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Securing economic recovery beyond COVID-19

In brief

- Government's medium-term policy priorities are economic recovery and fiscal consolidation.
- Recovery from the global recession triggered by the coronavirus pandemic is expected to be highly uneven, and interrupted by new waves of infection.
- In South Africa, the pandemic led to a steep economic decline and accelerated the deterioration of the public finances. The economy is expected to contract by 7.8 per cent in 2020, returning to real GDP growth of 3.3 per cent in 2021. Economic growth is expected to average 2.1 per cent over the three-year forecast period.
- Tax revenues for 2020/21 are forecast to be R312.8 billion lower than projected in the 2020 *Budget Review*.
- The consolidated deficit has risen from 6.4 per cent of GDP in 2019/20 to 15.7 per cent this year. Gross national debt has risen from 63.3 per cent of GDP in 2019/20 to 81.8 per cent of GDP in the current year. Interest payments on the debt have reached 4.8 per cent of GDP.
- The social compact agreed to between government, business, labour and civil society prioritises short-term measures to support the economy, alongside crucial structural economic reforms. Fiscal measures will narrow the budget deficit and stabilise debt over the next five years to return the public finances to a sustainable position.

Introduction

The 2020 *Medium Term Budget Policy Statement* (MTBPS) charts a course that will enable South Africa to begin the difficult task of economic recovery. Government's central policy goals over the next three years are to position the economy for faster, broad-based economic growth, and to return the public finances to a sustainable position. Achieving these objectives will require determined action.

Working with its social partners in business, labour and civil society, government has begun implementing an economic recovery plan, with immediate measures to boost confidence and investment, and longer-term reforms to promote sustained higher economic growth.

In the short term, the economic recovery plan will focus on building infrastructure, expanding electricity generation, allocating digital spectrum, and supporting rapid industrialisation and employment. At the same time, government will roll out structural reforms such as modernising network industries, reducing barriers to entry, and increasing regional integration and trade. The National Treasury estimates that, in combination, these reforms can raise growth to over 3 per cent over the next 10 years and create more than 1 million jobs.

To support economic recovery, it is critical that fiscal imbalances do not act as a drag on growth or continue to widen. With mounting debt and interest payments that now consume 21 cents of every rand of main budget revenue, the public finances face the risk of a debt spiral. Stabilising debt to avoid such a crisis will involve significant expenditure reductions across government.

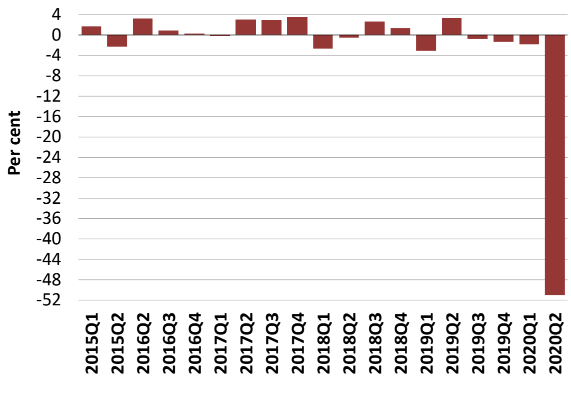
The June 2020 special adjustments budget was prepared in an environment of extreme uncertainty. At that time, real GDP was expected to contract by 7.2 per cent this year, with a strong recovery in 2021. Given this outlook, and with a large increase in public-sector borrowing to fund consumption expenditure, government proposed a three-year fiscal consolidation.

Since June, more data has become available. The economy is expected to contract by 7.8 per cent in real terms this year, and the 2021 outlook is more uncertain. Job losses have been particularly severe. Government therefore proposes a five-year fiscal consolidation that enables continued support for the economy and job creation. The fiscal measures outlined in this MTBPS will bring the state's debt burden under control, realign the composition of spending from consumption towards investment, and improve investment conditions by lowering the cost of capital.

