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Rebuilding Fiscal Buffers in the Post-Pandemic Era: Fiscal Normalization, Consolidation, and Structural Reform

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Rebuilding Fiscal Buffers in the Post-Pandemic Era: Fiscal Normalization, Consolidation, and Structural Reform

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Abstract

The economic fallout from the prolonged pandemic has required extensive policy responses, leaving a large dent in the policy space. A key challenge to fiscal authorities in a post-pandemic environment is how to adjust fiscal policy to maintain a good balance between rebuilding fiscal buffers and maintaining necessary policy support. To this end, this paper argues that post-pandemic fiscal adjustments can be presented in three overlapping phases: fiscal normalization, fiscal consolidation, and fiscal structural reform. Fiscal normalization should start by reducing some emergency measures based on a need assessment. Meanwhile, a clear fiscal consolidation plan should be prepared with specific fiscal targets and measures, which should be carefully selected to meet the evolving policy priorities of the country. In addition, both fiscal normalization and consolidation must consider structural reform priorities. Post-pandemic fiscal adjustments require careful consideration of multifaceted policy challenges, but at the same time, they also provide great opportunities for larger-scale resource rebalancing among various policy priorities and the incorporation of new initiatives.

JEL classification: E62, H62

Keywords: Fiscal Buffer, Fiscal Adjustment, Fiscal Normalization, Fiscal Consolidation, Fiscal Structural Reform

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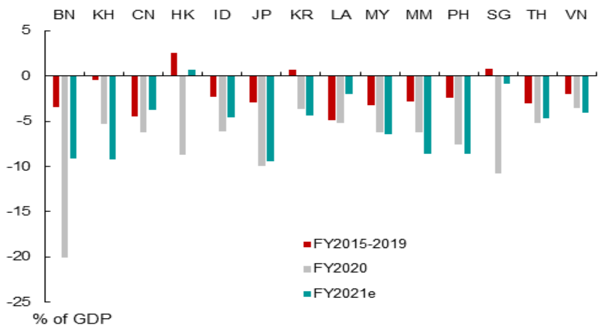
I. Introduction

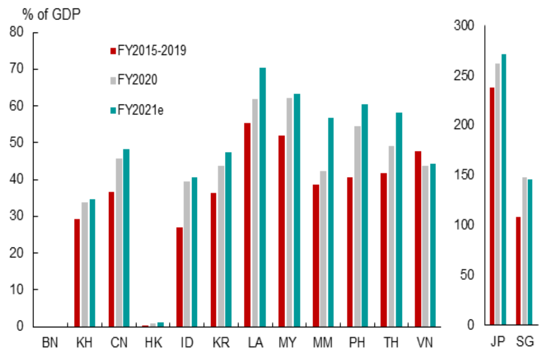
1. **The economic fallout from the prolonged pandemic required extensive policy responses, leaving a significant dent in the fiscal space**. Sizable stimulus packages and weak revenue collection have resulted in the deterioration of fiscal positions in member economies, with sizeable increase in fiscal deficit and government debt compared to the pre-pandemic period (Figures 1 and 2). Amid uncertain economic recovery prospects, the fiscal deficit in the region remained elevated in 2021, although the fiscal balances of some member economies have started improving.[3] This narrower deficit, however, seems not necessarily a result of active fiscal consolidation but cyclical factors, such as stronger growth and higher commodity prices that have driven higher tax collection, played a bigger in many cases.

Figure 1. Fiscal Balance, 2015-2021



Notes: Fiscal year for BN, HK, JP, MM, PH, SG, and TH is different from the calendar year. For CN and MM, pre-pandemic data only cover FY2018-2019. 'e' denotes estimate
Source: AMRO (2022b)

Figure 2. Government Debt, 2015-2021



Notes: Fiscal year for BN, HK, JP, MM, PH, SG, and TH is different from the calendar year. For MM, pre-pandemic data only cover FY2018-2019. 'e' denotes estimate.
Source: AMRO (2022b)

2. **A key challenge to fiscal authorities is how to adjust fiscal policy to a good balance between rebuilding fiscal buffers and maintaining necessary policy support**. There is a growing need to prepare post-pandemic fiscal adjustment strategies, in which the normalization of existing emergency support measures is an important first step to secure some fiscal resources. A strong commitment to fiscal consolidation is essential to rebuild fiscal space and maintain market confidence. However, it also needs to avoid overly relying on fiscal austerity to ensure adequate support for vulnerable sectors, economic recovery, and long-term development priorities, which will improve debt sustainability in the long run. This paper aims to present a framework for designing a fiscal adjustment plan in a post-pandemic era, emphasizing the multifaceted policy challenges this plan should address.

