Macro-fiscal considerations in response to the COVID-19 crisis

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Summary

1. The Covid19 shock is likely to mean a large and permanent fall in South Africa's national income. While the impact of the shock is uncertain this note assumes a negative scenario.
2. The public sector as a whole can (and should) intervene to achieve four objectives: (a) stabilizing flows of income; (b) creating 'breathing space' for firms and households to adjust to lower income; (c) providing macroeconomic "bridging finance" to solvent households and firms; and (d) ensuring that the burden of adjustment is distributed equitably.
3. Government's fiscal programme should be adjusted in response to four unavoidable imperatives: (a) fighting the virus; (b) preventing a collapse in wage payments; (c) underwriting the extension private balance sheets and (d) providing social relief of the distress. The costs of resourcing these interventions is likely to be far smaller than the cost of not doing so.
4. If the public sector is unable (or unwilling) to play this role the social, political and economic consequences could be unacceptable. But a fiscal response depends on government's ability to finance itself. Tax revenue will fall further, and government borrowing will accelerate strongly into volatile market conditions. A scenario in which government is unable to access financing at sustainable rates could well emerge.
5. Cash balances are a first line of defence, and the national revenue fund does have sizable buffers. Surpluses across consolidated government (e.g. the UIF) can be wound down at a measured pace towards zero if necessary. External sources of concessional credit can also be activated, for instance through the IMF. But rising to the challenge posed by Covid19 may also require consideration of the appropriate use of public pension funds and the balance sheet of the South African Reserve Bank.
6. To ease funding pressures (on both the public and current accounts), South Africa may need extraordinary measures to finance itself from its own resources. A "solidarity tax" would use existing tax handles to temporarily draw-in larger contributions to the national effort from affluent South Africans.
7. The success of government's macroeconomic response depends on the ability of South Africans to restore a path of growth, productivity improvement and fiscal sustainability. If the shock is permanent, and not reversed decisively, these efforts to cushion the blow may not succeed or may add to the crisis over the medium term.

[1] This memo was prepared by Michael Sachs, drawing on input and comment from the Covid19 Economists Group, convened by Miriam Altman and including Tania Ajam, Andrew Donaldson, Stuart Theobald, David Francis, Imraan Valodia, Alex van den Heever, Mzukisi Qobo. Comments were also received from Anthony Altbeker, Kenneth Creamer, Haroon Bhorat, Stephen Gelb, Laurence Harris, Michelle Joubert, Sonja Keller, Monale Ratsoma and several anonymous reviewers. The result is the responsibility of Michael Sachs alone.

1. This memo aims to frame discussion about fiscal and financial considerations in response to the Covid19 shock. The current focus on action related to the management of the three-week lock down is appropriate but as the weeks of economic dislocation turn into months, the force of necessity may trigger unprecedented fiscal, financial and monetary action. In this context, the appropriate use of the broader public balance sheet will become increasingly important. Government should consider identifying options and planning their execution, so it remains ahead of events.

I: A NEGATIVE OUTLOOK

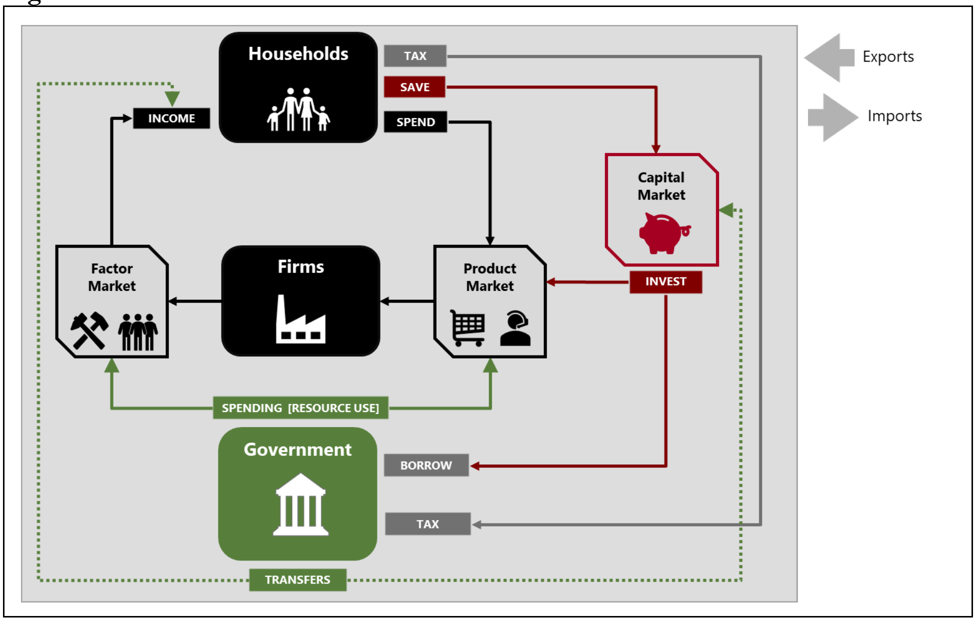
2. Beyond the devastating health impacts, the COVID-19 pandemic will have a deep and sustained economic impact around the world. The global economy is unlikely to rebound strongly as balance sheets will be damaged and large sectors of the global economy will be damaged, perhaps irreparably.
3. In South Africa, a scenario in which economic dislocation last for three to six months is likely. Government has acted early to suppress the transmission of the virus. However, as noted in the recent Imperial College report, "*the more successful a strategy is at temporary suppression, the larger the later epidemic is predicted to be in the absence of vaccination due to lesser build-up of herd immunity*" (Ferguson et al. 2020). The report goes on to note that "*if intensive … packages aimed at suppression are not maintained, our analysis suggests that transmission will rapidly rebound, potentially producing an epidemic comparable in scale to what would have been seen had no interventions been adopted.*" In other words, while acting early can result in short-term suppression, an extended period of restrictive measures may still be necessary.
4. South Africa must balance the health imperative to save lives with the social implications of restrictions on economic activity (which also have serious consequences for life and wellbeing). A response framework beyond April 21 might consider geographically targeted lockdowns to contain localised outbreaks, and the resumption of production as far as possible. Nevertheless, rising mortality rates could result in a self-imposed popular lockdown where it is difficult to restore production.
5. The economic disruption is directed strongly towards labour-intensive sectors, especially services. Casualised, informal and other precarious workers were the first casualties (although many security, cleaning and hygiene functions performed by outsourced workers may still be in operation). It is likely that hundreds of thousands have lost their jobs already and many more are vulnerable. As cash flows dry up and bankruptcies mount, the fall in wage payments will extend into the formal sector. It is too early (and the situation too uncertain) to reach strong conclusions, but by some estimates 1 million jobs could be permanently at risk (Montalto 2020). In the short term, this constitutes a massive macroeconomic shock that will across every community in South Africa (and into the region), with particularly severe effects on households living in poverty.

