ANNEXURES

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A

Fiscal risk statement

Introduction

This statement sets out the main fiscal risks to the baseline assessment of the public finances outlined in Chapter 3 of the Medium Term Budget Policy Statement.

Fiscal risks are developments that may cause public finance outcomes to deviate from forecasts if they materialise. Over the medium term there are three primary concerns. The first is a sustained economic contraction in 2020, leading to larger revenue shortfalls with far-reaching effects on service delivery. High contingent liabilities pose a second risk, as failing to implement extensive governance and operational reforms at Eskom and other major state-owned companies would further drain public resources. The third is increased pressure on subnational government budgets, which could spur growth in unpaid liabilities and other accruals in provinces and municipalities.

The main long-term risk to fiscal sustainability is that the recent trend of slow economic growth continues. In this context, the fiscal risk statement analyses several major expenditure commitments over the next two decades.

This statement categorises fiscal risks in the four areas shown in Figure A.1.

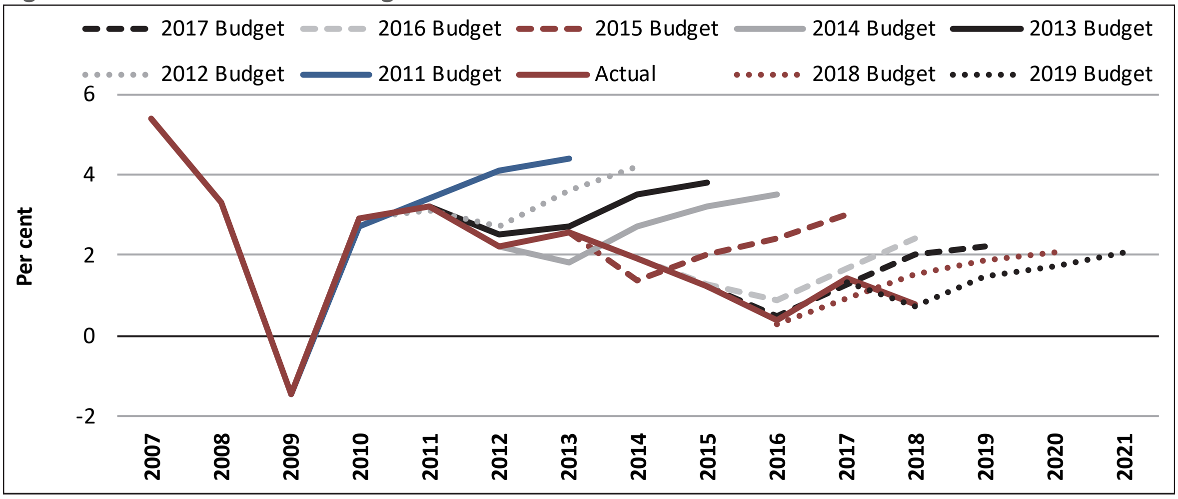
Figure A.1 Fiscal risks framework

Risk category	Major issues considered under each sub-topic
Macroeconomic risks	▪ Uncertainty of nominal GDP and revenue growth over the medium term ▪ Debt sustainability under different macroeconomic scenarios ▪ Impact of a larger deficit and macroeconomic shocks on financing requirement
Expenditure risks	▪ Unpaid bills and accruals within provincial and local governments ▪ An unfavourable wage agreement significantly above CPI inflation ▪ Worsening financial management in municipalities
Contingent and accrued liabilities	▪ Quality and quantity of state-owned companies' guarantee exposures ▪ State-owned company debt obligations falling due over the next decade
Long-term economic and fiscal risks	▪ Reduction in economic growth potential ▪ Effects of demographic changes, lower potential growth and lower inflation on sustainability of expenditure

Macroeconomic risks

Figure A.2 shows that, over the past nine budget cycles, government has overestimated GDP growth in its forecasts. The deviations are not unique to the National Treasury, and reflect both domestic risks that materialised and technical revisions to historical growth outcomes. As economic growth projections have been revised down over time, the gap between forecasts and outcomes has decreased, reducing (but not eliminating) the risk of a large, unanticipated variance.

