Fiscal risk statement

Introduction

Government is committed to stabilising national debt as a share of GDP, and assuring the long-term sustainability of public finances. This report sets out the National Treasury's assessment of risks that can affect the achievement of these objectives. It also proposes a framework for responding to these risks, and serves as the basis for discussion of fiscal choices facing the country.

The most significant fiscal risks over the next three years are lower-than-expected economic growth, higher-than-expected increases in compensation budgets, and the parlous finances of some state-owned companies and public entities.

The risk framework is organised into four broad categories: macroeconomic, policy and budget execution, contingent and accrued liabilities, and long-term spending commitments. Fiscal risks are interdependent and highly correlated: when a risk materialises it can have consequences for more than one category. For example, an economic contraction could weaken a state-owned company's balance sheet, triggering a call on a government guarantee, at the same time that tax revenue is declining. Similarly, an unanticipated increase in the public-sector wage bill could displace other essential spending items and erode the long-term financial position of the Government Employees Pension Fund (GEPF).

Figure A.1 Government's fiscal risk framework

Risk category	Major issues considered under each subtopic
Macroeconomic risks	▪ Impact of slower-than-expected nominal GDP and revenue growth ▪ Debt sustainability under different economic scenarios ▪ Effect of macroeconomic outlook on expenditure and debt-servicing costs
Policy and budget execution	▪ Unplanned or emergency spending requests leading to pressures on the expenditure ceiling ▪ Implementation risks around proposed in-year expenditure estimates
Contingent and accrued liabilities	▪ Quality of guarantee exposures, particularly to state-owned companies ▪ Funding status of the social security funds and the GEPF
Long-term spending commitments	▪ Impact of long-run growth, demographic changes, and new policy proposals ▪ Infrastructure and maintenance backlogs

Institutional strengths and fiscal risk

The global financial crisis exposed vulnerabilities in public finances around the world, and triggered debt crises among seemingly solvent governments. Much of the increase in public debt stemmed from:

- An unwillingness or inability by national governments to control expenditure
- Hidden deficits and uncontrolled borrowing in the lower tiers of government
- Choices by public agencies and state-owned companies that committed national budgets to implicit guarantees, without following normal budget processes, such as the pursuit of loss-making mandates
- Unanticipated bailouts of private-sector financial institutions
- Large issuances of foreign-denominated debt that grew rapidly as local currencies depreciated
- Underfunded social security systems.

South Africa has several institutional strengths that support fiscal sustainability:

- The Constitution and the Public Finance Management Act (1999) entrench a centralised, accountable framework for fiscal management. All money received by national government must be paid into a National Revenue Fund, except money reasonably excluded by an act of Parliament. All government budgets and budgetary processes must promote transparency, accountability and the effective financial management of the economy, debt and the public sector. The budget is presented in consolidated terms, reflecting the spending of public entities, social security funds and provincial governments, including amounts that are not financed from the National Revenue Fund.
- The majority of government debt is denominated in rands, with long maturities. The domestic bond market is deep and liquid, reducing debt-refinancing risks. Loans and guarantees by subnational government are limited and subject to national legislation. Provinces are almost entirely funded through transfers from national government. Borrowing by local governments is capped and limited to major metros with significant revenue-raising powers.
- The medium-term expenditure framework creates a more predictable, open and transparent budget process. Across government, budget execution is highly effective. Instances of spending exceeding appropriated limits are rare. The fiscal framework is underpinned by credible macro-fiscal forecasts. The South African Revenue Service (SARS) has consistently improved the efficiency of the tax system and has typically exceeded revenue collection targets. And despite new spending pressures, government has maintained the expenditure ceiling.
- South Africa has a record of fiscal sustainability, reflected in government's willingness to reduce the deficit in response to rising debt. This policy commitment to fiscal sustainability is supported by the South African Reserve Bank's inflation-targeting regime, which helps manage inflation expectations, and the floating exchange rate, which absorbs external shocks.
- The financial sector is well capitalised and regulated. The likelihood of failure of a major bank or the financial sector itself is very low. In its 2014 financial system stability assessment, the International Monetary Fund (IMF) determined that South Africa's financial sector was adequately capitalised to withstand severe shocks.
- Looking further ahead, the National Treasury's long-term model suggests that existing core social spending priorities (e.g. education, health and social grants) are sustainable over the coming decades. In addition, the GEPF is well funded.