Lockdown economics

6. The lockdown implies an impairment in the **circular flow of income** (Figure 1). As household spending is curtailed and economic uncertainty reduces demand, firms lose their revenues. Within months (or weeks, or even days, depending on the nature of the business) firms will run out of cash needed to make wage payments. This will undermine household spending further resulting in a series of interacting demand and supply shocks (Surico and Galeotti 2020).
7. In addition to the domestic impact of the lockdown, South Africa faces a large **external shock**. The dollar prices of commodity exports have collapsed (Hausmann 2020). An unprecedented capital outflow from all emerging markets has, at time of writing, halved the value of South African equities. The associated sharp depreciation of the rand will raises the cost of imports, while more than 40% of exports are exposed through linkages to disrupted global supply chains (Faulkner 2020). Continuing turbulence on global capital markets should be assumed in the months ahead.

8. The shape and structure of South Africa's economy is likely to change even once the crisis has passed. There will be lasting damage to several large economic sectors. The aviation industry is unlikely to return to its pre-Covid19 structure. Similarly, tourism, retail and other services sectors will remain in distress for a lengthy period. Other sectors – for instance telecommunications and health – may have a chance to restructure and grow in the wake of the crisis.

Figure 1: Circular flow of income



Public-sector response

9. The public sector can respond to achieve four macroeconomic objectives:

- **Stabilize the flow of income** to cut short the chains of interacting supply and demand shocks. This requires a large injection of cash into the economy and complementary actions to support the cash flows of households and firms.
- Provide **macroeconomic "bridging finance"** to solvent firms and households. This implies taking liabilities onto the balance sheet of the public sector as far as possible in the expectation that these liabilities will be unwound at a future date.
- Cushion the impact of the fall in national income by extending it over time. This provides **breathing space** for agents to adjust to lower income, in effect "flattening the curve" of the income shock. If households and firms have time to adjust, they have a better chance of avoiding the most devastating economic and social consequences
- Changing the **distribution of the burden** of adjustment in the interests of equity, solidarity and social justice. Wealthy South Africans have seen a vast destruction of financial wealth. But workers and poor communities will see the largest impact on their consumption levels. Redistributing the burden will require strong action through taxes and transfers.

10. Public action to achieve these aims can only be sustained for a limited time. Moreover, macroeconomic intervention will only be successful if a growing and productive economy can be quickly restored. Decisive action for economic transformation and structural reforms that unlock productivity growth and private investment will become even more pressing.

11. Government's macro-fiscal programme should be adjusted in response to four concrete imperatives in the coming year:

    i. **Fighting the virus**: Financing the health sector's response to the epidemic to ensure it is overcome as rapidly as possible.

ii. **Maintaining wage payments**: Ensuring the flow of income to households by underwriting the formal sector salary bill, even (on a temporary basis) where companies and sectors are effectively insolvent

iii. **Relieving social distress**: Providing social support to the poor, unemployed, causal workers and the informal sector

iv. **Underwriting credit**: Keeping financial markets open and ensuring that banks can extend cash and credit to solvent companies and households.

12. This programme implies that the value of transfers, subsidies, net-lending and guarantee exposure by the fiscus would rise significantly in response to the crisis. But these increased outlays will not be sustainable and would need to be unwound once the crisis abates. This implies that, even while deploying resources in response to the crisis, government will need to articular a credible path to sustainable fiscal adjustment in the post-crisis environment. This is easier said than done. Even with a large fiscal effort, most South Africans could experience a fall in their income. A withdrawal of fiscal support would feel like a second step down a ladder (which it might very well be). This implies that increased redistribution from the affluent to the very poor would need to be achieved now. A step in this direction might be a temporary **solidarity tax**, which utilises existing tax handles to draw-in resources from the most affluent South Africans.

Table 1: Selected Private Forecasts

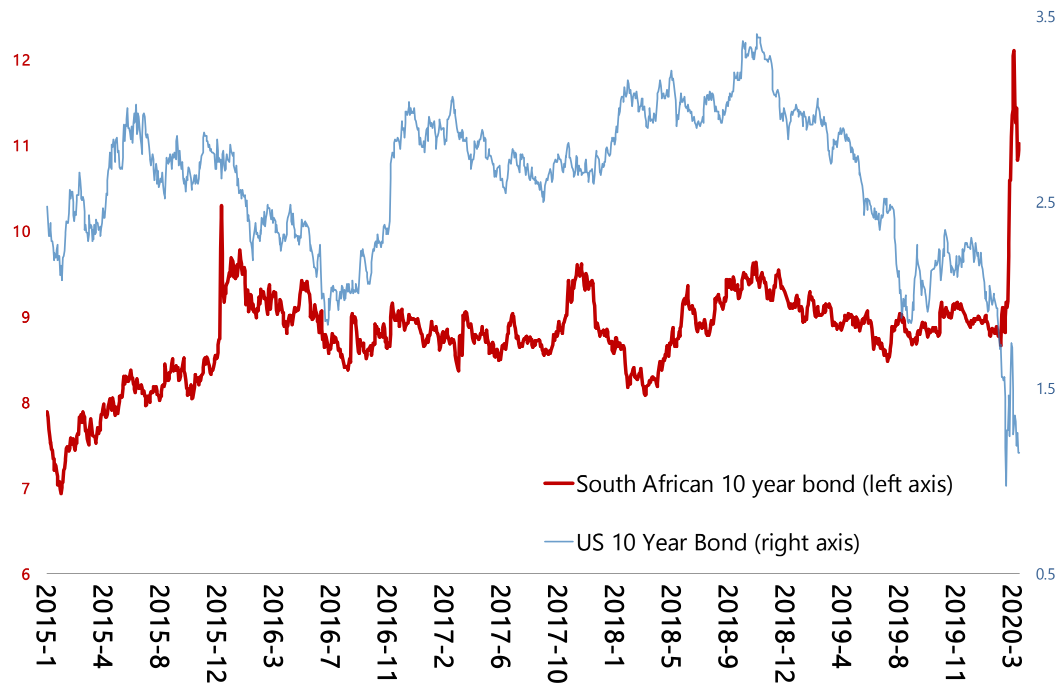
	GDP growth 2020	**Budget deficit** 2020/21	**Debt-to-GDP** 2021/22
RMB	-4.5	9.3	79.3
Intellidex	-5.6	10.6	73.1
HSBC	-6.7	12.0	82.0
JP Morgan	-7.7	12.0	81.0

