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Public Sector Practice

Closing the $30 trillion gap: Acting now to manage fiscal deficits during and beyond the COVID-19 crisis

Countries can not only take immediate steps to create a credible debt story for funding the deficit but also consider a portfolio of interventions to ensure their longer-term financial sustainability.

by Rima Assi, Mael de Calan, Akash Kaul, and Aurelien Vincent

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July 2020

In response to the COVID-19 crisis, governments around the world have ramped up their relief and stimulus spending[1] to unprecedented levels—just as tax revenues have slumped. The result could be a worldwide $10 trillion deficit in 2020 and a cumulative shortfall of up to $30 trillion by 2023.[2] As deficits mount, governments must consider a wide range of options. Some are, in effect, monetizing their debt through central banks. Others lean on additional borrowing or are considering ways to reduce deficits or sell off assets.

Whichever path governments choose, they face a great balancing act: managing record fiscal-deficit levels while restoring economic growth.[3] We estimate that they will seek to raise debt equivalent to an additional 20 to 25 percent of global GDP over today's level, as a direct result of the crisis. To start with, governments must make sure they can not only raise enough credit from debt capital markets (DCMs) and multilateral institutions but also optimize the cost-to-risk ratio of their debt portfolios. Yet for most countries, the greater challenge will be to ensure that increased debt-servicing costs do not crowd out vital investments or trigger big tax increases that would damage competitiveness and reduce aggregate demand at a time of crisis.

All this will not be easy. Our analysis suggests that higher levels of sovereign debt will add as much as $2.5 trillion a year to the debt-servicing[4] costs of governments over the next decade. They will need bold strategies that consider every available lever to master the great balancing act—and to avoid the worst-case scenario: a debt crisis compounding the economic one that COVID-19 has already unleashed. The timing of these strategies will be one of the most complex and instrumental success factors. To avoid disrupting the economic revival, fiscal measures should not come too early, but to avoid losing control of the fiscal trajectory, they should not come too late.

Governments can scale up their capabilities to optimize existing revenue streams and contain expenditures, focusing in each case on operational excellence while taking care not to hamper the economic recovery. In some countries, an even greater opportunity lies in making government balance sheets transparent, including assets such as land, property, and state-owned enterprises (SOEs).

Many countries have considerable scope to manage and generate income from the assets on their balance sheets more effectively. We estimate that, globally, balance-sheet measures could raise up to $3 trillion a year by 2024, enough to fund the entire incremental cost of crisis-related debt service, at least until 2032. This route could prove essential for governments that have limited or very costly access to DCMs—a group that includes about half of all countries—those rated as subinvestment grade (BB+ and below). But balance sheets could also provide powerful options for countries that can more easily access debt, and these include many of the world's largest economies.

The winning recipe in this unprecedented crisis will uniquely combine economic-development and public-finance strategies. Sustainable economic growth provides the foundation for building public wealth and raising tax monies in the future, but a disciplined and healthy fiscal trajectory is necessary to sustain economic prosperity in the medium to long term.

In this article, we focus on the fiscal response and build on the assumption that many governments

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[1] Ziyad Cassim, Borko Handjiski, Jörg Schubert, and Yassir Zouaoui, "The $10 trillion rescue: How governments can deliver impact," June 2020, McKinsey.com.

[2] Rima Assi, David Fine, and Kevin Sneader, "The great balancing act: Managing the coming $30 trillion deficit while restoring economic growth," June 2020, McKinsey.com. These figures are based on a McKinsey analysis, as of May 8, 2020, of the impact of a scenario in which the virus recurs, long-term growth is slow, and the world recovery is muted. This is considered the most likely scenario in a recent McKinsey Global Executive Survey.

[3] Ibid.

[4] "Debt servicing" is defined as repayment of interest and principal.

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feel the growing constraint of fiscal deficits. We also shine a spotlight on both the immediate steps countries can take to develop a credible debt story to fund their deficits and the broad portfolio of fiscal and financing interventions they can consider to ensure longer-term financial sustainability. Although governments typically consider policy changes—in taxation, for example—the article also focuses on operational levers. We suggest an approach that countries can use to pinpoint, prioritize, and sequence their options so that they can design and implement measures to achieve or maintain fiscal sustainability over the next two to three years. Last but not least, we consider how governments can build or strengthen their nerve centers for managing the fiscal crisis, so that they can shape and execute their rescue plans.