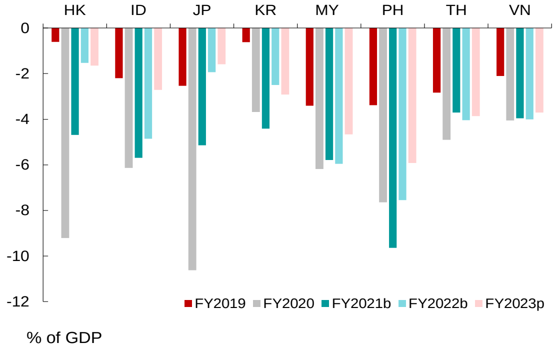
II. Medium-term Fiscal Targets

3. **Most member economies plan to start fiscal consolidation in coming years**. Except Malaysia, Thailand, and Vietnam, which still needed to maintain strong fiscal policy support, most ASEAN+3 economies started to narrow their fiscal deficits in 2022 by reducing stimulus measures.[4] Assuming a smooth and gradual economic recovery from the pandemic, the annual budgets and medium-term fiscal targets of member economies show that sizable fiscal adjustments will continue in 2023, particularly in Indonesia and the Philippines, while

[3] The fiscal deficit is estimated to have increased in Cambodia, Korea, Malaysia, Myanmar, the Philippines, Thailand, and Vietnam, while it decreased in other countries.
[4] This note utilizes medium-term fiscal projections published in congruence with the 2022 annual budget to examine fiscal deficit targets, given that no official fiscal consolidation plan has been announced yet. This note is only able to use three-year fiscal projections for eight selected ASEAN+3 economies where data is available.

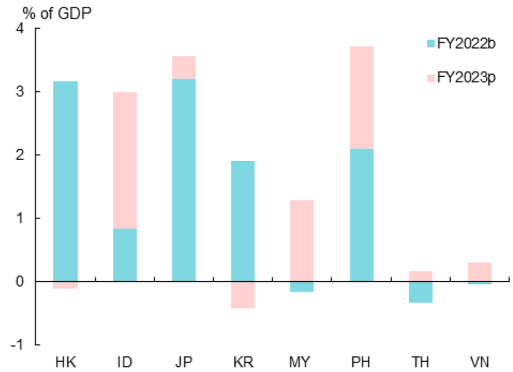
Thailand and Vietnam plan minor adjustments (Figures 3 and 4). However, the timing and scale of fiscal adjustments will depend on various factors, including the recovery momentum as well as the need for policy support (AMRO, 2022a).

Figure 3. Fiscal Balance Targets/Projections in Selected ASEAN+3 Economies, 2019-2023



Note: b and p denote budget and projection, respectively.
Source: National authorities; AMRO staff calculations

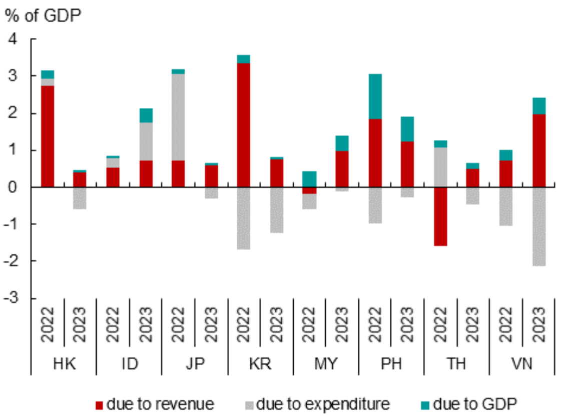
Figure 4. Fiscal Adjustment in Selected ASEAN+3 Economies, 2022-2023