Figure A.2 Revisions to real GDP growth forecast



Source: National Treasury

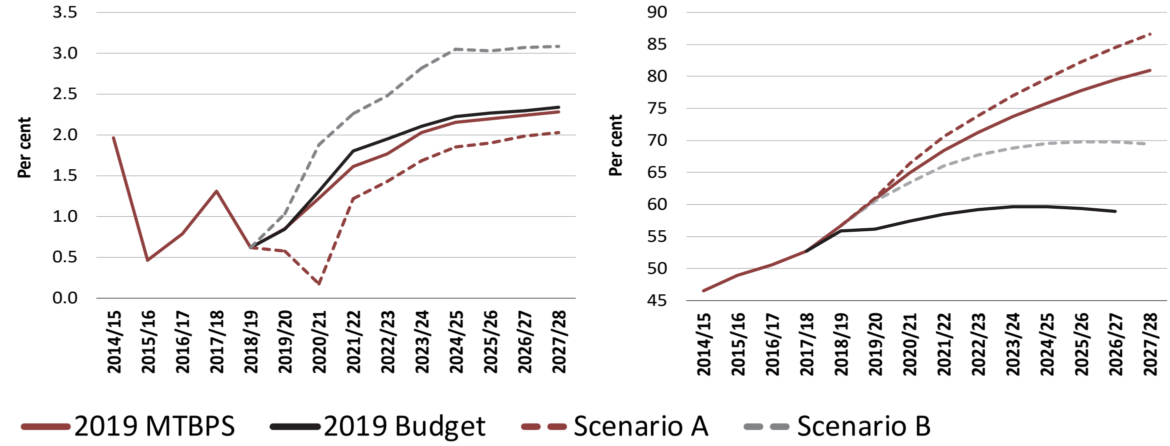
Fiscal scenarios around the baseline economic forecast

Chapter 2 presents the National Treasury's baseline economic forecast. Three scenarios have been modelled around this forecast, as set out below. Given the complex nature of long-term modelling, any moderate deviation from the assumptions could result in substantially different outcomes.

Scenario A – Insufficient reforms results in the primary balance widening by between 1 and 2.7 percentage points of GDP over the medium term. Debt-service costs as a share of revenue will increase from 15.1 per cent in 2019/20 to 22.5 per cent in 2027/28. 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 – Stronger domestic growth results in the primary balance closing more quickly than the baseline forecast. Debt stabilises at 69.8 per cent of GDP in 2025/26.

Figure A.3 GDP growth scenarios **Figure A.4 Gross debt-to-GDP scenarios**



Source: National Treasury

Debt management risks

Since the tabling of the 2019 Budget, the risk of a sovereign credit downgrade has increased as low economic growth and high government debt, exacerbated by support for state-owned companies, persisted. A downgrade by Moody's to sub-investment grade would increase borrowing costs and reduce the range of institutions that can invest in South African government bonds.

Government has a prudent debt management strategy in place that enables it to manage the risks associated with elevated borrowing. Long-dated fixed-rate instruments finance the bulk of the borrowing requirement. Although short-term bonds are cheaper, using these long-dated bonds protects the public finances from sudden changes in interest and exchange rates. In addition, most of government's borrowing requirement is financed in domestic markets, which reduces exchange rate risk. Non-resident holdings of South African bonds peaked at 42.8 per cent in March 2018 and have since declined to 36.9 per cent in September 2019.

Table A.1 shows the sensitivity of the debt portfolio to changes in interest-rate, exchange-rate and inflation assumptions. In the case of a 10 per cent change in any category, government would continue to finance its borrowing requirement, but at greater cost. State-owned companies, however, would likely struggle to refinance existing debt or issue new debt.