To ensure fiscal sustainability in and beyond the crisis, consider every lever

To address the immediate priority of funding larger fiscal deficits, governments must raise more debt, either through DCMs or multilateral institutions. To do so, they will need to pull a number of debt-management levers to improve their debt-issuance and -management capabilities—and to optimize the cost-to-risk trade-offs of their debt portfolios.

Just as important, the government of each country will need a credible debt story to demonstrate its medium-term fiscal sustainability and its capacity to generate sustainable economic growth—for example, by financing growth-oriented capital expenditures. That kind of a narrative can reassure investors and ultimately lower the cost of debt for sovereign issuers. In the context of the COVID-19 crisis and its impact on public finances, most countries will have to consider a broad portfolio of solutions in their fiscal plans—both levers for implementation after the crisis passes and levers that can be pulled quickly if the amount of debt raised doesn't bridge their deficits (Exhibit 1).

Most governments can push to optimize revenue streams and contain some public spending, but the great balancing act will limit their scope to use these traditional budget-balancing tools. Our analysis suggests, for example, that attempts to close crisis-era government deficits through fiscal austerity would require cutting public expenditures by about 25 percent—which no government would contemplate. Likewise, using only tax increases to fund the deficit would raise taxation by 50 percent, which would hurt taxpayers, limit corporate investment, and reduce national competitiveness. That's why governments have to consider unlocking the funding potential of balance-sheet assets.

A thoughtful approach to all three nonsovereign-debt levers—balance-sheet funding, revenue-stream optimization, and the containment of spending—can give governments medium- to long-term support to help them fund the additional debt burden accumulated during the crisis. We estimate

Exhibit 1

Given the scale of the fiscal challenge, governments can consider a broad portfolio of available levers.

	Build excellence in debt issuance and management	Unlock funding potential of balance-sheet assets	Optimize revenue streams	Contain expenditures
Objectives	Debt issuance and management capability improvement for best cost/risk portfolio	Nonstrategic sovereign assets leveraged to raise short-term capital	Operational-lever analysis to increase collection without hurting economic recovery efforts	Expenditure review to improve efficiency of spend in light of new COVID-19 realities
Levers	● Upgrade debt story and communication strategy ● Optimize debt issuance with improved debt-management tools ● Partner with Central Bank to monetize part of the debt	● Create transparency and improve accuracy of assets on balance sheet ● Collateralize sovereign assets to raise more debt ● Use lending solutions to finance capital-expenditure projects (eg, PPP[1]) ● Sell nonstrategic assets ● Privatize SOEs[2] ● Leverage reserves	● Upgrade fraud deterrence and detection process ● Improve revenue collection through better citizen service ● Incentivize prepayment ● Improve management of assets to increase their yield	● Reallocate budget away from noncore categories ● Optimize procurement ● Use value engineering to streamline capital expenditure ● Review staff utilization and increase productivity ● Optimize social-welfare policies

Enablers of medium-term fiscal sustainability

[1]Public–private partnership.
[2]State-owned enterprises.

that nonsovereign-debt levers could finance all annual repayments, from 2024 to 2032, of the debt raised to fund the recovery from 2020 to 2023.