Note: Fiscal adjustment here refers to a reduction in the fiscal balance target. b and p denote budget and projection, respectively.
Source: National authorities; AMRO staff calculations

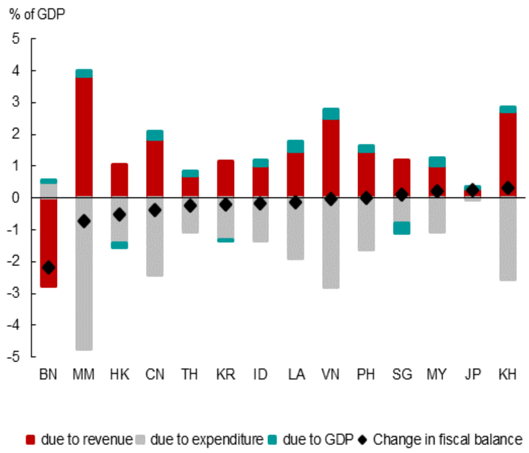
4. **Post-pandemic fiscal consolidation plans rely more on revenue improvements than spending cuts.** Higher economic growth will narrow fiscal deficits through automatic stabilizers (i.e., higher tax revenues and smaller social security spendings) and the positive denominator effects of higher GDP. Reducing fiscal deficit beyond this automatic change requires additional policy efforts, where spending cuts still play an essential role in some economies in reducing deficits to meet fiscal targets. With the calibrated cuts of stimulus spending, the post-pandemic fiscal consolidation plans of member economies focus primarily on revenue increases (Figure 5), which is similar to the post-Global Financial Crisis consolidation experience (Figure 6).[5]

Figure 5. The Decomposition of Fiscal Adjustment Plans in Selected ASEAN+3 Economies, 2022-2023



Source: National authorities; AMRO staff calculations

Figure 6. The Decomposition of Average Annual Change in Fiscal Balance, 2010-2019



Notes: The ASEAN+3 balance is the GDP weighted average of fiscal balance with GDP in USD using market exchange rates.
Source: AMRO Fiscal Dashboard; AMRO staff calculations

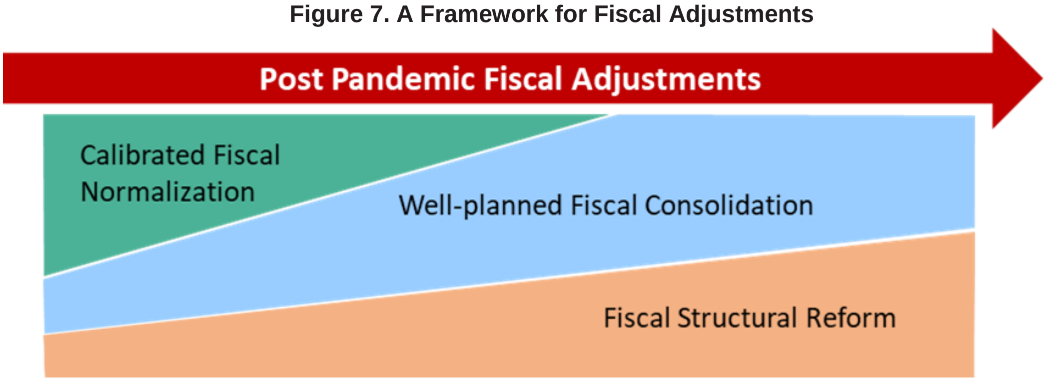
[5] This is based on a simple decomposition of fiscal balance changes ($\Delta(ob_t/Y_t)$) into three components - revenue change, expenditure change and GDP change, i.e. $\Delta\left(\frac{ob_t}{Y_t}\right) = \frac{ob_t}{Y_t} - \frac{ob_{t-1}}{Y_{t-1}} = \frac{\Delta R_t}{Y_t} - \frac{\Delta E_t}{Y_t} - \frac{\Delta Y_t \times ob_{t-1}}{Y_t Y_{t-1}}$

