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Building a bridge to recovery beyond COVID-19

In brief

- Government has responded to the COVID-19 pandemic with large-scale economic relief measures. Support is targeted at the most vulnerable South Africans. These steps will also build the capacity of the public health system to respond to the pandemic.
- The National Treasury expects the economy to contract by 7.2 per cent in 2020. Households and firms are grappling with the combined effects of economic restrictions and the continued spread of the virus.
- The public finances, which had reached an unsustainable position before the pandemic, are now dangerously overstretched.
- This special adjustments budget is a bridge to the October 2020 *Medium Term Budget Policy Statement* (MTBPS). Over the next several months, government will prepare a set of far-reaching reforms. Determined implementation of these measures will stabilise public debt, contain the budget deficit, and fully restore economic activity to build confidence, increase investment and promote job creation.

Overview

This special adjustments budget has a dual purpose. It reports on the COVID-19 fiscal measures, and the resulting adjustments to the division of revenue and departmental allocations. It also sets out government's commitment to strengthen the public finances, and to position the economy for faster and inclusive growth.

Public spending priorities as proposed in the 2020 Budget have been reordered in response to the coronavirus pandemic. Government has prioritised saving lives, and took the difficult step of severely restricting economic activity at a time when GDP growth was already weak. The scale of the crisis, and the continued uncertainty of epidemiological and economic outcomes, have required rapid decisions in response to fast-changing conditions. South Africa, like other middle- and low-income countries without large savings, has to balance essential public-health interventions – such as prolonged lockdowns – with severe economic effects – such as job losses, lower tax revenue and higher poverty.

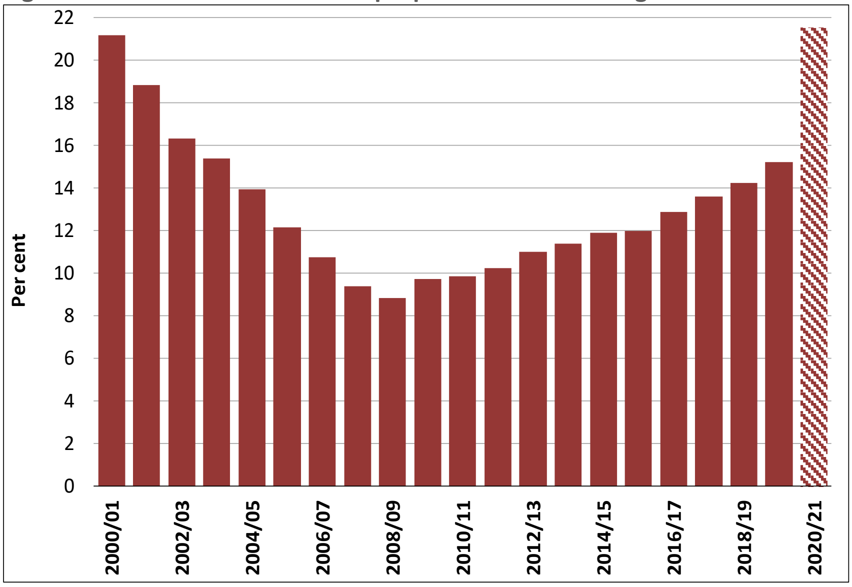
In March, government initiated a wide-ranging relief package to manage the immediate impact of the virus. This involves scaling up capacity in the public health system and mitigating the effects of restricted economic activity for households and businesses. Concurrently, the Reserve Bank has reduced interest rates and provided support to the bond market, while indicating it is prepared to take additional action as required.

The COVID-19 adjustment fast-tracks normal budget processes to provide resources to frontline services, provincial and local government, and firms and households. Yet the evolution of the pandemic and its effects remain highly uncertain.

Avoiding the looming crisis in the public finances

Even as South Africa responds to the current health and economic crisis, a fiscal reckoning looms. The public finances are dangerously overstretched. Without urgent action in the 2021 budget process, a debt crisis will follow. Failure to contain ballooning debt and debt-service costs, and narrow the budget deficit, would damage the country's long-term economic prospects. Over the medium term, compensation and debt-service costs would be the largest expenditure items, and outstrip the investments government makes in human capital, social and economic infrastructure, and service delivery. As Figure 1.1 implies, rising public debt means that an ever-increasing share of tax revenue is transferred to bondholders.

Figure 1.1 Debt-service costs as a proportion of main budget revenue



Source: National Treasury

This document is a bridge to the October 2020 MTBPS, which will set out Cabinet's proposals to stabilise public debt and accelerate economic growth – and by which time a fuller picture of the effects of the pandemic is expected to emerge.

