by continued consolidation since their peaks in 2015, which created the fiscal buffers to partly weather the COVID-19 shock. Public debt is still above 50 percent in Albania, Montenegro, and Serbia.

All Western Balkan countries now have higher debt than before the global financial crisis (GFC) and their risk premiums exceed those of peer countries. When comparing debt between the 2008 GFC and 2019, Albania, BiH, and Kosovo have seen a moderate increase of 13 to 17 pp of GDP, North Macedonia and Serbia an increase of just over 25 percent of GDP, and Montenegro a surge in PPG debt of close to 50 pp of GDP. Since 2008 access to finance has become easier as markets stayed liquid and costs of financing plunged. Yet sovereign credit ratings have been largely unchanged except in Serbia and Albania, where fiscal consolidation and debt reduction improved them. Risk premiums for Western Balkan countries are thus 300–400 basis points higher than those of peers—a concern as international financing conditions tighten.

In some countries higher public debt is due to lack of countercyclical fiscal policy in good times. To better understand the variation in countries' fiscal positions and their ability to accommodate the shock, it is useful to look at recent fiscal policy: growth has been strong in most Western Balkan countries for the past few years, but not all of them used it to create the fiscal buffers they now need. Building fiscal

Figure 4. Avoiding pro-cyclical fiscal policy in 2013–18 helped reduce debt in several Western Balkan countries; not in all.



Note: Fiscal policy was assessed using the output gap and the change in cyclically adjusted primary deficit. Output gap was calculated using the HP filter, and the revenue and expenditure elasticities of 1 and -0.1 were used to assess their cyclicality (IMF approach). Where both the output gap level and the change in cyclically adjusted primary deficit is positive (negative), fiscal policy is characterized as counter-cyclical tightening (expansionary). Where the output gap is negative (positive) and the change in cyclically adjusted primary balance positive (negative), fiscal policy is characterized as pro-cyclical expansionary (tightening).

buffers in good times allows for easier and more effective intervention in bad times. Using a proxy for fiscal cyclicality based on a time series of government revenues and expenditures, their elasticities to output, and GDP series smoothed by the Hedrick-Prescott filter, we estimate patterns of Western Balkan fiscal policies throughout the past decade. Figure 1 shows that following the GFC, Western Balkan governments have pursued tightening fiscal policies most of the time, which allowed some of them to reduce debt levels from their peaks a few years ago. And although fiscal policy in several countries turned pro-cyclical recently, the magnitude of pro-cyclicality is much smaller than before.

Fiscal policy is leading the response to COVID-19 as all Western Balkans support households and firms

Like other countries, Western Balkan governments have used fiscal stimuli to counter the slump and provide support to households and businesses. The size and the choice of support depends on each country's fiscal space and access to finance. All countries in the region are spending more on health care, medicines, and equipment–an immediate policy priority. Additionally, governments introduced measures to support households and firms through tax breaks, deferrals, wage subsidies, credit lines, and social assistance to the most vulnerable. Subsidized credit lines, for example, have been offered by Montenegro and North Macedonia through their development banks and by Albania through credit guarantees. The Serbian government announced the largest package of assistance to the economy and citizens, with a direct budget impact of 6.7 percent of GDP and national development bank loan guarantees worth 4.4 percent of GDP. Still, the state budget for social safety net programs fell slightly despite this large increase in spending to mitigate the COVID-19 effects.

These types of measures are necessary for crisis mitigation but ultimately how effective they are will depend on how well they are adapted to the specific context of each country. The rationale of the interventions is to preserve incomes and the productive capacity of the economy by preventing forced closure of businesses or employee layoffs due to short-term revenue shortfalls. Wage subsidies