5. **While the need for policy support continues, some economies have started various measures to rebuild fiscal buffers.** As the economic situation gradually recovers from the worst of the pandemic-induced crisis, ASEAN+3 economies are beginning to shift their fiscal policy focus away from crisis support. Policy transition in the post-pandemic era seems gradual, and in various directions, depending on economic recovery prospects. Indonesia, for instance, has introduced a tax reform package aiming to generate more revenue and has revised its fiscal decentralization law to strengthen the implementation of fiscal rules at the local government level. Meanwhile, Korea's plan focuses more on expenditure cuts, such as tightening spending on government officials' current expenses and cutting subsidies to private sector projects.[6] In Malaysia, a more gradual fiscal consolidation than previously planned has been announced, and the size of the COVID-19 fund has been reduced from MYR39 billion in 2021 to MYR23 billion in 2022.

III. Framework for Post-Pandemic Fiscal Adjustments

6. **Post-pandemic fiscal adjustments can be presented in three overlapping phases—fiscal normalization, fiscal consolidation, and fiscal structural reform**. AMRO (2020) highlights four critical areas of focus in designing the post-COVID-19 pandemic policy – Recovery, Risk management, Restructuring and reform, and Rebuilding of policy space (4R). Given the extensive stimulus packages, efforts to rebuild fiscal policy space should start by normalizing existing emergency support measures. This, however, does not necessarily mean directly returning to pre-pandemic fiscal policy by stopping emergency support measures; the key to policy normalization is adjusting fiscal policy measures to properly reflect evolving needs, and a gradual policy transition based on a careful assessment of post-pandemic policy priorities and existing support measures. The speed and extent of such policy normalization should be determined by country-specific situations, and it is essential these policy adjustments are gradually merged into a well-planned fiscal consolidation. At the same time, policy support focus also shifts to a structurally improving fiscal position as well as strengthening long-term growth potential by addressing post-pandemic structural challenges. A successful fiscal adjustment must be accompanied by appropriate structural reforms, with fiscal reform an essential part of it. These three fiscal adjustment phases are illustrated in Figure 7.

Figure 7. A Framework for Fiscal Adjustments



Source: AMRO staff illustration

7. **Governments must prepare clear fiscal adjustment plans with specific fiscal targets and measures to achieve them.** In most countries, annual budget plans and medium-term fiscal projections are not explicit in quantifying the impact of discretionary measures to achieve fiscal targets. As specific quantity targets are important in fiscal

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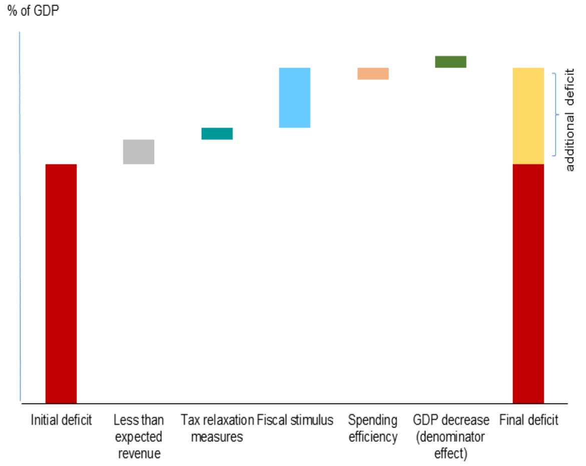
[6] In August 2021, Korean government announced its plan to cut spending by an additional 1.7 percent of GDP. (see https://english.moef.go.kr/pc/selectTbPressCenterDtl.do?boardCd=N0001&seq=5200)