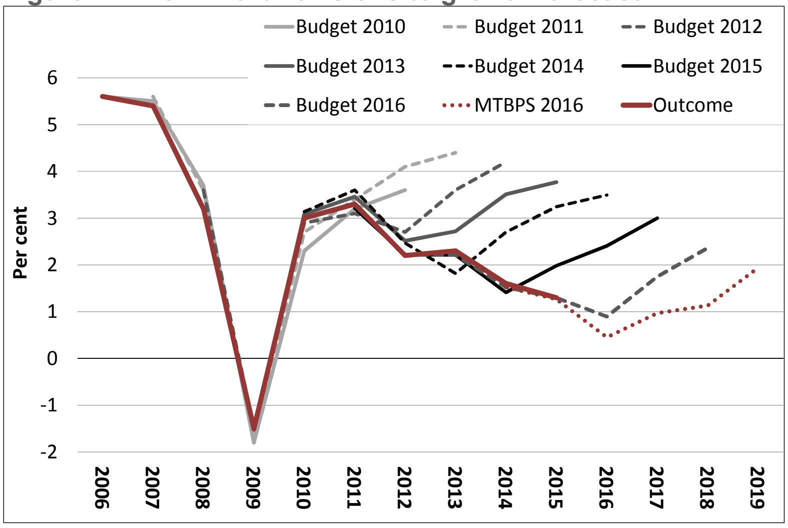
Despite these strengths, there are significant risks to the fiscus. Slower-than-expected economic growth raises the possibility of missed fiscal targets. Efforts to shift the composition of expenditure continue to be frustrated by strong growth in the wage bill and underspending on capital budgets. Contingent liabilities (which include guarantees to state-owned companies) have grown strongly, as have financing pressures from the sovereign debt stock.

Macroeconomic risks

The main risk to fiscal consolidation in any country is slower-than-projected GDP growth. Consequently, inaccurate or biased economic forecasts undermine the fiscal outlook. A 2013 review by the Bureau for Economic Research at Stellenbosch University found that the National Treasury's growth forecasts were on par with, or better than, those of private-sector economists, the IMF and the bureau's own. The National Treasury's GDP forecasts provide a credible basis for fiscal planning.

However, domestic growth forecasts have been revised downwards in each successive budget since 2011. Reasons for these revisions have included downward revisions of global projections by the IMF and lower-than-anticipated commodity prices. There have also been domestic shocks to growth such as electricity shortages, labour disruptions and drought. Downward revisions resulted in tax revenue collection underperforming against the forecasts. They have also made fiscal targets more difficult to achieve, because the targets are often expressed as a percentage of nominal GDP.

