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Fiscal outlook: taking action to stabilise public debt

In brief

- The COVID-19 pandemic has led to a sharp deterioration in the economic and revenue outlook. The fiscal position, which was already unsustainable, will require significant adjustments as the immediate health effects subside.
- In 2020/21, the consolidated deficit is projected to increase to 15.7 per cent of GDP. If this trend is not reversed, South Africa is likely to face a sovereign debt crisis.
- Government remains committed to achieving fiscal sustainability, measured as stabilisation of the debt-to-GDP ratio, and to narrowing the budget deficit. This will require large spending reductions and moderate tax increases in the forthcoming medium-term expenditure framework. Over the next several months, government will prepare fiscal consolidation proposals that will be published in the October 2020 *Medium Term Budget Policy Statement* (MTBPS).

Overview

The COVID-19 pandemic erupted when South Africa was already in a weak fiscal position. The 2020 *Budget Review*, released a few weeks before the President declared a national state of disaster, noted that gross government debt was projected to increase from 65.6 per cent in the current year to 71.6 per cent of GDP by 2022/23. In recent months, fiscal deterioration has accelerated: gross national debt is now expected to reach 81.8 per cent of GDP in the current year.

The halt in economic activity resulting from the lockdown, and its lasting consequences, are expected to result in tax revenue underperformance of R304.1 billion in 2020/21 compared with the 2020 Budget estimate. Expenditure will increase as government reprioritises and allocates funds to contain COVID-19. As a result, the gap between revenue and expenditure is expected to widen, leading to a sharp increase in the gross borrowing requirement. Since February, the cost of government borrowing has risen due to credit rating downgrades and capital market outflows.

Beyond 2020/21, government has considered two scenarios: a passive approach, in which South Africa continues on its current trajectory and debt spirals out of control; and an active scenario, in which major reforms and fiscal consolidation are implemented rapidly to stabilise debt in 2023/24.

Figure 4.1 Main budget revenue and expenditure

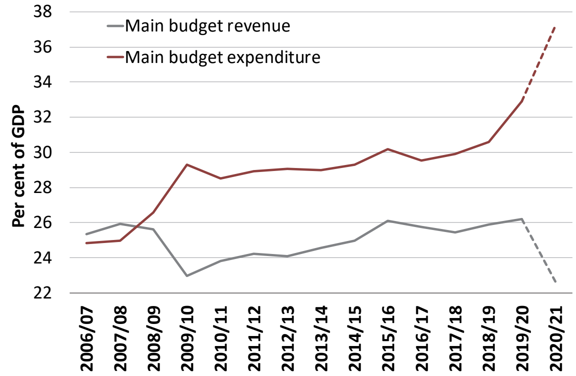
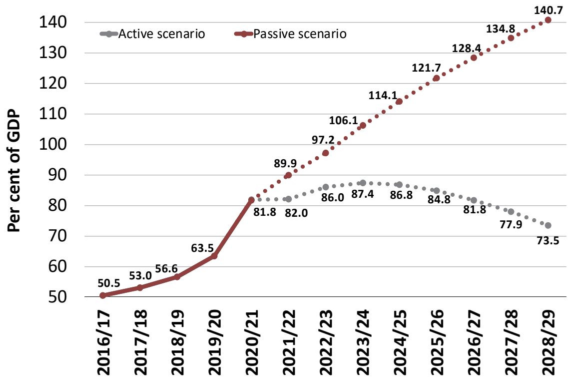


Figure 4.2 Debt outlook scenarios



Source: National Treasury

In the passive scenario, economic growth recovers but remains low, debt spirals upwards and debt-service costs crowd out public spending on health, education and other policy priorities. Rising debt, and the possibility that government will be unable to repay it, leads bondholders to require higher returns, pushing up debt-service costs. A weaker currency, lower confidence and capital flight reduce GDP growth and revenue collection. Cabinet recognises that this scenario is not a viable option for South Africa and it is presented here for illustrative purposes only.

In the active scenario, government stabilises debt through a combination of reforms that boost economic growth and measures to increase revenue collection and lower expenditure.

Cabinet has adopted the active approach. It has endorsed the target of a primary surplus by 2023/24, meaning revenue will exceed non-interest expenditure. This will require spending reductions and revenue adjustments amounting to approximately R250 billion over the next two years. These measures require difficult choices that will affect the economy and distribution of public resources. The 2020 MTBPS will set out these proposals in detail.

