ECONOMIC COMMENTARY

24 June 2020

NEDBANK

Supplementary Budget 2020

Economics | South Africa

Emergency Budget suggests that the hippo's jaws will remain wide open

- **Key fiscal metrics:** Unsurprisingly, the emergency budget paints a dismal picture of the country's finances. The **consolidated budget deficit** doubles to 15.7% of GDP in 2020/21 from the already dangerously high 6.8% estimated at the time of the 2020 National Budget, just over three months ago. The **main budget deficit** soars to 14.6% of GDP from February's 6.8%. The **primary budget deficit** (which excludes debt service costs) jumps to 9.7% of GDP from 2.6% in the 2020 Budget. The adverse impact of the COVID-19 pandemic and the strict lockdown on economic activity and therefore tax revenue is mainly to blame. National Treasury now expects the economy to contract by 7.2% in 2020 (previously 0.9%), followed by a modest recovery of 2.6% and 1.5% in 2021 and 2022 respectively. This and the COVID-19 tax concessions reduces **main budget revenue** to R1.1 trillion, a massive R298.5 billion or 21.4% less than in February. **Main budget expenditure** rises to R1.8 trillion, around R43 billion or 2.4% higher than in February, due to the bailouts offered to SOE's earlier this year, COVID-19 spending and higher debt service costs.
- **Financing:** The **gross borrowing requirement** jumps to R776.9 billion in 2020/21 (R432.7 billion in February) and is then estimated to decline to R580.5 billion by 2022/23. National Treasury acknowledges that the domestic bond market is under pressure, noting that foreign investors sold about R58 billion of SA government debt after the March and April 2020 ratings downgrades and the outbreak of COVID-19. Government will **drawdown sterilisation deposits** (money deposited at the Reserve Bank to offset excess market liquidity resulting from the purchase of foreign currency reserves) and use funding from international institutions to contain domestic borrowings. **Issuance** will be focussed on shorter-dated bonds with a weighted average time-to-maturity of 7- to 10-years, compared with 15 years previously.
- **Debt metrics:** Gross government debt climbs to R3.97 trillion or 81.8% of GDP from February's projection of R3.56 trillion or 65.6% of GDP. It then increases to R4.83 trillion or 86% of GDP by 2022/23.
- **Market implications:** The exceptionally poor fiscal outlook will hurt global risk appetites for SA's assets. It is difficult to ascertain whether the decision to focus bond issuance around the most liquid 7- to 10-year maturities will help to flatten the yield curve. The key to lowering the cost of funds will be to lift economic growth and job creation substantially through meaningful structural reforms. National Treasury also stresses that '*…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.*' Government proposes the right medicine: continued spending restraint, measures to boost long-term economic growth and significant reforms of SOE's to reduce their reliance on public funds. After over a decade of missing budget commitments, the onus is now on government to take the necessary steps towards fiscal sustainability. Investors, both local and foreign, will remain wary of SA Inc. until government starts to take the tough decisions needed to avoid a sovereign debt crisis.
- **Economic implications:** Increased government spending will provide some support to a battered economy in 2020. Thereafter the fiscus will become a major drag on growth. Government will have to reduce spending, raise revenues and finance an enormous deficit. Higher taxes will hurt both households and companies, while public sector borrowing will continue to crowd-out the private sector, placing further downward pressure on private sector fixed investment.

Table 1: **Main Budget Framework**

	2019/20	2020/21		2021/22	2022/23
	Feb-20	Feb-20	Jun-20	Jun-20	Jun-20
Revenue (Rbn)	**1345.3**	**1398.0**	**1099.5**	**1268.2**	**1378.8**
% of GDP	*26.2*	*25.8*	*22.6*	*23.8*	*24.5*
Expenditure (Rbn)	**1690.6**	**1766.0**	**1809.2**	**1763.8**	**1809.3**
% of GDP	*32.9*	*32.5*	*37.2*	*33.1*	*32.2*
Main Budget Balance (Rbn)	**-345.3**	**-368.0**	**-709.7**	**-495.6**	**-430.5**
% of GDP	*-6.7*	*-6.8*	*-14.6*	*-9.3*	*-7.7*
Primary Balance	**-140.5**	**-138.7**	**-473.2**	**-232.4**	**-129.5**
% of GDP	***-2.7***	***-2.6***	***-9.7***	***-4.4***	***-2.3***

Source: National Treasury

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Fiscal Framework:

Expenditure

- As expected, consolidated expenditure for the current fiscal year has been revised upwards to R2.04 trillion from R1.95 trillion at the time of the February budget. The increase is mainly the result of an amount of R145 billion that has been allocated for government's COVID-19 response.
- The good news is that the R145 billion (a main budget amount) is not all additional expenditure. The review proposes several downward adjustments to expenditure (main budget non-interest expenditure is cut by R109 billion), which means in the end, main budget non-interest expenditure for the current fiscal year is only R36 billion higher than what was proposed in February.
- The additional R145 billion will be spent as expected. The bulk will go towards 'support to vulnerable households for 6 months' (R40.8 billion) and the second biggest slice of the additional expenditure is allocated to health (R21.5 billion). Also included, is an amount of R19.6 billion that has been set aside and is likely to be used for job creation and protection. The bulk of R190 billion cut in expenditure will be shouldered by national departments (R54.4 billion cut) and suspensions to provincial equitable shares (R20 billion).
- Classified by department, there were no sacred cows, cuts were made for most departments even learning and culture. The review explains how Treasury went about adjusting expenditure. Treasury chopped allocations to programmes with a history of poor performance or slow spending, underspent funds due to delays from the lockdown were taken away from departments, money was also taken away from projects that could be rescheduled to 2021/22 or later and they also redirected spending within functions to the COVID-response.

Table 2: Functional Allocation of Non-Interest Expenditure:

	Feb 2020	June 2020	% change	% of total
Non-Interest Expenditure	**1536724**	**1572731**	**2.3**	**100.0**
General public services	618840	619599	0.1	39.4
Peace and security	207006	212991	2.9	13.5
Economic development	88381	80886	-8.5	5.1
Community development	219727	221835	1.0	14.1
Health	55516	58430	5.2	3.7
Learning and culture	151543	138364	-8.7	8.8
Social development	198497	223837	12.8	14.2
Provisional allocations: COVID-19 package	-	19575		1.2
Provisional allocations not assigned to votes	-7786	-7786	0.0	-0.5
Contingency reserve	5000	5000	0.0	0.3

Source: National Treasury

- The review underscored a renewed urgency by Treasury to reverse what was a rather precarious fiscal position even before the COVID-19 pandemic. This dire fiscal situation is highlighted in the supplementary budget review when the composition of expenditure is discussed. In the document it is stated that '*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.*' **The point being made is that the composition of expenditure is of such a nature that it hamstrings the delivery of the very things that are required to increase GDP growth and so set the country's fiscal position on a better footing.**
- **It therefore goes without saying that when examining expenditure by economic classification, compensation to employees is cut.** For this fiscal year compensation is cut by R1.4 billion but is allocated R0.8 billion from the R145 billion, which brings the total cut to R0.6 billion. **For those hoping for a bigger cut, it must be understood that the current cut is probably unprecedented.** In previous budgets Treasury has attempted to only slow the rate of increase in compensation, this time however, compensation has been cut. The consolidated spending plans show a similar pattern.

- A new strictness will be implemented when it comes to the 2021 Medium-term Expenditure Framework. Public expenditure reviews will begin next month and will be based on zero-based budgeting principles. This means that there will be no fat, as each department will have to justify their expenditure and any expenditure will need to be backed by rigorous analysis.
- It would have been unrealistic to expect spending to decline significantly at this time, so the measured increase in expenditure was expected for this fiscal year and perhaps over the medium-term. The steps National Treasury outlines to contain expenditure should have been in place all along. Money should not have been spent on poor performing programmes and zero-based budgeting should have been in place before the COVID-19 pandemic. It is not as if South Africa was in a great fiscal space before COVID-19. Hopefully this new fiscal discipline will be maintained until the country is on a better fiscal footing.

Revenue

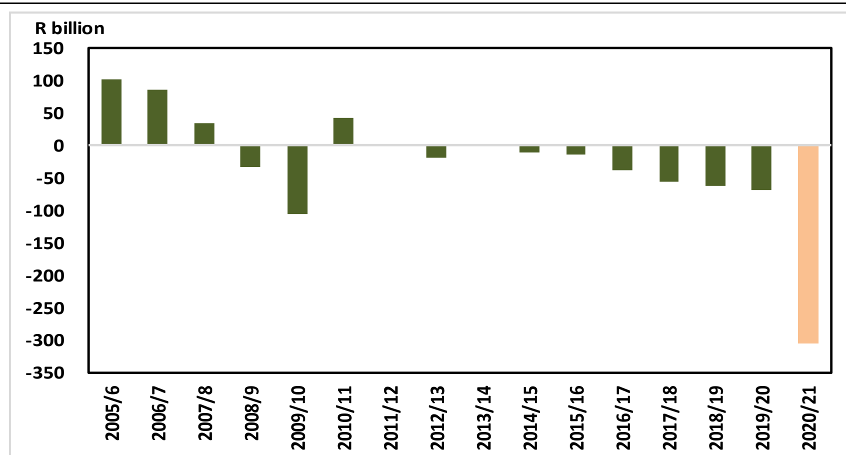
The supplementary budget shows a significant revision in revenue from that outlined in the 2020/21 budget in February, with the revenue-to-GDP-ratio for the fiscal year revised down to 22.6% from 25.8%. The impact of the COVID-19 shock on revenue is expected to be the biggest on record, and far exceed that of the 2008 global financial crisis.

