ABSA

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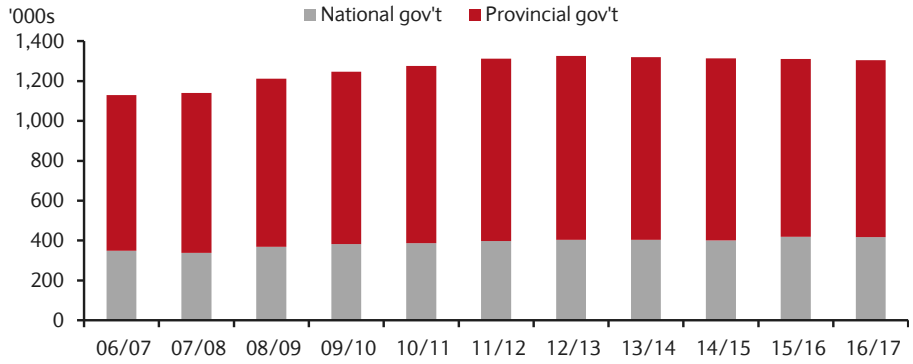
South African fiscal sustainability

The problem of public sector pay

- For many years now, public sector pay increases have outpaced inflation, while the number of civil servants has risen as well, reaching a peak in 2012/13 and easing only very gradually thereafter. Now, South Africa's spending on public sector compensation is a higher share of GDP than it is in most other countries.
- National Treasury has warned that many departmental compensation budgets will be breached if the current wage negotiations settle at more than CPI. An average pay hike of CPI + 1% would see compensation about ZAR19-25bn higher than currently targeted by 2020/21, depending on headcount assumptions.
- Wage negotiations were put on ice in February pending fresh guidance from the new executive, but despite broad goodwill for President Ramaphosa's economic reform agenda, we doubt that public sector unions will accept a pay deal that does not provide real (ie, inflation-adjusted) wage increases.
- We also question whether the government has the appetite for a more vigorous program of headcount reduction, especially since many of the most labour intensive departments are ostensibly at the front line of service delivery and elections are due in a year's time. Natural attrition, combined with hiring freezes and early retirement, has been shrinking the public sector headcount, but the pace has been slow: about 0.4% per year since 2012/13.
- Thus, we think public sector pay remains a big upside spending risk for the fiscus and a significant obstacle to deficit reduction and debt stabilisation.

FIGURE 1

South Africa has about 1.3mn national and provincial government workers



Source: National Treasury, Absa Research

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Public sector wage negotiations are a big source of upside spending pressure, threatening fiscal consolidation

As we discussed in our recent analysis of South Africa's 2018 Budget, we think the country faces a significant fiscal struggle over the coming years as it tries to rein in the budget deficit and stem the rise in public indebtedness. This report examines one particular source of upside spending risk in more detail: public sector pay. The government and various public sector unions, representing 1.3mn public sector workers, are currently negotiating a new pay deal to replace the three-year deal that expires at end-March. We think these negotiations are unlikely to settle at a level that is comfortably consistent with the 7% increase for employee compensation penciled into the budget for 2018/19 and similar increases in each of the subsequent two fiscal years. National Treasury has warned that any pay deal in excess of CPI would breach the compensation envelope, but it would be unprecedented for South Africa to get a wage deal signed with zero projected uplift in real compensation. Also, absent an unlikely forced retrenchment program, we doubt that headcount could be managed down fast enough to offset upside pay gains.

More public sector workers with ever higher pay over the past decade

South Africa's spending on public sector worker compensation has ballooned over the past decade due to rising employment levels and above inflation pay deals

