Fiscal risk statement

Introduction

This statement focuses on medium- and long-term risks to the public finances. Short-term risks are outlined in Chapter 3 of the *Medium Term Budget Policy Statement*. The fiscal risk statement also provides an update on the fiscal sustainability of government's social policy commitments, based on updated demographic and pricing estimates. The main risk categories are outlined in Figure A.1.

Figure A.1 Fiscal risk framework

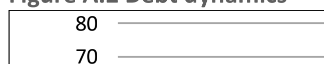
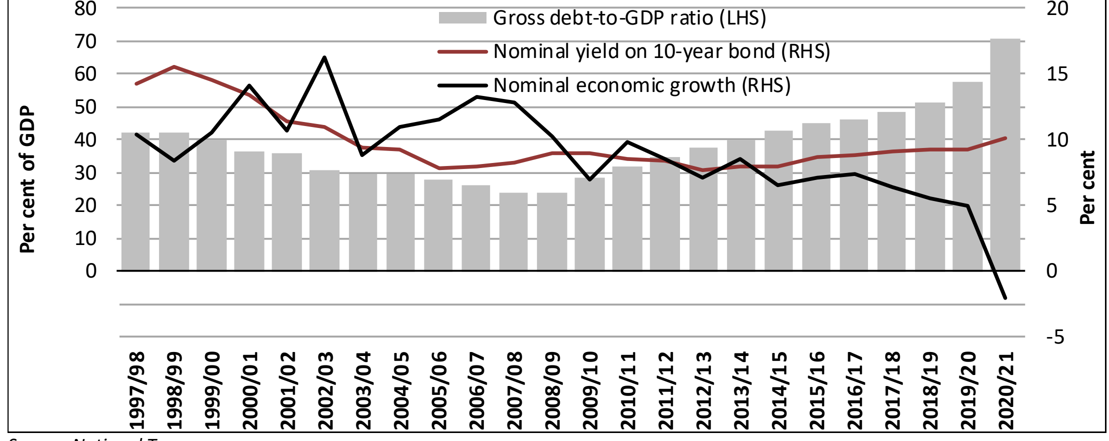
Risk category	Major issues considered under each sub-topic
Macroeconomic risks	▪ Declining economic growth ▪ Interest and exchange rates ▪ Debt trajectory
Expenditure risks	▪ Compensation costs ▪ National health insurance ▪ Subnational government
Contingent and accrued liabilities	▪ Government guarantees ▪ Financial position of state-owned companies
Sustainability of social expenditure	▪ Effects of pricing and demographic changes ▪ Effects of lower long-run growth

Macroeconomic risks

Since the 2008 global financial crisis, economic growth has trended downwards, resulting in persistent shortfalls in tax revenue that have not been matched by adjustments to spending growth. This in turn has led to wider budget deficits, higher borrowing and a rapid increase in the ratio of debt to GDP.

Because the interest rate government pays on its borrowing exceeds the rate of GDP growth, this ratio will continue to increase until government runs a sufficiently large primary budget surplus. The size of the surplus needed to stabilise the debt-to-GDP ratio depends on the gap between the interest rate and the rate of growth, as well as the existing level of indebtedness.

Figure A.2 Debt dynamics

Source: National Treasury

Scenarios around the baseline economic forecast

The baseline economic forecast (presented in Chapter 2) underpins the fiscal framework. Small changes to assumptions in the baseline can have significant effects on variables such as GDP growth, inflation, interest and exchange rates. To illustrate this, two alternative scenarios have been modelled.

Scenario A shows the effect of lifting the licensing threshold for embedded electricity generation, which causes more rapid investment in generation capacity and lifts overall investment, alleviating the electricity constraint and improving business confidence. The primary budget surplus reaches 0.3 per cent of GDP in 2024/25 due to stronger economic growth, and the debt-to-GDP ratio stabilises at 76.5 per cent in 2025/26. Conversely, Scenario B shows global financial conditions tightening more rapidly than expected, leading to slower global GDP growth, higher interest rates and currency depreciation. This in turn will result in higher inflation and slower growth in South Africa. Tightening financial conditions lead to higher debt-service costs, and the debt-to-GDP ratio stabilises at 79.9 per cent in 2025/26.