Rebuilding the economy

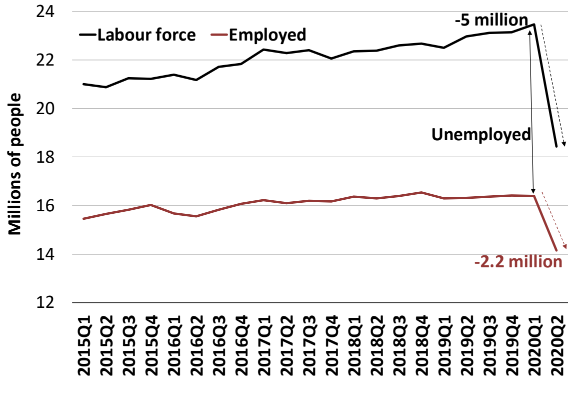
The coronavirus pandemic and measures to protect public health have had a far-reaching impact on the economy. Real GDP contracted by 51 per cent in the second quarter on a quarter-on-quarter, seasonally adjusted and annualised basis.

Figure 1.1 Real economic growth



Source: Statistics South Africa

Figure 1.2 The labour market



Source: Reserve Bank and Statistics South Africa

Plummeting household and business income, alongside severe restrictions on movement, led to a spike in job losses, large-scale business closures and a near-complete halt in international goods trade. By June 2020, the number of people in employment had fallen by 2.2 million, leaving South Africa with only 14.1 million workers employed.

The June 2020 special adjustments budget significantly reordered public expenditure priorities and increased spending to provide emergency resources to frontline services, provincial and local government, and firms and households, with a focus on the most vulnerable South Africans.

The budget made additional allocations to critical frontline services, and raised the state's contingent liabilities through a R200 billion credit guarantee scheme for firms. In addition, it made provision for additional tax relief of R70 billion and temporary unemployment relief of R40 billion. By the end of September, R47.4 billion had been paid to 10.6 million beneficiaries from over 931 000 employers through the temporary employer/employee relief scheme. The Reserve Bank has also provided support to households and firms by lowering the main interest rate (the repurchase rate) by 2.75 percentage points since March 2020.

To enable this critical support to the economy, government breached the spending ceiling, allowed a temporary increase in the fiscal deficit and significantly expanded its borrowing.

Implementing the economic recovery plan

Chapter 2 reviews government's plans for economic recovery, developed in conjunction with its social partners in business, labour and civil society.

The Infrastructure Fund will complement the plan's focus on capital investments. Government has committed R100 billion over 10 years (of which R18 billion is over the medium term) to this blended finance fund, which is designed to crowd in private-sector finance and expertise to support infrastructure delivery. To improve infrastructure planning and fast-track a project pipeline, an Investment and Infrastructure Office has been created in the Presidency.

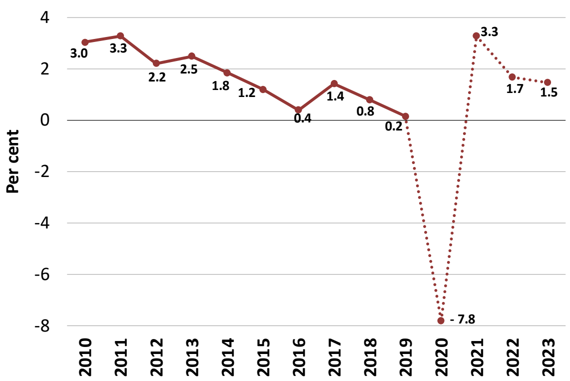
Major structural reforms will also be pursued, backed by timelines, to raise long-term potential growth. Operation Vulindlela (open the way) – a joint initiative of the Presidency and the National Treasury – will speed up implementation of priority reforms determined by the President.

Economic growth and the public finances

COVID-19 accelerated an economic and fiscal deterioration that was already under way.

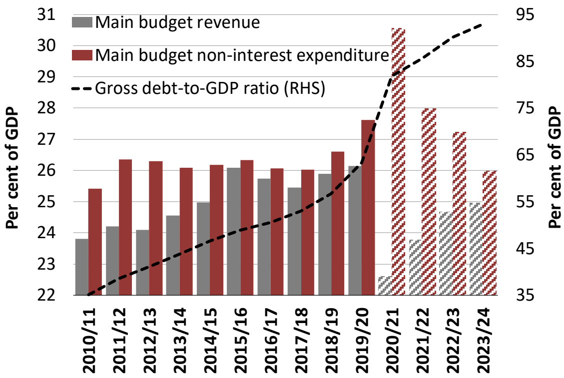
For many years, South Africa's macroeconomic policy has been designed to support stable and sustainable growth. Nevertheless, structural weaknesses in the real economy have contributed to persistently poor economic outcomes and reduced long-term potential growth. These weaknesses include declining productivity, falling investment levels, an unreliable and unstable electricity supply, and deteriorating global competitiveness.