Fiscal sustainability supports growth

Since March 2020, government has focused on addressing the immediate health and economic consequences of COVID-19, which have led to a steep drop in projected tax revenue and an increase in projected expenditure. The economy is expected to recover moderately as lockdown conditions are eased. But without significant policy action, the economy is too weak – and the stock of debt is too high – for GDP growth and revenue to recover sufficiently to stabilise government debt.

Narrowing the budget deficit and stabilising the debt-to-GDP ratio require continued spending restraint, economic measures to boost long-term growth and reforms to state-owned companies to reduce their reliance on public funds. Additional tax revenue should come primarily from improved tax collection as enforcement is strengthened to enhance compliance, alongside other revenue measures.

In the long term, South Africa needs sustainable public finances to support highly redistributive spending on education, healthcare and social welfare. By increasing confidence and investment, fiscal sustainability promotes long-term economic growth, job creation and rising incomes.

2021 medium-term expenditure framework budget process

The budget process for the 2021 medium-term expenditure framework (MTEF) begins in July. To achieve Cabinet's debt-stabilisation objectives, this process will have to make significant spending adjustments, informed by the results of forthcoming public expenditure reviews. The intent is to ensure that fiscal measures are structured efficiently, and promote growth in productivity and employment by encouraging private-sector investment.

Consultations on the MTEF will also be guided by the principles of zero-based budgeting, in which departmental expenses must be justified, accompanied by rigorous analysis. Programmes that have little impact on economic performance or service delivery will be phased out.

Medium-term fiscal position

Government has revised its fiscal outlook in line with the active scenario. All projections for 2021/22 and beyond set out below adopt this approach.

In the 2020 Budget, the main budget deficit was projected at 6.8 per cent of GDP in 2020/21, narrowing to 5.9 per cent of GDP by 2022/23. This included a proposed net reduction of non-interest spending totalling R156.1 billion over three years. The measures taken in the 2020 Budget moderated spending as a share of GDP and improved the composition of expenditure, but did not stabilise debt. Gross national debt was projected to continue rising over the medium to long term.

Since February 2020, the fiscal position has continued to deteriorate. Main budget expenditure is now projected to increase to 37.2 per cent of GDP in 2020/21, relative to the 2020 Budget estimate of 32.5 per cent. This reflects the response to COVID-19 and higher debt-service costs.

In-year revenue outlook

Since the tabling of the 2020 Budget, fallout from the pandemic has caused an unprecedented reduction of the in-year revenue projection. Revenue collection for 2020/21 is now expected to be R304.1 billion lower than the 2020 Budget estimate. Revenue shortfalls include tax relief measures amounting to R26 billion in foregone revenue implemented as part of the COVID-19 relief package. More significantly, the shortfall reflects the expectation that the tax base will temporarily shrink as businesses close and people lose their jobs.