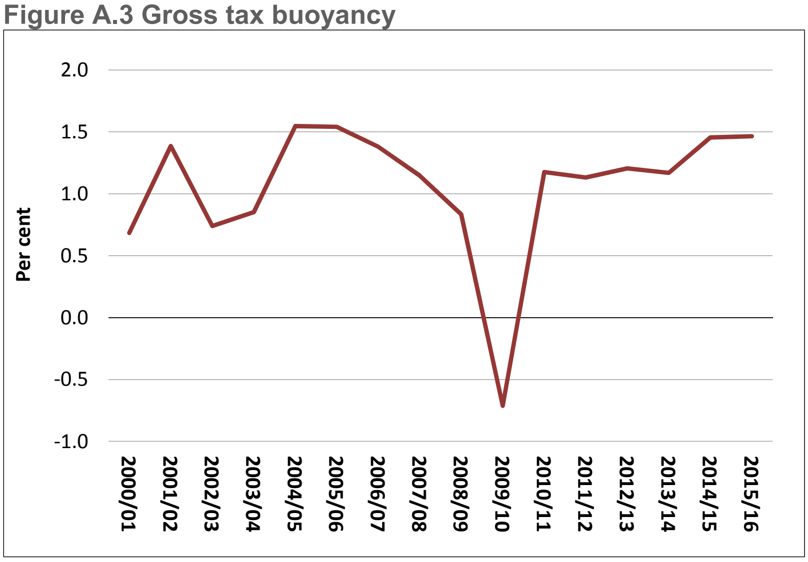
Figure A.2 Downward revisions to growth forecast



Source: National Treasury

Tax revenue projections are also affected by the relationship between each tax type and its base. Over the past four years, the aggregate tax-to-GDP buoyancy – the ratio of tax revenue growth to nominal GDP growth – has remained at about 1.2 or higher.

Figure A.3 Gross tax buoyancy



Source: National Treasury

Significant changes to tax policy have contributed to buoyancy: less generous relief for fiscal drag, increases in personal income tax rates, phasing out of certain deductions, and strong growth in the excise and fuel levies. Underlying economic factors have also sustained tax buoyancy, even as growth has slowed. Strong wage growth, particularly at the upper end of income distribution, has supported personal income tax receipts, even as employment creation weakened. Exchange rate depreciation has buoyed receipts from corporate income tax, while imports have remained resilient in the face of higher import prices, adding to revenue from customs duties and VAT. Wage gains and rising asset prices have fed into resilient household demand, particularly for durable goods.

The National Treasury's revised economic forecast indicates that a number of these trends may not be sustained over the medium term. Accordingly, revenue projections have been revised down significantly, reflecting lower tax bases and conservative buoyancies.

On the expenditure side, the inflation forecast directly influences major spending items, including compensation budgets, which is explicitly linked to consumer price index inflation. Changes to exchange and interest rates influence the cost of servicing debt, and the cost of imported goods such as medicines, fuel and capital equipment.

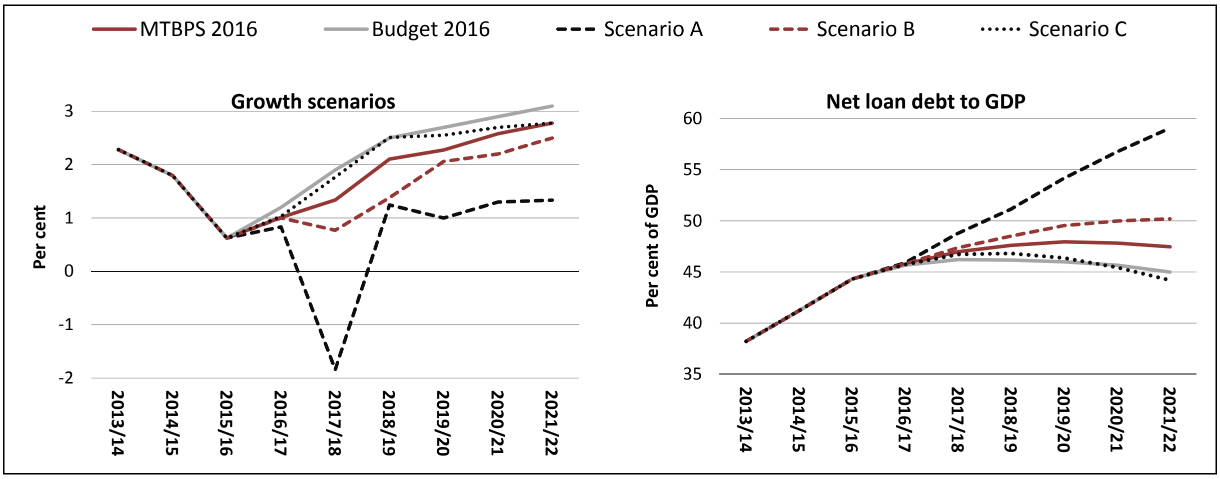
Macroeconomic scenarios

To assess the magnitude of fiscal risks flowing from macroeconomic factors, the National Treasury has developed three moderate-probability scenarios:

- **Scenario A – Long-term decline in potential growth**: *Projected GDP growth for 2016 does not change, but growth is considerably lower over the medium term and fails to rise above 2 per cent in the long term.* In this scenario, the implementation of reforms is slow, perceptions of policy uncertainty continue, global growth remains weak and commodity prices do not recover. These developments further erode domestic confidence, and constrain investment and economic growth. As a result, the sovereign credit rating is cut to sub-investment grade, as government struggles to stabilise growth of public debt. Government faces higher borrowing costs as the risk premium is elevated over a lengthy period. Domestically, long-term government bond yields are considerably higher than the baseline. A weaker rand raises inflation over the medium term, but returns to the target range due to persistently weak demand. The repurchase rate increases in 2017, in response to higher inflation, but remains unchanged from the baseline thereafter owing to weak growth.
- **Scenario B – Heightened global turbulence:** *GDP grows by only 1 per cent in 2017 and reaches 1.9 per cent in 2019.* Over the long term, growth rises above 3 per cent. In this scenario, global turbulence returns, as the impact of Britain's decision to leave the European Union and concerns about China's transition are realised. This prompts an additional downward revision of global growth forecasts. Global productivity growth continues to decline as a result of slow implementation of policy reforms and lower trade intensity. Slower growth in developing economies is accompanied by higher risk aversion, reduced capital flows and weaker commodity prices. As a consequence, the domestic risk premium rises. State borrowing costs are assumed to mirror the increase in the risk premium. The weaker rand puts upward pressure on inflation.
- **Scenario C – Stronger export response to rand depreciation**: *GDP growth reaches 1.6 per cent in 2017 and stabilises at about 2.5 per cent in the outer years.* The rand has depreciated significantly in recent years, yet the increase in exports has not been commensurate. In this scenario, exports respond more strongly to a depreciation in the exchange rate. Demand from other emerging markets is also stronger, despite events in the European Union. Consequently, global demand is moderately strong, with average commodity prices 3 per cent higher than current baseline assumptions.

Figure A.4 illustrates the results of these scenarios for GDP growth and net loan debt in comparison with the baseline forecast used in the MTBPS.

Figure A.4 Growth scenarios and results



Source: National Treasury

The fiscal results in these scenarios are as follows, assuming that the expenditure ceiling remains in place and that government does not respond with new fiscal measures:

- Scenario A results in the primary balance widening by between 1.5 and 3 percentage points of GDP over the medium term. In this scenario, the primary balance remains in deficit even over the long-term and, as a result, the debt-to-GDP ratio does not stabilise.
- Scenario B results in moderate deficit slippage relative to the MTBPS of between 0.2 and 0.8 percentage points over the medium term. In this scenario, it is anticipated that the primary balance will return to surplus as growth recovers. As a result, debt is expected to stabilise in 2021/22 at 2 to 3 percentage points higher than the MTBPS target.
- Scenario C results in the primary balance closing more quickly than the baseline forecast. Debt stabilises at 47 per cent of GDP in 2018/19.

The two downside scenarios (A and B) assume a mildly higher inflation outlook resulting from a weaker rand exchange rate. However, a significant revision of the inflation outlook will raise the cost of inflation-linked expenditure such as compensation budgets, which will increasingly crowd out other spending items.

