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South Africa's debt: Has the budget overpromised?

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Introduction

On 24 July 2020, Finance Minister Tito Mboweni delivered an adjustment budget following the havoc created by the impact of Covid-19 on people's health and the country's economy.

Despite the initial impression of a sizeable stimulus package of R500 billion announced by President Cyril Ramaphosa in April, the adjustment budget foresees an increase in expenditure of only R36 billion compared to what had been announced in the February 2020 speech. The deficit, however, expands dramatically because of the impact of the pandemic on government revenues. This is partly as a result of R70 billion in tax relief, but is mostly the result of dramatic declines in corporate and individual income taxes as well as declines in VAT receipts and excise taxes. In total, the government expects revenue to fall by R304 billion compared to the figures announced in the budget in February.

The result is a record-breaking deficit of 15.7 per cent of GDP on the consolidated budget (which includes public entities, but not the state-owned companies), compared to the 6.8 per cent expected in the February budget. This also means that the debt ratio is now expected to increase from 64 per cent in 2019/20 to 82 per cent in 2020/21 (see Figure 1), an increase of nearly twenty percentage-points in one year.

The Budget Review for the adjustment budget portrays two possible adjustment paths over the next few years, one called the 'passive scenario', the other the 'active scenario'. Though no detail appears on the underlying assumptions for these two scenarios, the former shows the debt burden increasing to 141 per cent of GDP by 2028/29, while the active scenario sees the debt burden peaking at just over 87 per cent in 2023/24, before falling to under 74 per cent in 2028/29. Figure 1 presents these two scenarios, while also extending the trends out to 2037/38.

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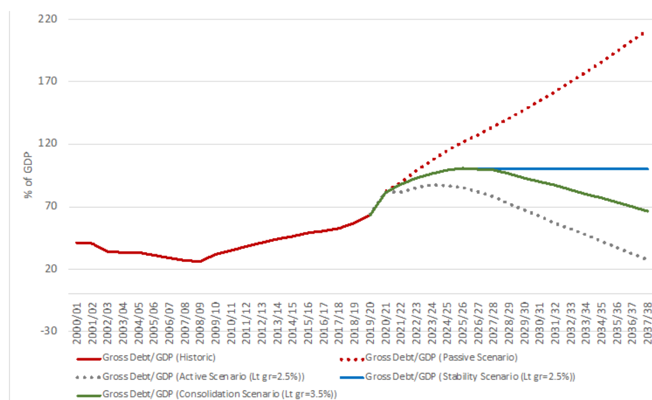
The passive scenario is in essence the current path, and reflects what would happen to the debt ratio if no significant changes were made. However, government's stated intention is to take the necessary steps to ensure that it follows the 'active scenario' path, which would return the debt-to-GDP ratio to its level prior to the global financial crisis in 2008/09 by 2037/38.

Figure 1: Public debt-to-GDP scenarios



Source: Supplementary Budget Review, author's calculations

In my view, this is not at all realistic.

In what follows, I try to show that Treasury appears to have underestimated the size of the primary surplus the government will have to run to keep it to the active scenario path. This is a critical point because achieving a primary surplus (which is an excess of tax revenues over non-interest spending) is necessary to stabilise debt to GDP when the amount of debt is large and when the growth rate is lower than the rate of interest, and because achieving a primary surplus involves either cutting non-interest spending or raising taxes. Achieving a primary surplus of the size needed to stabilise the debt ratio below 90 per cent is, in my view, politically and economically undesirable as it would necessitate either an impossibly large increase in taxes or an implausibly large a cut in spending.

The 'active' and 'passive' scenarios

When charting the future trajectory of the debt ratio, it is necessary to make a number of assumptions about economic growth, inflation and the interest rate on government debt. In all scenarios discussed below, I assume that inflation averages 4 per cent per year and that nominal interest rates stay at 9.2 per cent.[1] Various economic growth scenarios are explored, as presented below, though the analysis uses Treasury's GDP growth assumptions for the first three years of the medium term (-7.2 per cent this year, followed by 2.6 and 1.5 per cent in the following two). For the active scenario the assumption is made that economic growth will slowly improve to 2.5 per cent by 2026/27, stabilising thereafter.[2]

Figure 2 shows that to realise the goal of the active scenario will require a 2 per cent primary surplus in 2021/22, but that this would have to increase to 7 per cent of GDP in 2028/29, before settling at 6 per cent in the early 2030s. The essential reason for this is that South Africa has a large stock of debt and the interest rate far exceeds the growth rate. In these circumstances, the only way to stabilise the debt ratio is to run large primary surpluses. (For a fuller explanation of the dynamics of the debt ratio, see the appendix.)

