Preview Document: Extra-ordinary adjustment budget, 22 June 2020[1]

South Africa needs a "Resilience Budget"

22 June 2020

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Introduction:

On Wednesday 24 June 2020, Finance Minister Tito Mboweni will present an emergency adjustment budget.

This extra-ordinary emergency budget is necessitated by the unprecedented economic shutdown over the last three months, which still continues in certain key economic sectors, like tourism.

While the lockdown has exacerbated the current economic emergency, the truth is that it just concertinaed a dangerous and unsustainable economic trajectory that South Africa has been on for a decade.

The true cost of this omni-crisis will be felt in many more people falling into poverty, many more households without breadwinners, and a country left with fewer resources with which to respond. Many people have lost their lives and livelihoods who need not have. There is no doubt that the ANC-led government will table this emergency budget with blood on its hands.

Poor economic growth and high levels of debt have obliterated South Africa's ability to engage in counter cyclical measures- i.e. to save in times of plenty, and to spend in a time of crisis. Furthermore, years of skills erosion meant that excellence and civic minded individuals were readily replaced with incompetent and self-enriching cadres. South Africans did not stand a chance. The most damning indictment of this government and its predecessors is that the country entered the COVID pandemic vulnerable and with no cover.

In short, South Africa has lost resilience. Businesses are vulnerable, families are vulnerable, government is vulnerable.

South Africa urgently needs a plan to restore resilience. We need a "resilience budget" that will help families through the worst of the present crisis, and then provide a clear plan to restore our economy to growth and, ultimately, to stave off a full-blown sovereign debt crisis.

In this dire context, a resilience budget must acknowledge that neither austerity (sharp cuts to basic services) nor a big expansion in spending is possible now. The only available option is a very careful deployment of debt to fund the crisis response, while ensuring economic reform can spur growth, and showing a clear path to debt stability.

This is how we will measure the Minister's emergency budget this week: does it provide a credible plan for a) deploying resources efficiently in the medium term to provide crisis relief, b) putting in place measures that will allow us to stabilise debt post-covid and avoid wide-scale impoverishment by growing the economy?

Ultimately, does it make South Africa more resilient for what is coming, or does it only exacerbate our vulnerability?

This "resilience budget" needs to be underpinned by honesty and humility. There are no easy solutions to South Africa's economic crisis. What we face is now so dangerous, and so complex, that it will take time to resolve, if at all.

We should give little credence to those who promise silver-bullet solutions. These ‘solutions’ usually require no work or sacrifice. Nothing lasting ever comes from such fleeting effort.

There is only one pathway out of poverty and toward prosperity. Economic growth that exceeds population growth, over a sustained period of time, is the only sure way to lift people out of poverty and to create a more prosperous society.

Achieving economic growth will require wide-ranging economic reform, and an unshakeable commitment to restoring fiscal discipline. Most importantly, it will require more than the now hollow clichéd promises to reform the economy – there is simply no more patience left for such promises, unless there is also measurable progress in implementing real reform.

This document sets out the DA’s expectations for a “resilience budget”, and what such a plan should entail.

What is driving the disintegrating fiscal outlook?

The number of simultaneous crises the Minister faces is mounting: the junk status downgrade, collapsing tax revenues, ever-increasing debt and debt service costs, rising unemployment, widespread business closures, little progress to show on economic reform, and no economic growth.

All of these contribute to a rapidly disintegrating fiscal outlook:

<u>Recession and unemployment:</u>

While forecasts vary, there is consensus that South Africa’s GDP will shrink sharply in 2020, as a result of the three month hard lockdown. Even now some economic activities remain prohibited, like the tourism industry, with little obvious health rationale for doing so.

Tourism contributes 7% to South Africa’s GDP, so the longer this sector remains shuttered, the worse our GDP contraction will be.

Summary of forecasts:

Institution	GDP forecast
IMF	-5.8%
SARB	-7%
Treasury	-7.1%
Citi Bank	-9%
Intellidex	-10.4%
Treasury (slow)*	-12.1%
Intellidex (no loans)**	-16.4%
Median of forecasts	-9.8%

* If reopening of economy follows a slower projection
** If government guaranteed loan scheme is not effectively deployed

If South Africa's GDP shrinks by the median of these forecasts, this means that R450 billion in economic activity would have been wiped out of the economy.