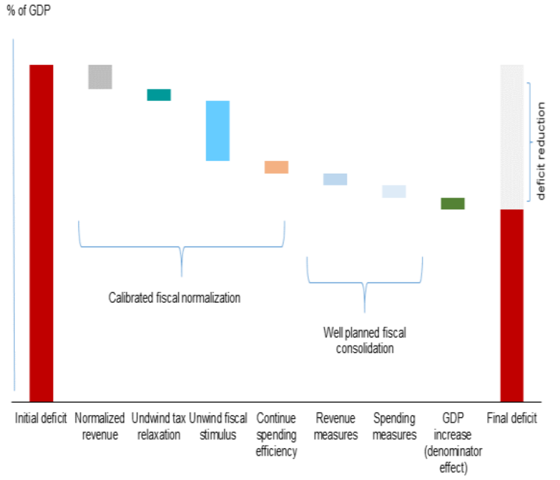
consolidation, presenting quantitative targets for different measures of consolidation plans will be helpful to achieve the targets and assess performance ex post. In particular, the fiscal impact of new discretionary policy measures, normalization of existing emergency measures, and automatic stabilizers should be clearly presented separately. For example, fiscal authorities should be able to decompose the additional deficit during the pandemic and the planned deficit reduction in the medium term into discretionary and automatic stabilizer parts (Figure 8 and 9). Additionally, quantitative targets should be based on credible medium-term projections that will be an additional risk aspect in the ex-post assessment of fiscal performance.

Figure 8. Fiscal Adjustments During the Pandemic



Source: AMRO staff illustration, developed from MMOF (2021)

Figure 9. Post-Pandemic Fiscal Adjustment Plan



Source: AMRO staff illustration

8. **Fiscal normalization should start by the tapering of some emergency measures based on a needs assessment.** The COVID-19 crisis required unusual fiscal responses and substantial reallocation of fiscal resources (Figure 8). As the pandemic situation improves, fiscal authorities need to assess the needs for specific support measures, and selectively reverse the temporary changes in resource allocation, such as by cutting emergency financial support to affected businesses and households, and unwinding broad reductions in taxes and fees (Figure 9). The financing of large stimulus packages through central banks' purchases of government bonds in the primary market as in Indonesia or in the secondary market as in the Philippines, must also be normalized to maintain central bank independence and the credibility of monetary policy frameworks (Agur et al. 2022). Given that most ASEAN+3 economies had substantial policy space and reserves before the pandemic, which enabled sizeable policy support, fiscal normalization at the outset of the pandemic will help start the process of rebuilding policy space.[7]

9. **The choice of fiscal consolidation measures should be well aligned with country-specific needs and evolving priorities**. Although existing research has often found that expenditure-based consolidation is more successful than revenue-based consolidation (Alesina et al. 2019), given the relatively low tax to GDP ratios due to narrow tax bases and generous tax incentives,[8] many member economies put more emphasis on improving revenue

[7] Fiscal normalization efforts are particularly challenging due to "deficit bias" in fiscal policy, which indicates an asymmetric discretionary fiscal policy over the business cycle. In crisis, government expenditure increases significantly to finance stimulus packages, leading to a higher fiscal deficit and the accumulation of debt. When the crisis is over, governments tend to delay measures to reduce fiscal deficits and debt stock—fiscal adjustment in the form of fiscal normalization—to avoid disrupting the economic recovery process.

[8] The average tax revenue to GDP ratio in ASEAN+3 and ASEAN economies in 2020 were 11.5 percent and 10.7 percent. Brunei Darussalam had the lowest ratio in the region with 1.9 percent, while Cambodia had the highest ratio of 20.5 percent.

collection as part of their fiscal consolidation. As the economic recovery momentum is still fragile, revenue enhancing measures should be implemented with proper assessment of their impact on economic recovery. In particular, improving revenue collection capacity—including strengthening tax administration—can be prioritized before introducing new taxes or raising tax rates.[9] Expenditure measures—such as rationalizing distortionary subsidies—are still an important aspect of fiscal adjustment in some economies, where rebalancing of spending priorities could be helped by a comprehensive expenditure review. Given the extensive resource reallocation across different government entities during the pandemic,[10] strong coordination with line ministries and sub-national government bodies will facilitate fiscal authorities' successful expenditure reprioritization. Country specific factors should determine the choice of specific measures and some examples are listed in Table 1.