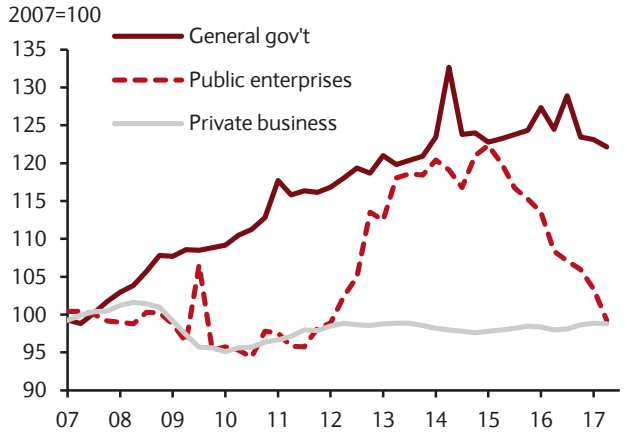
The fiscal burden of South Africa's public sector employment has swollen dramatically since the global financial crisis due to increases in both the numbers of civil servants and wage settlements, which have consistently outpaced inflation and even private sector pay gains. According to the latest SARB data, in little more than a decade since the end of 2006, the number of workers in general government has increased by over a quarter, while the number of workers in public enterprises has, after spiking, fallen to be roughly flat and the number of private sector formal non-agricultural employees has remained roughly flat (see Figure 2). Over the same period, remuneration per worker in the public sector has increased by 26% in real (ie, inflation adjusted) terms, versus 14% for the private sector (see Figure 3). These SARB data, however, are based on the Quarterly Employment Statistics survey of StatsSA, the latest release of which for (Q3 17) puts total government employment at 1.51mn, down 5.5% y/y, because of a big drop in employment at extrabudgetary institutions, presumably as a result of a temporary surge in employment at the Independent Electoral Commission in Q3 16 to run the local government elections.

Nuanced differences between StatsSA's and Treasury's data on government employment

Notably, the StatsSA data on total government employment includes national departments (472k) and provincial government departments (1040k) but also local governments (313k), extrabudgetary institutions (94k), and universities and technikons (115k). Because entities such as local governments are excluded from the national budget, for the purposes of this fiscal risk assessment here it is better to use the PERSAL data from the government's payroll

FIGURE 2

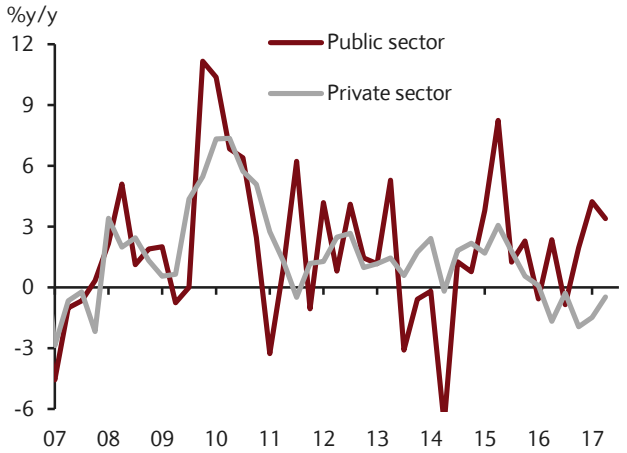
Civil service employment up by a quarter over past decade…



Source: SARB, StatsSA, Absa Research

FIGURE 3

…with real pay gains in most years



Source: SARB, StatsSA, Absa Research

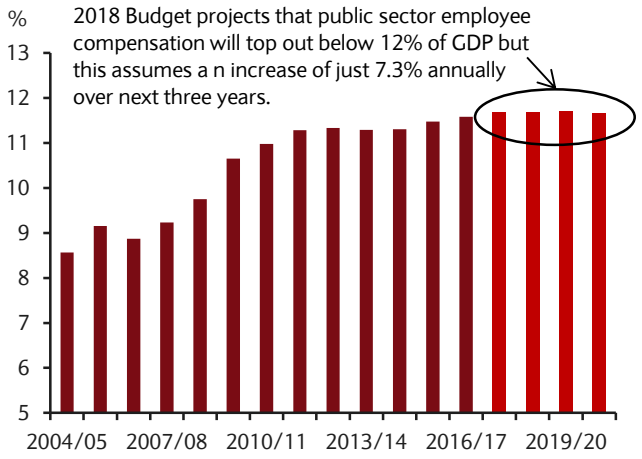
system. This is what National Treasury based its analysis on when it revealed the extent of its concern about the ballooning public sector compensation costs in a seven-page annex to the Medium Term Budget Policy Statement (MTBPS) in October last year. At that time, National Treasury put full-time equivalent government employment at 1.30mn at the end of FY 2016/17, as opposed to StatsSA's figure of 1.54mn. In addition to excluding local government employment, National Treasury noted that about 240,000 employees on the government's payroll were contracted through initiatives such as the Community Work Programme and the Expanded Public Works Programme and hence were excluded from its analysis, since such workers are not formally part of the public service. These workers are not part of the current public sector pay negotiations.