To illustrate how severe this downturn will be, between 2008 and 2010, during the global financial crisis, South Africa's GDP contracted 6% (see figure 1). This contraction led to an increase in unemployment from a low of 21.5% to 25.5%, a 4 percentage point increase (figure 2).

Treasury has said that between 3 and 7 million people could lose their jobs. If even this lower figure is realised, that would represent an increase in unemployment at least 5 times as bad as the global financial crisis.

On a per capita basis, South Africans have been getting steadily poorer for the last six years. GDP per capita is now the same as it was in 2014, and this downward trend will accelerate now. South Africans will soon be no better off than they were in 2008.

As for businesses, StatsSA (Business Impact Survey, as at end April 2020) has reported that 90% of businesses showed a drop in revenues, 36% of businesses reported laying off staff, and 8.6% of businesses reported permanently shutting down.

Importantly, 29,3% of businesses reported that they were unable to survive another month without turnover. Since this survey was at end April, these businesses still faced lockdown for all of May.

Figure 1: Annual GDP growth 1995-2019

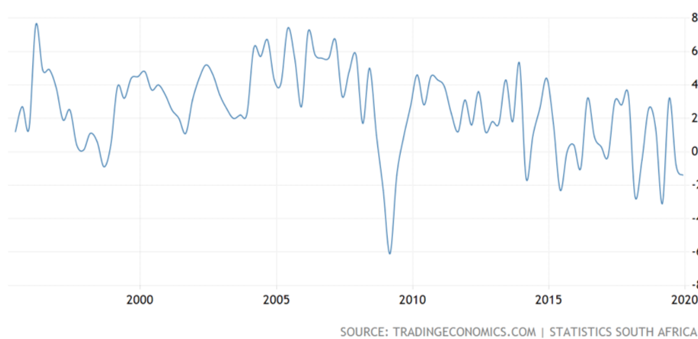


Figure 2: Unemployment Rate

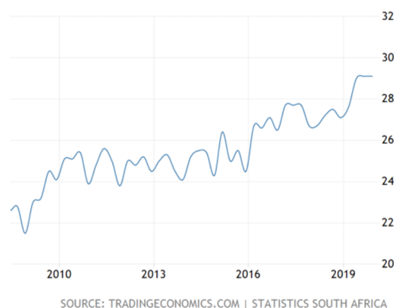
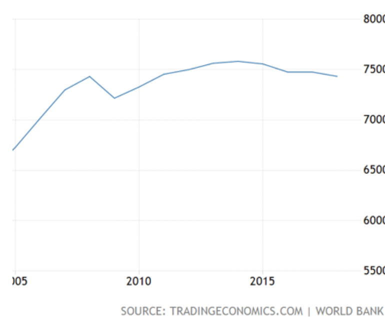


Figure 3: GDP per capita (USD)



Junk status, rising debt and debt costs:

South Africa's downgrade to junk status by Moody's Investor Services in late March 2020 was a long time coming.

The primary consequences of this downgrade have been an increase in the price that government must pay to borrow money, and rand devaluation.

Since January 2020, SA government debt yields have risen on all bar the 2 year debt:

SA govt bonds	YTD change
2 year	-135 bp
5 year	34 bp
10 year	110 bp
20 year	142 bp
30 year	146 bp

This results in government paying ever more to service debt.

Debt service costs are already the fastest growing item on the budget. In the 2020 main budget, before lockdown, interest charges were projected at R229 billion. This is more than we spend on healthcare, social grants or policing. Over the coming three years, debt payments will outstrip the education budget (R385 billion) and will be the single biggest state expense (besides the public wage bill which, at R713 billion, is not measured in a single line item), crowding out more and more spending on basic services.

Tax revenues, cuts and stimulus:

National Treasury projects a budget deficit of a record-breaking 14%.

The majority of this deficit will be made up of lost revenue, as SARS projects a R285 billion reduction in tax revenues for this year alone. This means that just to maintain spending at the pre-lockdown February budget levels, government will have to fund this R285 billion hole.

South Africa already has a very progressive taxation system. There is nothing that can be done on the revenue side of the equation anymore. Our only option is to reconsider spending priorities and to spend more efficiently even in essential areas.