13. But while the economic disruption continues, tax revenue will fall, and government's fiscal programme will require significant financing. Projections by private banking analysts suggest a GDP contraction of 7 percent during 2020, leading to a fiscal deficit of 12% of GDP and a debt-to-GDP ratio in excess of 81% in 2021 (see Table 1).

14. Looking to the crisis response, the interest rate on sovereign borrowing will be critical. Bond yields spiked last week and remain elevated (see Figure 2). If such rates are sustained (or even increase) government borrowing may become unsustainable. Already 15 cents of every rand collected in tax revenue is transferred to bond holders. As tax revenue falls and government's borrowing needs increase, the burden of interest payments can quickly become chronic. The loss of investor confidence can become self-fulfilling: the increased cost of debt to the fiscus will lead to a fiscal crisis more quickly than the fiscus can adjust, even before considering the emergency spending that Covid-19 requires. This possibility, and the damage it portends, needs serious and urgent attention.

15. In volatile and uncertain conditions, unprecedented policy interventions by fiscal and monetary authorities could be imposed by the force of necessity. Substantial capital outflows in recent weeks threatened the bond market and constrained liquidity in the banking system. The SARB responded proactively, indicating that it would purchase government bonds on the secondary market and announcing prudential measures to support bank lending. The SARB's action has stabilised the bond market and created breathing space for now, by the months ahead will remain challenging.

Figure 2: 10-year bond yields (January 2015-March 2020)



Source: South African Reserve Bank

II: DEPLOYING THE PUBLIC BALANCE SHEET

16. Mario Draghi wrote last week that:

> "It is the proper role of the state to deploy its balance sheet to protect citizens and the economy against shocks that the private sector is not responsible for and cannot absorb. States have always done so in the face of national emergencies… The key question is not whether but how the state should put its balance sheet to good use." (Draghi 2020)

17. The "consolidated public sector balance sheet" consists of the assets and liabilities of general government and public corporations, including the central bank (Agénor and Montiel 2015; International Monetary Fund 2018). The elements of the public sector balance sheet are shown in Figure 3.

Figure 3: Composition of the public-sector balance sheet

Assets	Liabilities
Nonfinancial assets	Special drawing rights
Fixed assets	Currency and deposits[2]
Land	Debt securities
Mineral and energy resources[1]	Loans
Other nonfinancial assets	Equity and investment fund shares[3]
Financial assets	Insurance, pension, and standardized guarantee schemes
Monetary gold and special drawing rights	Pension entitlements
Currency and deposits	Claims of pension funds on pension managers
Debt securities	Other insurance, pension, and standardized guarantee scheme liabilities
Loans	Financial derivatives and employee stock options
Equity and investment fund shares	Other accounts payable
Insurance, pension, and standardized guarantee schemes	
Financial derivatives and employee stock options	
Other accounts receivable	**Net Worth (= Assets – Liabilities)**

[1] This category includes both "mineral and energy resources" or "permits to use natural resources," as relevant for each country.
[2] Includes bank notes and coins issued. These are normally reflected in the balance sheet of the central bank, but in some cases also the central government's, depending on country-specific arrangements for the issuance of currency. In exceptional cases, countries may allow designated commercial banks to also issue currency under the authorization of the central bank, but this is unusual.
[3] In the *Government Finance Statistics Manual 2014* conceptual framework, corporations' liabilities in the form of "equity and investment fund shares" is equal to the value of its shares at current market prices. Where a public corporation is fully owned by the government or the market value of shares cannot be observed because they do not trade in the market, the value of equity and investment fund shares is calculated as a residual (assets minus liabilities other than equity), so that the statistical net worth of such a corporation is zero. Therefore, own funds of public corporations are equal to the value of equity and investment fund shares plus net worth.

(International Monetary Fund 2018)

Considerations on South Africa's public balance sheet

18. All wealth controlled and managed by government and other public agencies can be considered as part of the public balance sheet. The interventions required to respond to Covid19 require a large increase in expenditures and a sizeable extension of government guarantees, leading to an erosion of public net worth. Given the scale of the crisis this makes absolute sense, and South Africa is fortunate to have a balance sheet to support its response.

19. However, government's balance sheet was already stretched to the limit prior to the crisis, with an unsustainable debt trajectory, a permanent budget deficit and little prospect of fiscal stabilisation on the horizon. Even if responses to Covid19 are well designed and executed, the market may be unwilling to lend government the resources it needs to carry out its programme at rates that are sustainable.

20. Government's rand borrowing is likely to shift to the short end of the yield curve, and the opportunity for new **foreign-currency bonds** may be significant. However, both these shifts (to the short-end and into foreign denominations) weaken the risk profile of government's liabilities. If the rand continues to depreciate the risks of foreign borrowing grow. In this light, government should reconsider the strategic risk benchmarks which set thresholds on the maturity and composition of debt liabilities.

21. If government is forced to reduce bond issuance, it could draw down on National Revenue Fund **cash balances**, reported in the 020 budget at R240 billion (National Treasury 2020). Cash management needs to take account of the gross financing requirement, including both expenditure and redemptions on debt. Nevertheless, leaving aside redemptions, the NRF cash balance means government could finance itself without bond issuance for around 8 months if bond issuance does not change dramatically (Keller, Sidiqui, and Gunasinghe 2020). These balances include sterilization deposits held at the reserve bank. Other cash balances on the public balance sheet (e.g. at the UIF) are also important, as they can be deployed in the short run without too much disruption asset markets. This size and scope of cash management operations require strong coordination between treasury and the reserve bank, where appropriate.