Table 1. Some Examples of the Post-Pandemic Fiscal Adjustment Measures

Spending Measures	Tax Measures	Financing Measures
Focusing on high priority/ impact spending • Improving resilience through better health, education, and infrastructure • Other areas based on the results of a public expenditure review	**Improving administration capacity and minimize tax leakage** • Improving tax service and compliance • Strengthening tax audits, collection system • Enhancing IT system, big data analytics	**Leveraging innovative financing** • PPP • Asset recycling • Blended finance • Patriotic bonds
Increasing spending efficiency • Reforming pension systems and health entitlements • Rationalizing distortionary subsidies (e.g., energy subsidies) • Better targeting of social welfare spending • Improving unemployment benefit design • Rationalizing military expenditure	**Reforming tax system** • Rationalizing special tax treatments • Strengthening property taxes • VAT/ GST-based consumption taxes • Reducing VAT exemptions	**Promoting ESG financing**
	Promoting environmental taxation • Taxing carbon emissions • Introducing fuel excises	
Streamlining tax expenditure • Publishing tax expenditure reports	**Imposing sin taxes** • Increasing tobacco and alcohol excises • Introduce sugar taxes • Gambling taxes	

Source: AMRO staff compilations

10. **Fiscal normalization and consolidation must consider structural reform priorities.** Fiscal consolidation measures are often contractionary and may slow the speed of economic recovery. Therefore, post-pandemic fiscal adjustments should also consider structural reform priorities. These can offset the temporary contractionary impact of fiscal

[9] Basri et al. (2021) shows that an improved tax administration can have a bigger impact on revenue collection than increasing the tax rate.

[10] Malaysia has re-prioritized its 2021 and 2022 budgets by allocating more funds to development expenditure and other growth supporting areas. These expenditure measures have contributed towards reducing its deficit by 1.5 percent of GDP. Indonesia has also tried to improve spending quality by reallocating and refocusing on activities that provide the most significant marginal benefits.

adjustments and structurally enhance long-term growth potential (Anderson et al., 2013).[11] For instance, a fiscal consolidation measure to increase tax revenue collection by rationalizing special tax treatments, such as tax incentives, may discourage foreign investors to invest in a country that adopts such measures. The country can, however, mitigate this risk by improving infrastructure and business environment to increase its competitiveness, and enhance tax services to reduce tax compliance burden. Another example is that money saved from rationalizing distortionary subsidies can be used to strengthen labor market competitiveness, or to minimize scarring of labor productivity, and develop future-ready human capital. Meanwhile, as structural reforms take longer to yield their full benefits, a careful policy mix between fiscal consolidation and structural reforms is needed to balance short-term and medium-term policy priorities.

IV. Challenges in Post-Pandemic Fiscal Adjustments

11. **Formulating a fiscal adjustment plan requires careful consideration of macroeconomic impact, market confidence, and political economy**. In addition to many country-specific factors, such as domestic and external economic conditions, monetary policy and exchange rate environments, and fiscal institutions (Molnar, 2012), establishing a good post-pandemic fiscal adjustment plan requires factoring in the following three aspects in particular.

- **Macroeconomic impact.** Empirical evidence on the economic impact of stimulus measures is mixed. Fuss et al. (2020) found little or no impact on the economy, other than higher levels of debt. Meanwhile, Deb et al. (2021) show that the announcements of fiscal stimulus measures positively impact economic activity and market confidence, but argue that the stimulus measures, focused primarily on saving lives, may not generate sufficient rates of return to service the high debt levels. Post-pandemic fiscal adjustments, which include both doing away with temporary stimulus measures and additional consolidation measures, are likely to affect the economy through various channels. Existing research on fiscal multipliers provides general guidance on the appropriate policy mix for specific policy priorities as the extent of economic impact depends on the specific policy measures as well as country-specific factors (Table 2).[12] Also, fiscal multipliers tend to be affected by other conjunctural factors. They tend to be higher in recessions and lower in expansions (see, for instance, Auerbach & Gorodnichenko (2012), Blanchard & Leigh (2013)), while high uncertainty could also increase the size of multiplier through confidence channel (Gbohoui, 2021). Given that the fiscal consolidation multipliers may be less sensitive to business cycle (Cugnasca & Rother, 2015), the post-pandemic fiscal adjustment plan should properly reflect the economic policy and structural environments that influence the extent of macroeconomic impacts of fiscal policy adjustments.[13] In the case of ASEAN+3 economies, Dime et al. (2021) estimate the government spending increase multiplier during the period 2000-2019 is between 0.73 and 0.88, while tax cut multipliers are between -0.41 and -0.62.