Table 2. Western Balkan Fiscal Policy Responses

Fiscal measures		Albania	Bosnia and Herzegovina	Kosovo	North Macedonia	Montenegro	Serbia
Fiscal Measures to Enable Health Systems Tackle the Pandemic							
1. Reallocation of health spending to COVID-19 responses		√	√	√	√	√	√
Fiscal Measures to Assist Hard-Hit Individuals and Firms							
A. Tax Administration and Policy Measures							
2. Postponement/suspension of tax filing deadlines							
Corporate income tax	Universal	√	√	√			
	Affected sectors				√		√
Personal income tax	Universal	√	√	√		√	
	Affected sectors				√		√
Social security contributions (SSC)	Universal	√	√	√		√	
	Affected sectors				√		√
Domestic value-added tax	Universal			√			
	Affected sectors						
3. Reduced or waived interest rates on tax arrears		√			√		
4. Tax policy measures							
Headline tax rate cuts							
Income tax rate cuts for micro-enterprises			√[1]				
Reduction of para-fiscal charges					√[1]		
New VAT exemptions				√	√		√
B. Expenditure Measures							
5. Subsidies/waivers for SSC payments			√	√	√	√	√
6. Subsidies/waivers for tax payments			√[1]			√	
7. Subsidized or rescheduled private sector rent payments		√		√			
8. Private sector wage subsidies	Universal						
	Affected sectors			√	√	√	√
9. Additional social transfers (social assistance, unemployment benefits, energy subsidies, pension increases)		√	√	√	√	√	√
10. Frontline public employees wage bonuses (healthcare, police, etc.)				√		√	√
C. Other							
11. Credit lines with subsidized interest rates				√		√	
12. Guarantee schemes		√			√	√	√
Direct fiscal cost estimate (percent of GDP)[2]		**2.2**	**1.6**	**2.9**	**3.3**	**1.0**	**6.7**
Guaranteed credit lines (percent of GDP)[3]		**1.5**	**0**	**0**	**0.4**	**2.6[4]**	**4.4**

Note: Measures as of May 25. 1/ Measures applied only by Republika Srpska. 2/ Not including the assessed additional cost on health spending and estimated revenue loss from tax payment deferrals. 3/ Sovereign guarantees issued to national development banks/funds for further on-lending to businesses. 4/ A credit line offered through the national development bank, but no sovereign guarantees were issued.

Table 3. Framework for Assessing Fiscal Policy Responses to COVID-19

Efficiency • Targetability • Speed • Resistance to abuse	**Flexibility** • Scalability • Reversibility
Cost and fiscal sustainability • Affordability • Predictability and control of costs	**Feasibility** • Administrative ease • Impacts of the pandemic and containment measures

Source: World Bank. 2020. The Fiscal Impact and Policy Response to Covid-19.

or tax exemptions, for example, have become popular in this crisis to help firms reduce fixed costs to stay in business and keep workers—many if not most firms in hospitality, passenger transport, and retail services (other than food and pharmacies) lose all their revenue during lockdowns. As a principle, in a crisis, fiscal policy responses should be efficient, flexible, feasible, and sustainable (Table 3). Speed is of the essence to ensure that pay outs reach firms before their cash flow runs out. They should be time-bound and carefully targeted to affected sectors because they are expensive. And they need to follow clear rules to reduce uncertainty and heighten compliance. There also may be serious tradeoffs the authorities ought to consider—narrow targeting of specific groups of firms, for example, may increase the administrative burden and prevent a timely response. Such measures help sustain incomes and protect productive capacity in the short term, but it is imperative that businesses maintain their productivity and enter recovery phase on a sound footing. And although time-bounded and reversible measures are needed, the speed with which support is unwound should correspond to the speed of recovery.

The higher spending and plunging revenues related to the COVID-19 crisis will increase fiscal deficits and public debt throughout the Western Balkans

Measures to protect lives and jobs have large fiscal costs and will cause public debt to rise. The spending-to-GDP ratio is expected to go up by an average of 2.5 pp of GDP. The transmission channels and the magnitude of the impact differ by country: from a standstill in transport and tourism, which account for almost a quarter of the Montenegrin and Albanian economies, to disruptions in global value chains for BiH, North Macedonia, and Serbia, and plummeting commodity prices for Kosovo. Recession therefore confronts all countries in the region. Higher government spending on health, provision of funds to liquidity-constrained households and businesses, and stimulus to aggregate demand in the recovery phase are all essential—even as revenues are falling because of a shrinking tax base, measures to lower the tax burden, and worsened taxpayer compliance.