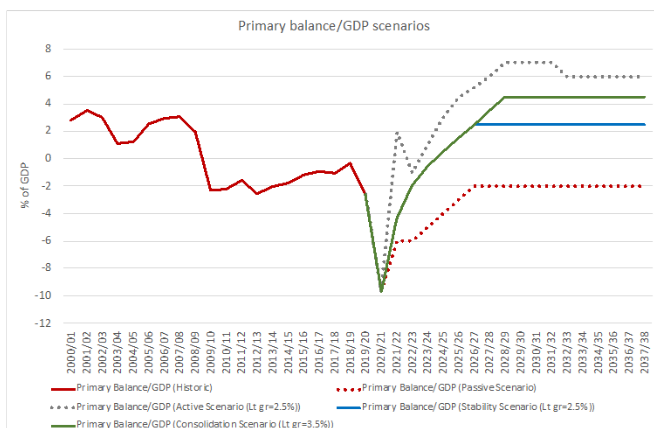
Compare this to the average actual primary deficit of 1.6 per cent for the period 2010/11 to 2019/20. Ignoring for a minute the exceptional impact of the Covid-19 crisis on the primary balance in 2020/21, and comparing the 1.6 per cent primary deficit in the period 2010/11 to 2019/20 to the 2 per cent primary surplus of 2023/24, implies that government needs to adjust spending and taxation by 3.6 per cent of GDP. Such an adjustment would be close to the 4 per cent average seen in IMF adjustment programmes of countries that made adjustments of at least 3 per cent of GDP (Lanau, Castellano, Khan 2019). But, as noted, this won't be enough for the debt ratio to track

[1] This translates into a real interest rate of about 5 per cent, which is about 1 percentage point higher than has been the case in the past decade. However, with debt levels rising and possible further credit downgrades looming, a 1 ppt increase in the risk premium is a plausible assumption.

[2] An economic growth rate of 2.5 per cent will in all likelihood only be realised if South Africa succeeds in lifting the hard ceiling the constrained electricity generation capacity of Eskom places on economic growth. In the absence of that it might be quite difficult to sustain an economic growth rate above 1 to 1.5 per cent per year. Higher growth would also necessitate a reversal of the loss of skills the economy is continuing to endure.

the active scenario. The primary surplus will have to rise another 5 percentage points of GDP if the debt ratio is to follow the active scenario trajectory (see Figure 2).

Figure 2: Primary balance to GDP scenarios



Source: Supplementary Budget Review, author's calculations

An adjustment of this scale far exceeds those seen in IMF adjustment programmes, and it is doubtful whether this path is politically or economically sustainable.

Even though a reduction in expenditure might in general release resources for investment and be supportive of economic growth, this large an adjustment would likely dampen economic growth merely by virtue of the fact that it would be a drag on aggregate demand. This, in turn, might render the policy self-defeating as it might dampen the denominator in the debt-to-GDP ratio more quickly than the numerator.

A more realistic adjustment path

What would constitute a more realistic adjustment path? The 'stability scenario' in Figures 1 and 2 show just such a path. It assumes economic growth slowly improving to 2.5 per cent by 2026/27 and stabilising thereafter. Unlike the active scenario, however, the primary balance rises to a surplus of 2.5 per cent in 2026/27 but remains stable thereafter. This scenario implies an adjustment of about 4 per cent of GDP in the primary balance compared to the average for the pre-Covid decade, which would be in line with the average adjustment in IMF programmes. If we followed that path, the debt ratio would stabilise at 100 per cent of GDP.

The last scenario is a 'consolidation scenario' that shows the debt-to-GDP ratio by 2037/38 returning to the level foreseen for 2020/21 in the February 2020 budget. It shows that economic growth would need to improve to 3.5 per cent per year and we would need to run a primary balance of 4.5 per cent by 2028/29, both stabilising thereafter. This scenario shows the burden of a high debt-to-GDP ratio by showing the high growth rates and primary surpluses required to just return the debt-to-GDP ratio to where it was supposed to be in 2020/21 according to the February 2020 budget.

Concluding remarks

A decade of unsustainable fiscal policy, followed by the impact of the Covid19 crisis, saw the public debt-to-GDP ratio increase from 26 per cent in 2008/09 to an expected 82 per cent in 2020/21. It is unlikely that the debt-to-GDP ratio can be stabilised at any level below 100 per cent, as doing so would require changes in the primary balance much greater (and much more painful) than is typically seen even in IMF adjustment programmes. This would not be politically or even economically sustainable, and the commitment to this trajectory is, therefore, not credible. Reducing the debt-to-GDP ratio once it reaches a 100 per cent will take GDP growth rates not seen since the mid-2000s and primary surpluses that are higher than those seen in IMF adjustment programmes.