National Treasury has been sounding the warning bell about public sector compensation

National Treasury's analysis in the annex to the MTBPS revealed that while nominal GDP has grown an average of 7.9% per year since 2008/09, spending on public service compensation has grown 10.3% per annum over the same period. This same analysis notes that between 2008/09 and 2016/17 "compensation spending increased by about 37% in real terms, or 4.1% per year" with roughly three-quarters of the increase coming from higher remuneration and the remainder from higher employment levels. The MTBPS points out that the share of employee compensation in the budgets of labour intensive national government departments – such as police, justice and defence – rose 10 percentage points between 2008/09 and 2016/17 to 67.7%. Meanwhile, in the nine provincial health departments, compensation's share of total spending rose 6.2 percentage points to 63.2% (see Figure 6). For consolidated government expenditure as a whole, employee compensation's share of total spending rose from 32.4% to 35.3% over the same period. This is equivalent to just shy of 12% of GDP and is exceptionally high by international and historical standards (see Figure 4). Once local government spending is included South African government spending as a percentage of GDP outpaces that of most other countries, even those such as Sweden and Brazil that have traditionally had high public service spending. Only Denmark has a higher proportion (see Figure 5).

FIGURE 4

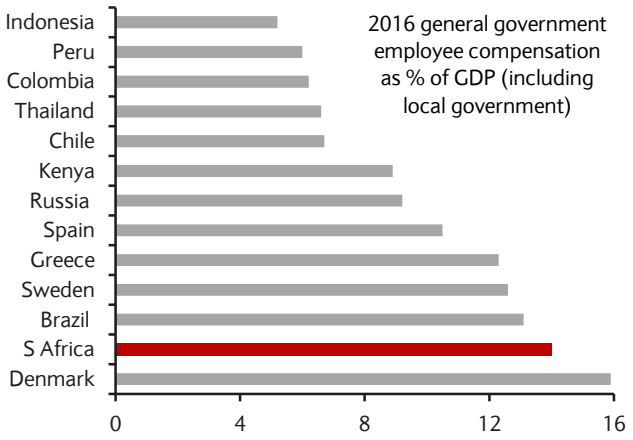
Public sector pay has mounted in recent years



Source: National Treasury, Absa Research

FIGURE 5

South Africa spends relatively more than most other nations



Source: IMF, Absa Research

FIGURE 6

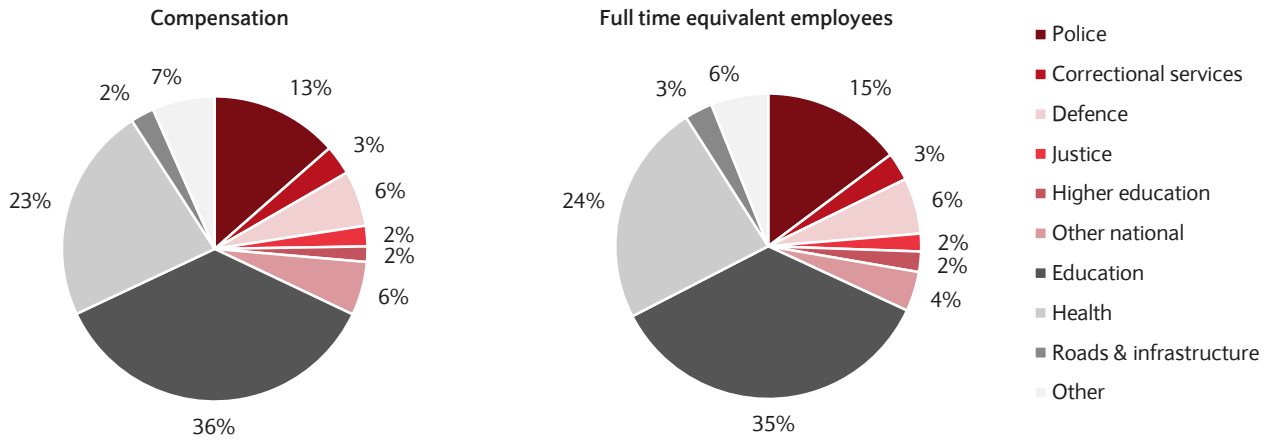
Share of compensation in labour intensive departments' spending has risen sharply…