COVID-19 tax relief measures

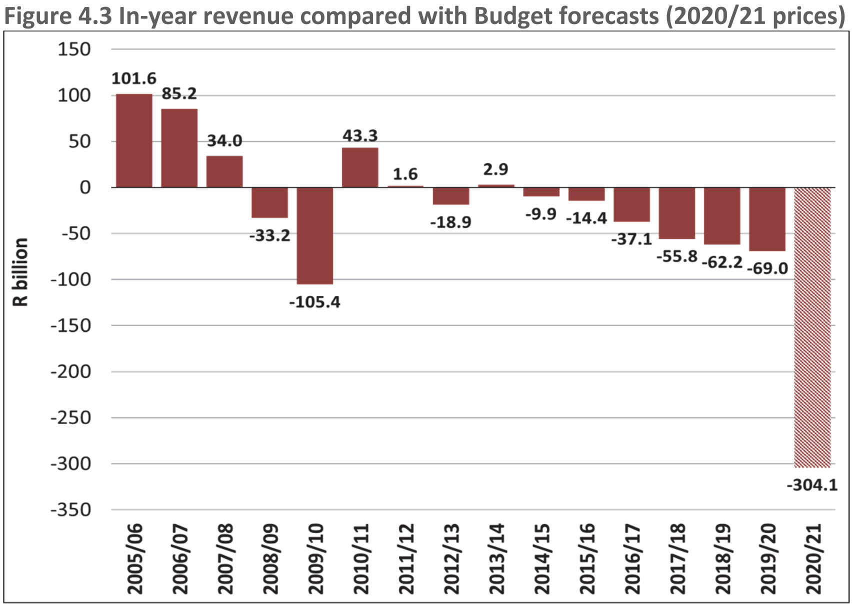
- An increase in the employment tax incentive by R750 per month for eligible employees and a further R750 per month incentive for all other employees who earn less than R6 500 per month from 1 April 2020 to 31 July 2020.
- A 35 per cent deferral of employees' tax liabilities (pay-as-you-earn) for businesses with a gross income of up to R100 million for four months from 1 April 2020.
- A 35 per cent deferral of the first or second provisional tax payments to be made between 1 April 2020 and 30 September 2020, and of the second provisional tax payment to be made between 1 October 2020 and 31 March 2021 for businesses with a gross income of less than R100 million.
- A four-month exemption in the skills development levy from 1 May 2020.
- A 90-day deferral for payments of alcohol and tobacco excise duties from 1 May 2020.
- A three-month postponement of the filing and payment date for carbon tax liabilities to 31 October 2020.
- Postponement of measures to broaden the corporate income tax base (restricting net interest expense deductions, and limiting the use of assessed losses carried forward) to at least 1 January 2022.
- A four-month 10 per cent increase in the available tax deduction for donations made to the Solidarity Fund from 1 April 2020.
- Consideration of applications to the South African Revenue Service, on a case-by-case basis, to defer tax liabilities without penalty if the business can show it is incapable of making payment due to the pandemic.

The measures were included in the Draft Disaster Management Tax Relief Bill and the Draft Disaster Management Tax Relief Administration Bill published for public comment on 1 April 2020 and again on 1 May 2020. These bills will be tabled in Parliament later this year.

The effect of multiple COVID-19-related shocks on revenue collection is expected to exceed that of the global financial crisis of 2008/09 (Figure 4.3). The current crisis particularly affects the largest tax bases:

- Personal income taxes are under significant pressure resulting from job losses, labour unavailability and employers' inability to pay full salaries. Salaries and wages will remain volatile through the recovery period.
- Corporate tax collections will be negatively affected by service and production closures during the lockdown, uncertainty concerning the pace at which normal activity can resume, and weak business and consumer sentiment. Companies of all sizes will be affected.
- Value-added tax (VAT) and customs revenue estimates have been revised down in response to lower confidence, lockdown-related sales restrictions and a much weaker trade outlook.

Figure 4.3 In-year revenue compared with Budget forecasts (2020/21 prices)



Source: National Treasury and SARS

The short-term impact of the pandemic is evident in the sharp reductions in collections for South Africa's two largest revenue items – domestic VAT and pay-as-you-earn – in April and May of this year.

Figure 4.4 Domestic value-added tax

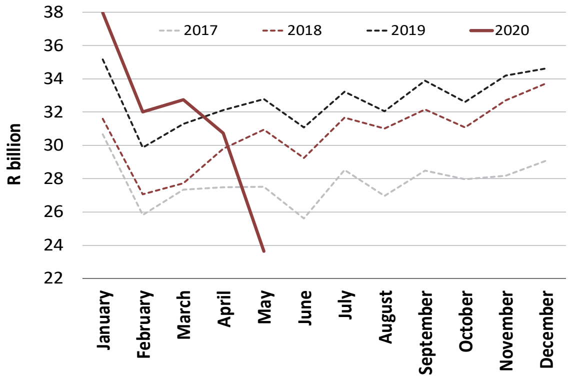
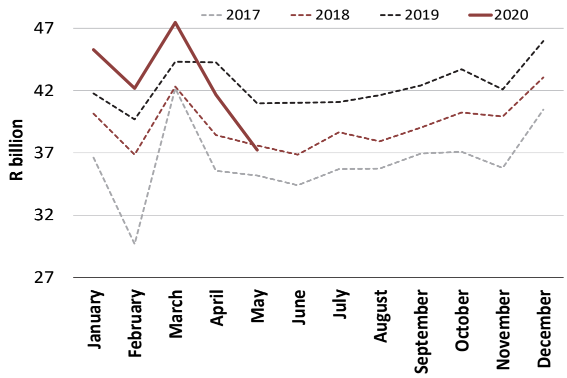