Table A.1 Sensitivity in debt stock and debt-service costs, 2020/21

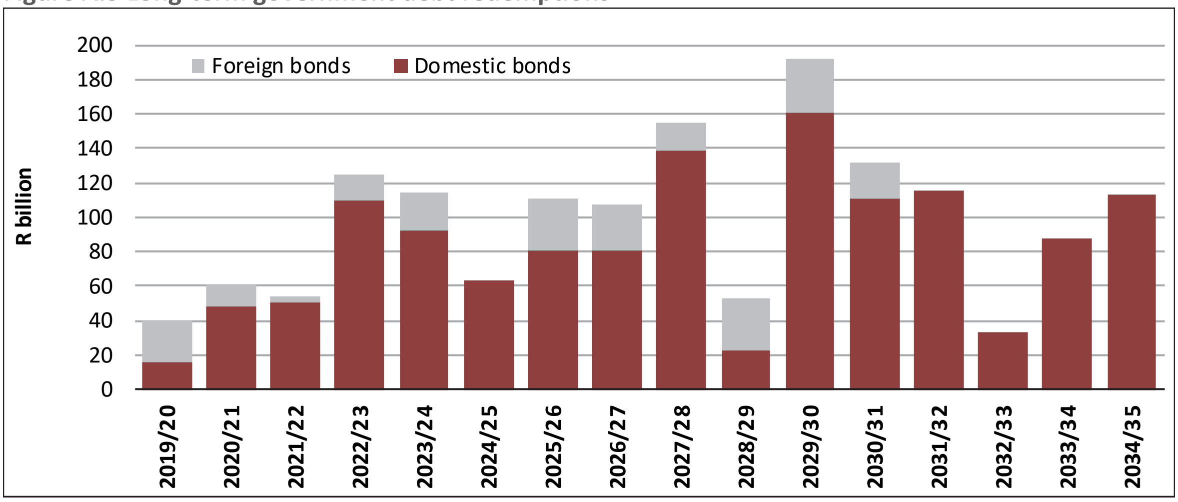
R billion	Debt-service costs[1]	Gross loan debt[1]
Effect of a 10 per cent change in:		
Interest rates	5.2	18.9
Rand/US dollar exchange rate	2.5	36.3
Headline inflation	0.1	3.1

1. Sensitivities are positive in the case of a variable rise or currency depreciation and negative in the reverse case
Source: National Treasury

Repayments of the principal portion of government debt – known as redemptions – are set to increase sharply in coming years. Long-term debt redemptions will increase to an annual average of R97.5 billion over the next decade.

If government rolls over maturing debt, the scale of debt redemptions would place substantial pressure on domestic capital markets, raising borrowing costs across the economy.

Figure A.5 Long-term government debt redemptions



Source: National Treasury, as at 30 September 2019

Expenditure risks

Unpaid bills or accrued debts from provincial and local governments remain a significant risk to sustainable public finances. Mounting accruals reflect several factors: poor financial management, employee compensation crowding out other spending and severe weaknesses in supply chain management.

Medical legal claims against provincial health departments continue to increase, from R80 billion in 2017/18 to R99 billion in 2018/19. Payments against these claims amounted to R2 billion in 2018/19, compared with R1.5 billion paid out in 2017/18.

In 2018/19, the financial position of local government deteriorated significantly. Uncollected revenues grew by 17 per cent to R147.8 billion, while overdue amounts owed by municipalities grew by 52.5 per cent from R23 billion in 2017/18 to R36 billion. Half of this amount is owed to Eskom.

A revised strategy to address municipal financial performance failures, which has been endorsed by the Budget Council and Budget Forum, is expected to address these failures. This strategy is discussed in Chapter 4.