	2008/09	2016/17
Department/Sector	**% of Total**	**% of Total**
National labour intensive departments	57.7	67.7
Correctional services	63.0	66.9
Defense	38.2	57.3
Justice	54.1	55.9
Police	70.0	76.6
Provincial health departments	57.0	63.2
Eastern Cape	58.0	65.6
Free State	64.7	64.1
Gauteng	52.0	62.2
KwaZulu-Natal	58.9	63.1
Limpopo	58.9	71.0
Mpumalanga	58.5	63.2
North West	56.6	62.0
Northern Cape	51.1	53.1
Western Cape	56.3	58.9
Total consolidated expenditure	32.4	35.3

Source: National Treasury, Absa Research

FIGURE 7

…but spending could be hard to cut since the most expensive parts of the civil service are at the frontline of service delivery



Note: Full time equivalent national and provincial government employees in 2016/17 were 1.3mn with a total cost of ZAR459bn
Source: National Treasury, Absa Research

National Treasury warned that current public sector pay trends are unsustainable, but it does not have the authority to set the government's stance in pay negotiations

National Treasury's warned in the MTBPS that with unchanged staffing levels, compensation budgets in many national and provincial departments would be breached even if the pay increase were limited to just CPI inflation. It added that the N "shortfall" in compensation budgets (ie, the amount of extra pay required assuming stable staffing levels relative to what is budgeted currently) would deteriorate substantially if the public-service wage talks led to a wage and benefit compensation uplift that exceeds CPI inflation. National Treasury's quantification of this potential "shortfall" is worth highlighting. The MTBPS stated that a CPI + 1% agreement would require an extra ZAR12.2bn in 2018/19, rising to an extra ZAR24.5bn by 2020/21. This stark warning received insufficient political

and investor attention, in our view, perhaps because there has been so much policy uncertainty and chaotic fiscal policy making (such as then President Zuma's surprise introduction of free university education) since the MTBPS. However, perhaps another part of the explanation is that the inflation outlook was seeming to improve over this period, which offered hope that government might have some room to deliver a "CPI plus" pay deal but still keep the total nominal increase in public sector compensation below 7%. Significantly, while National Treasury can raise the alarm about the rising fiscal and macroeconomic risks in public sector pay trends, it does not have the authority to unilaterally determine the government's stance on civil service pay deals (or decide on instruments to lower the number of public sector workers).

DPSA had tabled an offer at end January that threatened to breach the Treasury's expenditure envelope, but pay talks have now been suspended pending fresh guidance from the new executive

Instead, that is the responsibility of the Department of Public Service and Administration (DPSA) in a collective bargaining process with South Africa's 17 various public sector unions through the Public Service Coordinating Bargaining Council. Negotiations to replace the current three year deal that expires on 31 March commenced last year but were suspended a few weeks ago, pending fresh guidance from the new political executive after President Ramaphosa replaced Jacob Zuma as the head of government on 15 February (followed on 26 February by the appointment of a new cabinet). However, at the time of the government's last offer, 26 January, the midpoint between the government and labour positions strongly suggested an average settlement well above the 7% uplift for employee compensation written into the budget for 2018/19, even if the pay increase for senior salary levels 13-16 (which is determined not in collective bargaining but by ministerial discretion) is simply CPI flat. Thus an overall compensation increase of more than 7% seemed likely purely on the basis of the salary uplifts above CPI alone (see Figure 8), even before considering the likelihood of expensive benefit adjustments in the first year of the new pay deal, and promotions and salary "notch progressions" that have become more or less automatic, rather than special performance incentives, and which add 1.5% per annum to the government's wage bill on average.