[11] Fiscal adjustments can be designed to promote structural reforms to increase economic resilience and boost growth potential, such as enhancing financial and corporate sector stability, improving labor market flexibility, and strengthening market competition. Public sector reforms, including PFM reforms, should be an essential part of structural reforms.
[12] The size of the fiscal multiplier is also determined by structural factors and conjunctural factors (Batini et al. 2014). The structural factors are trade openness, labor market rigidity, the size of automatic stabilizers, the exchange rate regime, debt levels, public expenditure management and revenue administration. Meanwhile, the conjunctural or temporary factors are the state of the business cycle and the degree of monetary accommodation to fiscal shocks
[13] In addition, Giavazzi and Pagano (1990) argue that fiscal consolidation could be even expansionary in some cases. Recently, Nie (2020) also found that tax-based fiscal consolidation measures could also be expansionary even for high-debt economies.

Table 2. The Size of Fiscal Multipliers in Selected ASEAN+3 Economies

Economy	Size of Fiscal Multiplier	References
Indonesia	• Spending increases: 0.22 ~ 0.76 Tax cuts: 0.16 • Spending cuts: -0.01 ~ -0.42 Tax increases: 0.37 ~ 0.45	• Ducanes et al. (2006)[1/] • Tang et al. (2010)
Malaysia	• Spending cuts: 0.20 ~ 0.28 Tax increases: 0.24 ~ 0.52	• Tang et al. (2010)
Philippines	• Spending increases: 0.27 ~ 0.74 Tax cuts: 0.03 • Spending cuts: 0.41 ~ 0.42 Tax increases: 0.09 ~ 0.12	• Ducanes et al. (2006) [1/] • Tang et al. (2010)
Singapore	• Spending increases: -0.23 ~ -0.17 Tax cuts: 0.28 ~ 0.81	• Tang et al. (2010)
Thailand	• Spending increases: -0.37 ~ -0.35 Tax cuts: 0.68 ~ 1.40	• Tang et al. (2010)
Korea	• Spending increases: 0.53 ~ 0.63	• Choi & Son (2016)
Cross countries that include ASEAN+3 economies	• Spending increases: 0.73 ~ 0.88 Tax cuts: -0.41 ~ -0.62	• Dime et al. (2021)

Note: 1/ Short-term fiscal multiplier
Source: AMRO staff compilation

- **Market confidence.** Market confidence in fiscal authorities' policy credibility, including their fiscal consolidation plans, has a big influence on authorities' financing conditions through risk premium and, more broadly, overall balance sheets of financial institutions and companies through interest rate channels (Corsetti, 2011).[14] Additionally, the deterioration in market confidence may increase the likelihood of a self-fulfilling sovereign crisis in certain cases. Given the successful deployment of stimulus measures during the pandemic, post-pandemic fiscal adjustments should start by establishing a credible consolidation plan. This must be accompanied by careful policy measures to balance the speed of fiscal consolidation in the medium-term with progress in economic recovery in the near- and medium-terms. Country specific factors should be carefully blended in the medium-term projection of the consolidation plan. For example, an economy with a higher rollover risk may need to front-load its fiscal consolidation efforts, given the prospect of interest rate hikes going forward. The main benefit of a credible fiscal consolidation plan is to effectively reduce policy uncertainty in the medium-term. Although fiscal consolidation may not lower public debt in the short-term, the private sector can plan and allocate resources better if it is clear how the government plans to reduce fiscal deficit, and what policy measures the government plans to deploy.