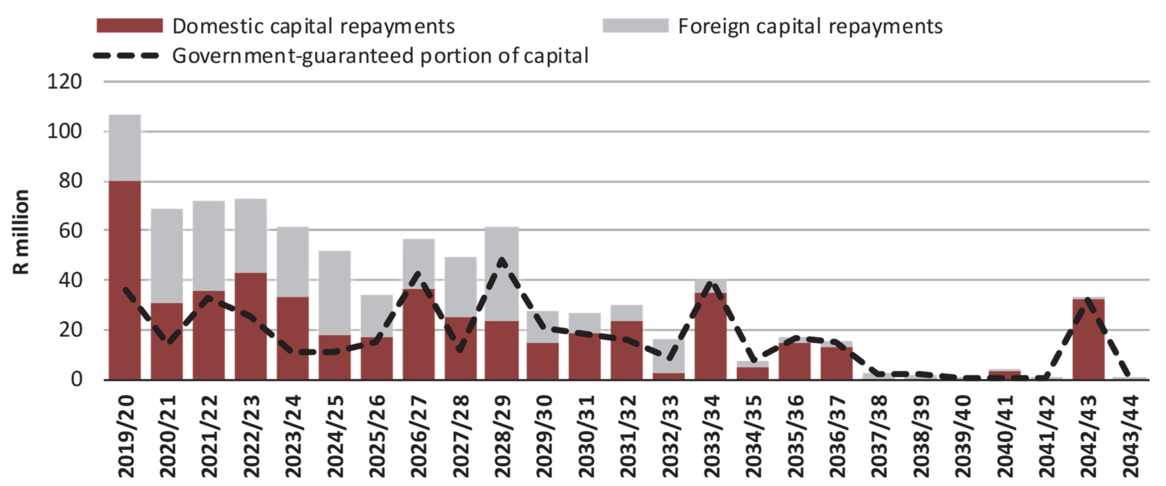
In 2020/21, negotiations will begin for a new public-service wage agreement. Another agreement that is above consumer price index inflation, as occurred in the previous three rounds of wage negotiations, would put additional pressure on the public finances. It would continue the trend of compensation crowding out other areas of spending, widen the structural deficit and limit government's ability to respond to any new fiscal pressures and risks. Annexure B discusses compensation trends.

Contingent liabilities

This section describes the risks posed by commitments that may result in future financial obligations (contingent liabilities) and by expenses that have been recorded but not yet paid (accrual liabilities). The financial condition of South Africa's major state-owned companies account for the vast majority of these risks to the fiscal framework, and these risks have already begun to materialise.

By 2021/22, contingent liabilities are expected to exceed R1 trillion. These liabilities consist of government guarantees and Road Accident Fund obligations. Government's guarantee portfolio has increased from R670 billion in March 2018 to R683.3 billion in March 2019, of which the largest facility has been granted to Eskom (R350 billion). By end-March 2019, R372.4 billion of these government guarantees had been used, bringing government's exposure from guarantees to 7 per cent of GDP. Over the next three financial years, guaranteed debt redemptions are expected to average R27.5 billion, up from R26 billion reported last year.

Figure A.6 Debt maturity profile of largest state-owned companies based on borrowings*



** Airports Company of South Africa, Denel, Development Bank of Southern Africa, Eskom, Industrial Development Corporation, Land Bank, South African Airways, South African National Roads Agency, Trans-Caledon Tunnel Authority and Transnet*
Source: National Treasury as at 30 June 2019

The interest-bearing debt of the 10 largest borrowers has grown from R266.7 billion in 2009/10 to R738.3 billion in 2017/18 – an increase of 177 per cent in eight years. The National Treasury estimates that this collective debt is likely to exceed R750 billion in 2018/19. In addition, the effective cost of debt for these entities, taking non-interest costs into account, has risen from 8.7 per cent in 2009/10 to 9.4 per cent in 2017/18. Total debt redemptions for these companies are estimated to average R82.4 billion annually over the 2020 MTEF period. Of this, 41 per cent consists of foreign debt.