FIGURE 8

Government's offer in late January would breach the 7% envelope increase in the Budget

	Percentage augmentation above CPI					
	2018/19		2019/20		2020/21	
	Government	Labour	Government	Labour	Government	Labour
Level 1-7	1.5	3.0	1.0	3.0	1.0	3.0
Level 8-10	1.0	2.0	0.5	2.0	0.5	2.0
Level 11-12	0.5	1.0	0.0	1.0	0.0	1.0

Source: PSA, Absa Research

Without detailed information about the distribution of workers at different salary levels, a detailed costing of public sector pay deals is difficult

Precisely costing any one particular scenario for a pay deal, particularly with sliding-scale uplifts above CPI, is difficult because the National Treasury and DPSA do not generally disclose how many of the 1.3mn public sector workers are in each of the 16 salary levels, nor the average compensation in each level, nor the distribution of total compensation between salaries (which are raised yearly) and benefits (which tend to be adjusted only at the start of a pay deal). For example, in the recently suspended wage talks the unions have downscaled their demand for an increase in the housing subsidy from ZAR1200 a month to ZAR1500 month (previously ZAR2500 a month) but only upon delinking of married couples' allowances, under which previously two civil servants married to one another received only one subsidy. Without detailed information from DPSA and National Treasury on the parameters of this benefit, it is impossible to cost it accurately. The 2015 public sector wage negotiations are a vivid reminder of how generous benefit adjustments in the first year of the pay deal can derail the Treasury's careful fiscal planning (see box below).

2015 public sector wage deal derailed Treasury's careful fiscal plans

In May 2015 the government signed a three year wage agreement with the public sector unions, in which it offered a 7% increase for the first year of the deal (after abandoning its effort to claw back the 0.6% it felt owed by the undershoot of actual CPI inflation compared with Treasury's forecast for the previous 2014/15 fiscal year) and CPI +1% for years 2 and 3. However, expensive upward adjustments in housing allowances (to ZAR1200 from ZAR900) and a 28.5% increase in medical aid cover meant that the total cost of the compensation uplift was estimated by us to be 10.6% in FY 15/16, with an extra cost to the Treasury of ZAR13bn in 2015/16 and ZAR31bn by the end of the three year wage deal. Thus, in the MTBPS the following October National Treasury had to do some significant fiscal juggling with reprioritizations from existing budgets and a big raid on the contingency reserve.

FIGURE 9

2015 wage deal delivered a wage and benefit increase of over 10% in FY 15/16…

	2014/15	2015/16	2016/17	2017/18
February Budget (ZARbn)	445.3	479.5	509.6	539.6
Wage deal adjustment (ZARbn)	n/a	13.0	22.0	31.0
Adjusted total compensation (ZARbn)	445.3	492.5	531.6	570.6
% increase (February budget)	-	7.7	6.3	5.9
% increase (new deal)	-	10.6	7.9	7.3
Adjustment cost (% of GDP)	-	0.3	0.5	0.6

Source: National Treasury, Absa Research

FIGURE 10

…causing a marked juggling of budget allocations in the 2015 MTBPS

Funding the public sector wage deal, ZAR bn	2015/16	2016/17	2017/18
National departments			
Allocations from contingency reserve	1.2	2.9	7.1
Reprioritization within baseline	0.0	0.9	1.0
Provincial departments			
Allocations from contingency reserve	3.8	7.1	18.9
Total	5.0	10.9	27.1
Cost of public sector wage deal	**12.2**	**20.6**	**31.1**
Costs to be funded or met through departmental budget savings	7.2	10.6	5.0
Contingency reserve drawdown	5.0	10.0	26.1
Original contingency reserves	5.0	15.0	45.0
New contingency reserve	0.0	5.0	9.0

Source: Absa Research, National Treasury

A pay deal averaging CPI + 1% could add ZAR19- ZAR24.5bn to the government's wage bill

Nonetheless, some very rough calculations can be made with some plausible assumptions. For example, assuming the CPI adjustment is the forecast produced by National Treasury, pay progression amounts to 1.5%, the benefit uplift costs an additional 1.5% in the first year and headcount attrition amounts to 0.5% per annum (compared with a 0.4% per annum average between 2012/13 and 2016/17), then an average pay deal of CPI + 1% leads to compensation figures about ZAR19bn above the budgeted target by 2020/21. As we have mentioned before, Treasury has projected the extra compensation to be about ZAR24.5bn by 2020/21 but perhaps it is assuming no headcount reduction.