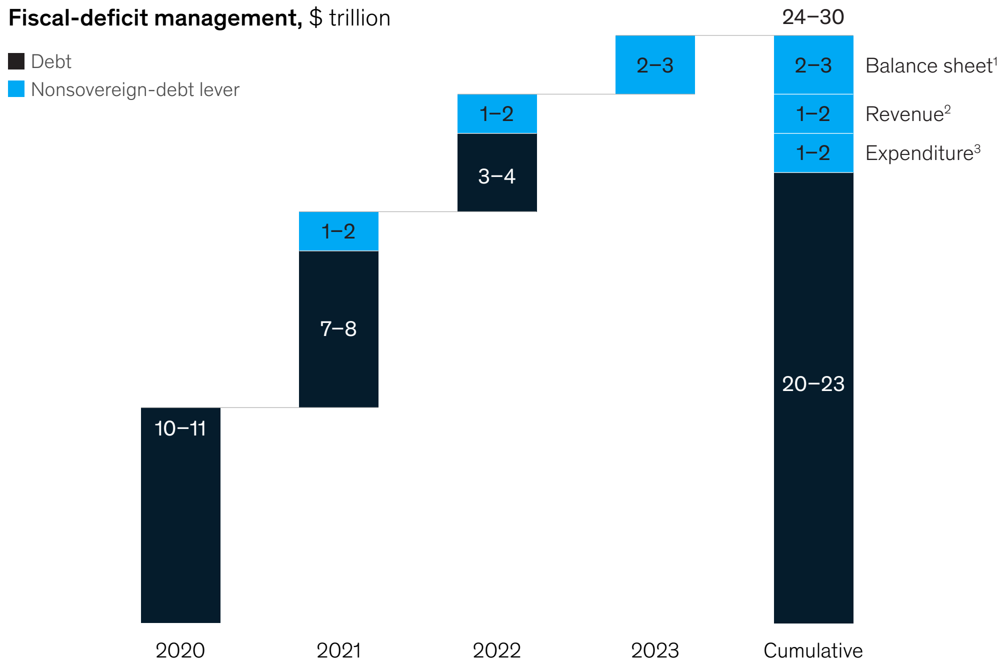
Our analysis suggests that nonsovereign-debt levers will ramp up over time to cover $4 trillion to $6 trillion of the cumulative deficit by 2023 if governments leverage their sovereign assets and increase their discipline and efficiency in collecting and spending revenue—assuming no major changes in fiscal policy. Governments would therefore finance 80 to 90 percent of their cumulative fiscal gap through conventional debt (Exhibit 2). In the advanced economies, which will account for the majority of the new debt issuance, debt-to-GDP ratios would probably rise from an average of 105 percent before the crisis to approximately 125 percent by 2023.

Revamp debt strategies and build credible debt stories

Countries raised $2.1 trillion in debt in the first half of 2020. Since the start of the COVID-19 crisis, the issuance of sovereign bonds has increased by about 25 percent compared with the same period in 2019. Governments have focused on short-term

Exhibit 2

Ramp up debt and nondebt levers to bridge the fiscal gap.



[1]Monetized assets to amount to recurring value of 3–5% of GDP.
[2]Revenues optimization to amount to 2–4% of total revenues through improved collection, resulting in 1–2% of GDP impact.
[3]Expenditure-review savings to amount to 4–5% of addressable spend (expected to be 50% for Organisation for Economic Co-operation and Development countries), resulting in 1–2% of GDP impact.
Source: Center for Strategic and International Studies; International Monetary Fund (IMF) 2020 Fiscal Monitor, Chapter 1; IMF World Economic Outlook; Organisation for Economic Co-operation and Development; World Bank; McKinsey analysis