This means that there is very little government can do to offer stimulus in the coming months. Indeed, there is no stimulus spending in this crisis because the state's fiscal position is so weak. The R500 billion package announced by government contains very little new spending at all – only R60 billion. The relief package relies overwhelmingly on tax deferments, UIF funds, and the guaranteed loan scheme to businesses.

This lack of fire-power in a time of crisis is the consequence of fiscal ill-discipline over the past decade.

Towards a Resilient fiscal framework:

It remains the most fundamentally important task of the National Treasury and the Minister to provide a clear plan to reduce the cost of South Africa's debt. In February, before this crisis, the Treasury waved the white flag of surrender on debt stability, conceding that there was no viable plan to achieve debt stability over the medium term. This is simply not acceptable.

Minister Mboweni must take responsibility for providing a clear plan to debt stabilisation.

While this must remain the unambiguous goal of fiscal policy, it is clear that it cannot be achieved this year, or even next. South Africa has growing financing needs over the coming years which must be met, meaning rising, not stabilising, debt levels over the medium term. This takes into account the reality that if we are going to fully open the economy then we must adequately finance the health system and the necessary health response, including reimbursing provinces for the additional cost burden which they have incurred.

Furthermore, history shows that fiscal consolidation is most successful in countries globally when economic growth is high and interest rates are low. In those countries which managed to consolidate in a low growth and high interest rate environment, a key ingredient was depreciating exchange rates and export growth. South Africa is unlikely to benefit from the latter in a current environment where trade and value chains have been disrupted. Globally, at least in the medium term, increased spending and higher debt ratios are expected.

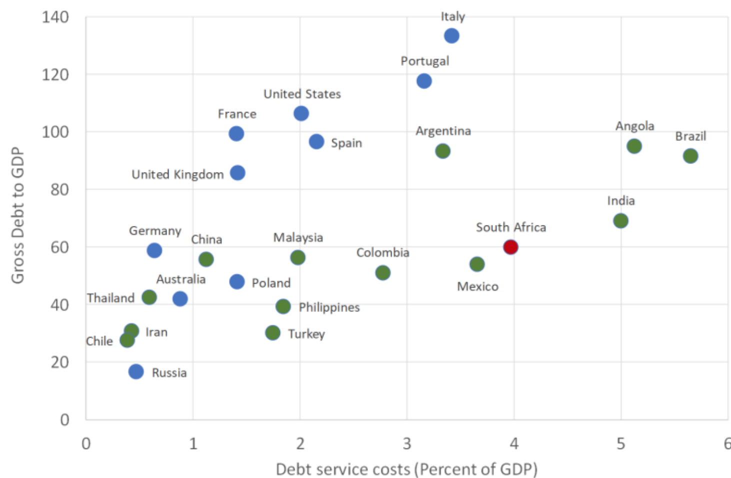
However, the groundwork for spending efficiency and debt-stabilisation in the post-COVID environment can and must be laid now (we expand on restructuring spending and priorities below on page 7).

It is possible, albeit optimistic, that actual reforms beyond indicative pronouncements may help to reduce the cost of debt.

Reducing debt service costs could allow us to maintain higher debt levels for longer, and still pay the same or less for that debt. This would improve the fiscal outlook, and allow the state to maintain essential spending on basic services and social support.

We must focus on reducing debt costs, which are not only affected by the size of debt but by (a) the debt trajectory, and (b) risk.

The problem is summarised in the following slide from Adj. Professor Michael Sachs (Wits). South Africa should aim to move leftwards in this slide, even if it is simultaneously moving higher too.



The cost of debt is influenced by real and perceived levels of risk.

<u>Risk:</u>

Perceptions about South Africa's risk can be reduced by (1) showing credible commitment to fiscal discipline, and (2) focusing on growth-spurring economic reform.

Even in a context of rising debt, the only way to achieve debt stability over time and reduce risk perceptions is to reduce spending on unnecessary and non-essential items. This is the only way to protect spending on essential basic services, and on growth-spurring infrastructure investment.