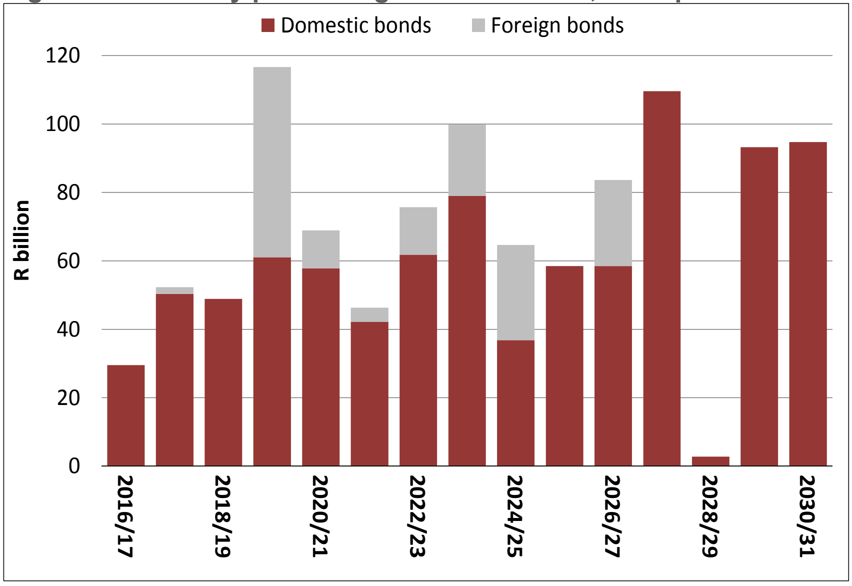
Macroeconomic risks and debt management

Debt-service costs are excluded from the expenditure ceiling because they are not part of discretionary spending. These costs are sensitive to movements in interest and exchange rates, as well as inflation. However, 88 per cent of government debt issuance is in the form of fixed-rate instruments with relatively long maturities. These instruments do not respond to adverse movements in the macroeconomic outlook.

The public finances are well protected against currency depreciation because government's debt stock is largely denominated in rands. However, weak economic growth and associated revenue underperformance would result in an unplanned increase in the borrowing requirement, and raise the cost of servicing new bonds.

Over the coming decade, redemptions of domestic and foreign debt are projected to increase, as shown in Figure A.5. This introduces significant refinancing risks. The fiscal strategy to reduce the budget deficit outlined in Chapter 3 helps to mitigate this risk. Over the medium term, government's bond-switch programme – which exchanges short-term for longer-term debt – and increasing cash balances will further mitigate this risk.

Figure A.5 Maturity profile of government debt, 30 September 2016



Source: National Treasury

The structure of South Africa's sovereign debt stock is sustainable and comfortably within global best-practice benchmarks. International investors hold about 35 per cent of total outstanding debt securities (including domestic issuances), indicating a moderate susceptibility to capital flight. Nonetheless, the depth of the domestic market reduces the likelihood of a liquidity crisis. The short-term rollover risk emanating from the Treasury bill portfolio is monitored through a benchmark limit of 15 per cent of domestic debt. Currently, Treasury bills are below this limit. More detail on sovereign debt is provided in the 2015/16 debt management report, available on the National Treasury website.

Policy and budget execution risks

Policy risks include unplanned or emergency spending requests that could breach the expenditure ceiling. Budget execution risks emerge when departments or entities do not achieve spending targets. At the aggregate level, budget execution has been good. Spending outcomes averaged 0.2 per cent over the initial estimate since the introduction of the non-interest expenditure ceiling. There are, however, budget execution risks associated with the 2016 MTBPS proposals. These include:

- Wage bill pressures – Between 2009/10 and 2012/13, strong growth in the public-sector wage bill increased compensation as a share of national and provincial non-interest spending. Salaries in health, education and policing are growing at more than 2 per cent in real terms – well above total spending growth. The current three-year wage agreement comes to an end in 2017/18, and there is potential for the assumptions about wage-bill growth to change once a new agreement is reached.
- Infrastructure underspending – National government spending on infrastructure was 5 per cent below published infrastructure budgets in 2015/16. The pattern was more pronounced in local government and state-owned companies, which spent 81 and 93 per cent of their infrastructure budgets respectively. Underspending strains existing infrastructure, accelerates wear and tear, and limits service-delivery capacity.
- Exchange rate pressures – The depreciation of the rand places pressure on departments that procure goods and services in foreign currency. If not well managed, this risk may shift the composition of spending further towards goods and services. If one of the downside scenarios considered in this statement materialises, sharper rand depreciation may place even greater pressure on budgets.

Over the medium term, policy risks are mainly associated with unanticipated spending requests. In higher education, for example, the MTBPS projects additional funding of the post-school education and training sector. Further spending demands, similar to those that have arisen in the last two budget cycles, will place additional pressure on spending limits.

These risks, if they materialise, are more likely to change the composition of spending than threaten the expenditure ceiling. Departments typically respond to wage bill pressures by moving funds from non-core goods and services, and from capital budgets to compensation. While government will maintain its expenditure targets, a higher wage bill may crowd out resources available for complementary inputs, eroding the quality of service delivery. Similarly, a zero per cent university fee increase in 2018 would likely result in a shift of resources from other priorities towards higher education.

Contingent and accrued liability risks

Government's major explicit contingent liabilities are its guarantees, which stood at R469.9 billion at the end of 2015/16. Total guarantee exposure was R263 billion at the end of 2015/16, because several entities had not fully used their available guarantee facilities. The largest guarantee exposure – more than R170 billion – supports Eskom's capital investment programme. An exposure of R200 billion relates to the IPPs. Eskom is obliged to purchase power from these independent producers over a 20-year period based on a power-purchase agreement approved by the National Energy Regulator of South Africa. Should Eskom be unable to do this, government must purchase the power on Eskom's behalf.

The most recent recapitalisation – combined with governance reforms and operational recovery – has improved Eskom's liquidity and profitability. The risk of default with the IPP guarantee is low as the regulator fully provides for IPP costs in the Eskom tariff determinations. These factors mitigate the risk arising from these guarantees. However, a deterioration in Eskom's financial position would increase the risk of both exposures.

Other key contingent liability risks are as follows:

- Passenger Rail Agency of South Africa – The fiscus has committed R53 billion to fund PRASA's purchase of new rolling stock and signalling equipment. The Auditor General and the Public Protector have found weak expenditure controls and contract management in this programme. This raises concern that PRASA will not be able to complete the programme on time and within budget. In addition, projected declines in PRASA's fare revenue and ridership numbers raise concerns about the company's sustainability.
- South African National Roads Agency Limited – Fiscal exposure to SANRAL debt stood at R35 billion as at 31 March 2016. The guarantee was put in place to support the expansion of the agency's toll roads portfolio. The new tolling dispensation has been implemented for phase 1 of the Gauteng Freeway Improvement Project. A 60 per cent discount was offered to road users between November 2015 and May 2016 on the settlement of the outstanding amounts. E-toll collections and auctions are still closely monitored against projected collection levels to ensure recovery. Over the medium term, national government and the Gauteng provincial government will supplement e-toll revenue. More generally, if government does not proceed with tolling to fund major freeways, difficult trade-offs will need to be confronted to avoid a deterioration in the national road network.
- South African Airways – Government has issued a R19.1 billion guarantee facility to SAA to ensure the company can continue to operate as a going concern. The carrier continues to post losses. There is currently a R14.3 billion exposure against the facility. Without the guarantees, SAA is technically insolvent. A new, full-strength board has been appointed and tasked with returning the airline to financial sustainability. The board has also been tasked with quickly filling vacant executive management positions.