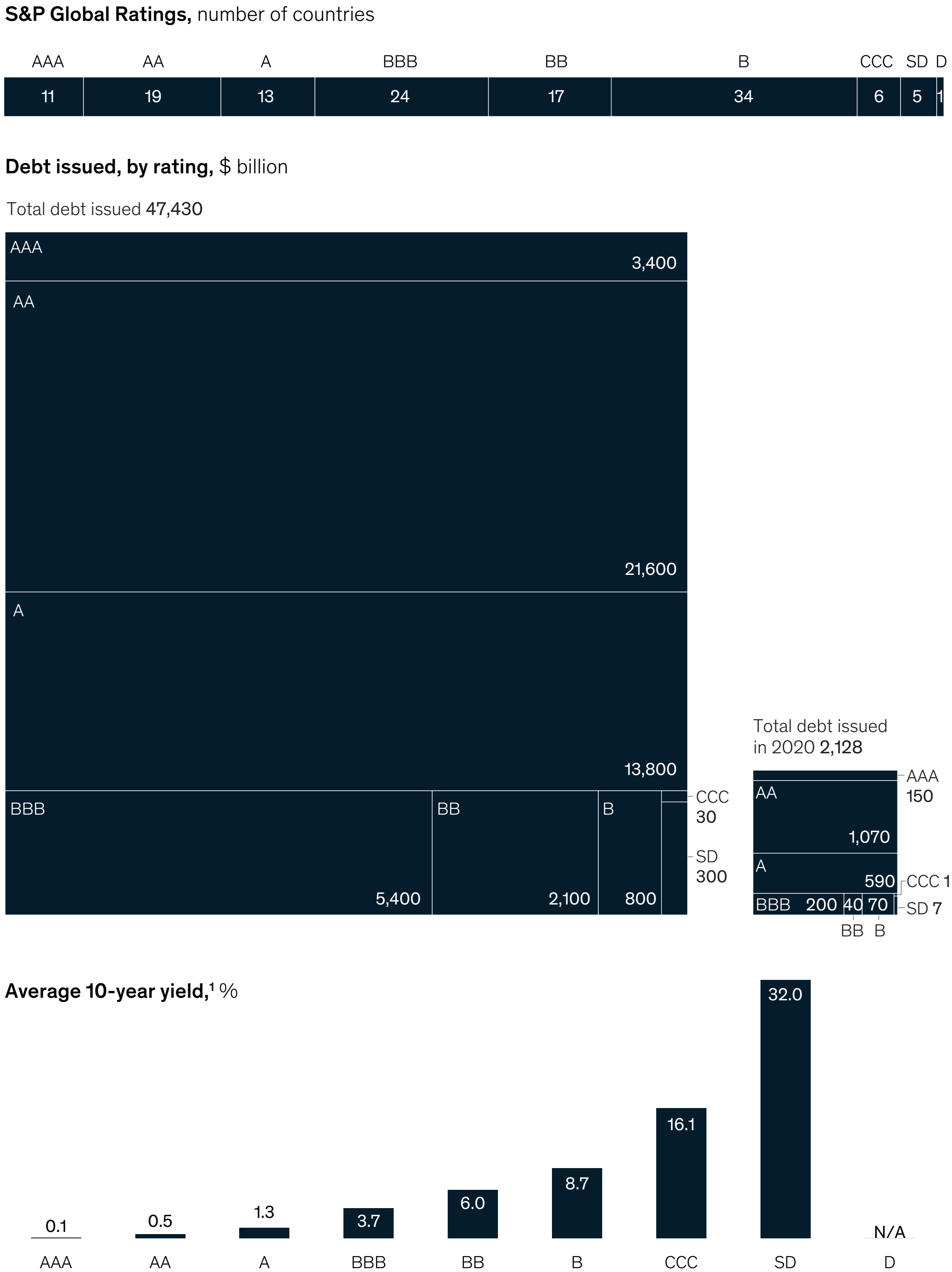
debt to manage their liquidity needs. Sovereign-bond issuance with tenors greater than one year fell by about 10 percent during the same period. Investment-grade countries—just over half the total—are leading the way, with about 90 percent of the debt raised in 2020 (Exhibit 3).

As the supply of sovereign debt increases, countries can create effective strategies to issue and manage debt and therefore attract investment. We estimate that they will raise an additional 20 to 25 percent of global GDP in debt over today's level as a result of the COVID-19 crisis.

A government-debt strategy must have a clearly articulated debt story mapping the path to long-term fiscal sustainability. A critical success factor for such a debt story is transparency and proactive communication: governments will need an up-to-date economic-development strategy and fiscal plan, with key economic metrics, including tax revenues, capital expenditures, and trade and GDP projections, as well as a solid approach to market communications. Other critical elements of the debt strategy include a fully operational debt-management office (DMO) and a clear internal institutional framework that identifies

Exhibit 3

Bridging the fiscal gap will require access to funding—which for many countries is not available at a reasonable cost.



[1]Calculated in May 2020, used as a proxy for cost of borrowing.
Source: Bloomberg; International Monetary Fund DataMapper; S&P Global Ratings

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budget and nonbudget entities and the rules for sovereign guarantees.

Indonesia's DMO, for instance, has issued bonds to fund the country's response to the COVID-19 crisis and its economic recovery. Its first "pandemic bond" raised $4.3 billion. Thanks to sound fiscal discipline in the preceding years—a deficit of less than 3 percent and a debt-to-GDP ratio of about 30 percent—Indonesia has the credibility to explore global bonds. It has issued an estimated $34 billion in net debt in 2020 and plans to sell a further $27 billion in pandemic bonds to cover additional spending.[5]

To unlock additional value, manage the balance sheet as an investor

Traditional funding sources are unlikely to plug the fiscal gap for most countries. Governments must also consider alternative solutions that leverage their assets and the depth of their balance sheets. Creating transparency, estimating the value of assets on the state's balance sheet more accurately, and unlocking that value through monetization strategies will be important to generate revenue that complements debt as a source of financing.

