

ANNEXURES

A

Fiscal risk statement

Introduction

The 2016 *Medium Term Budget Policy Statement* identified South Africa's most significant fiscal risks as lower-than-expected economic growth, the possibility of claims against the guaranteed debt of some state-owned companies and higher-than-expected increases in compensation budgets.

The first two risks have materialised.

The current outlook is characterised by a deteriorating macroeconomic position over the medium term, severe revenue underperformance, expenditure pressures, and contingent liability risks that are beginning to crystallise. Sources of uncertainty include decisions on the scope of funding for higher education and the outcome of public-service wage negotiations.

Government's approach to reporting risks to the fiscal outlook is summarised in Figure A.1.

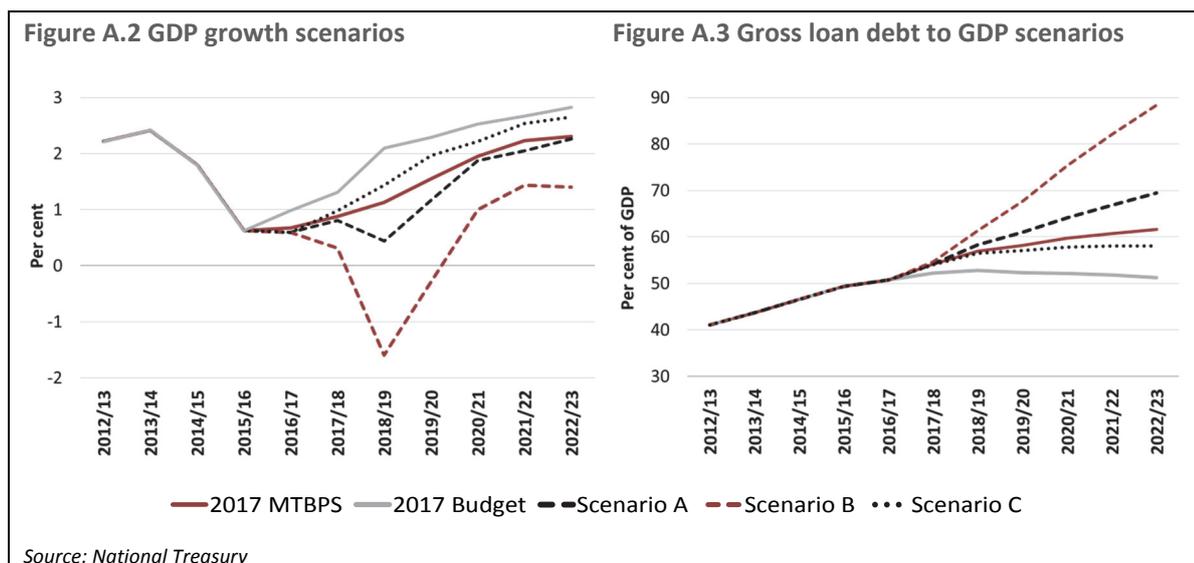
Figure A.1 The fiscal risks framework

| Risk category | Major issues considered under each sub-topic |
|------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Macroeconomic risks | <ul style="list-style-type: none">▪ Impact of slower-than-expected nominal GDP and revenue growth▪ Debt sustainability under different economic scenarios▪ Effect of the macroeconomic outlook on expenditure and debt-servicing costs |
| Policy and budget execution | <ul style="list-style-type: none">▪ Unplanned or emergency spending requests leading to pressures on the expenditure ceiling▪ Implementation risks around proposed in-year expenditure estimates▪ Costs of poorly planned infrastructure projects |
| Contingent and accrued liabilities | <ul style="list-style-type: none">▪ Quality of guarantee exposures, particularly to state-owned companies▪ Governance, profitability and debt obligations of public-sector institutions |
| Long-term spending commitments | <ul style="list-style-type: none">▪ Impact of long-run growth, demographic changes and new policy proposals |

Macroeconomic risks

As noted in Chapter 3, the most serious risk to medium-term revenue collection is a further deterioration in the economic outlook. A related risk is uncertainty about tax buoyancy – the ratio of revenue growth and economic growth – which can be affected by the composition of GDP, taxpayer compliance and tax administration. Excluding next year’s proposed tax increase of R15 billion, the current baseline assumes a buoyancy of 1.1 in 2018/19. However, if buoyancy were to decline to 1.0, the tax shortfall would increase by R8.5 billion.