Figure 4.5 Pay-as-you-earn



Source: National Treasury and SARS

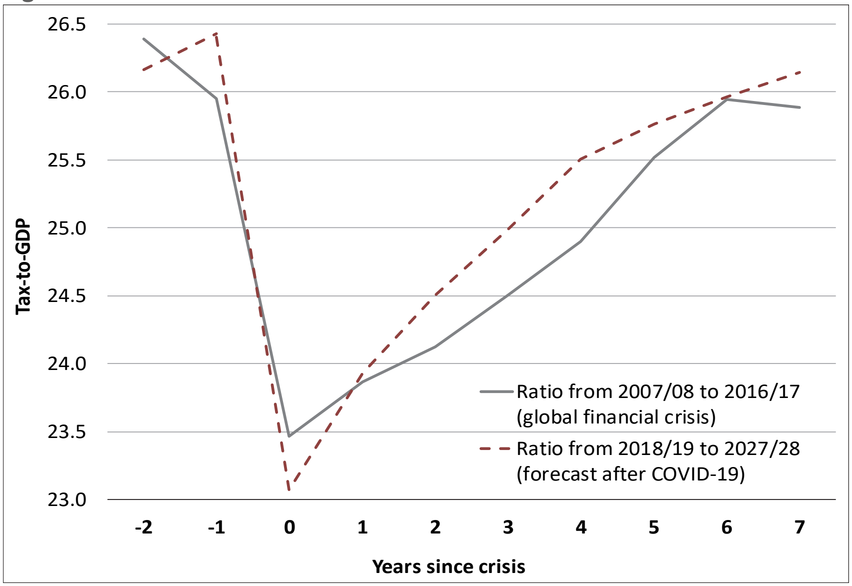
Medium-term revenue outlook

Following five years of large tax increases, the 2020 Budget did not propose new tax measures. Given the extent of fiscal consolidation now required, however, both expenditure reductions and tax increases are necessary to stabilise debt. The active scenario assumes tax increases of R5 billion in 2021/22, R10 billion in 2022/23, R10 billion in 2023/24 and R15 billion in 2024/25. The 2020 MTBPS will revisit these projections, and the Minister of Finance will announce tax policy proposals in the February 2021 Budget.

As growth recovers, so will tax receipts. Corporate income taxes are highly volatile during and after economic shocks, with sharp contractions as lower profits and assessed losses reduce tax payments over several years, followed by a rebound as profits become taxable. As employment and salaries normalise, personal income taxes should be augmented by higher effective tax rates, while recovering consumer demand and investment will bolster VAT and import duties.

In the current year, tax revenue as a proportion of GDP falls sharply. After 2020/21, tax revenue as a proportion of GDP is expected to follow a similar trajectory to that experienced after the global financial crisis. Additional tax measures, alongside economic recovery, will increase the tax-to-GDP ratio.

Figure 4.6 Tax-to-GDP after crisis



Source: National Treasury and SARS

Improved tax collection and administration will be an important element in achieving fiscal stabilisation. Over this period, the South African Revenue Service (SARS) will aim to increase tax receipts by:

- Focusing on international taxes, particularly aggressive tax planning using transfer pricing.
- Increasing enforcement to eliminate syndicated fraud related to VAT refunds and import valuations.
- Expanding the use of third-party data to find non-compliant taxpayers.
- Improving the collection of debt due to the fiscus, and ensuring that outstanding taxpayer returns are filed and liabilities paid.

Expenditure outlook

Main budget expenditure is projected to peak at 37.2 per cent of GDP in 2020/21.

Over the medium term, main budget non-interest expenditure is expected to decrease as a share of GDP. Spending reductions amounting to about R230 billion are required in 2021/22 and 2022/23, followed by further reductions in 2023/24.

These measures are in addition to proposed medium-term reductions of R160.2 billion to the public-service wage bill set out in the 2020 Budget, which are yet to be finalised. Failure to achieve these reductions will require larger reductions to wages and other spending areas in the outer years of the spending framework, and higher revenue increases.

Main budget balance

The main budget balance and the primary balance will narrow over the medium term in order to stabilise debt in 2023/24.