It has become increasingly difficult for state-owned companies to access funding in capital markets, due to poor financial performance as a result of weak revenue growth, poor operating performance and unsustainable debt-service costs. Rising interest rates and increasingly unfavourable loan terms and conditions raise the risks associated with borrowing. As a result, many companies are repeatedly requesting guaranteed lines of credit from government.

Eskom

Eskom remains the most serious risk to the fiscus, as it has a significantly high debt burden and has made limited progress with the necessary reforms announced in February. Eskom had used R289 billion of its R350 billion government guarantee facility by 31 August 2019, with another R43 billion committed to specific funding instruments but not yet used. The utility relies on government support, borrowing from existing facilities and securing new debt to maintain a positive cash balance. In the current financial year, government has provisionally allocated appropriations totalling R49 billion for Eskom. Annexure C discusses Eskom in more detail.

Denel

Government has guaranteed R4.4 billion to military equipment manufacturer Denel to enable it to obtain financing. In August 2019, government granted Denel an additional R1.8 billion in funding through the contingency reserve to pay creditors, implement a turnaround plan, restart stalled operations and meet its existing orders for equipment. During 2019/20, the Department of Public Enterprises is expected to appoint a chief restructuring officer to oversee and execute the company's turnaround plan.

South African Airways

Over the past 13 years, South African Airways (SAA) has incurred over R28 billion in cumulative losses. The airline is insolvent and, in its current configuration, unlikely to ever generate sufficient cash flow to sustain its operations.

Government has transferred R5.5 billion to SAA in the current year to enable the carrier to extend maturities on outstanding debt obligations, giving it time to develop an affordable repayment plan with creditors. However, without a debt repayment plan supported by government, the airline's lenders are unlikely to extend outstanding government guaranteed debt of R9.2 billion beyond the end of the fiscal year, or to provide additional facilities needed for SAA to remain liquid. If this happens, government is contractually required to step in and repay this debt.

South African Broadcasting Corporation

Government allocated R3.2 billion to the South African Broadcasting Corporation (SABC) through the contingency reserve in the current year. The funds are intended to help the SABC pay its bills, acquire new content and conduct maintenance. To date, government has released R2.1 billion of these funds based on the SABC's progress in meeting associated conditions. The National Treasury is working with the Department of Communications and Digital Technologies to ensure that the SABC progresses towards meeting the rest of the conditions before releasing the remaining R1.1 billion. A chief restructuring officer will be appointed to implement a revised turnaround plan.

South African National Roads Agency Limited

Since 2014/15, the South African National Roads Agency Limited (SANRAL) has incurred annual average losses of R1 billion. The agency is not generating sufficient cash from its toll portfolio to settle operational costs and debt redemptions falling due over the next three years. Government has extended a total guarantee facility of R38.9 billion to the agency, of which R30.3 billion had been used by 31 March 2019. Over the medium term, SANRAL is expected to repay R10.7 billion of maturing debt obligations and R10.8 billion worth of interest payments. To enable SANRAL to pay these obligations, government will implement direct user charges as outlined in the White Paper on National Transport Policy.

Road Accident Fund

The Road Accident Fund (RAF) is projected to become government's largest contingent liability by 2021/22, despite receiving an ever-increasing share of combined fuel tax revenues.