To assess the magnitude of macroeconomic and fiscal risks, the National Treasury developed three scenarios around the baseline economic forecast. The baseline fiscal outlook is presented in Chapter 3.



Scenario A – Local currency downgrade with limited effects. The local currency rating is downgraded due to the weak growth trajectory and widening fiscal deficits. Growth slows to 0.6 per cent in 2018 and 0.9 per cent in 2019. However, the impact on capital flows and interest rates is limited by stronger world growth and increased global risk appetite. The yield on long-term government bonds is 90 basis points higher on average compared to the baseline. Inflation expectations remain well anchored.

Scenario B – Local currency downgrade with pronounced effects. The local currency rating is downgraded without the offsetting benefits of strong global growth. GDP contracts by 1.2 per cent in 2018 and 0.8 per cent in 2019. The risk premium increases by 200 basis points and remains at that level. The yield on long-term government bonds is 180 basis points higher on average compared to the baseline. Borrowing costs increase, while investment and consumption decline. Inflation peaks at 6.6 per cent in 2018.

Scenario C – Higher global growth and commodity prices. Global growth improves by an annual average of 0.5 percentage points over the medium term. Export commodity prices increase by 5 per cent over the same period. The risk premium is 50 basis points lower than in the baseline scenario, reflecting lower global risk aversion. GDP growth increases to 1.4 per cent in 2018. By 2020, GDP growth is 2.4 per cent, as higher incomes promote stronger consumption and investment demand. Inflation remains well anchored in the 3-6 per cent target band and the rand is slightly stronger compared to the baseline. Bond yields are 30 basis points lower on average compared to the baseline.

The scenarios assume that no new revenue or expenditure measures are taken to compensate for fiscal slippage. The fiscal results of the scenarios are as follows:

- **Scenario A** would result in the primary deficit widening to 2.0 per cent of GDP by 2020/21. The cumulative tax revenue shortfall against the 2017 MTBPS baseline would be between R130 billion

and R140 billion owing to the effect of lower buoyancies and weaker nominal GDP growth. As a result, the debt-to-GDP ratio would not stabilise.

- **Scenario B** would result in an even larger fiscal slippage. The cumulative tax revenue shortfall over the 2018 medium-term expenditure framework (MTEF) period would be between R400 billion and R450 billion. The primary deficit would widen to 4.9 per cent over the medium term and remain above 4 per cent over the longer term. Debt would grow rapidly, reaching over 80 per cent of GDP by 2022/23.
- **Scenario C** also results in a primary deficit over the medium term. However, the primary balance would close and go into surplus over the long term. Higher GDP growth would lead to improved tax revenue collection over the next three years. As a result, debt would stabilise at 58.0 per cent of GDP in 2021/22.

The fiscal scenarios assume that South Africa would be able to increase borrowing from capital markets at affordable rates. However, in the event of a much worse fiscal position, accompanied by further credit ratings downgrades, it is likely that bond yields would rise and the exchange rate would depreciate. Both developments would increase debt and debt-service costs. Given the persistence of the current account and budget deficits, sharply higher bond yields and currency depreciation could prompt significant turmoil in domestic capital markets, reinforcing a cycle of fiscal deterioration.

