POLICY BRIEF

Financial and Fiscal Commission (2021)

The financial and fiscal impacts of COVID-19 in South Africa: Public revenues and fiscal impulse

Executive Summary

The pandemic has triggered the most significant recession ever recorded in South Africa's economic history. It has exposed many of the structural weaknesses in the domestic economy and increased the risk of a public debt spiral, which is undermining the country's fiscal credibility. In order to inform economic policy design, the Commission undertook to measure the impact of the COVID-19 pandemic on South Africa's fiscal policy by examining public revenues and the fiscal impulse. A quantitative approach of financial programming, descriptive analysis and macro-econometric time-series techniques was used, based on the most recent empirical data. The Commission's research found that South Africa's fiscus is particularly vulnerable given that public revenues are, to a large extent, derived from household income and consumption, both of which have been negatively impacted by the pandemic. Furthermore, the fiscal impulse analysis reveals that the primary balance deteriorated to nearly -7.5% of gross domestic product (GDP), which has heightened fiscal sustainability risks and compels consolidatory efforts and reprioritisation at the aggregate level.

Background

The COVID-19 pandemic has caused an unprecedented shock to the South African economy with significant financial and fiscal consequences. However, even prior to the pandemic, both South Africa's financial stability and fiscal position have been deteriorating. In the decade preceding the onset of the pandemic, tax revenue has been in decline, the sovereign credit rating has been downgraded to sub-investment, and debt-servicing costs have escalated, causing public debt levels to soar. The underperformance of tax revenue has been particularly prevalent in tax collectables on corporate income, which diminished significantly prior to the impact of COVID-19.

FINANCIAL AND FISCAL COMMISSION

THE FINANCIAL AND FISCAL COMMISSION

The Financial and Fiscal Commission is a body that makes recommendations and gives advice to organs of state on financial and fiscal matters. As an institution created in the Constitution of the Republic of South Africa, it is an independent juristic person subject only to the Constitution itself, the Financial and Fiscal Commission Act, 1997 (Act No. 99 of 1997) (as amended) and relevant legislative prescripts. It may perform its functions on its own initiative or at the request of an organ of state.

The vision of the Commission is to provide influential advice for equitable, efficient and sustainable intergovernmental fiscal relations between national, provincial and local spheres of government. This relates to the equitable division of government revenue among three spheres of government and to the related service delivery of public services to South Africans.

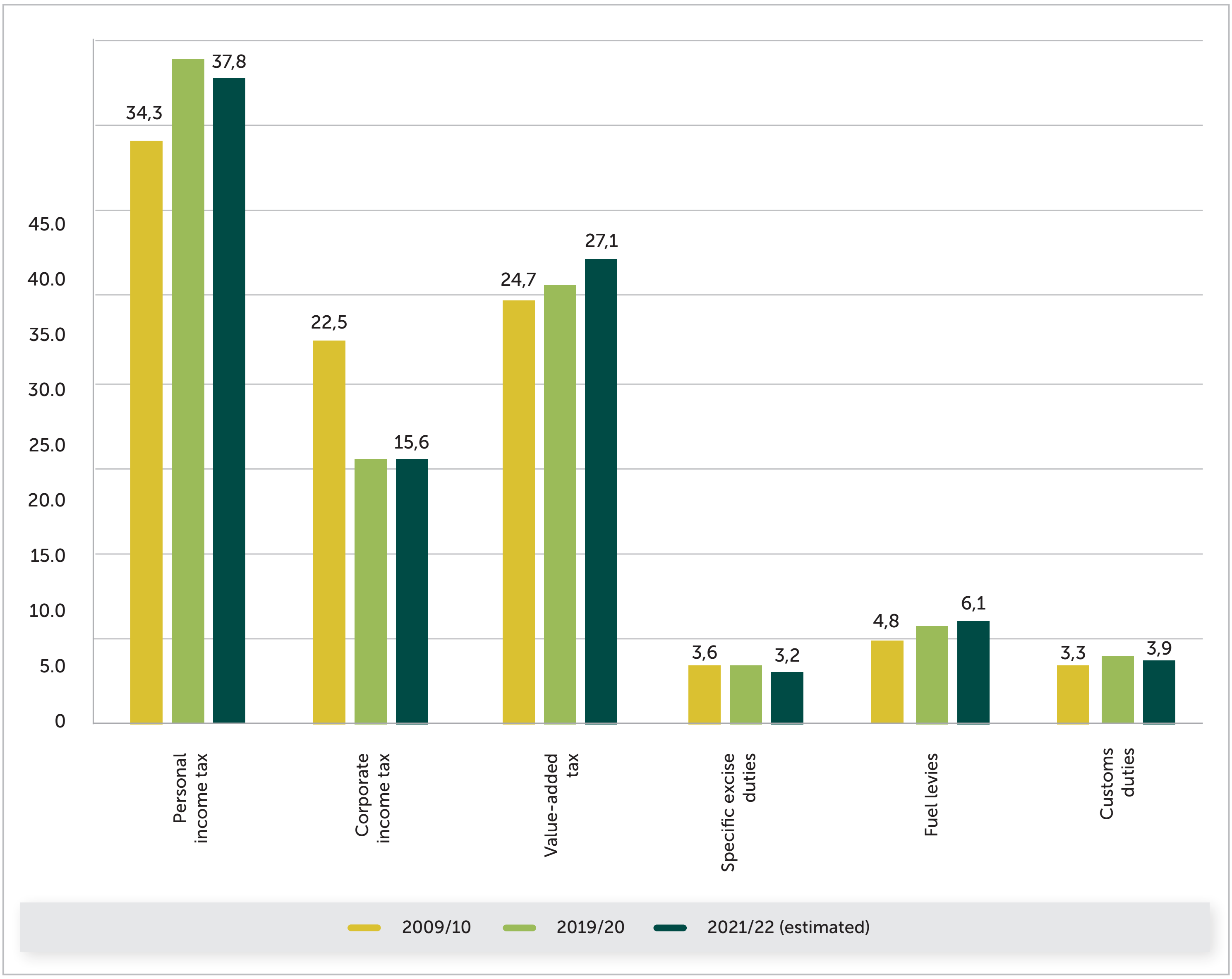
Through focused research, the Commission aims to provide proactive, expert and independent advice on promoting the intergovernmental fiscal relations system using evidence-based policy analysis to ensure the realisation of constitutional values. The Commission reports directly to both Parliament and the provincial legislatures, who hold government institutions to account. Government must respond to the Commission's recommendations and the extent to which they will be implemented at the tabling of the annual national budget in February each year.