Transparency is important to attract both financiers and potential investors. We estimate that governments could raise 2 to 3 percent of GDP a year by monetizing the assets on their balance sheets. Global public assets are worth more than 200 percent of global GDP, around half of it in real estate—a tremendous untapped opportunity to raise additional cash resources.

To capture it, governments should manage their assets as investors: they will need to review the value and returns of their real-estate holdings, SOE investments, and other assets. Start by identifying high-potential assets and prioritizing opportunities to optimize them. First, government agencies should determine which assets to consider. Top-value assets can be identified and categorized with the help of a scan of inventories provided by agencies and other inputs from them and from experts. The assets in question might include downtown buildings, surplus land in high-value areas, and assets identified through the hypotheses of agencies or experts.

The next step is to size the opportunities after an initial opportunity assessment that considers the value-creation levers that will have the greatest impact, comparative assets, case examples, and the capital base. These opportunities include high-value property for sale or lease, buildings in relatively low-density areas that can be developed more intensively, and select businesses and infrastructure that can be divested or optimized.

Governments can further filter such a list of sized opportunities through a qualitative feasibility assessment that draws on the views of agencies to arrive at a short list of the top five to ten opportunities. Each of them can then undergo a deep-dive analysis to evaluate nuanced legal considerations and assess sources of additional value. These vetted opportunities may then move forward.

[5] Announcement by the government of Indonesia, April 6, 2020.

Governments can provide seed equity to create an infrastructure fund as a special-purpose vehicle (SPV) to monetize the public real-estate portfolio by raising debt against it. Previously unrecognized or undervalued real-estate assets can be transferred to the fund at market value and then used as collateral to finance development. A review of existing assets conducted in a US state, for example, revealed an estimated $600 million to $1.1 billion in potential untapped annual recurring value. Real estate accounted for about 70 percent of the value of the reviewed assets, infrastructure and operating businesses (such as transportation companies) for 15 and 10 percent, respectively.

In Singapore, the creation of an active holding company to maximize the ROE of national commercial assets contributed about $3 billion to the country's budget.[6] New Zealand was the first country (in 1991) to adopt a transparent balance sheet applying international accounting standards. It has since tracked the evolution of its net worth (assets less liabilities), which has now reached 45 percent of GDP. As a result, the country raised its credit rating to AA+ and reduced the cost of servicing its debt.

This kind of review allows governments not only to increase the potential value of such holdings but also to enable alternative funding solutions: they can collateralize sovereign assets to raise more debt, use nonrecourse lending solutions (such as public–private partnerships) to finance capital expenditures, and exploit or sell nonstrategic assets (for example, by raising revenue from land).

To increase revenues, make the most of collection levers

In an environment of decreasing revenue pools, governments must not only rethink the way they collect revenues but also ensure that they collect everything to which they are entitled. Revenue-collection agencies, such as tax and customs authorities, can strengthen their collection capabilities. More efficient collection, inspection, and compliance could increase fiscal revenues by 3 to 5 percent, which would compensate for 15 to 20 percent of the global drop in fiscal revenues expected as a result of the slowdown. The use of advanced analytics to improve the selection of audited taxpayers, for example, enabled one Organisation for Economic Co-operation and Development country to generate $400 million in additional revenues.

Such a transformation requires strong leadership and disciplined execution, with three distinct components (Exhibit 4):

Exhibit 4

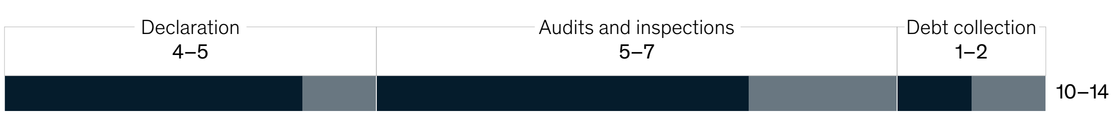
There is a significant revenue-acceleration opportunity from operational levers.

Core levers in tax and customs value chain

● Near term ○ Longer-term or policy-related potential

Registration	Declaration	Payments	Audits and inspections	Debt collection
○ Formalize establishments	● Improve declaration-verification intelligence ○ Revise current tax/tariff regime (eg, structure, levels)	○ Reduce payment delays	● Improve field-inspections operations and auditing	● Accelerate undisputed debt collection ● Enhance disputed debt-collection operations

2- to 3-year potential out of addressable baseline, by value-chain segment, %



[6] Dag Detter et al., "Putting public assets to work," Citi Perspectives, 2019.

