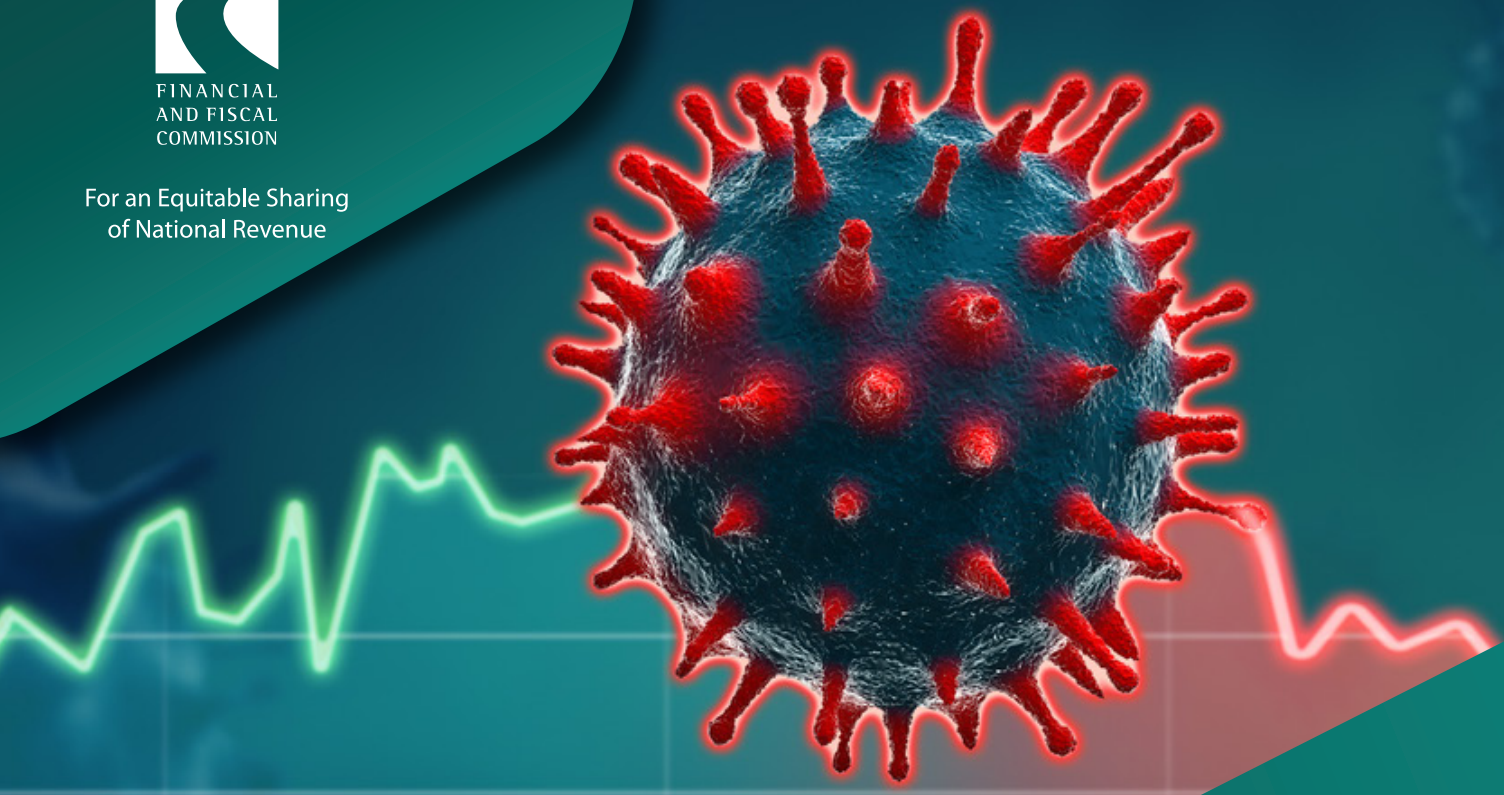
FINANCIAL AND FISCAL COMMISSION

For an Equitable Sharing of National Revenue



POLICY BRIEF

Covid-19 and the Fiscal Framework

The Financial and Fiscal Commission

The 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, 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 and may perform its functions on its own initiative or on 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 the national, provincial and local spheres of government. This relates to the equitable division of government revenue among the 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 both to 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.