A phased approach to managing the pandemic

Government is responding to the pandemic in a phased manner:

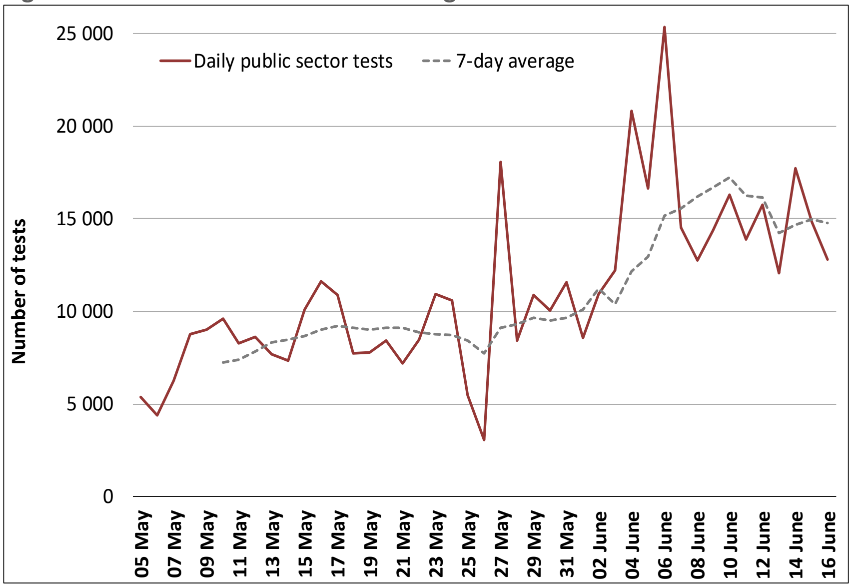
- Phase 1 is to **preserve** the economy through a set of immediate, targeted and temporary responses.
- Phase 2 is a plan to **recover** from the immediate effects of the crisis by supporting investment and employment.
- Phase 3 is a **pivot** to position the economy for the faster growth needed to restore the country's long-term prosperity.

Supporting households and businesses

The COVID-19 fiscal package identifies R500 billion in economic relief. It includes R190 billion in main budget spending – of which R145 billion is allocated immediately – to protect lives and support livelihoods, R70 billion in tax policy measures and a R200 billion loan guarantee scheme to support short-term economic activity. In addition, the Reserve Bank has reduced interest rates and provided additional support to the bond market, financial-sector regulations have been eased to support the flow of credit to households and businesses, and commercial banks have introduced temporary payment holidays.

Major investments in the public health system aim to ensure it has sufficient capacity to manage the continued spread of the virus. An amount of R21.5 billion is made available to healthcare through reprioritisation and new funds. Over 1 million COVID-19 tests have been conducted since the start of the pandemic and the number of public-sector tests has more than doubled over the past month, averaging about 14 000 tests per day.

Figure 1.2 Public-sector COVID-19 testing

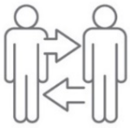


Source: Department of Health

To date, more than 18 million South Africans have received temporary COVID-19 grants, which – along with other interventions for vulnerable households – will cost about R41 billion. In its first few weeks of operation, the COVID-19 loan guarantee scheme had provided small businesses with over R10 billion worth of loans. As of mid-June, the Unemployment

Insurance Fund had provided R23 billion in COVID-19 relief to over 4.7 million workers.

To the greatest extent possible, the balance sheets and operational capacity of the broader public sector have been adjusted to form part of the national response. These include state-owned companies, the social security funds and public entities such as the National Health Laboratory Service and the South African Social Security Agency. The National Treasury and the Reserve Bank have coordinated fiscal and monetary policy responses.



Government has strengthened its working partnership with the private sector in response to the national emergency. The private health sector has made valuable contributions, providing critical care beds at a favourable rate and complementing efforts to ramp up testing. The Solidarity Fund, a private-sector initiative, has augmented government's efforts to procure medical and personal protective equipment. To support economic relief efforts, nearly R12 billion in debt relief has been extended to over 124 000 small and medium-sized enterprises by the banking sector. Commercial banks have also granted 90-day payment holidays to more than 2 million clients for relief totalling R16.5 billion to date. Initiatives such as the Sukuma Relief Programme and the South African Future Trust are providing interest-free loans and grants to small and medium-sized firms.

In the context of a sharp economic downturn in developing countries, international finance institutions have announced a range of support mechanisms. Government intends to borrow US$7.0 billion from multilateral finance institutions for its pandemic response. This includes a US$1 billion loan from the New Development Bank. As a member of the International Monetary Fund (IMF), South Africa intends to borrow US$4.2 billion through the IMF's rapid financing instrument, which is a low-interest emergency facility.

Decline or renewal?