22. Government should expand its access to external resources through **official creditors**. Official international creditors can offer concessional rates, helping to keep the overall burden of debt-financing lower. Given the parlous state of the public balance sheet, and the likely consequences of the lock down, an aggressive programme to access lending might include:

    - Engaging with the *International Monetary Fund*. The IMF is useful for two purposes: providing concessional credit and framing government's response in a manner that builds market confidence and thereby reduces the pressure on bond markets. Hopefully, special IMF facilities related to the Covid19 crisis will come with little conditionality. Beyond this, IMF conditionalities need to be engaged with robustly to ensure the South Africa retains maximum room for manoeuvre.

- Raising South Africa's voice strongly in favour of augmented global credit through the IMF and other channels. It is in the interest of the advanced economies to limit the damage inflicted on the developing world.
- Open lines of financial diplomacy with *China*. If history is any guide the appetite of western countries for sustaining the flow of official credit could wane as the crisis unfolds (see Eichengreen 2019). Meanwhile, China's creditor positions an influence in the world economy is likely to be strengthened by the crisis and its aftermath. One channel of engagement is the New Development Bank, but the possibility of bilateral credit extension should also be explored.
- Activate loans from the *World Bank* and other multilateral development banks to finance the health response to the virus.
- Engaging *global central banks* to provide swap lines that ease the pressure on foreign currency liquidity, and the potential for these pressures to disrupt financial markets.

23. This is not the moment for the unloading large quantities of bonds, equities or other **domestic assets held in public-sector funds**. Nevertheless, a measured and well-paced draw-down of the full UIF surplus should be contemplated to offset the shock to wages; this is after the purpose of the fund and there is no reason in principle why the fund's accumulated surplus should not be wound down to zero (see paragraph 36). The sale of special bonds to public (as well as private) funds would enable them to make contributions to the national effort that are consistent with their fiduciary responsibilities. Going further, the use of the GEPF and other public pension funds to manage impacts on public salaries may also be warranted (see paragraph 62 below) . Again, this needs to be planned carefully.
24. **State owned companies** present a complex problem. Many faced deep financial difficulties even prior to the crisis. The lockdown will mean a sudden fall in revenues for Eskom, SAA, Transnet and others. These entities, just like private sector firms, will need to maintain their payrolls and other payments during the crisis. But the extent of their financial impairment will worsen significantly. While maintaining their operations for now, government needs to prepare for an even more aggressive resolution of challenges at state-owned companies once the crisis passes.
25. An expansion of external resources is important, but strategy must be developed for engagement with **domestic private asset holders**. South African pension funds face a large fall in the value of their assets, and elevated withdrawals as their contributors lose their jobs. Existing channels of engagement with domestic funds should be expanded to ensure continuity of domestic investment in government bonds and ensure thorough discussion of policy measures prior to implementation. Targeted financial instruments that enable voluntary participation of pension funds at concessional rates in the interests of long-term development could also be considered. A special "Covid19" bond to finance the crisis response at low and stable interest rates could be developed as a vehicle to channel pension fund support for the crisis response and recovery effort(see for instance Stuart Theobald 2020). Engagement with private funds could also consider special arrangements that ease the ability of contributors to draw down or borrow against their pension fund assets.
26. The **balance sheet of the SARB** will need careful consideration. Secondary-market bond purchases have so far been aimed at providing extra liquidity. Stronger action may be required to hold down the long-term interest rate faced by government (and by extension all domestic agents). This could be done if South Africa joined the growing number of emerging markets who recognise the need for domestic-oriented balance sheet interventions By taking government bonds onto its balance sheet in large enough quantities through open-market operations, the SARB could aim to align the yield on long-dated bonds with potential growth rate of the economy that is anticipated in a post crisis world. The participation of the SARB in quasi-fiscal operations should not be ruled out, for instance to backstop government-guaranteed lending to the private sector or support the balance sheets of public institutions that are critical for national response to the disaster.

27. Reserve bank action to lower the interest rates will have consequences. Ultimately, success will depend on a restoration of economic growth and fiscal sustainability. In the meantime, large and sustained quantitative would pressure on the balance of payments, potentially leading to exchange rate depreciation that endangers financial stability and raises the prospect of inflationary spiral. In this context, consideration should be given to capital market regulation measures that curtail capital outflows and shift domestic funds into the bond market. South Africa's macroprudential framework already provides for automatic stabilizers on the capital account due to the 25% regulatory limit on the share of assets allowed to be held outside of the country by local asset managers. In line with the IMF's institutional view on capital controls, government should consider how fiscal, monetary, macroprudential and capital market regulation interact.

Considerations on design and implementation

28. In conditions where social and political order is challenged, these interventions may turn out to be the least bad alternatives. But the economy rests on a foundation of real production, as the lockdown shows in stark relief. Fiscal and financial action can shift the temporal and distributional incidence of the shock but cannot substitute for the real economic activity. Using the public balance sheet amounts to a macroeconomic overdraft facility that provides bridging finance to the economy. However, if economic activity does not rebound strongly, and if a longer-term path to growth, productivity improvement and fiscal sustainability cannot be found, these interventions can quickly become counter-productive, adding a new and debilitating dimension to South Africa's parlous economic condition.

29. Government should seek to sustain financial market order and keep interest rates down. This means acting to build the confidence of markets, and working in a consultative, transparent and legal manner, even when executing actions at odds with interests of market participation. Whatever action is contemplated, a lot depends on the details of how it is executed. In this regard, three issues are important:

    - Monetary and fiscal authorities will need to find new ways of coordinating their action during the crisis. Indeed, this could make the difference between an orderly drawing down of balance sheets to finance a temporary shock and a collapse into national bankruptcy.
    - Consideration should be given to the separation of the financing and budgeting of the Covid19 response from the rest of government operations. In effect funding for the crisis response can be quarantined to facilitate the resolution of post-crisis challenges.
    - All interventions should be designed in a manner that can be unwound or reversed at a later stage. But as we have already said (in paragraph 12) this is easier said than done.