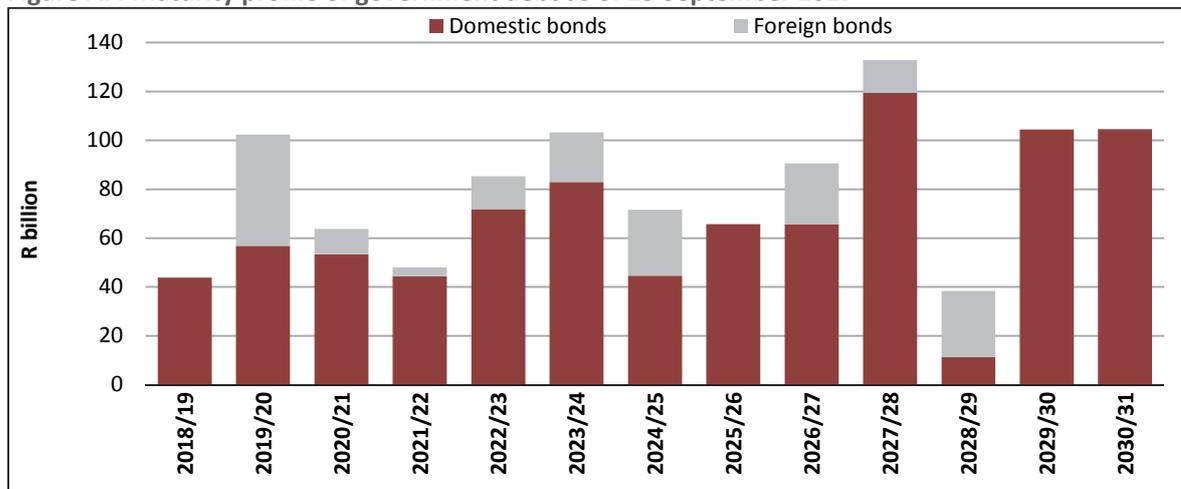
Macroeconomic risks and debt management

Over the next decade, redemptions of domestic and foreign debt are projected to increase, as shown in Figure A.4.

The main macroeconomic variables that affect government's ability to service its debt are economic growth, inflation, exchange rates and interest rates. A significant proportion of debt is linked to inflation. A sudden spike in inflation would increase both the debt stock and debt-service costs. An exchange rate depreciation would also raise debt-service costs and lead to an upward revaluation of debt stock.

Interest rates are affected by domestic and global events. Domestic factors mainly relate to perceptions of macroeconomic and fiscal policies. If there is widespread belief that the public finances are unsustainable or vulnerable to a shock, the risk premium on debt could rise, increasing interest rates and debt-service costs. Global events that could lead to higher interest rates include tightening financial conditions and major geopolitical risks.

Figure A.4 Maturity profile of government debt as of 29 September 2017



Source: National Treasury

Over the medium term, government's bond-switch programme – which exchanges short-term for longer-term debt – and growing cash balances will mitigate this risk. However, the bond-switch programme itself poses a risk if it raises the effective interest rate paid by government on debt, potentially leading to higher debt-service costs.

South Africa's sovereign debt stock is well-structured and remains comfortably within global best-practice benchmarks. Global investors hold about 41 per cent of total outstanding debt securities (including foreign-denominated issuances), indicating a potential exposure to capital flight. 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.

Medium-term policy and budget execution risks

Policy risks include unplanned spending requirements that cannot be accommodated within the expenditure ceiling. Budget execution risks emerge when departments or entities exceed their spending ceilings. At the aggregate level, budget execution has been good. Spending outcomes in 2016/17 remained within the expenditure ceiling. The main medium-term expenditure risks are the public-service wage bill and additional funding needs for higher education. Demands for additional financial support to state-owned companies, which are likely over the medium term, are discussed later in this chapter.

Over the three-year spending period ahead, the contingency reserve amounts to R16 billion, which is considerably smaller than it has been in previous budgeting cycles. This diminishes government's capacity to respond to spending risks.

Departments have proposed a range of policy interventions that are currently not funded. These include significant additional funding for the post-school education and training system, national health insurance (NHI), qualified teachers for Grade R, the implementation of the Defence Review, land restitution and large infrastructure projects.