- South African Post Office – Currently, government has a R4.4 billion guarantee exposure to the South African Post Office. A new board and CEO were appointed, and the company has been able to raise funding to repay creditors, implement a turnaround plan and reach a settlement with labour to mitigate the possibility of strike action.
- Land Bank – Government provided the Land Bank with a R6.6 billion guarantee in 2014/15, of which R5.3 billion has been drawn down as at 31 March 2016. The guarantee has helped the bank expand its lending by 10 per cent in 2015/16, despite a weak operating environment, and chart a path to stabilisation. The relatively short maturities of the bank's funding liabilities are gradually becoming longer, relieving pressure on the institution's cash flows, but they do still pose moderate risk to the fiscus. The bank is conducting an internal review to improve operational efficiency and developmental effectiveness. Lenders have highlighted the bank's strong governance and relationship with the shareholder as reasons to continue supporting its funding programme.
- The Road Accident Fund – RAF liabilities at the end of March 2016 were revised up to R155 billion from the R132 billion reported in the 2016 Budget. These liabilities are projected to grow to R345 billion in 2019/20. The RAF has been insolvent for over 30 years, despite having a dedicated revenue stream in place to settle claims. Government has not yet tabled legislation to create a new equitable and affordable benefit arrangement to replace the fund. Various options exist to reduce the RAF contingent liability, including increases in the RAF fuel levy. The new replacement scheme will be structured to ensure sustainability.

Government maintains its policy stance that any intervention to support state-owned companies must be deficit neutral. Entities receiving support from government will be required to provide sound business plans, improve governance and address operational inefficiencies.

Long-term fiscal risks

The National Treasury regularly updates its long-term fiscal model to determine the sustainability of its major social spending commitments. In general, the current commitments appear sustainable over the long term. However, the sustainability of existing programmes is heavily influenced by changes to demographic and GDP growth estimates.

Changes to the level and age structure of the population have significant implications for the costs of social programmes such as social grants. Population estimates have changed significantly over the past few years. The National Development Plan (NDP) made use of the model released by the Actuarial Society of South Africa in 2011, calculating a base population of 50.6 million for 2012. The 2011 Census estimated the 2012 population at 51.8 million. The NDP projected the population would be between 58.2 million and 61.5 million by 2030. However, the latest actuarial projections put the population at 65 million in 2030. In general, a larger and older population will place greater pressure on social spending.

Lower long-term GDP growth would make the financing of large-scale new policy proposals more difficult. The current level of spending is sustainable if economic growth returns to its historic average of 3 per cent. However, if growth remains stuck below 2 per cent over the long term, a stable debt path will be difficult to sustain at the current levels of expenditure, even if no new policy initiatives are taken.

Ensuring fiscal sustainability while implementing new initiatives currently on government's agenda would require a significant acceleration of economic growth to boost tax revenue; policy measures to increase the structural levels of taxation, with rates raised across all major tax types; and/or shifting resources from other priorities.

Another long-term risk stems from municipal finances. Insufficient spending on infrastructure and maintenance raises the long-term cost of replacement infrastructure or maintenance, and shortens the useful life of capital assets. Furthermore, weak municipal financial management creates risks for the broader public sector because municipalities do not settle their financial obligations on time. A decline in municipal own-revenue sources would increase their dependence on fiscal transfers, with deleterious consequences for service delivery. To mitigate this risk, government has made changes to the *municipal infrastructure grant* to prioritise maintenance and strengthen infrastructure planning. Changes have been made to the *municipal systems improvement grant* to enhance operational efficiency. And government has initiated a review of the municipal pensions system.

Conclusion

The outlook for the period ahead suggests that fiscal risk is elevated, primarily because the potential for weaker-than-expected economic performance threatens the revenue forecast. The outlook for contingent liabilities is also a source of vulnerability. The macroeconomic and fiscal policies outlined in Chapters 2 and 3 are, in part, designed to reduce these risks, and ensure that government's fiscal targets are achieved.

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