III: FISCAL IMPERATIVES

30. Substantial fiscal intervention cannot be avoided. The public sector will need to respond to at least four imperatives:

- Fighting the virus
- Backstopping wage payments
- Extending the balance sheets of firms and households
- Relieving social distress

31. The classic principles of counter-cyclical fiscal intervention are useful guides to government's response - interventions must strive to be:

- **Timely**: A sudden stop in the circular flow of income means time is limited. Action must be rapid and impact immediate. In this crisis, we must ensure that households and firms can get access to cash directly, at scale and in good time. This strongly suggests the use of existing channels and structures, where these are effective. Interventions that require design changes and institutionbuilding will certainly be necessary, and planning must begin. But even for these second-round interventions a key consideration will be the speed of uptake and delivery.

- **Targeted for maximum impact**: The timeliest responses will need be necessarily broad-based. Public-sector financial systems can achieve this. Social grants are well targeted at the poorest households, and SARS has a strong interface with formal sector firms. Beyond the initial broad-based response, resources need to be more finely targeted at these groups, for instance through a special covid-19 grant.
- **Temporary:** As is the case with monetary policy, fiscal interventions will need to be unwound. Interventions should be clearly designed and communicated as temporary top ups, bonus payments, deferments etc.

Fighting the virus: health sector response

32. The immediate policy priority will be the financing of the **public health sector** and other activities related to fighting the virus (e.g. defence and police). Their expanded requirements must be accommodated. There will be many constraints on the roll-out of the health response, and finance should not be one of them. Provincial health departments and other critical departments need to be assured of additional resources ahead of the Adjustments Appropriation. Consideration might be given to a special Covid19 conditional grant to achieve this.
33. Fiscal resources may also be required for crisis responses in **private hospitals**. It is essential that all South Africa's health resources are made available on an equitable basis. The terms, conditions and contracting of publicly-finance private health operations needs to be urgently considered. A wide range of collaborative initiatives are already underway with private hospitals groups and health sector service providers. In some cases, services may be provided at no charge or discounted prices, but far better collaboration and more lasting partnerships will be achieved if the state undertakes to meet costs on reasonable terms and is proactive in structuring these arrangements. This requires allocations within which these arrangements can be contracted.

Backstopping wage payments

34. A critical aspect of government's role will be to sustain the flow of income to households, so that citizens are able to subsist at acceptable levels during the crisis. Formal sector salaries are a fundamental element in the circular flow of income, and the economic welfare of all South Africans – including the unemployed, informal workers and not economically active population – depend on the continuation of wage payments in myriad ways.
35. Government could act as "payroll of last resort", at least on a temporary basis. As the real economy becomes cash constrained firms and their employees will look to the public sector to backstop the flow of salaries to households. This will include the employees in firms that are forced into bankruptcy. Of course, the public sector will not be able to subsidize the salaries of workers previously employed by bankrupt companies, forever – these interventions will need to be unwound once the situation normalizes. But even if government can delay the inevitable, this would avoid the most calamitous social consequences.
36. The *Unemployment Insurance Fund* is the obvious choice to finance this intervention., If necessary, its accumulated surplus should be wound down to zero, and used to finance wage support well beyond the current and past contributors to the fund. Legislative changes – based on social agreement – may be required to facilitate this outcome. If payments are effective and the crisis is extended, the fund's liquid assets may be drained. Action to liquidate its bond holdings could be counterproductive, as this would simply add to pressure on the bond market. A possible solution might be for the SARB to take the UIFs bonds onto its balance sheet, for instance through a repo.
37. While the UIF has ample resources, administrative weakness mean that it is doubtful the fund will be able to deliver at the scale, speed and scope required. An alternative channel of payments could be established by the *South African Revenue Service* (SARS), which already collects the bulk of UIF

contributions and has a strong administrative interface with employers. Re-engineering SARS processes in order to enable tax credits and cash payments financed from the fiscus should be considered. SARS may not be a perfect vehicle for such operations, but it is the best one we have.

Table 2 Breakdown of assets under management by PIC, 2018/19

R billion	GEPF	UIF	Comp Fund[1]	Other	Total
Asset class					
Equity	1 032.4	40.0	16.2	–	1 088.7
Bonds	574.9	89.5	41.5	13.1	719.1
Money market	75.1	18.4	8.5	34.0	136.0
Property	95.4	4.8	0.1	1.4	101.6
Unlisted investments	70.9	13.6	1.9	–	86.4
Total	**1 848.7**	**166.3**	**68.2**	**48.5**	**2 131.7**

1. Includes the Compensation Pension Fund

Source: Public Investment Corporation and National Treasury

Extending the balance sheets of firms and households[2]

38. As the economic crisis deepens liquidity problems will become solvency problems, not just for small businesses but for mining companies, local industry and major (systemically important) employers. Large, small and micro business and households alike will find their lines of credit strained as obligations rise, income falls, and cash becomes scarce.

39. In order to enable a recovery once the epidemic passes, it is vital that firms survive the epidemic intact. Many firms will be mothballed during the lockdown, but it is essential to keep them alive. If a massive wave of bankruptcies ensues, it will be far more difficult for output, aggregate demand and employment to recover after the crisis. This means keeping their cashflow going even at a lower level implied by curtailed production, so that they can meet their commitments.

40. Lines of credit should be held open to solvent firms and households. But the huge uncertainty generated by the crisis means that distinguishing between solvent and insolvent is difficult, if not impossible. This implies that standard insolvency rules may need to be relaxed or suspended through regulatory action.

41. As a complement to wage support, government should act to alleviate the burden of private transfers on corporate income flows. Forbearance on rent, interest, mortgage payments or insurance premiums could help preserve cash for salary payments, while preventing bankruptcy. Government could engage with the beneficiaries of these transfers (i.e. large landlords and insurance companies) to ease private sector transfers and fiscal resources or guarantees may be needed.

42. Ensuring that **the banks** can maintain and extend credit is a critical imperative, but it must be done in a manner that preserves the stability of the financial system. Government should make sure banks lend more to firms and households but must also ensure that lending doesn't go too far. This will require a fine regulatory balance. Rising bankruptcies will impose large costs on banks, which will be short of income as fees fall and funding costs rise. Attention to financial stability is critical, but South African banks are well capitalised, and this should preserve them through the crisis.