- *Improving the tax system to strengthen long-term sustainability.* One key move is to simplify and improve corporate tax and VAT regimes—for example, by launching electronic-invoice programs. The necessary steps include designing specific tax regimes for microactivity and informal businesses and redesigning exemption regimes and incentives to ensure that they actually do promote investment and economic development.

- *Reforming tax and customs administration to improve enforcement and collections.* The key steps here include ramping up the processes and capabilities for inspections and audits—for example, by using advanced-analytics techniques and third-party data from banks, utilities, retailers, and other sources. Governments and tax authorities must also have the ability to make debt-collection processes more stringent and to move more quickly against defaulters.

- *Improving compliance.* The levers available include launching or strengthening initiatives to register businesses and individuals. Governments can also reduce barriers to compliance—for example, by increasing the use of remote payments and prefiling and, where appropriate, giving defaulting taxpayers a clean start. Longer-term levers include launching or strengthening taxpayer-education programs through mass-communication media.

Achieve material savings without hurting the economic recovery

New COVID-19 realities, such as the increased adoption of digital technologies and greater demand for healthcare, give governments a unique opportunity to revisit their planned expenditures and, in many cases, to enhance the delivery of services. To make good on this new reality, governments should enable the norms it requires, such as physical distancing, sanitization, and remote working. Each of them has budgetary implications.

Governments will also have to consider the trade-offs between achievable fiscal savings and their effects on the economy and explore anything that helps them to do more with less. In the short term, they may well have to deprioritize all expenditures that aren't urgent. To achieve material savings, governments must consider four levers:

1. accelerating efficiency through best-practice procurement measures,[7] such as centralized spending on common categories and enforcing reference prices by developing a price index

2. reducing the wage bill without reducing headcounts; one tried-and-tested method is to optimize the use of labor and to eliminate "ghost workers" (salaries paid for nonexistent roles)

3. reviewing subsidies and their application, with a focus on transparency and using digital tools to spot leakages while streamlining eligibility processes and delivering benefits[8] more efficiently

In an environment of decreasing revenue pools, governments must not only rethink the way they collect revenues but also ensure that they collect everything to which they are entitled.

[7] See Tera Allas, Diego Barillà, Simon Kennedy, and Aly Spencer, "How smarter purchasing can improve public-sector performance," March 2018, McKinsey.com.
[8] See Melanie Brown, Damien Bruce, and Mike McCarthy, "Social spending: Managing a $5 trillion challenge," August 2019, McKinsey.com.

4. making infrastructure and capital deployment more effective through value engineering to streamline capital expenditures, among other things; governments can also improve the delivery of initiatives by monitoring contractors more effectively

Value engineering includes the implementation of design-to-value and lean-execution techniques to standardize designs. It can, for example, be used to reduce hospital construction costs by streamlining design standards for recurrent platforms (such as the rooms of patients) and by optimizing specifications. Typically, value engineering can save up to 20 percent of the total construction cost of a hospital project and about 10 to 15 percent of the capital cost of roads, housing, and schools.

Develop a fiscal-sustainability plan now

Countries have different degrees of freedom to act, and these differences will influence the levers each country uses in its fiscal-sustainability plan, which will depend on its starting fiscal position and ability to unlock short-term funding. The resilience of its midterm approach to economic and fiscal issues will be important as well.

What countries do with each lever and the timing of its implementation will vary (Exhibit 5):

— Investment-grade countries with broad access to DCMs can prioritize increasing their access to debt markets by updating their debt stories and strategies. They can then plan their fiscal consolidation after the economic recovery.