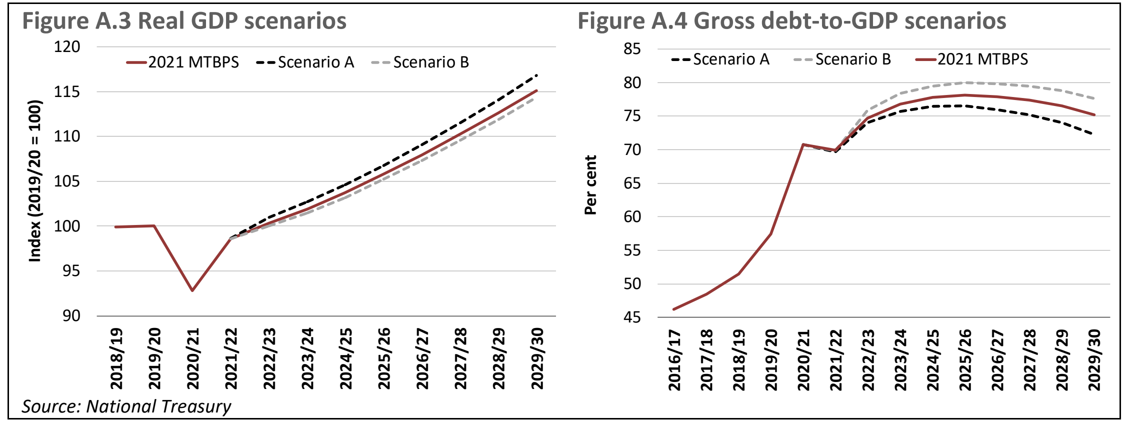


Figure A.3 Real GDP scenarios | **Figure A.4 Gross debt-to-GDP scenarios**

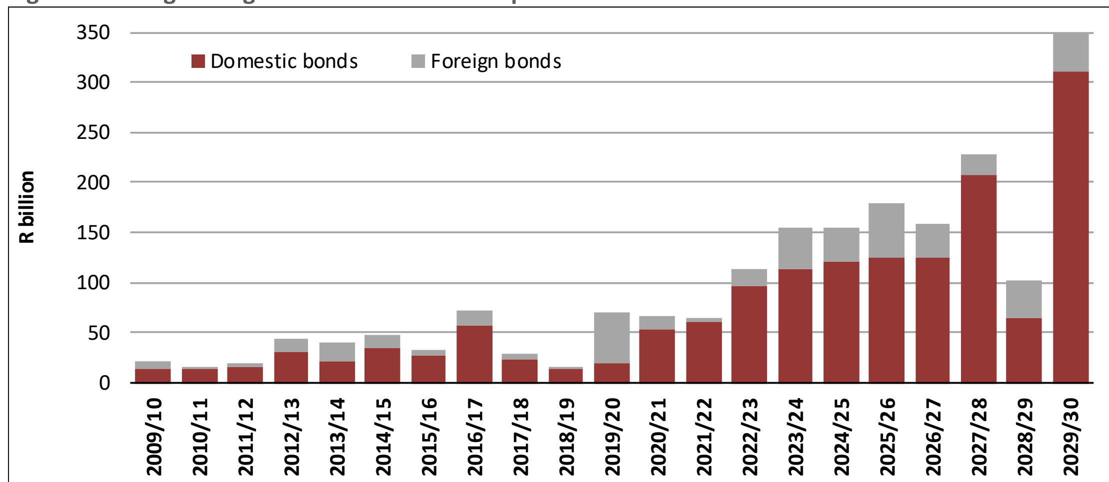
Source: National Treasury

Debt trajectory

Since 2009/10 government has been running large budget deficits, resulting in an increase in debt stock from R805 billion in 2009/10 to about R5.5 trillion in 2024/25. Over the same period, debt-service costs

increased from about R57 billion to R365.8 billion, crowding out expenditure on essential services such as health, social development, and peace and security. To put public debt on a sustainable trajectory, government's fiscal consolidation allocates a portion of unanticipated current and future revenue towards reducing government's gross borrowing requirement. Over time, this will reduce debt levels and debt-service costs.