Figure 1.3 Real GDP growth and projections



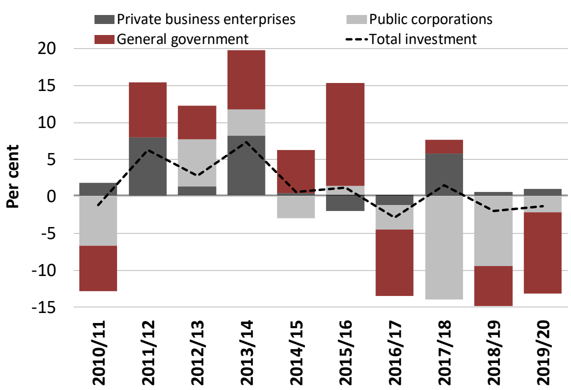
Source: Statistics South Africa and National Treasury

Figure 1.4 Main budget revenue and spending*



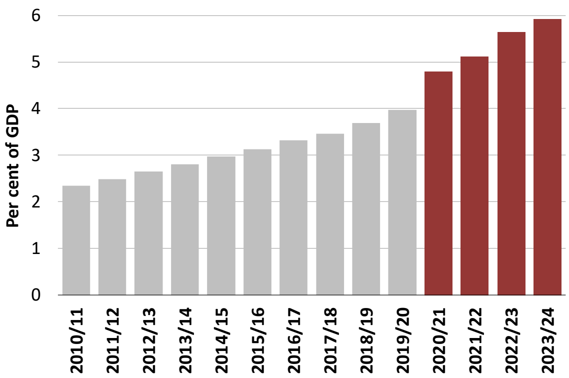
**Excludes Eskom financial support and transactions in financial assets and liabilities*
Source: National Treasury

Figure 1.5 Real growth in investment



Source: Reserve Bank

Figure 1.6 Debt-service costs



Source: National Treasury

Public spending and GDP growth: diminishing returns

Over the past decade, increased government spending has failed to promote growth. Since 2008, real spending growth has averaged 4.1 per cent annually, well above annual real GDP growth of 1.5 per cent. Yet despite high levels of expenditure, supported by increased debt accumulation, growth has not recovered to pre-2008 levels.

This year, the consolidated fiscal deficit is projected at 15.7 per cent of GDP, up from 6.4 per cent of GDP in 2019/20. The debt stock is expected to reach nearly R4 trillion, or 81.8 per cent of GDP, in 2020/21. Over the medium term, debt-service costs are the fastest-growing item of spending. Failure to address the deterioration in the fiscal position could lead to a sovereign debt default, which would result in a reversal of many gains of the democratic era.

Recent work by the Reserve Bank on fiscal multipliers – which measure the impact of government spending on GDP – shows that the economic benefits of higher public spending have decreased over the past decade, and may have been exhausted. South Africa's fiscal multiplier is currently low, or possibly negative. This decline is likely for several reasons, including spending patterns that have historically skewed towards consumption rather than investment, regulations that impede innovation and productivity, and a high debt burden, with interest payments crowding out investments in the economy. Fiscal consolidation, alongside structural reforms outlined in the economic recovery plan, could markedly improve the effect of public spending on GDP. Chapter 3 discusses the research on fiscal multipliers in more detail.

Stabilising debt and controlling the rise in borrowing costs will directly improve South Africa's attractiveness as an investment destination. If investors believe that fiscal deficits will remain elevated, with the accompanying expectation of higher interest rates, they will view the cost of capital as too high to justify medium- to long-term investment. This is the "crowding out" effect of government spending.