The most pressing is higher education, where government is considering options to increase affordability for students. The additional funding required for the post-school and education sector is difficult to determine without firm policy guidelines. However initial costing of the options suggests that the funding requirement could range from R17.7 billion to R40.7 billion in 2018/19. Medium-term options are discussed in detail in Chapter 4, and the long-term costs of higher education are discussed later in this annexure.

The primary budget execution risks stem from:

- **Departmental spending limits on compensation of employees.** Assuming stable personnel numbers and salary increases pegged to Consumer Price Index (CPI) inflation, National Treasury expenditure estimates for national departments exceed next year's budgeted compensation ceilings. The departments of Defence and International Relations and Cooperation will need to take strong remedial measures to avoid exceeding their compensation ceilings. Such action can take the form of shifting resources from other budget lines into compensation, limiting recruitment of new personnel or finding other means to reduce headcounts. Many other national and provincial departments – provincial health in particular – are facing similar pressures.
- **Public-service wage negotiations.** The shortfall in compensation budgets will deteriorate substantially if the public-service wage talks leads to an agreement that exceeds CPI inflation. For example, a CPI + 1 agreement would raise the national shortfall in 2018/19 to R8.2 billion, with the gap in provincial compensation budgets amounting to R4 billion. At this level, a three-year agreement would push the national shortfall to R11.8 billion by 2020/21, and provincial compensation spending would need to increase by R12.7 billion.

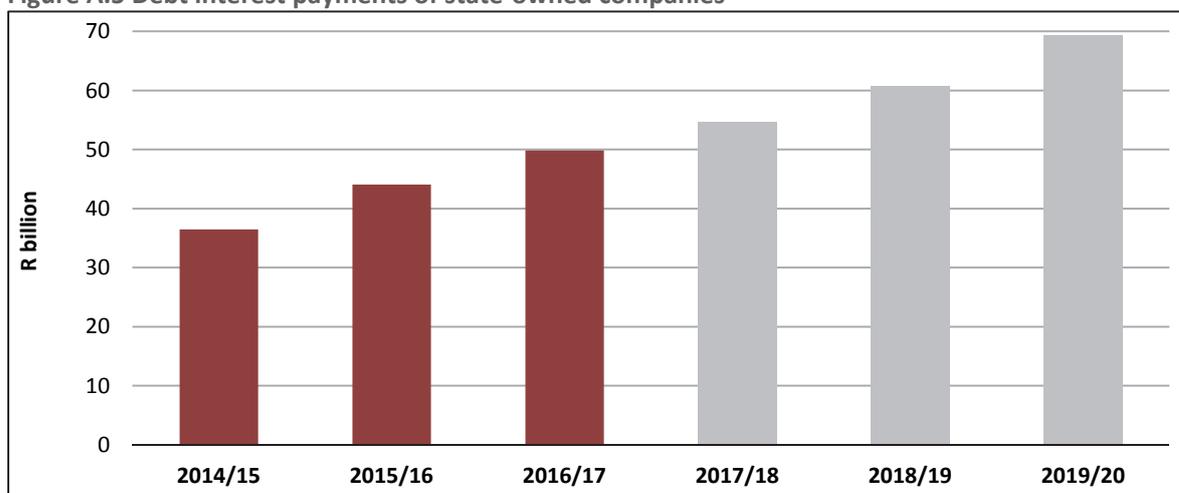
- **Unpaid provincial invoices.** Many provincial departments are delaying payment of bills, contributing to a rising hidden deficit that poses significant budget execution risks. Provinces started the current financial year with unpaid bills of R26.4 billion from 2016/17, a 30 per cent increase from the prior year. Health departments accounted for 52.6 per cent of unpaid bills.
- **Medical negligence claims.** Medical negligence claims are legal claims for malpractice (e.g. leading to lifelong disability) in public health facilities. Although some of these claims are legitimate, others are unjustified or excessive. Estimated pay-outs for medical negligence claims have grown at an average rate of 45 per cent since 2012/13, and amounted to R1.2 billion in 2016/17. The contingent liability arising from claims against the state at the end of 2016/17 totalled an estimated R56 billion. The Department of Health is considering establishing teams of clinical and legal experts to help defend provinces against unjustified or excessive claims.
- **Financial management challenges in municipalities.** Weak financial management, high remuneration levels and poor maintenance of infrastructure threaten the sustainability of some municipalities. While demand for services has risen, low levels of economic growth have put pressure on consumers' ability to pay for services, while transfers from national government are growing more slowly than in the past. As a result, some municipalities have fallen into financial distress and face liquidity problems. To manage these difficulties, these municipalities are delaying payments to Eskom, water boards and other creditors, contributing to financial imbalances in other parts of the public sector.