Figure A.5 Long-term government debt redemptions



Source: National Treasury

Expenditure risks

Compensation spending

Employee compensation absorbs a high level of public expenditure. Government is working with public-service trade unions to find a fair and sustainable approach to remuneration. Apart from the matters described in Chapter 3 and Annexure B, a specific risk to the fiscal framework now lies with the judiciary. If the Constitutional Court overturns the Labour Appeal Court's decision that the 2018 wage agreement was unlawful and that government could not be compelled to honour it, the state may be required to implement the agreement retroactively. Such a decision would have significant effects on the fiscal framework. Should this occur, government would have to consider a reduction in the size of the public service and other fiscal adjustments.

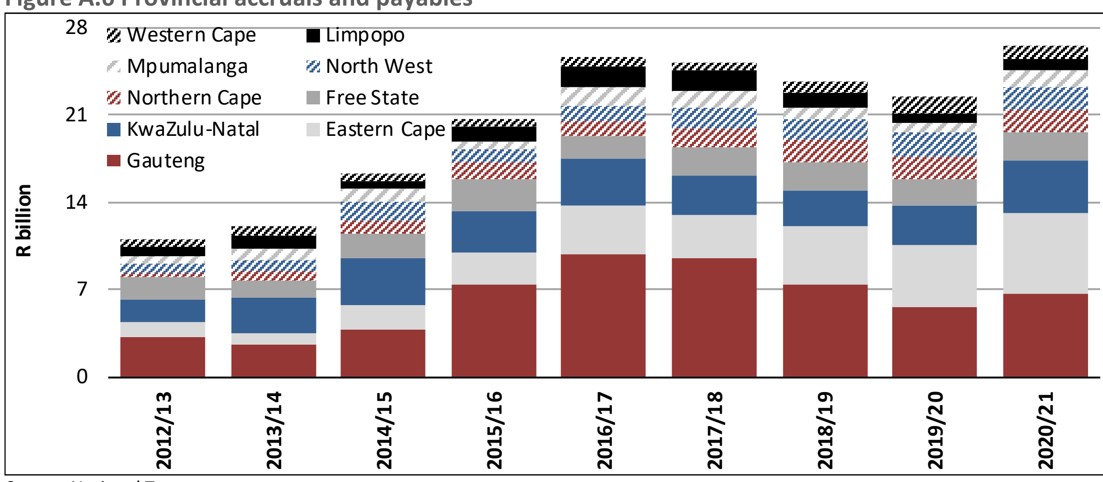
National health insurance

A limited costing of the national health insurance policy proposal has previously shown that it would require about R40 billion per year in additional funding in the first five years, and perhaps considerably more over time. At present, however, there is insufficient capacity in the health sector to work substantively on national health insurance. The *national health insurance indirect grant* has been underspent, the National Health Insurance Fund has not yet been established and the National Health Insurance Bill still needs to be passed by Parliament. It is therefore unlikely that national health insurance will be a significant cost pressure in the medium term.

Subnational government risks

Unpaid provincial invoices increased from R22.4 billion in 2019/20 to R26.6 billion in 2020/21, with R14.2 billion due within 30 days. The accumulation of these short-term liabilities affects procurement budgets for subsequent years, as provinces will need to pay down accruals before purchasing goods and services.