The Commission consists of women and men 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 African's in the execution of its duties.

FINANCIAL AND FISCAL COMMISSION

Policy Brief

Covid-19 and the Fiscal Framework

02 February 2021

Executive Summary

The short-term effects of the Covid-19 pandemic are increased spending (on health care and relief for households) and decreased revenue (for national and municipal governments). Additional funds are needed to expand health care facilities and staffing, with the cost burden falling disproportionately on regions with the highest incidence of Covid-19 (Gauteng, Western Cape and KwaZulu-Natal). At national level, government expects a shortfall of over 20% on pre-pandemic income estimates, while metros (where most Covid-19 incidences occur) expect a shortfall of about 30% in own revenues. Government's stimulus package draws primarily on three sources: A R200-billion credit guarantee scheme (only for formal businesses), the Covid-19 TERS and increased social grants, and budget reprioritisation. The lockdown due to Covid-19 led to hardship for workers and businesses, with the lower-income workers and informal businesses being most affected, especially in the metros. The Covid-19 social grants have been extended and will now end in January 2021, but the economy remains fragile, unemployment is high and demand is depressed. The Commission found that overall the stimulus package has fallen short of ambitions, while the relief to households may have been comparatively robust but still fell short of replacing lost income. As debt and the need for social relief to households mount, government will need to be innovative. Therefore, the Commission recommends that government restructure the economy to achieve greater dynamism and equality.

Background

In the short run, the Covid-19 pandemic affected the budget in several ways: by increasing the need for expenditure on health care and public health measures, as well as relief for households that lost/lose their livelihoods; and by slashing revenues for the national government and for municipalities that historically raise a significant share of their budgets from rates and services.

New expenditure demands fall under four main headings. (a) health care, mostly to expand hospital capacity in terms of both physical equipment and staff; (b) public health measures to respond to the pandemic; (c) alleviation of economic distress and promotion of recovery, in response to the national and global depression resulting from the pandemic; and (d) the long-run stimulus for economic growth. All these needs affect the spheres of the state and the regions differently. The national, provincial and municipal governments have divergent responsibilities and revenue sources. The main metro areas and some secondary cities have a much higher incidence of Covid-19 than the rest of the country, although they are able to finance services largely from their own revenue, whereas smaller towns (especially in the historic labour-sending regions) are too impoverished to raise their own funds.

Research Findings

1. **Health care.** Additional funds are needed primarily to expand equipment and beds in existing hospitals, establish field hospitals, procure testing materials and personal protective equipment, and hire additional staff. Provincial governments are mainly responsible for delivering health care, with some of the larger metropolitan municipalities also providing health care through local clinics, although the effect of the pandemic on these clinics remains unclear. The extent of Covid-19 and associated health care needs differ across provinces and municipalities, as highlighted by the disparities in the death rate, with the pandemic disproportionately affecting the traditionally urban provinces of Gauteng, Western Cape and KwaZulu-Natal. Both provinces and the national health departments have to implement numerous public health care measures, such as a national communication framework, field hospitals and additional health care professionals, with the cost burden falling disproportionally on regions that have the highest incidence of Covid-19 cases.

2. **Relief and recovery.** Initially, the pandemic affected the South African economy through slower growth in its major trading partners – first China and subsequently Europe and the US. As it took hold in South Africa, economic activity and demand were depressed. The lockdown imposed extraordinary hardships in the form of mass layoffs, salary sacrifices, the closure of most informal enterprises, and liquidity challenges in formal businesses, with smaller producers being most affected. Estimates indicate that in April 2020, in Level 5 lockdown, only around a third of employees were expected to work. In Level 4, the figure climbed to about half. In extended Level 3, the only industries that remain closed were effectively bars and clubs, although other providers of personal services often had to operate at between 50% and 75% of capacity. In providing economic support during the lockdown and the phased economic re-opening, the government had four main goals: to

minimise formal retrenchments, to cushion lower-income workers against the loss of pay, to compensate informal workers, and to provide liquidity for formal businesses of all sizes.