Concerns over weak growth and rising fiscal deficits have already led to credit rating downgrades. As a developing country, South Africa cannot sustain debt at current levels without incurring extremely high costs. South Africa's sovereign risk premium – the additional amount it has to pay investors to compensate for perceived risk – has risen markedly in recent months as non-residents have sold off government bonds, further exposing the domestic banking sector to rising fiscal risks. As a result, real borrowing costs are increasing for both government and the broader economy. This negatively affects the investment needed to raise potential growth and create jobs, and results in rising debt-service costs.

These considerations inform the proposed fiscal stance.

Improving the efficiency and composition of spending

The 2021 medium-term expenditure framework (MTEF) proposes fiscal adjustments amounting to 1.2 per cent of GDP in 2021/22 and 1.9 per cent of GDP in 2022/23. Compared with the 2020 Budget, main budget non-interest expenditure excluding technical adjustments is reduced by R60 billion in 2021/22, R90 billion in 2022/23 and R150 billion in 2023/24. Revenue proposals to be announced in the 2021 Budget will amount to R5 billion in 2021/22, R10 billion in 2022/23 and R10 billion in 2023/24. Government debt is forecast to stabilise at 95.3 per cent of GDP in 2025/26.

Consolidated government spending accounted for 35.9 per cent of GDP in 2019/20 compared with 29.6 per cent of GDP in 2008/09. The proposed consolidation focuses on improving the composition of spending. Excluding COVID-19 fiscal support, real compensation expenditure will decline by an average of 3.5 per cent per year over the medium term, compared with real growth of 3.2 per cent in payments for capital assets. These changes will support higher long-term growth.

Since 2008, the real cost of the public-service wage bill has risen by 51 per cent. As discussed in Annexure B, the main reason for this growth is an increase in unit costs, rather than headcount. The contributions of hard-working public servants are essential for national development, and government is committed to providing fair and sustainable compensation. But with much state borrowing funding consumption, the wage-setting process has become divorced from economic reality. Government's proposed adjustments to the wage bill are discussed in Chapter 3.

Over the medium term, government will phase in the principles of zero-based budgeting – supported by comprehensive expenditure reviews that are under way – to analyse and justify departmental spending. These initiatives will help to streamline bureaucracy, eliminate programmes that no longer add value and reform those in need of improvement.

Government is committed to finalising the Public Procurement Bill during 2021/22 following the end of the public comments phase, and reviewing the full range of national, provincial and municipal provisions. Significant procurement reforms will be supported by greater use of automation and technology. This will include the provision of real-time information regarding tax compliance, and the profile and historical performance of prospective service providers. Concurrent reviews of regulations governing public-private partnerships will promote greater efficiency and encourage private-sector participation.

Transparency in COVID-19 procurement

Four days after the President announced a national state of disaster on 15 March 2020, the National Treasury issued the first of three instruction notes to regulate emergency procurement of critical health supplies. The last of these notes allowed for increased flexibility with suppliers to speed up delivery in response to the public health emergency.

Acting on reports of malfeasance, the National Treasury withdrew the emergency regulations and required all state bodies to revert to an open-tender system. It has published the details of all COVID-19-related procurement, including the names of companies awarded contracts, and law-enforcement agencies are investigating cases of criminal behaviour. In addition, the National Treasury has collaborated with the Auditor-General to publish Preventative Control Guidelines, which provide a toolkit to identify fraud, corruption and misappropriation of funds.

Overview of the 2020 MTBPS

Economic outlook

Chapter 2 reviews the medium-term economic outlook. Real GDP growth is forecast at -7.8 per cent in 2020, revised down from -7.2 per cent projected in the 2020 special adjustments budget.

The economy is expected to recover to a real GDP growth rate of 3.3 per cent in 2021, with growth averaging 2.1 per cent over the medium term. The outlook is subject to significant downside risks. Conversely, swift implementation of structural reforms can provide additional support for growth.