Figure A.6 Provincial accruals and payables



Source: National Treasury

Although the payment of medico-legal claims remained stable at R1.7 billion in 2020/21, estimates of potential liability show that these remain a risk to the fiscus. Government is seeking statutory reform that would reduce state liability for medical claims through the State Liability Amendment Bill, which is being revised. The bill proposes making provision for in-kind services and periodic payments instead of the payment of private-sector rates and large lump sum amounts. Total claims increased from R111.2 billion in 2019/20 to R120.3 billion in 2020/21, with the Eastern Cape accounting for 32 per cent of claims.

The financial position of South Africa's 257 municipalities deteriorated significantly as COVID-19 exacerbated existing managerial weaknesses. In June 2019, 163 municipalities met at least one of the financial distress metrics. That number has increased during the pandemic, and an update on municipal finances is being prepared. Overdue payments owed by local government increased from R60 billion in 2019/20 to R73.7 billion in 2020/21. Over the same period, uncollected revenues increased from R191.4 billion to R232.8 billion.

The National Treasury, working with provincial governments, has begun a series of interventions to stabilise the finances of the 112 municipalities that adopted budgets in 2021/22 that are not fully funded, which will result in an inability to meet all their obligations. Where possible, expenditure will be limited to available funds or revenue collection will be improved. A separate process is under way for the minority of municipalities in deepest financial distress.

Contingent liabilities

Contingent liabilities represent financial commitments that government may have to fulfil in the future if particular events materialise. Most contingent liability risk originates in the poor financial performance of major state-owned companies; some of these risks have already begun to materialise.

By 2023/24, contingent liabilities are expected to exceed R1 trillion. They consist of government guarantees to state-owned companies, the Renewable Energy Independent Power Producer Programme, public-private partnerships, and obligations to the Road Accident Fund and other social security funds.

The guarantee portfolio increased from R693.7 billion in March 2020 to R789.8 billion in March 2021, of which R567.6 billion has been taken up. The increase is driven largely by the issuance of a R100 billion guarantee to the Reserve Bank as part of government's COVID-19 loan guarantee scheme, although actual exposure is only about R18.4 billion due to low demand for these loans. Exposure to Eskom debt declined as it repaid some maturing guaranteed debt. Over the next three years, redemptions of

guaranteed debt will average R19.3 billion, down from R35.6 billion in 2020/21 and R27.5 billion in 2019/20.

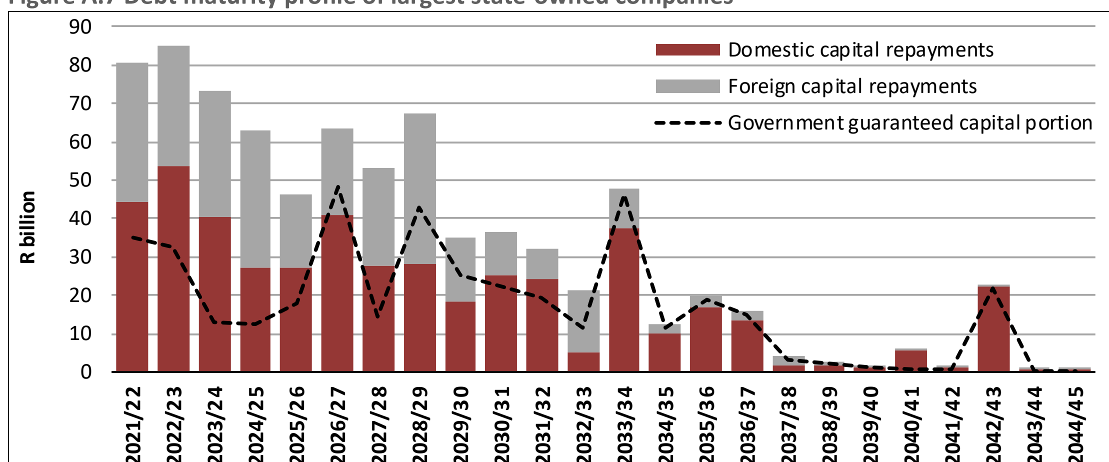
The volume of government's guarantee exposure from state-owned companies declined between 2019/20 and 2020/21. The risks associated with existing guarantees remain elevated because of the companies' poor financial performance and limited access to capital markets. Requests for new guarantees have declined since government published minimum criteria for guarantee applications from public entities and their shareholder departments. These criteria require state-owned companies to demonstrate their ability to service their debt before any guarantee is issued. Enforcing the criteria will help ensure that guarantees are issued only in cases where the risk to the fiscus is minimal.