In 2020 most Western Balkan countries will experience major shortfalls in public revenues. Compared to 2019 revenue is projected to drop, by almost 8 percent in Montenegro to more than 10 percent in Serbia and Kosovo. Revenue collection could drop even more if containment restrictions continue into the second quarter of the year.

In the baseline, however, revenue shortfalls are projected to outpace the nominal contraction of GDP in most countries, even with a gradual recovery in the second half of 2020. Authorities in most Western Balkan countries have announced measures to subsidize social security

Box 1. COVID-19 Tax Policy and Administration Response Measures in Western Balkans

Authorities in all Western Balkan countries have responded to the COVID-19 outbreak by deferring tax filing deadlines. In Albania, BiH, and Kosovo, the measures cover personal and corporate income tax and social security contributions and apply to all taxpayers. In Kosovo, domestic VAT and property tax payments are also deferred. In Montenegro, postponement of payroll taxes and contributions applies to all taxpayers. On the other hand, authorities in Serbia and North Macedonia have adopted a more targeted approach, granting postponement only to taxpayers from the sectors of the economy most affected.

For most countries in the Western Balkans, tax postponement measures are valid through April or May 2020. Differentiating the impact of the measures from the impact of the tax base contraction is difficult, but it appears that for most countries the combined impact surpasses 1 percent of GDP. If restriction measures are maintained beyond May 2020, policymakers must decide whether to extend the postponement or redesign the measures. Once recovery is underway, the authorities must also decide on the tax treatment of this period, e.g., by rolling-over tax liabilities to 2021 or waiving the obligation altogether.

Tax policy and administration measures in the Western Balkans broadly correspond to measures taken in EU countries. The first responses in the EU support both firm' and households cash-flow, either by extending tax filing deadlines or reducing the interest rate for late tax filing, typically for two to three months. However, unlike Western Balkan countries, many EU countries have targeted flexibility on tax payments only to the firms and households most severely hit by COVID-19. Another notable difference is the coverage of tax postponement for VAT liabilities and reduced deadlines for paying tax refunds to increase firm cash-flow.

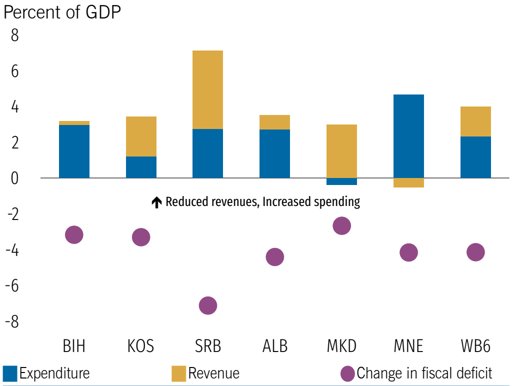
Tax policy measures should be time-bound and focused on micro, small and medium enterprises (MSMEs) with little access to financial markets. With little fiscal space available, authorities in the Western Balkans deciding on tax policy measures to support recovery should target MSMEs and the self-employed, for whom financing constraints are most binding. Among the options there are temporary income tax rate cuts, one-off tax liability waivers, temporary increases in allowed expenses, and sector-based tax holidays, e.g., for hotels and restaurants.

For the recovery, the Western Balkan countries have fewer options for tax policy responses than their EU peers. With generally lower tax rates than EU peers, countries in the region will find it very difficult to mobilize revenue even after restrictive measures are lifted. And with less access to international financial markets, authorities in the Western Balkans have few tax-policy options like tax rate cuts to support economic recovery.