Contingent liability risks

Government's major explicit contingent liabilities are its guarantees. Total guarantees issued to public institutions, independent power producers and public-private partnerships stood at R688.8 billion in 2016/17. Total guarantee exposure was R445 billion, because several entities had not fully used their available guarantee facilities. Between 2011/12 and 2016/17, the combined profitability of the state-owned companies, measured by return-on-equity, declined from 7.5 per cent to an estimated 0.2 per cent. A growing portion of their operating expenditure is funded through debt.

Lenders, alarmed by governance failures, are taking a more active stance. As a result, state-owned companies are having difficulty raising debt, or are forced to refinance debt at higher rates. This situation creates liquidity challenges, leading to greater demands on the fiscus. Addressing this requires not only stabilisation measures at troubled entities, but a broader restructuring of state-owned companies and an acceleration of the reforms highlighted in recent editions of the *Budget Review*.

Figure A.5 Debt interest payments of state-owned companies*



* Entities listed in schedule 2 and 3 of the PFMA

Source: National Treasury

Total interest payments by state-owned companies are projected to increase from R49.8 billion in 2016/17 to R69.3 billion by 2019/20. Given the sharp increase in interest commitments, some entities may have insufficient cash to settle their obligations unless immediate reforms are implemented to improve governance and boost profitability.

The largest government guarantees are described below.

Eskom

The largest state guarantee (R350 billion) supports Eskom's capital investment programme. Eskom is experiencing financial turbulence because of weak governance. This has led to a qualified audit opinion and a violation of some debt covenants with lenders. Eskom forecasts that electricity sales growth over its planning period will be flat, with revenue growth secured through tariff increases. However, the National Energy Regulator of South Africa could grant tariff increases below Eskom's application, as it did during the multi-year price determination process for April 2013 to March 2018. There are also risks that sales growth will perform below projections, or decline as households and businesses improve their energy efficiency. If this happens, Eskom will likely apply for even steeper tariff increases.

Any of the options required to stabilise Eskom could have significant fiscal implications. If higher tariffs slow economic activity, tax revenue collections will be lower, delaying government's fiscal objectives of closing the deficit and stabilising debt. However, if Eskom does not secure sufficiently high tariff increases its financial position may weaken, requiring it to seek government assistance.

Government has extended its R350 billion guarantee from 31 March 2017 to 31 March 2023 because of delays in Eskom's capital investment programme. The extension of the guarantee will allow Eskom to use the remaining portion to complete its planned capital expenditure programme. The Eskom board has developed a plan to address governance concerns that they will share with lenders. The regulator is expected to rule on Eskom's application for a tariff increase for 2018/19 as well as its Regulatory Clearing Account application. If these applications are successful it would represent a step-change in Eskom's future revenues. Combined with strong cost management, this could allow the utility to cover all its obligations without fiscal support.