Revenue collection for 2020/21 is now expected to be R304.1 billion, lower than estimated in the 2020 Budget (compared with R105.4 billion effect in the 2008 financial crisis), primarily due to a temporary reduction in the tax base as businesses closed, people lost jobs or earned less and receipts from foreign trade was reduced. Value-added tax (VAT) and customs revenue estimates have been revised down to reflect the impact of lower confidence, lockdown-related sales restrictions and a weaker trade outlook. Some relief measures were implemented to assist depressed households and companies.

These include:

- 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% 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% 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.
- A four-month 10% increase in the available tax deduction for donations made to the Solidarity Fund from 1 April 2020.

Chart 1: In-year revenue compared with Budget forecasts (2020/21 prices)



Source: National Treasury, 2020 Suplimentary budjet

- The recovery on revenue collection will depend on how fast economic activity return to normality as the lockdown measures are phased out gradually. **According to National Treasury, it would take up to 7 years for the tax-to-GDP ratio to return to pre-COVID-19 level of around 26%.**

- **Personal income taxes** are expected to remain under significant pressure due to job losses and employers' difficulties to pay full salaries. **Corporate tax collections** will be negatively affected by service and production disruptions during the lockdown as well as weak confidence due to uncertainty of when activity will return to normal. As a result, the 2020/21 supplementary budget also did not propose new tax measures in the current year, but increases are expected in the coming years given the need for fiscal consolidation and stabilisation of debt. Tax increases of R5 billion are expected in 2021/22, R10 billion in 2022/23, R10 billion in 2023/24 and R15 billion in 2024/25, along with the economic recovery.
- Other measures planned to help tax revenue collections and fiscal stabilisation include: Improvement in the tax administration, with SARS planning to increase tax receipts by focusing on international taxes, 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 and improving the collection of outstanding debt and ensuring that outstanding taxpayer returns are filed and liabilities paid.

Deficit, Debt & Financing

- The gross borrowing requirement more than doubles, from R344.2 billion to R776.9 billion, in 2020/21.
- Borrowing from international markets will account for the bulk of new borrowing.
- Short-term borrowing averages R60 billion a year over the MTEF period.
- Long-term borrowing is 37% higher than on the original 2020 Budget, averaging R419.9 billion per annum over the next two years.
- More bonds will be issued in the 7- to 10-year duration, compared with 15 years previously.

Table 3: Financing the Budget

	2020/21		2021/22		2022/23	
	Feb-20	Jun-20	Feb-20	Jun-20	Feb-20	Jun-20
Domestic short-term loans	**48.0**	**146.0**	**48.0**	**56.0**	**55.0**	**64.0**
Domestic long-term loans	**285.2**	**410.0**	**278.2**	**327.9**	**262.2**	**317.2**
Market loans (gross)	337.7	462.5	337.4	388.4	385.8	451.4
Loans issued for switches	-	-	-	-	-	-
Redemptions	-52.5	-52.5	-59.2	-60.5	-122.9	-134.2
Foreign loans	**17.0**	**110.5**	**40.5**	**27.5**	**38.0**	**47.4**
∆ in cash & other balances	**17.7**	**43.2**	**-0.3**	**84.2**	**3.5**	**1.9**
Total	**368.0**	**709.7**	**366.4**	**425.4**	**359.3**	**430.5**

Source: National Treasury

The sharp increase in borrowing raises the aggregate public debt stock to R3.97 trillion in 2020/21, from R3.26 trillion in 2019/20 and R3.56 trillion estimated in the February 2020 budget. As a result, debt-to-GDP ratio jumps to 81.8%, 20 percentage points more than the 61.5% projected in February. Debt service costs will absorb 21.5% of 2020/21 revenue, compared with 16.4% expected in February, and average 21.4% over the MTEF period.

Government will adopt measures to stabilise and reduce the debt stock. The Minister stressed that such 'active management' of the debt stock will cap the debt-to-GDP ratio at 87.4% in 2023/24 and reduce it to 73.5% by 2028/29. **In the absence of active debt stabilisation measures the debt-to-GDP ratio will surge to 140.7% by 2028/29, according to National Treasury projections.** Stabilising and reducing debt will require achieving a surplus in the primary budget − balance before debt service costs − starting in 2023/24. This in turn will necessitate spending reductions and revenue adjustments totalling R250 billion per annum from that year.

These figures show that the further rise of the public debt stock − breached the 50% mark in 2016/17 − to even higher and more unsustainable levels will tighten the fiscal space further. This is a precarious situation, as debt service costs will rise further if the deterioration of global financing conditions raises the cost of borrowing in both global and local markets significantly. The expected debt trajectory suggests that external rating agencies are likely to downgrade their ratings further into non-investment grade, as the debt stock will reach a level that is much higher than similarly rated sovereigns. **Failure to stabilise and reduce the debt stock over the coming years will prompt further downgrades, raise the cost of debt even further and make the recovery process even more difficult.**

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