State-owned companies

Access to capital markets has become more restricted for state-owned companies as a result of weak revenue growth, poor operating performance and mounting debt-service costs. Rising interest rates and increasingly unfavourable loan terms also raise the risks associated with borrowing. The COVID-19 pandemic and associated restrictions on economic activity have delayed the execution of capital investment projects, muted tariff adjustments and slowed the collection of payment from users.

Total debt redemptions for state-owned companies will average R73.4 billion a year over the medium term, with foreign debt making up 45 per cent of the total.

Figure A.7 Debt maturity profile of largest state-owned companies*



**Airports Company South Africa, Denel, Development Bank of Southern Africa, Eskom, Industrial Development Corporation, Land Bank, South African Airways, South African National Roads Agency Limited, Trans-Caledon Tunnel Authority and Transnet*
Source: National Treasury as at 31 March 2021

Denel

Denel is experiencing difficulties in meeting its obligations and is negotiating with stakeholders on a way forward. Government provided recapitalisations of R1.8 billion in 2019/20 and R576 million in 2020/21, and extended a R5.9 billion guaranteed debt facility to Denel. Several repayment obligations have fallen due this year. Government has allocated R2.9 billion in 2021/22 to settle these repayments.

Eskom

Eskom continues to pose a significant risk to the public finances, as it relies on government guarantees to finance its operations. Eskom had used R281.6 billion of its R350 billion government guarantee facility by 31 March 2021, with another R7 billion committed. Equity support of R31.7 billion was provided to Eskom in 2021/22, with the last tranche of R11.7 billion disbursed on 1 July. To enable Eskom to execute its borrowing plan, the Minister of Finance approved a special dispensation to allow Eskom to access

additional guaranteed debt of R42 billion in 2021/22 and R25 billion in 2022/23, which falls within its existing guarantee facility. The utility has made progress in its unbundling plan by establishing a transmission company that is now registered with the Companies and Intellectual Property Commission. Eskom has developed a new corporate structure and allocated debt between its proposed electricity generation, transmission and distribution entities. This proposed restructuring needs to be approved by lenders. The utility has a deadline of 31 December 2021 to complete legal separation of the transmission unit, with the other two units following in the next 12 months.

Road Accident Fund

The Road Accident Fund receives about R42 billion in fuel levies each year and pays out R40 billion in claims, but has a growing backlog of unpaid claims that reached R14.8 billion in 2020/21. Government developed the Road Accident Benefit Scheme to reform and stabilise the Road Accident Fund's funding model. The proposed scheme would set predetermined social benefits through a no-fault system that facilitates more equitable and quicker claims payments, unencumbered by significant legal fees. Parliament rejected the bill in September 2020 and Cabinet is considering how to accommodate the objections raised at that time. The Fund's accumulated liabilities were last estimated at over R450 billion.

South African Airways

South African Airways (SAA) received R21 billion in support from government in 2020/21. This included R10.3 billion for the settlement of government guaranteed debt, R7.8 billion for the implementation of the business rescue, R2.7 billion for SAA's subsidiaries, and R267 million for calls on guarantee obligations on which the airline had defaulted. The Department of Public Enterprises has identified a strategic equity partner to buy part of SAA and aims to finalise the transaction in early 2022.