South African National Roads Agency Limited

Government provided SANRAL with a R38.9 billion guarantee to expand its toll roads portfolio. In response to public concerns about electronic tolling in Gauteng, SANRAL introduced a lower-cost dispensation. However, collections remain lower than projected, making it difficult for the agency to service its debt. Government has clarified the conditions of the SANRAL guarantee. This gives SANRAL more room to borrow under the guarantee and allows the agency to service all its commitments over the medium term. Over the long term, an improvement in toll revenue collection is needed to ensure SANRAL's sustainability. If government does not proceed with tolling to fund major freeways, difficult trade-offs will need to be made 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 continues to operate as a going concern. Total recapitalisation of R10 billion will be provided in 2017/18. An amount of R5.2 billion has already been provided, with the remaining R4.8 billion to be transferred by 31 March 2018. These funds will be used for working capital and to settle debt, enabling the airline to reduce its interest expenses. Even after the capital allocation, government's exposure to SAA debt remains significant at R15 billion. There is risk that if SAA's financial fortunes do not improve, there will be further calls on the remaining guarantee. A new, full-strength board has been tasked with returning the airline to financial sustainability. The appointment of a permanent chief executive officer, who will start on 1 November 2017, is a critical step in ensuring that the airline's turnaround strategy is aggressively implemented. If SAA executes a successful turnaround in line with its projections by 2019/20, its reliance on guarantees will subside, as will government's risk exposure.

Denel

Arms manufacturer Denel faces refinancing and default risk on government-guaranteed debt amounting to R1.85 billion. The group has struggled to refinance debt due to concerns about corporate governance failures and corruption. Government has extended Denel's guarantee to 30 September 2018. The group has exited the Denel Asia Joint Venture, which it entered into with VR Laser Asia in January 2016, and has withdrawn its court case against the National Treasury and the Minister of Finance.

Trans-Caledon Tunnel Authority

Government has issued a R25.7 billion guarantee to the TCTA. The agency relies on payments from the Department of Water and Sanitation's Water Trading Account to settle obligations with lenders. Weak financial management at the department threatens the ability of the TCTA to meet its commitments, raising the likelihood of a call on the guarantee. In the long term, government's ability to deliver water infrastructure could be compromised.

Road Accident Fund

The RAF has been insolvent for over 35 years and its total liabilities continue to grow to unsustainable levels. An immediate concern is claim amounts that have been settled in court but not yet paid. These amounted to about R8.5 billion at the end of 2016/17 and are forecast to grow over the medium term. Government has tabled legislation to create an equitable and affordable benefit arrangement to replace the fund. The replacement scheme is expected to significantly reduce costs, but will not eliminate the accumulated liability of the current fund.

Long-term spending commitments

The National Treasury regularly updates its long-term fiscal model to determine the sustainability of its major social spending commitments. The outlook for these programmes is largely determined by demographic changes, GDP growth, sector-specific cost pressures and trends in the use of public services.

Population estimates have changed significantly over the past few years. The National Development Plan (NDP) had 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. The increase largely reflects an unanticipated spike in fertility rates in the 2000s. This has been reflected in higher-than-expected enrolments in primary schools, and will affect high school enrolment rates from 2018. At the same time, infant mortality has been declining for a number of years, and life expectancy rates have been increasing. Higher numbers of young and older people place additional pressure on the public finances, because a large portion of social spending is directed towards these two age groups.

Since the National Treasury initially presented its fiscal modelling results in 2014, the economic growth outlook has been revised down. This has led to lower estimates of long-term potential growth and a higher expenditure-to-GDP ratio. The current modelling exercise assumes low, baseline and high growth scenarios, with long-term real GDP growth stabilising at 1.5, 2.5 and 4.5 per cent respectively. If growth remains at 1.5 per cent (the average over the past five years), spending would likely grow sharply as a share of GDP from current levels, even if no new policy initiatives are undertaken. If growth remains fixed at about 2.5 per cent (average growth over the past decade), spending is likely to grow gradually as a share of GDP over the coming decade. At a minimum, economic growth of about 3 per cent is required to sustain current spending commitments.

In addition to analysing the trend of current commitments, the National Treasury regularly models the costs associated with policy choices under consideration in government.