Table 1.1 Macroeconomic projections

	2019	2020	2021	2022	2023
Calendar year	**Actual**	**Estimate**		**Forecast**	
Percentage change unless otherwise indicated					
Household consumption	1.0	-7.9	4.7	2.2	1.9
Gross fixed-capital formation	-0.9	-19.6	-1.4	3.9	3.9
Real GDP growth	**0.2**	**-7.8**	**3.3**	**1.7**	**1.5**
GDP at current prices (R billion)	**5 078**	**4 885**	**5 240**	**5 553**	**5 877**
CPI inflation	4.1	3.2	4.1	4.4	4.5
Current account balance (% of GDP)	-3.0	-0.8	-1.6	-2.0	-2.7

Source: Reserve Bank and National Treasury

Fiscal policy

Chapter 3 outlines the medium-term fiscal policy stance, which focuses on stabilising the public finances through revenue measures and large reductions to the public-service wage bill. The consolidated budget deficit will narrow from 15.7 per cent of GDP in 2020/21 to 10.1 per cent in 2021/22 and 7.3 per cent by the outer year. The composition of expenditure will shift away from consumption towards capital investment.

Table 1.2 Consolidated government fiscal framework

R billion/percentage of GDP	2019/20 Outcome	2020/21 Revised	2021/22	2022/23 Medium-term estimates	2023/24
Revenue	**1 518.1**	**1 276.7**	**1 457.6**	**1 595.8**	**1 705.7**
	29.5%	*26.3%*	*27.4%*	*28.3%*	*28.6%*
Expenditure	**1 848.7**	**2 037.8**	**1 993.5**	**2 079.6**	**2 139.2**
	35.9%	*41.9%*	*37.5%*	*36.9%*	*35.9%*
Budget balance	**-330.6**	**-761.1**	**-535.9**	**-483.9**	**-433.4**
	-6.4%	*-15.7%*	*-10.1%*	*-8.6%*	*-7.3%*
Total gross loan debt	**3 261.3**	**3 974.1**	**4 551.8**	**5 071.3**	**5 536.2**
	63.3%	*81.8%*	*85.6%*	*90.1%*	*92.9%*

Source: National Treasury

Expenditure priorities

Chapter 4 sets out proposed medium-term functional allocations, including adjustments in the current fiscal year. The budget will prioritise capital spending and continue to support vulnerable groups.

Table 1.3 Consolidated government expenditure

R billion	2020/21 Revised[1]	2021/22	2022/23 Medium-term estimates	2023/24	Average annual growth 2021/22 – 2023/24
Learning and culture	398.3	399.0	406.7	411.3	1.1%
Health	226.2	235.3	242.0	246.3	2.9%
Social development	315.4	312.2	329.9	335.7	2.1%
Community development	208.2	221.1	232.2	236.4	4.3%
Economic development	211.3	224.7	236.3	242.0	4.6%
Peace and security	216.8	210.7	213.3	214.5	-0.4%
General public services	69.8	71.0	70.4	71.2	0.6%
Payments for financial assets	86.5	42.9	26.2	23.7	–
Total expenditure by function	**1 732.6**	**1 716.7**	**1 757.0**	**1 781.0**	**0.9%**
Debt-service costs	225.9	271.8	317.6	353.1	16.1%
Contingency reserve	–	5.0	5.0	5.0	–
Total expenditure	**1 958.4**	**1 993.5**	**2 079.6**	**2 139.2**	**3.0%**
Consolidated expenditure including June 2020 budget adjustments	**2 037.8**	**1 993.5**	**2 079.6**	**2 139.2**	**1.6%**

1. 2020/21 excludes June 2020 budget adjustments
Source: National Treasury

Additional information

The 2020 MTBPS includes the following annexures:

- Annexure A contains the fiscal risk statement, which outlines medium- and longer-term risks that could affect baseline projections for economic growth and the public finances.
- Annexure B presents data on the compensation of public-service employees.
- Annexure C provides technical information and data.
- Annexure D is the glossary.

The Public Finance Management Act (1999), read together with the Money Bills and Related Matters Act (2009), empowers the Minister of Finance to table an adjustments budget in the National Assembly when necessary. Alongside the MTBPS, government is tabling the 2020 *Adjusted Estimates of National Expenditure*, which is the second adjustments budget of 2020/21, following the June special adjustments budget.

Conclusion

The 2020 MTBPS is prepared in the context of the deepest global contraction since the 1930s. Budget preparation has had to adapt to emergency circumstances, despite an already weak fiscal position prior to the current crisis. Ensuring the return to sustainable public finances, and more rapid, employment-rich economic growth, requires hard choices and determined implementation of economic reforms.