Therefore, even if the government succeeds in stabilising the debt-to-GDP ratio, it will be at a high level and this will be a fixture of the South African economy for at least the next 10 to 15 years. This has four implications, three for fiscal policy and the fourth for monetary policy:

- To return to a moderate but sustainable growth path, the South African economy requires significantly higher levels of public infrastructure investment. President Ramaphosa sees infrastructure investment as key to his so-called third phase of recovery from the Covid-19 crisis. But the high debt-to-GDP ratio implies little room to borrow to finance such investment. An investment-driven growth strategy will therefore

require a strong public-private partnership (PPP) model where the private sector builds, operates, and finances public infrastructure.[3] Usually, to ensure budgetary agility and room to manoeuvre, good practice suggested that governments not operate more than 15 per cent of their infrastructure using PPPs. However, the public debt burden in South Africa will require a much larger private sector share in public infrastructure construction. Thus, the principles and models used for such construction will need to be carefully considered.

- In its Letter of Intent to secure the $4.3 billion (± R70 billion) IMF loan, government expressed a willingness to explore the introduction of a debt ceiling. The danger exists that if the active scenario in the Supplementary Budget is used as guide to set the debt ceiling at 90 per cent of GDP, South Africa will not be able to honour its commitment, which would undermine our credibility rather than strengthen it. A more realistic debt ceiling would be at 100 per cent of GDP. In addition, imposing a debt ceiling should be accompanied by the realisation that it represents not so much a commitment to the debt ceiling itself, but to the expenditure and revenue measures needed to contain the deficit and debt.

- There will be little room for fiscal policy to play a countercyclical role in future recessions. Fiscal policy has run out of bullets for the foreseeable future. Once the debt-to-GDP ratio stabilises, merely preventing future recessions from causing the high debt to GDP ratio to spiral out of control again will take careful planning, and no room for countercyclical policy.

- As a result, the full burden of countercyclical policy will fall on monetary policy at a time when the high debt-to-GDP ratio translates into a steep risk premium on interest rates. Risk premiums of this size (also associated with a junk credit rating) will, in turn, limit the extent to which the South African Reserve Bank can lower interest rates even though it will carry the full burden for countercyclical policy.

[3] However, this will have to be done in a manner that does not imply future liabilities to government. Instead of government borrowing to finance the construction of a government building such as a school or office complex and then having itself incur maintenance and debt service costs in future, it can enter into a PPP agreement whereby the private partner borrows the funds to construct the building (a typical build, finance, operate, and transfer agreement). However, if the government then has to pay that private partner annually a fee that will allow the private partner to maintain the building and service its debt, the government also incurs a contractual liability (which will only be contingent upon the private partner delivering in terms of the contract). Thus, although the debt might not be counted as public debt, the government nevertheless incurs a future liability. Therefore, if the government wants to avoid future liabilities by entering PPPs, it will have to enter contracts where the private partner charges not government, but the direct consumers of the service, such as the users of a toll road or patients in a hospital whose medical aids cover their bills. Whether it can achieve this without also offering some kind of guarantee is a matter for debate, especially after the e-tolls fiasco.

Appendix – Explaining budgetary aggregates

Whereas the consolidated budget balance (also called the conventional budget balance) is the difference between total revenue collected by government and total government expenditure, the primary balance is the difference between total revenue and non-interest government expenditure. The primary balance excludes interest payments because these are not discretionary – everyone, even government, usually has to pay its interest cost, especially if it hopes to have continued access to capital markets.

Why should the government run a primary surplus when the interest rate exceeds the growth rate?

Suppose we have a country with a GDP of R4 000 in 2019. Suppose further that at the end of 2019 public debt (i.e. the debt of government) was R2 000. That gives a public debt to GDP ratio in 2019 of 50 per cent (2 000/4 000). We express public debt as percentage of GDP, because the taxes needed to pay the interest on that debt comes from total income (either directly as corporate and personal income taxes, or from VAT levied on consumption, which itself depends on income). GDP is in essence the total of all income in the country.

Also suppose, for the sake of simplicity, that there is no inflation. If in 2020 the economic growth rate in that country is 1 per cent while the interest rate is 5 per cent, GDP will increase from R4 000 to R4 040. If the public debt to GDP

ratio is to remain unchanged, at 50 per cent, public debt can be allowed to increase by only R20 – from R2 000 to R2 020. However, if the interest rate on debt is 5 per cent, or R100 (which is 5 per cent of R2 000), but we only want the debt to increase by R20, we need to pay the remaining R80 of interest with tax collections.

Thus, government can run a consolidated budget deficit of R20 (let us suppose it is the difference between R1 020 of total expenditure and R1 000 of revenue), which will translate into a primary surplus of R80 (the difference between R920 of non-interest expenditure and R1 000 of revenue – the R920 equals R1 020 of total expenditure minus R100 of interest expenditure).

If the primary surplus is smaller than R80, or if the government runs a primary deficit, the debt to GDP ratio will rise above 50 per cent. For instance, suppose that instead of a R20 consolidated budget deficit and a R80 primary surplus, government runs a R150 consolidated budget deficit and a R50 primary deficit, debt will increase by R150 from R2 000 to R2 150, which, with GDP only increasing to R4 040, means that the public debt to GDP ratio increases from 50 per cent to 53.2 per cent (2 150/4 040).

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