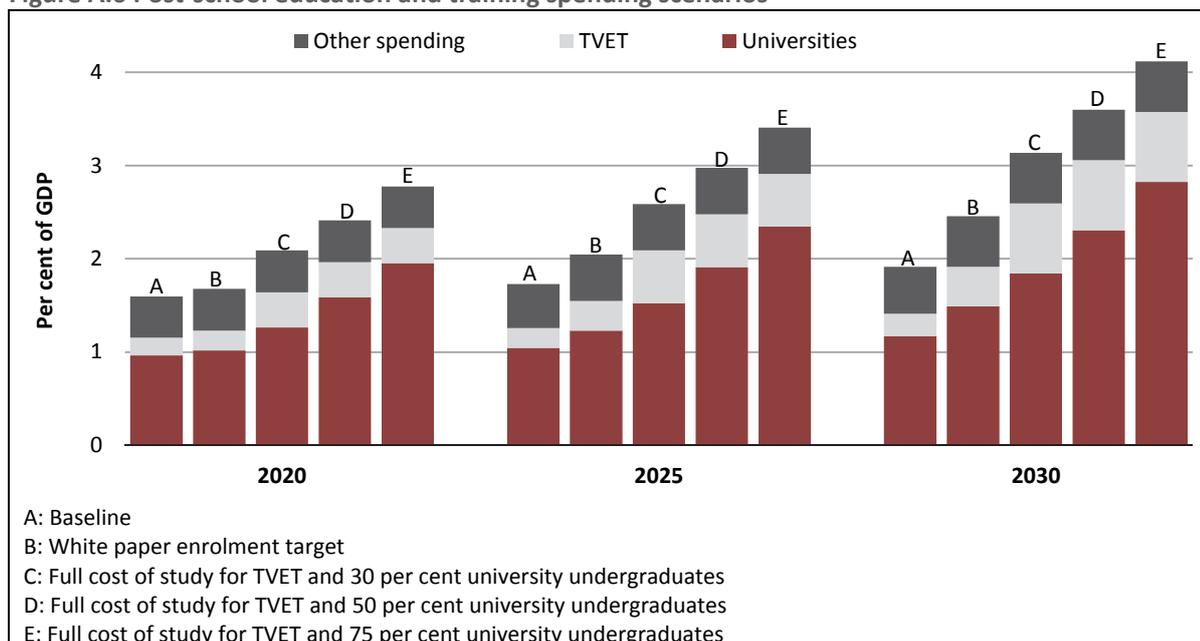
Post-school education and training

Major reforms are being considered in post-school education and training. The white paper on post-school education and training proposes to significantly increase enrolments at universities and technical and vocational education and training (TVET) colleges. The Commission of Inquiry into Higher Education and Training has submitted its report to the President on the feasibility of providing fee-free higher education. In addition, government is exploring the possibility of providing financial aid towards the full cost of study for students from poor and middle-income households.

Working with the Department of Higher Education and Training, the National Treasury has estimated the costs of achieving the enrolment targets set out in the white paper, as well as the costs of providing financial aid to cover full cost of study to 30 per cent, 50 per cent and 75 per cent of undergraduate university students. In the white paper scenario, university enrolments increase from about 980 000 in 2015 to 1.6 million by 2030. TVET enrolments grow from about 730 000 to 2.5 million over the same period. At a minimum, these changes would result in public expenditure on post-school education and training rising from 1.4 per cent to 2.5 per cent of GDP. This projection assumes, however, that fees and other forms of income would keep pace with the rise in enrolments. A more probable scenario is that government would have to fund shortfalls from fees and other income sources, shouldering an increasing share of total post-school education and training costs.

If government were to target the white paper enrolment rates while providing additional subsidies to poor and middle-income students, spending would increase more rapidly. Providing financial aid for the full cost of study to 75 per cent of undergraduate university students, for example, would push post-school education spending up to 4.1 per cent of GDP by 2030/31.