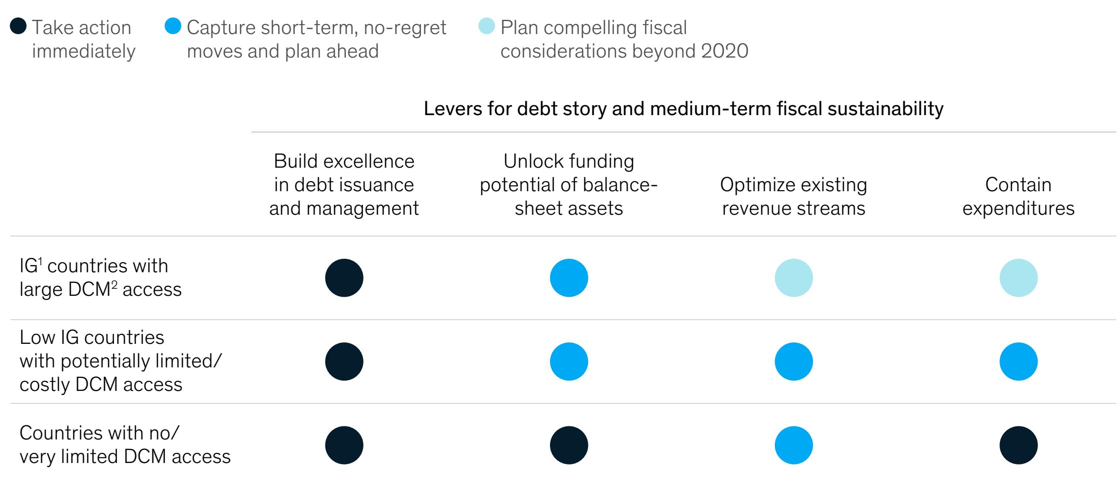
— Countries with potentially limited or costly access to DCMs may need to emphasize making their assets more transparent (and therefore improve their debt story) and use alternative funding solutions. They will also have to plan for fiscal consolidation in the shorter run and communicate their medium-term fiscal plans, including the actual levers used quickly to achieve fiscal sustainability.

— Countries with no or limited access to DCMs will need to pull all available levers to develop a comprehensive, sustainable plan that allows them both to cover their short-term expenditures and to maximize their medium-term access to finance.

Exhibit 5

Depending on archetype, countries have several courses of action.

Action timeline, by country archetype



[1]Investment grade.
[2]Debt capital market.

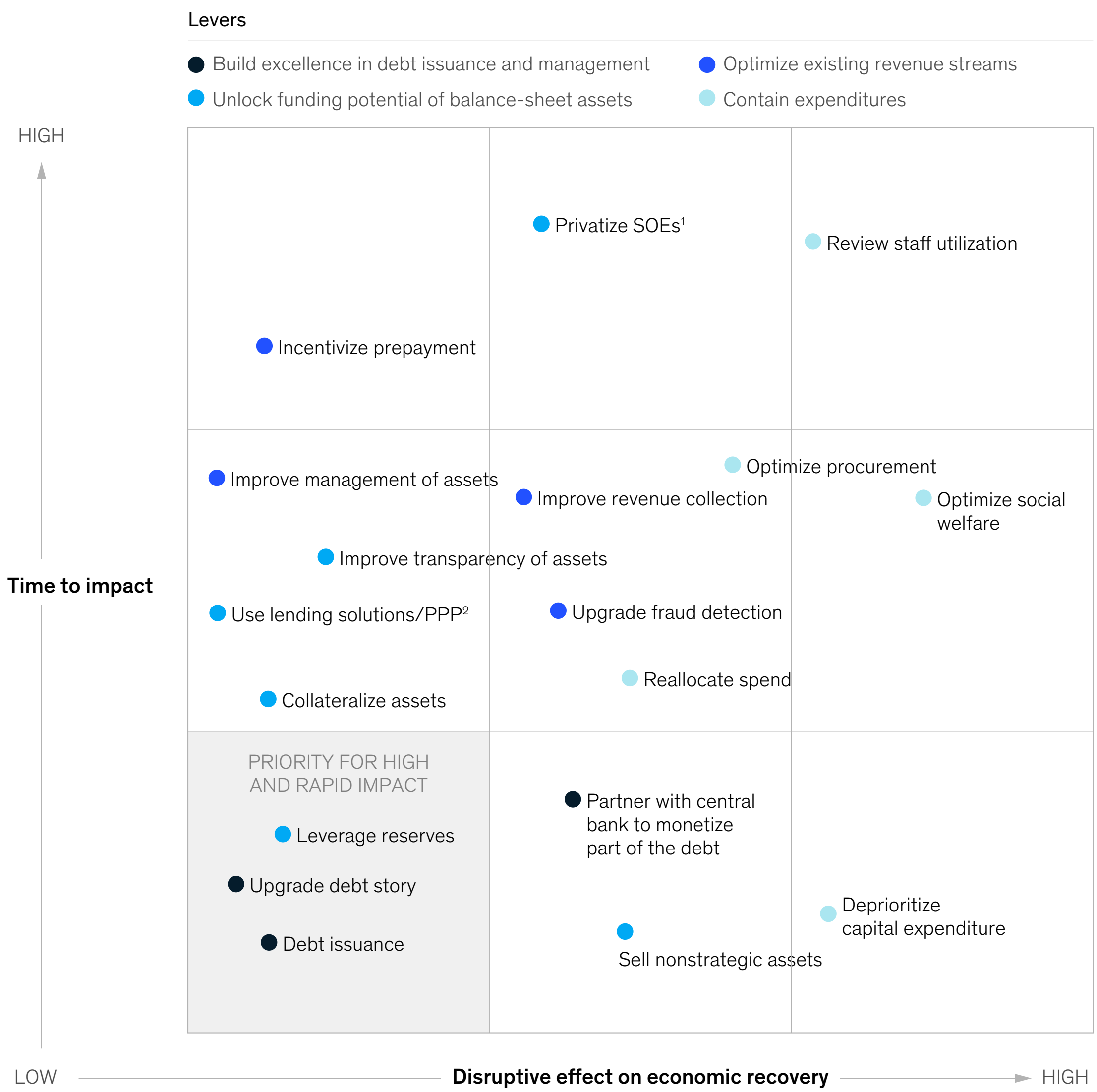
As each country builds its fiscal-sustainability plan, governments can prioritize easily implemented levers that will work quickly and will not hamper the economic recovery in the short term. Improving the debt story, leveraging reserves, and reallocating expenditures, for example, are all likely to achieve short-term results without significantly disrupting the economic recovery. However, the impact of these levers will vary from country to country (Exhibit 6).