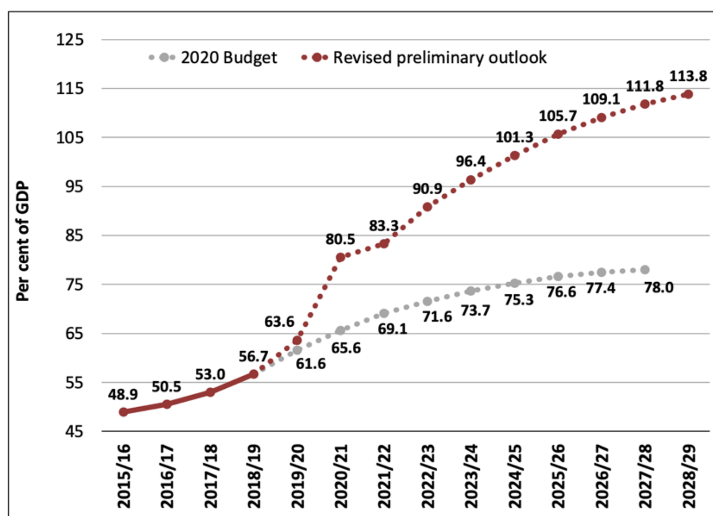
To do so, government must stick by the R160 billion cut in public sector wage expenditure over the medium term. This is essential, and without these cuts (and possibly deeper ones), government will not be able to stave off a debt crisis.

The government's wage bill currently accounts for 35% of total public expenditure, with spending projected to grow from R585 billion in 2018/19 to R713 billion in 2021/22.

<u>Debt trajectory:</u>

The Minister needs to demonstrate that the government is committed to reducing overall debt levels over time by showing a clear path to debt reaching a maximum, and then beginning a slow descent.

Such a path was not shown in the February main budget. And in leaked presentations from Treasury to Nedlac ahead of the Emergency Budget, Treasury does not seem to be able to show such a path now either (see graphic below, source National Treasury). According to Treasury's projections, debt will reach 113.8% of GDP by 2028, <u>and will still be growing</u>.



Restructuring: Priorities and Spending:

Recently the Finance Minister expressed that South Africa should think about moving to a zero-based budget. Zero-based budgeting would mean that in every budget cycle expenditure begins at zero and scrutiny is applied to policy objectives and the amount allocated to achieve them.

The DA has called over the years for a comprehensive spending review. Underlying both calls is the need for the South African government to reassess its expenditure baselines, that is how much it costs for the government to deliver on its policy mandate.

However, the following challenges are faced by this approach: the political will and expertise required to conduct the exercise, the length of time a comprehensive spending review requires even if the political will and expertise were present, the need to interrogate the policy mandate themselves before contemplating the least cost approach to fulfil them. Furthermore, is the ability to successfully conduct the review in the first place.

Since 2013 the National Treasury has conducted performance and expenditure reviews (PERs) of selected public programmes.

The spending review into provincial road expenditure was initiated in 2014 and terminated in 2016 as the lack of data made it impossible to complete the cost analysis and costing model.[2]

The Social Housing PER report states that “accurate spending data on all the projects approved in the seven years under review was not available”.

Similarly, the review into TVET acknowledges that, “data was not available on the cost of courses delivered by all public TVET colleges across the sector.” Furthermore that “there is limited data on final graduation rates”.

[2] https://www.gtac.gov.za/perdetail/Provincial%20roads%20-%20technical%20report.pdf

As an initial step to realising spending efficiency and reform South Africa should focus on:

a) **The collection of appropriate data and data transparency**

   The bottom line is that we cannot credibly review or manage what we cannot even measure. In the absence of accurate data to inform spending South Africa is flying blind. The first step to a zero-based approach and/or annual spending reviews is collecting appropriate data and making that data easily available for public consumption.

b) **The policy mandate which informs expenditure baselines, as opposed to looking at the most cost-efficient way to fulfil bad policy.**

   The FFC has already recommended reprioritisation, which we propose be done according to the following principles:

   - Impact on growth: spending must be aligned to interventions which have the most significant multiplier effects. Spending on infrastructure and service delivery are examples of areas which have wide and deep economic benefits. Infrastructure investment in particular is strongly linked to economic output, but South Africa's gross fixed capital formation is on a downward trajectory.
   - Contribution to social net: In addition to high levels of poverty (over 50% of the population is chronically poor), over 20% South Africans face above average risks of slipping into poverty. Meaning that prior to the COVID epidemic approximately 75% of South Africans lived with poverty as a constant threat in their lives. The provision of a strong 'trampoline' is essential.