The efforts of Western Balkan countries should therefore focus on tax administration, starting with giving taxpayers flexibility in paying tax liabilities accrued before and during the pandemic. Options are payment plans that allow for rolling over a portion of tax payments to 2021 at concessional interest rates, but with incentives for early payment. Authorities can also speed up tax refunds by relying on post-filing audits.

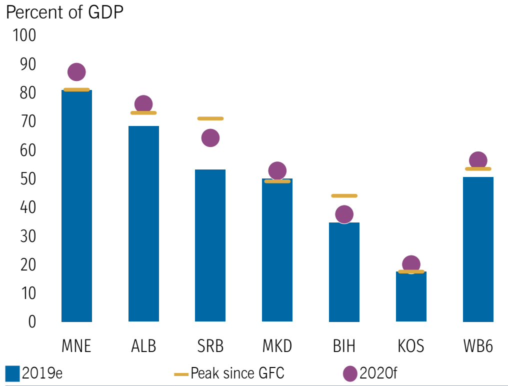
Figure 5. Fiscal deficits are set to rise…

General Government Fiscal Balance



Source: Ministry of Finance.
Note: GFC stand for Global Financial Crisis.

Figure 6: …wiping out recent debt declines.



Source: Ministry of Finance.

contributions and private sector wages (either at the minimum wage level or a percentage of the average wages). Only in Republika Srpska in BiH will the government explicitly subsidize PIT payments; elsewhere in the Western Balkans wage subsidies are defined in gross terms, such as "payment of payroll taxes," so PIT collection is expected to start gradually recovering in the second quarter. Indirect taxes like VAT, excises, and customs duties could also rebound quickly, depending on when containment restrictions are lifted. However, since most Western Balkan tax laws provide for carry-over of losses, CIT revenue is not expected to rebound much in 2020. Moreover, there may be operational problems in revenue administrations due to health measures that further undermine revenue performance and taxpayer compliance.

Fiscal deficits will widen to deal with the COVID-19 shock, increasing the financing needs. In some countries deficits are expected to almost triple. For 2020 the average deficit for the region is estimated at 5.9 percent of GDP in 2020, far above the 1.8 percent in 2019. The deficits of Albania, Montenegro, and Serbia are expected to reach about 7 percent of GDP, with deficits in the rest of the region reaching almost 5 percent. PPG debt for the region is also projected to rise from 50.4 percent of GDP in 2019 to more than 57 percent of GDP. Serbian PPG debt is projected to grow the most—by 11 pp of GDP, which coincides with the size of the support package to fight COVID-19 impact.

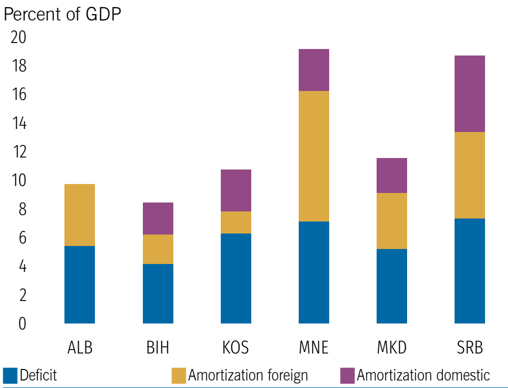
Borrowing needs will surge in some Western Balkan countries just as financial markets tighten

With deficits rising, borrowing needs will surge in some Western Balkan countries. Gross financing needs to cover the fiscal deficit and debt amortization are 19 percent of GDP in Serbia and Montenegro. The composition of a country's investor base will affect whether its financing needs be met. The central bank, local banks, and international institutions[4] will be more willing to maintain or increase

4 Through, e.g., the IMF Rapid Financing Instrument, the World Bank Fast-Track Facility and standard lending instruments, and EU grants and Macro-Financial Assistance.

their exposure to the country, and sticky local investors may facilitate more near-term borrowing, even if that adds to medium-term sustainability concerns. Where possible, the central banks have been releasing liquidity to local banks by reducing their reserve requirement. As debt rises, future budgets will need to account for rising interest payments—and Albania, Montenegro, and Serbia already spend more than 2 percent of their GDP on interest.