The Commission consists of commissioners appointed by the President: the Chairperson and Deputy Chairperson, three representatives of provinces, two representatives of organised local government and two other persons. The Commission pledges its commitment to the betterment of South Africa and South Africans in the execution of its duties.

The COVID-19 pandemic has created many structural changes in the labour market, with lasting effects on South Africa's fiscal position. The unemployment rate stood at 32.8% in the fourth quarter of 2020, with an estimated 1.4 million individuals becoming jobless and thus without any source of income during that period (Stats SA, 2021). This has massive implications for South Africa's projected tax base and future fiscal prospects.

Research findings

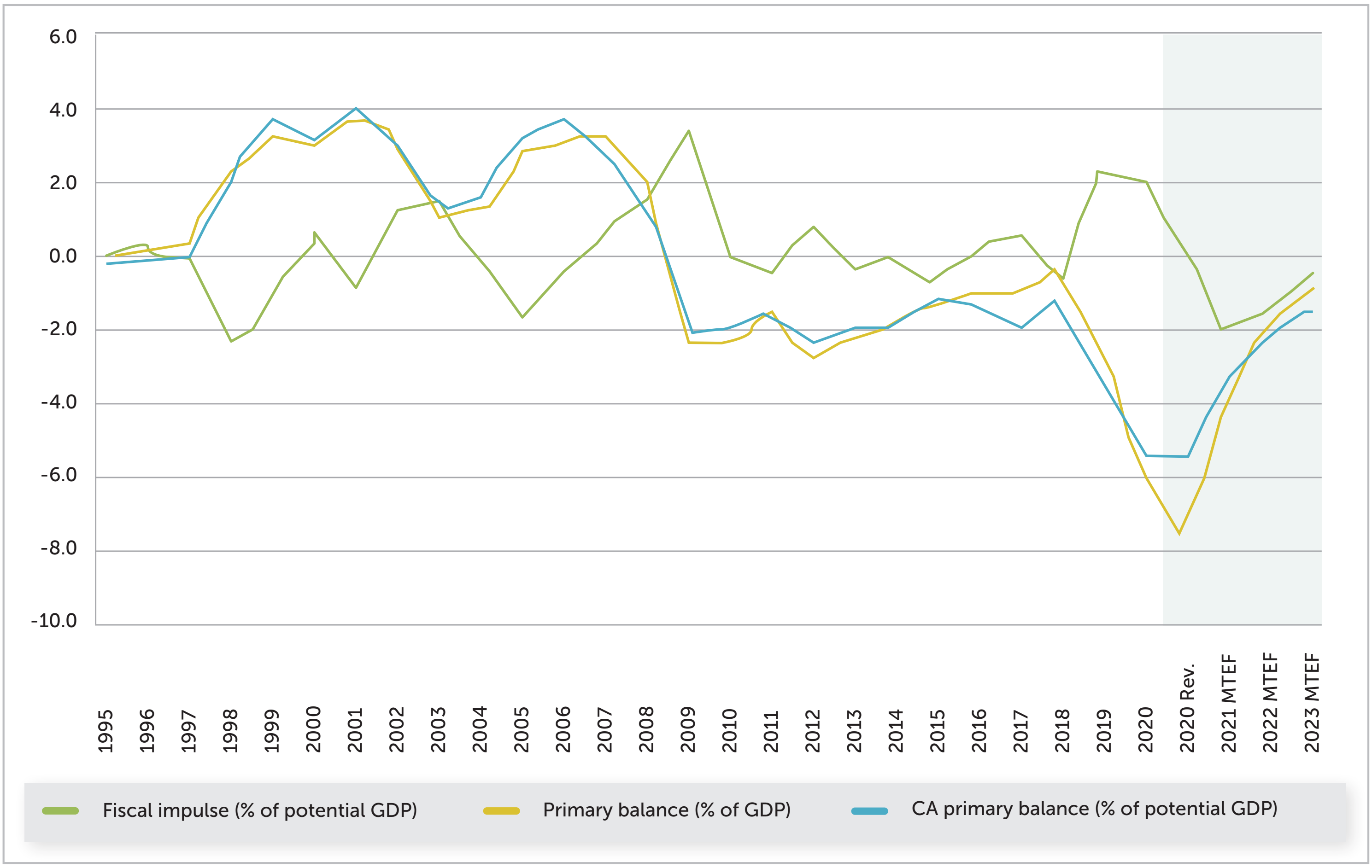
Figure 1: Share of total tax revenue (top 90%, in percentage)