43. Two forms of intervention are required of banks, and policy coordination with the banking sector should aim maximize their impact. First, *loan forbearance* means either suspending interest on existing loans or extending and capitalising interest. This eases the cash flow needs of firms and households in the short term. Second, *new credit* will be needed for firms and households as a bridge to the recovery.

[2] This section draws extensively on (Stuart Theobald 2020)

44. The banking sector is well positioned to distributed new credit and manage collections and risk. But public resources are needed to mitigate the risks faced by the banking sector and enable them to provide low-cost funding for households and firms. A share of the additional risks can be backed by the fiscus – through grants or loan guarantees - or on the balance sheet of the reserve bank. A national treasury supported guarantee fund, alongside SARB-supported low-rate funding should be considered. The fiscal package in response to Covid19 might include an allocation to capitalise such a guarantee fund; the SARB is probably best placed to identify personnel to manage it though in a ring-fenced entity, as it has the best ongoing relationships with the banks. Government could also extend finance by taking equity stakes in large firms, possibly through its development finance institutions. Policy attention should be focused ensuring that banks extend bridging finance into the solvent real economy.

Relieving social distress

45. The immediate supply shock has had a huge and direct impact on the incomes of specific sections the poor and working class: low-wage, low-skill workers on the periphery of the formal sector and informal microenterprises[3]. These workers have no contracts and weak bargaining power in response to the lockdown. Large numbers (perhaps in the hundreds of thousands) would have lost work and income in over the last week, and even greater numbers will face risks and uncertainty over the next three months.

46. These workers fall outside the reach of public systems of social insurance – including UIF payments and social grants. About 19 percent of formal sector workers are not registered with the UIF (Bhorat, Oosthuizen, and Stanwix 2020), and most of those in personal services work (e.g. domestic workers) can also be expected to find themselves without a job. In a normal economic shock, the appropriate response might be for the public sector to act as "employer as last resort", absorbing labour the same wage in activities that benefit the public. This option – in which workers come forth at the going wage for public works programmes – would appear precluded by the lockdown. And government's public works programmes are decentralised would take time to scale up.

47. The income shock will be very large across the lower end of the distribution. Bassier et al estimate a 30 per cent fall for those households that rely on informal income. More generally, Figure 4 shows that poor households depend to a very great extent on wages, remittances and other forms of income. While grants can will be sustained, these other sources will take a very large knock.

48. Adding resources into the Employment Tax Incentive is helpful because it provides a subsidy to labour-intensive firms to keep workers on their books. But many firms and households would have liquidated their casual workers immediately, and we should expect many more to be retrenched in the months ahead. These newly unemployed workers cannot be reached by the ETI. Therefore, interventions that effectively target those who have experienced a change in their position - people who have lost their job or livelihood due to the lockdown – are urgent and necessary (Bhorat, Oosthuizen, and Stanwix 2020). But it could take time to design, and a new rapidly deployed grant would be subject to execution risks.

49. The first order of business is to provide a simple cash injection using existing channels. This means using existing social grants which are very well targeted at the poorest households4. Therefore, a **broad-based top up of all social grants should** be considered. This could be structured as a lump sum payment – e.g. a fixed amount of R500 to all grant beneficiaries.

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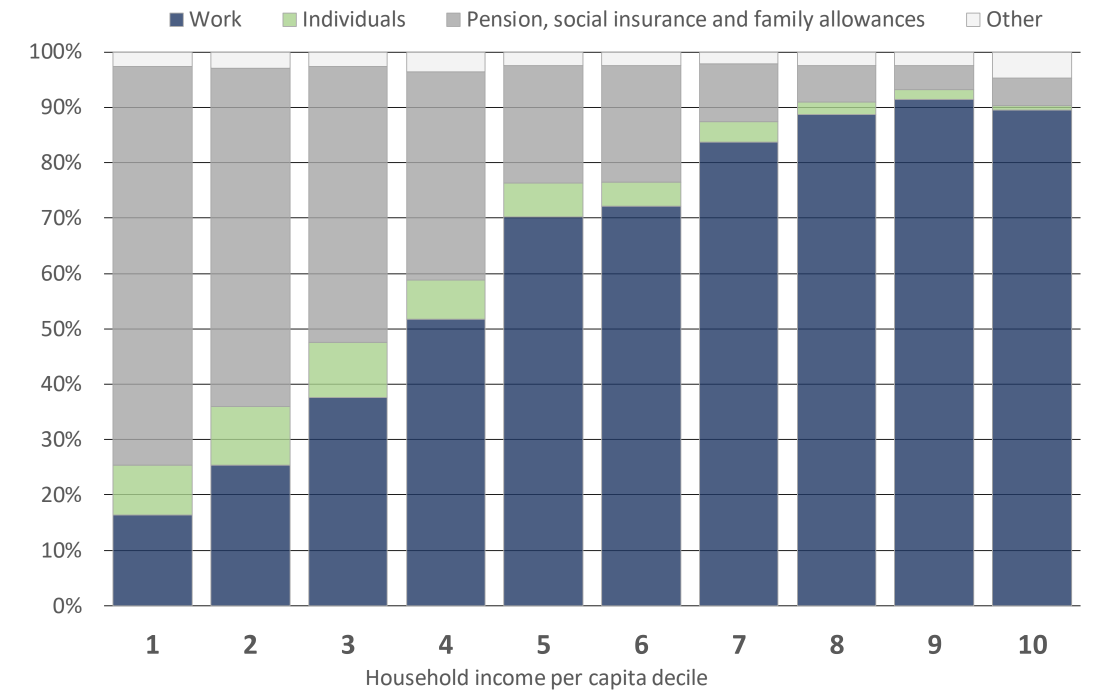
[3] Here we are focussing on people in *informal employment:* this covers employees in the formal sector and private households who are not entitled to basic benefits like pension and medical aid and who do not have rewritten employment contracts, as well as employees of informal sector firms. This is different from *the informal sector*, which can be defined as owners and employees of informal firms as well as own-account workers and unpaid workers in household business who are not registered for tax. Informal employment is thus a broader concept that includes within it those working for informal sector firms (Bhorat, Oosthuizen, and Stanwix 2020)

[4] There is evidence that prior to the lockdown many informal workers are resident in households that receive social grants, especially the child support grant (Bassier et al., 2020; Bhorat et al., 2020). However, as income and work opportunities evaporate it can be expected that patterns of residence will change as casual and informal workers will exercise their "reservation option" at a household that has a dependable source of income – i.e. social grant.