South African National Roads Agency Limited

The South African National Roads Agency Limited (SANRAL) has incurred annual average losses of R2.5 billion since 2014/15 and has been unable to successfully issue a bond since 2017, largely due to uncertainty about government's position on the user-pays principle. Government has extended a total guarantee facility of R37.9 billion to the agency, of which R28.4 billion had been used by 31 March 2021. While policy uncertainty remains, SANRAL is still responsible for maintaining its toll portfolio and continues to service the debt used to fund construction. To date, R5.5 billion has been collected in toll revenue against an initial projection of R20.2 billion. Without a policy decision that reinstates government support for the user-pays principle, SANRAL will remain a significant burden on the public finances.

Long-term fiscal sustainability of social spending

The National Treasury models long-term costs to determine the sustainability of major social spending commitments. Sustainability generally depends on the nature and pace of demographic change and the rate of GDP growth, as well as sector-specific cost pressures and trends in the use of public services. For example, healthcare prices tend to increase faster than consumer price index (CPI) inflation, partly because of the significance of imported equipment and medicine, and long-term demographic trends affect the burden of disease.

There are three major changes to the assumptions underpinning this update: lower long-run economic growth, lower inflation and a decline in the population growth rate. Annual GDP growth in the baseline scenario ranges between 1.6 and 2.3 per cent a year over the forecast horizon, after reaching a low of -7.2 per cent in 2020/21. Population growth will continue to decelerate from 1.4 per cent in 2018 to 0.6 per cent in 2040 under the Statistics South Africa baseline scenario, which results in the population increasing from 60 million in 2021 to 71 million by 2040. Real output per capita declines by 8.4 per cent

in 2020/21. It is forecast to grow by an average of 1 per cent between 2022/23 and 2030/31, and by an annual average of 1.5 per cent between 2030/31 and 2040/41.

Social assistance

Assuming that the uptake rate of social grants stabilises at current levels, and excluding beneficiaries of the temporary *special COVID-19 social relief of distress grant*, beneficiary numbers will grow from 18.3 million in 2020/21 to 22.6 million in 2040/41. Although spending on social assistance is currently expected to remain relatively stable as a percentage of GDP, any unfunded expansion of social protection represents a significant risk to the fiscus.

Basic education

Basic education inflation averaged 8.5 per cent in the past decade, while CPI inflation averaged 4.8 per cent. This is indicative of mounting price pressures, largely driven by rising remuneration of teachers. Education spending has remained stable as a proportion of GDP, however, because the number of teachers has not increased. If current trends in wages and employment continue, spending on basic education is projected to increase from 4.8 per cent of GDP in 2020/21 to 6 per cent of GDP in 2040/41, even as class sizes increase.

Health

An ageing population is associated with increased health expenditure. The elderly proportion of the population is projected to grow by 2.5 per cent per year over the next two decades, reaching 6 million by 2040. Healthcare inflation has also tended to exceed CPI inflation over the past decade. The long-run cost of healthcare is driven by the extent of private-sector contracting, the cost of goods and services, and demand. These factors are likely to dominate under current or national health insurance policies. If current policies and trends persist, healthcare spending is projected to increase from 4.5 per cent of GDP in 2020/21 to 6 per cent of GDP in 2040/41.

Higher education

Price pressures in the higher education sector have exceeded CPI inflation over the last decade, partly due to real wage increases. Assuming this trend continues, expenditure on university education will grow from 1.3 per cent of GDP in 2019/20 to 1.5 per cent of GDP in 2040/41, placing pressure on the fiscus. Within technical and vocational education and training (TVET) colleges, price pressures have increased at a faster pace than inflation partly due to enrolment rates. Assuming enrolments remain stable at about 670 000 students per year, spending in the TVET sector will remain stable over the same period, at 0.2 per cent of GDP.

Conclusion

Government faces a range of fiscal risks over the medium to longer term. Significant efforts will be required across the entire public sector to prevent these risks from materialising – and to mitigate those that do.

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