Governments will also need to utilize other levers, but their timing will be specific to each country. Those with easier access to the DCM are likely to give the economy more time to recover by scheduling other, more disruptive levers for the medium to long term. Countries with no or limited access to the DCM will probably need to pull these disruptive levers in the short term, since they must struggle to finance their immediate fiscal deficits.

Exhibit 6

A detailed fiscal plan will require prioritization of sublevers based on time to impact and disruption to economic recovery.

Prioritization matrix



[1]State-owned enterprises.
[2]Public–private partnership.

Last but not least, governments will need to upgrade their ability to shape and execute their fiscal plans through a fiscal nerve center, which can improve and speed up responses to disruptions and optimize the fiscal impact of government policy during the rapidly evolving crisis. Such a nerve center can also help finance ministries use real-time economic and fiscal dashboards to make fiscal decisions, develop new initiatives, accelerate existing ones, and coordinate key budget entities.

With the nerve center established, governments can act on three immediate needs. First, they can build fiscal scenarios and project cash flows to comfort their constituents and investors by creating transparency. Second, they can simultaneously develop robust fiscal-sustainability plans, implement prioritized levers, and monitor progress. Third, they can act immediately to strengthen the future fiscal sustainability of their countries by implementing structural levers while remaining mindful of the potential impact on the country's economic recovery. Then they can use their performance on key outcome and practice metrics to identify which levers to prioritize in the fiscal-rescue plan. Benchmarking performance against similar countries will help highlight the levers that can have the greatest impact and guide the plan's development.

COVID-19 has created a perfect storm for public finance: sharply increasing expenditures, declining revenues, and therefore unprecedented and enduring fiscal deficits. In this environment, governments cannot rely on business as usual to finance their deficits and ensure their fiscal sustainability.

Instead, they should act quickly to create a credible debt story and consider the full portfolio of levers available to them given their fiscal starting position, their ability to raise short-term debt, and the resilience of their medium-term fiscal plans. That approach will not only help them develop and implement robust fiscal-rescue plans for 2020 but also ensure they put their countries on a path to fiscal sustainability.

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The authors wish to thank David Chinn, Dag Detter, Jonathan Dimson, Marco Dondi, David Fine, Jeremy Giglione, Marc Homsy, Ali Abid Hussain, Kevin Sneader, and Todd Wintner for their contributions to this article.

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