Table 4.1 Active scenario medium-term budget balances

	2020/21	2021/22	2022/23
R billion/percentage of GDP	**Revised**	**Medium-term estimates**	
Main budget revenue	**1 099.5**	**1 268.2**	**1 378.8**
	22.6%	*23.8%*	*24.5%*
Main budget expenditure	**1 809.2**	**1 763.8**	**1 809.3**
	37.2%	*33.1%*	*32.2%*
Non-interest expenditure	1 572.7	1 500.6	1 508.2
	32.4%	*28.2%*	*26.8%*
Debt-service costs	236.4	263.1	301.1
	4.9%	*4.9%*	*5.4%*
Main budget balance	**-709.7**	**-495.6**	**-430.5**
	-14.6%	*-9.3%*	*-7.7%*
Primary balance	**-473.2**	**-232.4**	**-129.5**
	-9.7%	*-4.4%*	*-2.3%*

Source: National Treasury

Consolidated budget balances

The consolidated budget includes the main budget and spending financed from revenues raised by provinces, social security funds and public entities.

Table 4.2 Consolidated budget balances

R billion	2019/20	2020/21	2021/22	2022/23
Main budget	-345.3	-709.7	-495.6	-430.5
Social security funds	-3.3	-49.1	-1.0	-2.4
Provinces	5.5	-2.6	0.6	1.9
Public entities	13.4	-0.3	5.5	9.5
RDP Fund[1]	-0.6	-0.1	-0.1	-0.0
Consolidated budget balance	**-330.3**	**-761.7**	**-490.6**	**-421.5**

1. Reconstruction and Development Programme Fund
Source: National Treasury

In 2020/21 the consolidated budget deficit will be revised from 6.8 per cent of GDP projected in the 2020 Budget to 15.7 per cent of GDP. Public entities, social security funds and provinces are projected to have a combined cash surplus in both 2021/22 and 2022/23.

Financing the gross borrowing requirement

Since February 2020, the gross borrowing requirement for the current year – the sum of the main budget deficit and maturing loans – has increased by R344.2 billion to R776.9 billion. The borrowing requirement will decline to R580.5 billion in 2022/23. Government has revised its financing strategy to minimise the effect of this deteriorating financial position on its stock of debt and on debt-service costs.

The domestic capital market is under pressure. In the wake of the March and April 2020 ratings downgrade and the outbreak of COVID-19, international investors have sold off about R58 billion in South African government debt. To moderate its domestic borrowing, government will draw down sterilisation deposits – money deposited at the Reserve Bank to offset excess market liquidity resulting from the purchase of foreign currency reserves. It will also source funding from international finance institutions.

Existing foreign cash deposits will be used to finance foreign currency commitments. The proceeds from international loans will be converted into rands to partially finance domestic commitments.

Short-term borrowing will increase by R98 billion to R146 billion in 2020/21, and will average R60 billion over 2021/22 and 2022/23. Borrowing in the domestic bond market will increase by R124.8 billion in 2020/21 to R462.5 billion, and average R419.9 billion over the next two years.

As a temporary measure, government revised its borrowing strategy to focus on issuing shorter-dated bonds with a weighted average time-to-maturity of seven to 10 years, compared to 15 years seen in the previous year. The strategy assists in managing the cost of raising debt and balances available market demand. When market conditions improve, government will resume issuing bonds over the full yield curve. Government will conduct a bond-switch programme to reduce its refinancing risk.

In a volatile global environment, with weak domestic growth and rising borrowing costs, short-term borrowing has become increasingly risky and difficult. As a result, the forward-looking risk rating for 2020, along with risks relating to liquidity, interest rate, refinancing and foreign currency, is expected to deteriorate. The inflation risk is expected to improve.