The drift into a debt spiral

South Africa's pre-pandemic economic outlook was weak, with GDP growth averaging 1.3 per cent between 2020 and 2022. The steep economic contraction associated with COVID-19 will put greater pressure on trade, investment and employment. Without swift and effective fiscal policy action, a recovery in economic growth once the pandemic has subsided will be insufficient to stabilise debt.

The recent sovereign rating downgrades by S&P Global Ratings, Moody's and Fitch highlight the perils of inaction. Between March and April, the rand depreciated more sharply than comparable developing-country currencies. Long-term government yields are above end-2019 levels, which means that government borrowing costs are higher. The steepness of the yield curve indicates investor concerns about fiscal sustainability.

If debt does not stabilise, government will be unable to borrow at affordable rates. This would in turn impede the ability of firms to invest and create jobs. It would also discourage households from making long-term financial commitments. In this environment, government could not raise sufficient tax revenues to sustain current spending levels and service its debt obligations. In time, this would lead to an unravelling of the social gains of the past 26 years.

If this spiral is not halted and reversed, it is likely that some state-owned companies and public entities will collapse, triggering a call on guaranteed debt obligations. Failure to substantially reduce costs, address long-standing governance failures, prosecute state-capture participants and undertake profound operational reforms has contributed to already unsustainable financial positions in many public-sector institutions. The pressure on public finances requires fundamental changes to the manner in which government supports these institutions, and such reforms will be implemented in the near term.

In the short term, the most important step to avoid these outcomes is to restore economic activity as soon as possible. The steps that government and the private sector are taking to limit the spread of the virus, along with the fiscal relief package and the phased relaxation of economic restrictions, will enable the economy to restart.

An active approach to forge a new economy

In his 21 April address to the nation, the President stated that government is "resolved not merely to return our economy to where it was before the coronavirus, but to forge a new economy in a new global reality". This requires bold, forthright and determined thinking and action to stabilise debt, increase the efficiency and composition of public spending, and unlock economic growth through reforms.

Cabinet has endorsed a 2021 budget process that moves towards debt stabilisation. The 2020 MTBPS will set out plans to narrow the deficit so that debt peaks at 87.4 per cent of GDP by 2023/24. An expanded partnership between government, business, labour and civil society is needed to agree on and implement far-reaching economic reforms.

To illustrate the policy outcomes that South Africa confronts, the National Treasury has prepared two scenarios. In the passive scenario, debt continues to rise, and debt-service costs outstrip spending on social and economic priorities. In the active scenario, government acts rapidly to stabilise debt by reducing spending and enacting economic reforms. The scenario discussions in this document reflect these approaches.

Cabinet has endorsed the active-scenario approach to stabilise debt and grow the economy. To promote fiscal consolidation, preparation of the 2021 medium-term expenditure framework (MTEF) will be informed by the results of forthcoming public expenditure reviews. Government's consultations on the MTEF, which begin next month, will also be guided by the principles of zero-based budgeting, in which departmental expenses must be justified, and accompanied by rigorous analysis. The 2021 MTEF will assume necessary revisions to the public-service wage bill.

Cabinet has also determined the following:

- Government will ensure sufficient capacity in frontline services – health, social protection and municipal services – to manage the evolution of COVID-19.

- The central fiscal priority over the medium term is debt stabilisation, which will require large spending and revenue adjustments. The manner in which this is done will affect growth. Cabinet has reiterated support for the proposed public-service wage bill reductions announced in February, which will improve the composition of spending.
- To reverse the decline in per capita incomes, the 2020 MTBPS will set out economic reform proposals focused on the underlying structure of the economy. These aim to reduce the cost of doing business. Government will take steps to improve the competitiveness of the economy by reducing the dominance of state-owned companies in network industries, and support new and existing sectors with large-scale job creation potential.

The special adjustments budget

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. Government normally tables an adjustments budget with a revised fiscal framework, a division of revenue amendment bill and an adjustments appropriation bill in October.

The fiscal and economic impact of the national state of disaster declared as a result of the COVID-19 pandemic has made it necessary to table the present adjustments budget, published as the 2020 *Supplementary Budget Review*, in June. A second adjustments budget is expected to be tabled in October.

The document is structured as follows:

- Chapter 2 sets out changes to the division of revenue and in-year spending plans.
- Chapter 3 discusses the initial impact of COVID-19 on the economy, and provides a revised economic outlook for 2020.
- Chapter 4 outlines the medium-term fiscal implications of the active scenario adopted by Cabinet, with a focus on debt stabilisation.
- Annexure A is the explanatory memorandum to the Division of Revenue Amendment Bill.
- Annexure B is the explanatory memorandum to the Adjustments Appropriation Bill.