Figure 7. Gross government financing needs are large for some countries.



Source: MOFs and World Bank projections.
Note: Pre-COVID financing needs were largely prefinanced in Montenegro with the Eurobond issue of €500 million in September 2019.

After the immediate crisis containment period, fiscal policy needs to strike a fine balance between supporting an economic recovery and ensuring fiscal sustainability

Relief measures should be limited to the immediate crisis containment period and the fiscal policy response should switch to measures supporting the economic recovery afterwards.[5] Although at this stage to the extent possible governments must react swiftly to boost health spending and preserve livelihoods and jobs, it is important to secure fiscal space for the needs that will arise to strengthen demand and support workers and firms to adopt to new market conditions during the economic recovery. The uncertain duration of the crisis, which will be determined by the trajectory of the pandemic, is a major dilemma for policymakers: in the first few months of a crisis, short-term mitigation measures such as wage subsidies can be very effective to preserve incomes, but because they deplete resources, they may become unsustainable if the crisis endures. Measures should be time-bound and planned with understanding of a country's capacities to ensure timely response, but also fiscal space.

A fine balance between ensuring fiscal sustainability and supporting economic recovery is needed to allow transitioning from immediate crisis response to recovery support measures. Like most emerging market economies, countries in the Western Balkans, especially those with little fiscal space, need to carefully weigh these tradeoffs. In tight fiscal environments, governments should:

- first consider reprioritizing expenditures and reducing spending inefficiencies;
- reinforce health sector capacity to prepare for a possible new wave of infection as the restrictions are gradually eased;
- reassess medium-term fiscal strategies to strike the right balance between fiscal stimulus and fiscal consolidation, including through the design of post-COVID 19 economic recovery measures that match the countries' fiscal capacities;
- reflect the structural shift in domestic revenue mobilization, including taxation of digital economy, and environmental tax reform (e.g. taxing carbon, revisiting fossil fuel subsidies);

5 For a review of economic policies to mitigate the effects of the pandemic, see Didier et al. 2020; Loayza and Pennings 2020, and Özler 2020.

- proactively address challenges faced by viable firms through short-term and time-bound horizontal aid support;
- strengthen tax compliance to protect against widening informality while reprogramming tax liabilities of affected sectors;
- strengthen public finance management and procurement to maximize accountability and trust;
- monitor fiscal risks and contingent liabilities from loss-making state-owned companies;
- improve public investment management–including project planning, execution, and procurement—and make green investment an important policy part of a green-growth strategy for recovery;
- in tandem with fiscal policy measures, utilize the post-COVID 19 economic recovery to address long-standing regulatory policy gaps; and
- adopt medium-term plans for restoring debt sustainability and fiscal rules.

Western Balkans Regular Economic Report
No.17 | Spring 2020
Fiscal Policy

View this report online:
www.worldbank.org/eca/wbrer

You and me
by Tanja Burzanovic (Montenegro)

Dr. Tatjana Burzanovic has a wide experience in the fields of graphic design, graphics in architecture, interior design. She has worked as an art editor, interior designer and graphic designer at various levels. Many of her art exhibitions have taken place at different places. She has received many awards for her arts and literary works. She has published a book with a title The Interrelation between Art Worlds, with the support from the Embassy of India for Austria and Montenegro in Vienna. Her artistic philosophy includes displaying of interrelationship between art worlds (spatial and temporal arts). The artist thus meditates between nature and the sprits and yet stems from the absolute idea and serves the goal of realization of absolute sprit. 'Grasping the meaning through the form' is a task of the art set by a contemporary thinker to demonstrate that building forms and creating sense are two simultaneous, intertwined, and absolutely inseparable processes in Arts. Without that recognition it is not possible to take any further step in investigating the nature of art and literature. She believes that art is a way to search the truth. Art is inseparable from searching the truth.

People forge ideas, people mold dreams, and people create art. To connect local artists to a broader audience, the cover of this report and following editions will feature art from the Western Balkan countries.