3. **Revenue shortfall.** The economic downturn meant a shortfall mostly at national and local government level, as provinces have only very limited sources of own revenue. At national level, SARS anticipates a shortfall of R300-billion, or over 20%, on its pre-pandemic estimates. This compares with a shortfall of just over 10% in the 2008/9 global financial crisis. National Treasury estimates that the pandemic will cut the metros' own revenue by around 30%, as most of this revenue comes from a mark-up on the sale of electricity and other services to businesses and households, as well as from rates. Metros face by far the greatest challenges, although they come into the crisis with much larger revenues per resident, as well as better infrastructure and higher staffing levels.

4. **Fiscal relief response.** Government has announced that it will spend R500-billion to deal with the pandemic and the associated economic fallout. Critically, the bulk of additional spending is expected to come from the private sector and social-protection funds. The budget itself is counter-cyclical, in the sense that it maintains spending levels despite a rapid increase in the deficit, to 15% of GDP. It increases spending by only 2.4%, or R43-billion. Government has drawn primarily on three sources for its stimulus package:
   - A R200-billion credit guarantee scheme channelled through private banks was the centrepiece of the stimulus package. However, lending under the scheme remained limited. By the first week of June, the banks had approved R7-billion worth of loans for 4800 businesses and rejected another 11 000 applications due to low credit worthiness. This intervention only provided support to formal businesses, which tend to be clustered in the most economically strong areas of the country.
   - R40-billion for the Covid-19 Temporary Employee/Employer Relief Scheme (TERS), paid for from the UIF surplus (which stood at R165-billion before the pandemic), and increased transfers to households through social grants and food parcels, with the aim of avoiding mass retrenchments and extreme hardship during the lockdown. Generally, the UIF grants only benefit formal employees, including domestic workers (although only around 10% of domestic workers received support). This means that the bulk of the funds are paid in metro areas and secondary cities where jobs are concentrated.
   - A substantial reprioritisation of the budget. While the fiscal response bolstered spending on health and social grants, it cut spending on industrial policy programmes designed to bolster manufacturing and value-adding services – that is, to promote diversification away from commodity dependency.

Challenges

Although the lockdown restrictions have eased, South Africa faces many challenges resulting from the pandemic, in particular:

- The unequal impact of the lockdown, which is aggravated by the unusually deep inequalities in South Africa. During the lockdown, lower-income workers typically faced the prospect of a loss of pay and had limited assets and savings. In contrast,

higher-income workers were more likely to be able to continue to work from home and had more resources to cushion a fall in income.

- The disproportionate impact on metros, as a result of higher incidence of Covid-19 (with the associated health care needs) and lower own revenue from rates and the mark-up on electricity and other services to businesses and households.
- The expected end to Covid-19-related social grants in January 2021, within the context of a fragile economy, with continued high joblessness, depressed local demand and slow global growth.
- The increased spending on health care that is not aligned to the incidence or growth rate in Covid-19 cases. In June 2020, the supplementary budget estimated that the pandemic would require an additional R20-billion for the national and provincial health departments, but the budget does not distinguish spending on public health measures as opposed to curative healthcare. With the anticipated R15-billion redirected from other provincial functions, the total provincial health care budget would increase by 7%, from R209-billion to R229-billion.

Conclusion and Recommendation

Overall, the stimulus package to date has fallen far short of ambitions, largely because it does not have a clear economic strategy to guide expenditure. As a result, the credit-guarantee fund has been unable to generate the anticipated spending, while other elements of relief package were undermined by administrative weaknesses. In contrast, the provision of relief to households proved comparatively robust, although both the Covid-19 TERS and the increase in social grants fell far short of replacing lost income for low-income families. As debt and the need for social relief to households mount, government will need to be innovative.

The Commission recommends that:

1. Government restructure the economy towards achieving greater dynamism and equality. Without effecting this type of structural change, maintaining redistribution through social grants and services will likely prove unsustainable as a result of mounting foreign debt.

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