Table 4.3 National government gross borrowing requirement and financing

	2019/20	2020/21		2021/22	2022/23
R billion	**Preliminary**	**Budget**	**Revised**	**Medium-term estimates**	
Gross borrowing					
Main budget balance	**-345.3**	**-368.0**	**-709.7**	**-495.6**	**-430.5**
Redemptions	**-70.7**	**-64.7**	**-67.2**	**-64.9**	**-150.0**
Domestic long-term loans	-19.4	-52.5	-52.5	-60.5	-134.2
Foreign loans	-51.2	-12.2	-14.7	-4.4	-15.8
Total	**-416.0**	**-432.7**	**-776.9**	**-560.5**	**-580.5**
Financing					
Domestic short-term loans (net)	36.1	48.0	146.0	56.0	64.0
Domestic long-term loans	305.4	337.7	462.5	388.4	451.4
Foreign loans	76.1	29.3	125.2	31.9	63.2
Change in cash and other balances[1]	-1.6	17.7	43.2	84.2	1.9
Total	**416.0**	**432.7**	**776.9**	**560.5**	**580.5**

1. A positive value indicates that cash is used to finance part of the borrowing requirement
Source: National Treasury

National government debt and debt-service costs

Gross national government debt is projected to increase from R3.26 trillion (63.5 per cent of GDP) in 2019/20 to R3.97 trillion (81.8 per cent of GDP) in 2020/21. By the end of 2022/23, gross loan debt is expected to amount to R4.83 trillion, or 86 per cent of GDP.

Table 4.4 Total national government debt

End of period R billion	2019/20 Preliminary	2020/21 Budget	 Revised	2021/22 Medium-term estimates	2022/23
Domestic loans[1]	**2 874.1**	**3 227.6**	**3 476.2**	**3 899.2**	**4 316.0**
Short-term	360.7	409.0	506.7	562.7	626.7
Long-term	2 513.4	2 818.6	2 969.5	3 336.5	3 689.3
Fixed-rate	*1 863.2*	*2 075.0*	*2 215.1*	*2 528.4*	*2 755.3*
Inflation-linked	*650.2*	*743.6*	*754.4*	*808.1*	*934.0*
Foreign loans[1]	**387.2**	**334.4**	**497.8**	**471.8**	**514.9**
Gross loan debt	**3 261.3**	**3 562.0**	**3 974.0**	**4 371.0**	**4 830.9**
Less: National Revenue Fund bank balances	-263.6	-221.6	-210.5	-115.5	-116.0
Net loan debt[2]	**2 997.7**	**3 340.4**	**3 763.5**	**4 255.5**	**4 714.9**
As percentage of GDP:					
Gross loan debt	*63.5%*	*65.6%*	*81.8%*	*82.0%*	*86.0%*
Net loan debt	*58.4%*	*61.5%*	*77.4%*	*79.9%*	*83.9%*

1. Estimates include revaluations based on National Treasury's projections of inflation and exchange rates
2. Net loan debt is gross loan debt minus the bank balances of the National Revenue Fund
Source: National Treasury

Debt-service costs will increase from R204.8 billion in 2019/20 to R236.4 billion in 2020/21, or from 4 per cent of GDP to 4.9 per cent of GDP. Debt-service costs are expected to reach R301.1 billion, or 5.4 per cent of GDP, in 2022/23.

Without adopting the active approach outlined above, debt will quickly spiral beyond 140 per cent of GDP, as shown in Figure 4.2. Over the next several months, government will clarify the adjustments required to narrow the deficit and stabilise debt. These actions, which will be proposed in the MTBPS, will result in the debt-to-GDP ratio peaking at a projected 87.4 per cent in 2023/24 and declining gradually thereafter.

State-owned companies

The financial performance of state-owned companies, which has placed considerable pressure on the public finances for several years, is likely to deteriorate in 2020/21. The pandemic and associated economic restrictions are expected to reduce revenues for entities such as the Airports Company South Africa, Eskom and the South African National Roads Agency Limited. Global market volatility may further limit the ability of state-owned companies to borrow in capital markets and service their debt obligations.

The COVID-19 pandemic underlines the urgent need for broad-based reforms at state-owned companies so that they can become efficient and financially sustainable. These reforms include rationalisation (reducing the number of and merging some state-owned companies, and incorporating certain functions into government), equity partnerships, and stronger policy certainty and implementation. Planned transfers from the fiscus will be strictly conditional on improving their balance sheets.

As discussed in Chapter 2, the special adjustments budget includes an additional allocation of R3 billion to recapitalise the Land Bank. No other in-year spending adjustments are proposed for state-owned companies.

Conclusion

Government has resolved to implement active economic reform measures that will significantly raise economic growth, alongside urgent measures to stabilise the debt-to-GDP ratio. Without these, government debt will continue to rise, crowding out expenditure on social and economic priorities. These proposals will be set out in the 2020 MTBPS.