Figure A.7 Collections on combined fuel taxes

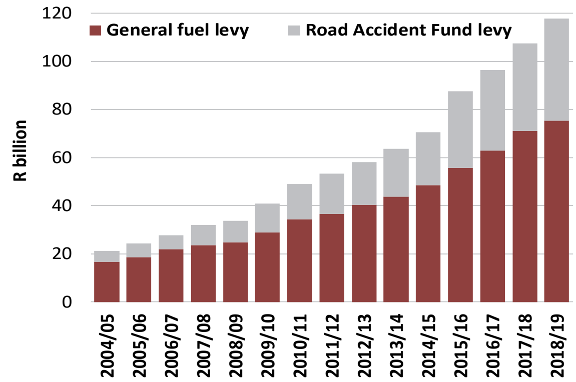
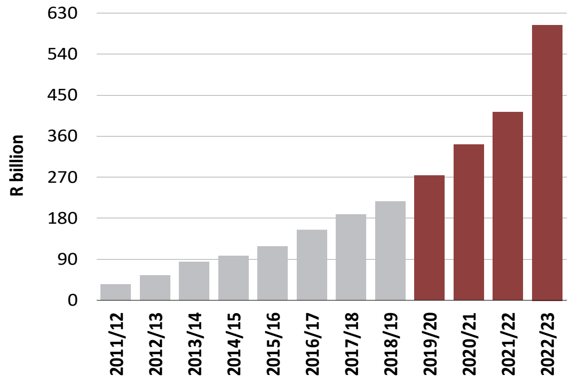


Figure A.8 Road Accident Fund liabilities



Source: National Treasury

In 2004/05, RAF levy collections accounted for 22 per cent of combined fuel taxes; by 2018/19, they had risen to 36 per cent. Claims against the fund have grown much faster than the increases in the RAF fuel levy, resulting in insufficient revenue growth to offset growth in liabilities. RAF liabilities are expected to grow from R341 billion in 2019/20 to R605 billion in 2022/23. Addressing the growing gap between revenue and liabilities requires a transition to the Road Accident Benefit Scheme, which would provide more equitable and sustainable support to accident victims.

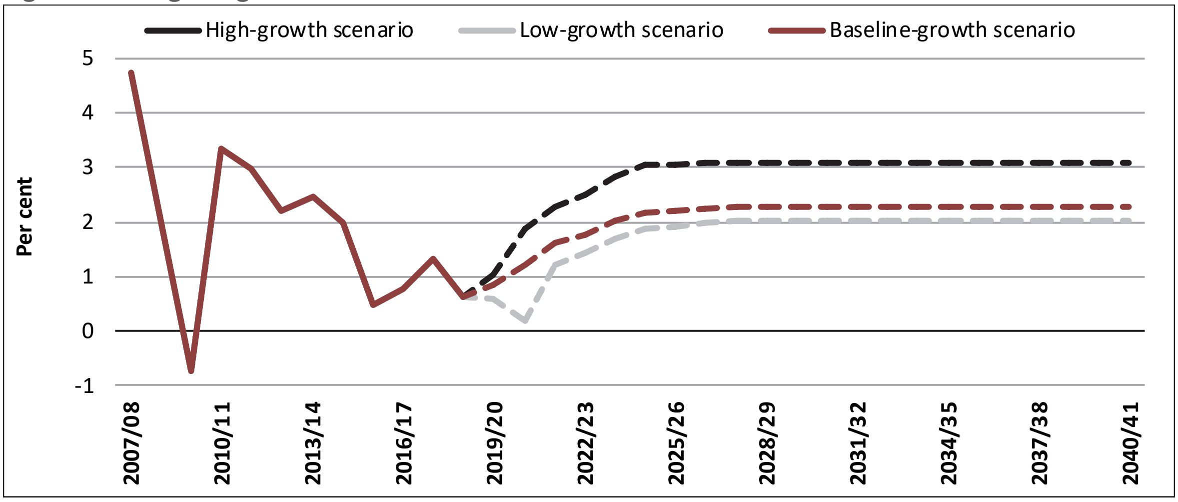
Long-term fiscal sustainability of social spending

The National Treasury maintains a long-term fiscal model that it uses to cost new policy initiatives and determine the sustainability of current expenditure commitments under certain assumptions of economic and demographic growth. There are three major changes to the assumptions in this update: lower long-run economic growth, lower inflation expectations and a demographic scenario that projects higher population growth.

Long-term results are highly sensitive to changes in assumptions, as the effect of even a small change in an assumption is compounded over decades. The results in this section depend on the assumptions discussed above, as well as sector-specific cost trend and policy assumptions. In the baseline scenario, social spending on grants, education and health is broadly sustainable over the long term, as lower long-run growth is largely offset by lower inflation.