- **Political economy.** Successful planning and implementation of post-pandemic fiscal consolidation requires proper considerations of both economic and political aspects of resource allocation changes by the plan. Political factors can substantially affect not only the overall process of fiscal consolidation but also the choice of policy measures to be adopted. For instance, elections could exacerbate the deficit bias by impacting the size, timing and the whole course of post-pandemic fiscal consolidation. Acknowledging that fiscal policy is inherently political, strengthening fiscal institutions, such as a fiscal responsibility law, fiscal rules, and an independent fiscal council will help reduce undue political influence on post-pandemic fiscal consolidation plans (Beetsma et al., 2017).

[14] Market confidence is also important to non-market access economies, although to a lesser extent. Donor countries or agencies and international organizations require strong policy commitment from recipient countries, where they agree to adjust their fiscal policies, to ensure they will pay off their loans. Some recipient countries also set their self-imposed targets under certain scenarios and policy mixes.

12. **Fiscal rules must be reviewed as an integral part of a fiscal adjustment plan**. Fiscal rules are an important building block of good fiscal discipline, and prudent and transparent fiscal rules can substantially enhance fiscal policy credibility. Several ASEAN+3 economies relaxed their fiscal rules during the pandemic to allow large scale fiscal responses to the unprecedented pandemic crisis.[15] As more economies start withdrawing their emergency support measures, reinstating fiscal rules should also be assessed and incorporated into post-pandemic fiscal adjustment plans. Also, certain members may consider introducing fiscal rules to supplement their post-pandemic fiscal adjustment plans and strengthen fiscal policy frameworks in the medium term.

13. **Post-pandemic fiscal adjustments provide a great opportunity for large scale resource rebalancing among various policy priorities and the incorporation of new initiatives.** Normalizing unprecedented pandemic policy responses necessarily involves equally large-scale policy adjustments and resource reallocation. This large-scale reshuffling of resources provides a good opportunity to reassess both existing and new policy priorities. Reshuffling can also result in the reallocation of resources based on these assessments, which cannot be done easily under incremental budgeting practices. For example, the rising demand for a green recovery can be incorporated in post-pandemic fiscal adjustment plans with careful assessment of environmental initiatives and other priorities. Rigorous assessment and analysis will help secure public support for the adoption of appropriate policy options, such as carbon taxation, green budgeting, and sustainable finance in the fiscal adjustment plan.

V. Conclusions

14. **Post-pandemic fiscal adjustments should strike a good balance between rebuilding fiscal buffers and maintaining necessary policy support**. Fiscal adjustment can be understood in three overlapping phases – fiscal normalization, fiscal consolidation and fiscal structural reforms. After unprecedented fiscal stimulus during the pandemic, fiscal normalization should start by reducing the stimulus based on a needs assessment. Meanwhile, fiscal consolidation should be planned with specific fiscal targets and measures, which should be carefully selected to meet the evolving policy priorities of the country. Some ASEAN+3 member economies with relatively low tax to GDP ratios may focus more on revenue-based measures. In addition, both fiscal normalization and consolidation must consider structural reform priorities to balance the full benefits of structural reforms in the medium-term with short-term impact of fiscal consolidation.

15. **Post-pandemic fiscal adjustments require careful consideration of multifaceted policy challenges, and should make use of the opportunity to rebalance resources towards new initiatives**. A good post-pandemic fiscal adjustment plan needs to factor in economic, market confidence and political economy considerations. Fiscal rules should also be assessed and incorporated into post-pandemic fiscal adjustment plans to strengthen fiscal policy frameworks in the medium-term. Large-scale policy adjustment needs after the pandemic provide a good opportunity to reassess existing policy priorities and new priorities, such as carbon taxation, green budgeting, and sustainable finance.

[15] Indonesia relaxed its budget deficit ceiling of 3 percent of GDP for three years from 2020 to 2022. Malaysia increased its debt ceiling twice from 55 percent to 60 percent in 2020, and 65 percent of GDP in 2021. Similarly, Thailand’s public debt ceiling was increased to 70 percent from 60 percent in September 2021. In addition, Malaysia has created a special account for the COVID-19 fund, which allows it to bypass the golden rule of spending and allow its government to borrow for this account.

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