Figure A.6 Post-school education and training spending scenarios



Source: National Treasury

National health insurance

Public health expenditure is driven by population growth, service utilisation rates and costs – with the latter element typically growing more rapidly than CPI inflation. A combination of growing utilisation, an ageing population and significant cost pressures means that health spending is likely to grow as a share of GDP even without policy changes.

Cabinet adopted the white paper on NHI in June 2017. The white paper estimates that full implementation of NHI would increase public health spending from 3.9 per cent in 2017/18 to 6.2 per cent of GDP by 2025/26. This projection assumes a long-term economic growth rate of

3.5 per cent. However, working with an assumed economic growth rate of 2.5 per cent and the white paper's costings, the National Treasury estimates that full implementation of the NHI will increase public health expenditure to 6.8 per cent of GDP in 2025/26.

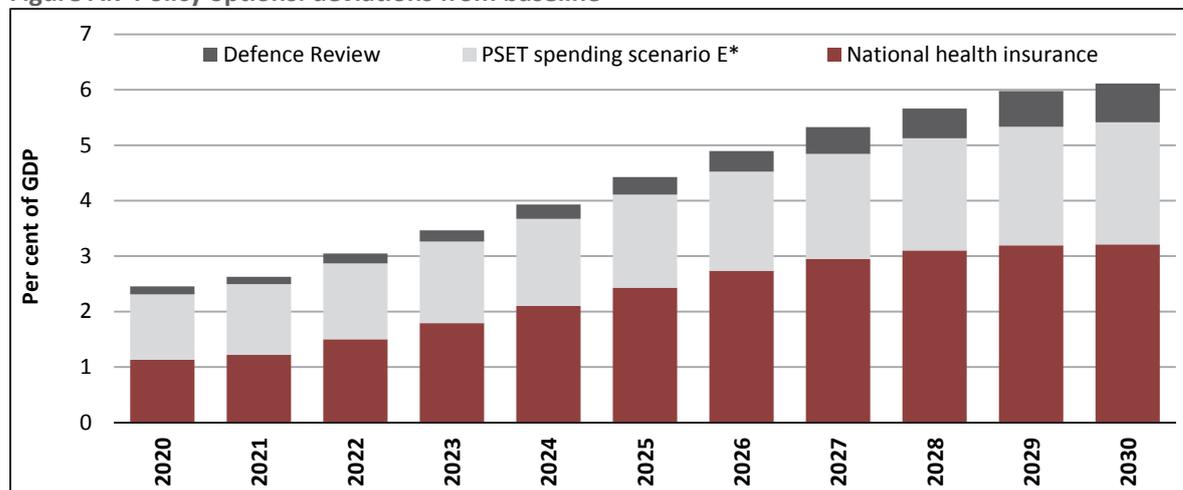
Social grants

Spending on social grants is driven by changes in the number of grant recipients and grant values. The baseline scenario projects that the number of grant recipients will grow from 17.3 million in the current year to 23.5 million recipients by 2030/31, with grant values increasing in line with CPI inflation. In the baseline growth scenario, social grants rise from 3.3 per cent of GDP to a peak of 3.5 per cent in 2030, before declining slowly thereafter. Even in the low-growth scenario, grant expenditure is projected to peak at 3.8 per cent of GDP.

Defence Review

Recommendations flowing from the Defence Review, if implemented in full, would add R53.3 billion to defence expenditure over the next six years. Over the longer term, the review proposes that defence spending grow from the current level of 1 per cent of GDP to 2 per cent of GDP.

Figure A.7 Policy options: deviations from baseline



*Post-school education and training: TVET and 75 per cent university undergraduates (see Figure A.6)

Source: National Treasury

Beyond current spending commitments on health, defence and higher education, the implementation of NHI, the Defence Review and scenario E of the post-school education and training projections would require additional spending of 6 per cent of GDP by 2030. In the absence of higher economic growth, several of government's current policy commitments will need to be revisited, because their cost implications appear to exceed available resources.

Conclusion

Fiscal risks are elevated over the medium term, 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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