50. This might be followed up with a new flat-rate **Covid19 social grant** available as a temporary payment to those without a wage, social grant, pension or unemployment benefit. This would need to be applied for through an online system that tests the applicant's ID against the social grants database and the payroll databases registered with SARS. IT would be available only for the duration of the lockdown (or in areas where the lockdown continues). It could begin only if the lockdown goes on for longer than a month.

51. Consideration also need to be given to targeted **in-kind support, particularly to ensure food security**. Possible measures include the extension of the school nutrition programme, support for community-based schemes and co-funding of welfare and community organisations.

Figure 4: Sources of income*



*Excludes imputed rent on own dwelling

Source: Living Conditions Survey (2014/15)

IV: GOVERNMENT BUDGET CONSIDERATIONS

Appropriation bill

52. Work could begin immediately on a Special Appropriation Bill to be tabled before the adjustment budget. A special appropriation would enable separation of the crisis response from normal budget operations. The non-Covid19 elements of the budget should remain constrained, while government ensures the response to the shock is large, temporary, timely and targeted.

53. The Appropriation Bill should outline the broadest possible package of Covid19 response actions. This includes measures to finance the fight against the epidemic, maintain wage payments, extend the balance sheets of households and firms, and protect vulnerable citizens. Section 16 of the PFMA could be invoked for the immediate crisis response up to its limit of around R19 billion. This would be followed by a Special Appropriation to make good the s16 financing and provide for further interventions.

Tax considerations and public-sector resource flows

54. While economic prospects remain uncertain, a sharp fall in tax revenue is likely in the months ahead. The payments of personal income tax will depend on the dynamics of wage payments. The fall in household expenditure will hit VAT, excise and petrol tax hard and swiftly. The disruption of global trade will impact on customs duties. Company taxes have a complicated lag structure so may take time to respond but falling profits and rising bankruptcies will eventually take their toll.

55. A simple and effective means of easing pressure on company income statements is to allow **deferments or tax holidays**. However, government needs to be circumspect in the use of these instruments for two reasons. First, in unpredictable market environment the ability of government to extract revenue from the economy could make all the difference to market access to borrowing. Second, once the crisis passes South Africa will need to strengthen its "tax state" and the redistributive function of the public finances. Excessive resort to tax holidays might be difficult to reverse as a general principle therefore cash subsidies should be preferred to tax expenditures in the crisis response.

56. The solidarity fund is a welcome development, but a **solidarity tax** should also be considered in the months ahead as a temporary measure. Establishing a new "wealth tax" would entail complex questions of design and execution. But a temporary change in existing tax handles could be structured to target affluent South Africans, for example through a temporary steeping of the personal income tax schedule. The lockdown will mean subdued household spending it is likely that affluent citizens will accumulate substantial cash buffers in the next few months and some fraction of these resources should be contributed to the national effort. Thought should also be given to how existing tax handles might more effectively target South Africa's super rich households in an equitable and law governed manner.

57. Several actions might be needed to change the pattern of resources flows and claims within the public sector. Many of these would require strong legislative and regulatory intervention, as well as agreement with social partners. Discretionary action to reduce spending pressure and realise resource flows for the public service might include:

   - Reallocation of the funding flows from the skills development levy. In general, SETAs are highly liquid and can draw down their reserves these while many of their activities are likely to be suspended during the lockdown. Skills Development Levy funds which could be converted into subsidies, over and above exempting employers from making SDL contributions.
   - Termination or deferral of non-medical payments by the Road Accident Fund, which would temporarily stop large payments to legal service providers
   - Legal proclamations that (temporarily) exempt government from medico-legal and related claims

Payments hierarchy

58. Government should reconsider its spending priorities in light of the requirements of the epidemic, an extended curtailment of economic activities and possible limits on borrowing. *In extremis*, if revenue collapses and bond markets are unreliable, month-to-month cash inflows (i.e. taxes) and outflows (i.e. spending) would need to shift into a **cash-rationing** mode. In any case, severe rationing of public expenditures that are not related to the crisis may be required.

59. In thinking about how to adjust cashflow, it is critical to consider the interaction of public and private cashflows. For instance, expenditure by government on salaries is cash in the hands of households used for purchases that count as revenue for firms. Taxes draw cash out of private hands for use by government. Transfers distribute cash into the hands of firms and households (so a tax is a negative transfer). In this sense, suspension of taxes is equivalent to a transfer or subsidy. But the way public cashflows are managed during the crisis will have immediate consequences for how the burden of the lockdown is distributed between households and firms.

60. If government cash flows are under pressure, the hierarchy of government commitments may become inverted. For instance, capital payments – usually regarded as the mainstay of fiscal stimulus – might

need to be suspended unless needed for activities directly related to the crisis response. In conditions of cash rationing, the hierarchy of spending priorities might look something like this:

i. Debt service costs
ii. Basic salaries
iii. Transfers to households
iv. Goods and services
v. Capital, maintenance, research, skills development etc
vi. Other transfers

61. *Debt service costs:* Interest payments are likely to place the fiscus under increasing pressure, crowding out expenditure on other items. These payments represent a transfer of resources to the affluent South Africans and foreigners, which is the price we pay for depending on their capital. But, as noted above, maintaining an open bond market is a critical strategic imperative during the crisis. Government must therefore fulfil its debt servicing obligations. At the same time, it is important that broader financial measures and proactive engagement with bondholders should be pursued with a view to sustainable debt management and financial stability.

62. *Basic salaries:* Maintaining public sector salary payments is critical for ensuring the effective provision of public services needed to fight the virus, but also a core element of ensuring social order by continuing the flow of income to households. The following factors may need to be considered in the context of crisis management:

- A **temporary compression** of the wage bill. This could take the form of a capping of salaries across the public sector at the top end: i.e. the political and state-owned company executives, and senior managers in public service, local government and all associated agencies. This would be important first step if salary reductions are required at lower levels and would communicate sacrifice on the part of government elites.