The baseline scenario assumes that GDP growth will average between 2 and 2.3 per cent, which is lower than previously assumed. Chapter 2 discusses the reasons behind lower long-term growth. The baseline demographic scenario produced by Statistics South Africa projects that population growth will continue to decelerate, from 1.6 per cent in 2018 to 1 per cent in 2040. The population is expected to grow from 58 million currently to 76 million by 2040. As a result, real output per capita is forecast to grow by an average of 0.7 per cent between 2020/21 and 2030/31, and by 1.2 per cent between 2030/31 and 2040/41.

Figure A.9 Long-run growth scenarios



Source: National Treasury

In the low-growth scenario, investment and job creation remains muted. In this case, maintaining government's current policy commitments will be difficult and will require repeated adjustments to either revenue or expenditure. The high-growth scenario assumes long-run growth of 3.1 per cent, which would ease fiscal pressures from social spending. This is based on the expectation that government will undertake the reforms outlined in Chapter 2.

Social assistance

The baseline scenario projects that beneficiary numbers will grow from 17.9 million in the 2019/20 to 22.5 million in 2040/41. The uptake rate of grants is expected to stabilise at current levels. Given these trends, spending on social assistance is expected to remain relatively stable at 3 per cent of GDP.

Basic education

Spending on basic education has averaged about 5 per cent of GDP over the past decade. Expenditure has largely been driven by rising teacher wages, which grew by an average of 9 per cent annually over the past five years. At the same time, teacher headcount growth has remained relatively flat. As a result, spending has been relatively stable. Assuming wage trends continue, spending on basic education would increase to between 5 and 6 per cent of GDP by 2040 to avoid significant growth in class sizes.

Health

South Africa spends about 8.5 per cent of GDP on health services, about half of which goes to the public health sector. Over the last 13 years, public and private spending on healthcare has grown by an annual average of 10 per cent. In the public sector, above-inflation wage increases for public-sector healthcare workers account for a disproportionate amount of this growth.

The National Health Insurance Bill was tabled in Parliament earlier this year. Assuming this bill is adopted, public health spending is expected to rise from about 4 per cent currently to between 5 and 6 per cent of GDP over the long term.

Higher education

The 2018 Budget expanded spending allocations for higher education and training to cover students from poor and working-class families. Once this policy is fully implemented, between 50 and 60 per cent of undergraduate university students and all students in technical and vocational education and training (TVET) colleges are expected to be fully subsidised.

Historically, higher education and training costs have outpaced inflation, largely because of above-inflation wage increases and some purchases in foreign currency. Assuming this trend continues, then the costs of university education would grow from 1.4 per cent of GDP in 2019/20 to 2 per cent of GDP in 2040. In this context it would be difficult to sustain the current policy of fully subsidised higher education training. A more sustainable fees policy, closely aligned with CPI inflation, would result in a more gradual increase in spending on university education to 1.5 per cent of GDP by 2040. The Department of Higher Education and Training is developing such a policy with higher education institutions.

Staffing costs, driven by enrolment rates, dominate costs in TVET colleges. If enrolment remains stable at around 700 000 students per year, spending in the TVET sector will decline over the long term from 0.3 to 0.2 per cent of GDP. However, enrolment growth in line with the 2013 White Paper on post-school education and training would raise the costs of subsidising TVET colleges to 0.6 per cent of GDP by 2040. This level of subsidy would be difficult to sustain over the long term.

Conclusion

The outlook for fiscal risks has deteriorated sharply over the past year. The public finances are highly vulnerable to the three principal risks covered in this statement. Achieving the economic and fiscal objectives set out in this *Medium Term Budget Policy Statement* will require a significant effort across the entire public sector to prevent these risks from materialising – and, where that is not possible, to mitigate and manage their consequences.