Efficiency: Spending which enhances government efficiency must be prioritised- this includes spending on technology, highly-skilled and effective personnel etc.Growth-focused reforms for jobs and prosperity:

We need to commit now to a home-grown package of reforms that fundamentally changes the way we operate as a society, in order to unlock economic growth. This is the only way to arrest South Africa's decline and put the country on a path to prosperity.

Monetary policy can support fiscal stimulus in a recession by maintaining an accommodative stance. SARB has cut interest rates and engaged in asset purchases. We welcome the SARB's continued emphasis on the fact that we cannot lean on monetary policy, through more aggressive asset purchases, to change the country's economic growth potential. We cannot use monetary policy to avoid difficult political decisions.

Growth, and only growth, can get South Africa out of the vicious cycle we are in now, and getting us onto a virtuous circle of more jobs, more tax revenue, better services, more jobs and less poverty.

A reform package is the essential first step in reclaiming the credit worthiness and credibility that is so central to attracting loans and investment.

The immediate benefit is that it will enable us to access loans at affordable interest rates. The more confident lenders are that we will be able to pay loans back one day, the more money they will be prepared to lend us, and the lower the rates they will charge.

If we fail to implement a home-grown reform package, we will have one imposed upon us by international lenders like the IMF:

In considering our economic recovery, the following principles must apply:

1. We need to reconsider the economic settlement which has resulted in social contracting between a bloated government, big business, and big labour to the detriment of small, medium sized business and the unemployed. We need a new economic strategy, replacing policies that benefit a few people with policies that create a competitive playing field.
2. We need to value real world results over intentions This means abandoning policies where the empirical evidence shows them to have failed.
3. We need to be realistic, understanding that we have limited and dwindling resources and must make difficult trade-off decisions. Decisions aren't taken in a vacuum and reality isn't optional.
4. Emphasize the proper role of government in a market led economy:

    a. Basic service delivery and facilitating economic growth. We need to fix the systems on which our lives and livelihoods depend: water, electricity, transport, communications, education, health, policing, and the regulatory framework.
    b. Improve the capability of the state to deliver services, by introducing meritocracy and excellence into the civil service, and being tough on corruption.

With this in mind, the DA proposes the following focus areas for economic reform:

1. Stem the immediate bleeding by **ending the lockdown and replacing it with a standard set of evidence-based safety rules and guidelines,** where each regulation is directly linked to reducing the spread of covid-19. A standard set of high-impact safety rules will improve compliance and enforcement *and* raise economic activity. This will protect lives and livelihoods.

2. **Cut the public sector wage bill over the medium term and grow public sector productivity** by: freezing wages for non-frontline workers for a three-year period; reducing head-office management staff by one third; introducing performance management systems across all sectors; appointing and promoting on performance rather than race, gender or other criteria. The money spent on salaries is crowding out productive investment in public infrastructure.

3. **Sell or shut down state-owned enterprises** that are not able to survive without bailouts,. South Africa cannot afford vanity projects such as SAA or a new nuclear build.

4. Make electricity cheaper and more reliable for households and businesses **by ending Eskom's monopoly and opening the electricity market to competition**. Municipalities must be able to buy directly from producers.

5. Make it easier to get and create jobs by **freeing up the SMME labour market.** Small businesses should be exempt from agreements reached by bargaining councils.

6. **Reject investment-killing policies of EWC, NHI, prescribed assets and SARB nationalisation.** The real world result of these policies is to scare off investment, capital and scarce skills.

7. **Abandon BEE system and target redress policies at disadvantage rather than race.** The DA's position paper on redress sets out the policies South Africa should pursue in order to remove the underlying inequalities that still exist as a consequence of past dispossession and discrimination. Abandoning BEE will make state spending vastly more efficient, which is strongly in the interest of the poor.

8. **Auction digital spectrum** to bring down data costs for individuals and businesses.

9. **Reform visa regulations** to enable more scarce skills to enter South Africa.

10. Tackle corruption in the private and public sectors by establishing an **independent, well resourced corruption-busting body** – effectively reestablishing the Scorpions.

In each of these 10 areas, the barrier to implementation is political. Each of these reforms is in the public interest, but is opposed by specific interest groups that benefit from the status quo, and/or by politicians committed to a failed ideology. None of these changes requires huge capital spends or complex design and implementation. Rather, what is needed is for the government to get out the way. South Africa's reality is that the governing party is the greatest impediment to social wellbeing and prosperity.