- The core **basic salary** amounts to around 70% of the salary bill. In the event of cash rationing other salary elements could be suspended for a short period. Contributions to the GEPF by the employer and employees amount to about R75 billion per annum (see Table 4). Similarly, suspending payments for housing benefit or medical scheme contributions could have self-defeating consequences if sustained over time, but resort to temporary measures in an emergency should not be ruled out.

- Care must be taken to ensure that **the GEPF** can maintain its outflow of benefits, the bulk of which have – at least until now – been financed from investment income. However, these benefits – which have grown rapidly in recent years (see Table 4Table 4) – could be moderated, for instance by reverting to the minimum required pension increase (which is 75% of CPI). More broadly, the most appropriate use of the GEPF in the event of an extended lockdown is to help manage the public sector wage bill.

- The role and position of **community health workers** needs consideration, as their work will be of critical importance in the months ahead. A dispensation which raises their remuneration - even if on a temporary basis without guarantees of future employment - should be considered.

- Resort to a wider **public sector salary cut** for the formally employed may be required as a temporary measure *in extremis*. Such an intervention should be reserved as a last resort in event of clear national danger, and if possible, negotiated with organised labour.

Table 3: Components of the salary bill*

R million	2019/20 Revised estimate of spending Annual	Monthly Ave	2020/21 Budget Annual	Monthly Ave
National departments	**175 015**	**14 585**	**177 034**	**14 753**
Salaries and wages	146 537	12 211	148 339	12 362
Social contributions	28 478	2 373	28 695	2 391
Provincial Departments	**387 519**	**32 293**	**394 751**	**32 896**
Salaries and wages	337 019	28 085	342 548	28 546
Social contributions	50 499	4 208	52 203	4 350
Total	**562 534**	**46 878**	**571 785**	**47 649**
Salaries and wages	483 557	40 296	490 888	40 907
Social contributions	78 977	6 581	80 898	6 741

Source: National Treasury

* Note that pension contributions in the hands of employees, housing and other benefits are included as part of salaries and wages

Table 4: Selected income and expenditure of the GEPF

R billion	2012/1	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Revenue							
Employer contributions	30.8	33.5	36.1	38.6	42.1	45.3	48.7
Employee contributions	17.1	18.7	20.3	21.7	23.4	25.1	26.9
Investment income[1]	49.9	54.0	68.5	69.0	69.5	72.0	84.2
Expenditure							
Benefits paid	43.2	57.9	85.8	83.1	88.3	94.9	102.5

1. Dividends on listed equities, interest on bonds and money market instruments and income from unlisted properties and unlisted investments excludes adjustments for value of financial assets

Source: Government Pensions Administration Agency

63. *Transfers to households:* Grant payments will be government's most effective instrument to mitigate the social burden of an extended lockdown. Government should also strive to maintain other payments to households which are effectively targeted at the poor. This includes NSFAS, payments for land restitution and housing subsidies among others.

64. *Goods and services:* In desperate circumstances, government can allow payments for goods and services to accrue[5]. Departments must be obliged to examine their goods and service expenditures in a manner that distinguishes between savings (e.g. air tickets) and deferrals (e.g. furniture purchases). The interaction between accrued liabilities and private sector solvency needs to be considered carefully. Any remedial measures, such as concessional loans to small businesses, could be offset entirely by a failure of the public sector to make payment for goods and services rendered.

65. *Capital and other asset-forming payments:* As noted above, in a cash constrained environment capital projects should be suspended to free up resources for more critical uses. The same goes for other expenditure items directed at asset accumulation or preservation – maintenance, skills development and capability building, research, IT and other systems investments, etc. On the other hand, capital spending vital to the crisis response should be funded on an urgent basis – ventilators, hospital beds and other equipment, and upgrading of buildings to serve as stepdown health care facilities. This might require reworking of subsidy designs.

66. *Other transfers:* Government will obviously need to render full payment of the equitable share to provincial and local government. However, conditional grants need to be carefully examined and

[5] Indeed, the public health system carries over about R25 billion in accruals each year. These accruals are symptoms of unresolved budget pressures that weaken the public health system

prioritised. Where public entities and universities can draw down on cash balances, transfers to these could be moderated.

Table 5: Annual and monthly spending of national, provincial and social security funds

	2019/20 *Revised estimate of spending*		2020/21 *Budget*	
R million	**Annual**	**Monthly Ave**	**Annual**	**Monthly Ave**
Current spending	1 561 217	130 101	1 650 334	137 528
Compensation of employees	567 426	47 286	576 815	48 068
Goods and services	210 660	17 555	220 152	18 346
Interest and rent on land	205 527	17 127	229 797	19 150
Transfers and subsidies	577 603	48 134	623 570	51 964
Households	*261 434*	*21 786*	*283 684*	*23 640*
Departmental agencies and accounts	*121 123*	*10 094*	*128 781*	*10 732*
Municipalities	*91 305*	*7 609*	*99 809*	*8 317*
Higher education institutions	*38 564*	*3 214*	*41 181*	*3 432*
Public corporations and private enterprises	*28 393*	*2 366*	*29 160*	*2 430*
Non-profit institutions	*34 375*	*2 865*	*38 278*	*3 190*
Capital	155 995	13 000	151 307	12 609
Capital transfers and subsidies	106 495	8 875	99 837	8 320
Municipalities	*41 981*	*3 498*	*40 959*	*3 413*
Departmental agencies and accounts	*25 207*	*2 101*	*25 028*	*2 086*
Households	*17 438*	*1 453*	*16 465*	*1 372*
Public corporations and private enterprises	*16 430*	*1 369*	*12 209*	*1 017*
Higher education institutions	*4 050*	*338*	*3 863*	*322*
Other	*1 388*	*116*	*1 313*	*109*
Payments for capital assets	49 500	4 125	51 471	4 289
Buildings and other fixed structures	*36 652*	*3 054*	*39 199*	*3 267*
Machinery and equipment	*11 983*	*999*	*11 501*	*958*
Total	1 781 248	148 437	1 878 702	156 558

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