Source: National Treasury (2021) and the Commission's calculations

Figure 1 represents the proportion of tax revenue by classification over a decade between 2009/10 and 2019/20, as well as the estimated after-tax revenue budget proposals for the 2021/22 financial year (i.e. the 2021 Budget). The data indicates that there has been a drastic substitution effect between corporate income tax (CIT) with personal income tax (PIT) and domestic (consumption) taxes on goods and services. This suggests that, over the past decade, South Africa's fiscus has become more dependent on labour and household income, as well as activities in consumption. The increase in the concentration and dependence on PIT and value-added tax (VAT) for public revenue generation has made fiscal revenue more vulnerable to COVID-19, especially due to the impact that the pandemic has had on household income and consumption behaviour.

Figure 2: Fiscal impulse, primary and cyclically adjusted primary balance (in percentage of potential GDP), 1995–2020, 2020 revised estimate and the 2021 Medium-term Expenditure Framework



Source: South African Reserve Bank (2021); National Treasury (2020) and the Commission's calculations

To measure South Africa's fiscal stance, Figure 2 calculates the fiscal impulse. The concept of fiscal impulse encapsulates the change in the government budget balance resulting from a change in government expenditure and tax policies. The series shows that, since the fiscal expansion adopted in the 2008–2009 financial crisis at the expenses of primary balance, in the last decade, the fiscal space has been under strain to implement real expansionary policy. With the onset of COVID-19 and its negative impacts on the economy, the fiscal space of the primary balance deteriorated even further, without a substantial change in the fiscal stance and impulse. This caused fiscal sustainability risk and the risk of public finance management credibility to escalate. As seen by the 2020 revised estimates, the primary balance deteriorated to nearly -7.5% of GDP, compelling the fiscal impulse towards a consolidatory stance to bring the primary balances towards a more sustainable range. Essentially, this means that the only viable course is reprioritising spending at the aggregate, while maintaining the same levels of goods and services delivered.

Conclusion and recommendations

South Africa's fiscal policy has been impacted most notably by the pandemic due to compositional changes that have occurred in South Africa's public revenues over the past decade. These changes have made the fiscus particularly vulnerable to the devastating impact that the pandemic has had on employment, household income and consumption behaviour. Furthermore, South Africa's fiscal position has been strained by low growth and a structural deficit in the primary balance. The government's prior attempt in 2019 to initiate an expansionary stance and stimulate the economy was interrupted by the onset of COVID-19, resulting in far less room to respond to the severe economic impact of the pandemic. In order to overcome these fiscal challenges, it is imperative for the state to consolidate its spending without jeopardising service delivery.

The Commission makes the following recommendations:

1. The Minister of Finance should develop a fiscal sustainability strategy and principles with objective fiscal markers in order to implement targeted financial reforms for inclusive growth, fiscal debt sustainability and fiscal credibility. The fiscal sustainability plan and principles should consider the fiscal, financial and socioeconomic consequences of the COVID-19 outbreak in order to direct financing, within justifiable means, and ensure the progressive realisation of the constitutional imperatives.

References:

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