FIGURE 11

Wage bill likely to breach MTEF targets for pay deals above CPI inflation even with reasonable headcount attrition

	Budget targets for public sector compensation given a ZAR459bn public sector comp bill in FY17/18	Assumptions for:				ZARbn shortfall given average percentage increase of wage package above CPI of:				
		CPI	Pay progression	Benefit uplift	Attrition	-0.5	0.0	0.5	1.0	1.5
2018/19	587.1	5.5	1.5	1.5	-0.5	3.5	7.5	9.5	12.4	15.4
2019/20	630.5	5.3	1.5	0	-0.5	-5.5	2.9	7.2	16.7	19.9
2020/21	677.3	5.5	1.5	0	-0.5	-14.7	-1.5	5.5	19.2	26.1

Source: National Treasury, Absa Research

Competition between South Africa's 17 public sector unions works against a restrained pay settlement

We have argued previously that we think a pay deal of CPI +1% on average for all salary levels for all three years would be an unprecedented degree of restraint. Competition between unions for membership probably works against close cooperation with the government as the employer. And unions, it must be remembered, exist to fight for the best possible deal for their members. The fiscal consequences of a wage settlement's impact on the fiscus may, understandably, not be the primary concern of the unions.

FIGURE 12

Competition between South Africa's 17 public sector unions works against "social pact" cooperation with government

Union	Full name	Membership end-2016	Domestic affiliation
DENOSA	Democratic Nursing Organization of South Africa	80146	COSATU
SAMA	South African Medical Association	7793	Unaligned
PAWUSA	Public Allied Workers Union of South Africa	9507	COSATU
SASAWU	South African State and Allied Workers Union	5707	COSATU
HOSPERSA	Health and Other Services Personnel Trade Union of South Africa	50539	FEDUSA
NATU	National Teachers Union	31979	FEDUSA
NUPSAW	National Union of Public Service & Allied Workers	27871	SAFTU
NAPTOSA	National Professional Teachers Organization of South Africa	46662	Unaligned
SAOU	South Africa Onderwysersunie	30238	FEDUSA
NEHAWU	National Education, Health and Allied Workers' Trade Union	205343	COSATU
POPCRU	Police and Prisons Civil Rights Union	162378	COSATU
PSA	Public Servants Association	205758	FEDUSA
UNIPSAWU	United National Public Servants Association of South Africa and Allied Workers Union	1278	FEDUSA
NPSWU	National Public Service Workers Union	9748	Unaligned
SADTU	South African Democratic Teachers Union	249656	COSATU
SAPU	South Africa Policing Union	77983	SAFTU
PEU	Professional Educators Union	10408	Unaligned
Grand Total		1212994	

Source: PSA, COSATU, SAFTU, FEDUSA

No sign yet whether the new executive leadership in South Africa will try to impose a much tougher wage settlement this year

However, there has been no indication from President Ramaphosa, the new Finance Minister (Nhlanhla Nene) or the new minister in charge of the DPSA (Ayanda Dlodlo) of whether they will look to reverse or alter the terms the government tabled as its revised offer on 26 January in a new effort to wrestle the fiscus into a consolidation trajectory. However, nor is it clear whether unions will stick with their current demands, given the 1 percentage point increase in VAT in the 2018 Budget, which along with other tax increases, has lifted the profile for headline CPI by 0.6 percentage points, such that National Treasury now forecasts it to average 5.5% in 2018/19. This is not much higher than Treasury's forecast of 5.4% at the time of the MTBPS, but just prior to the tabling of the 2018 Budget (and around the time of the government's last offer) the outlook for CPI in FY 2018/19 had improved significantly. Absa's (relatively bearish) forecast was for a 5.0% average in FY 2018/19, and the contemporaneous prints were very low, coming in at 4.7% for December and 4.4% for January. Thus, the wage negotiations then were apparently taking place without clear agreement on the CPI foundation in the first year of the deal. (In previous multi-year wage deals the first year's increase is a fixed percentage increase for the salary portion plus some adjustments to the fixed benefits such as housing allowance, with only the subsequent years' deals characterized as "CPI plus something".) Usually, the CPI measure used in those outer years is the forecast made by National Treasury in the Budget for the relevant fiscal year. It is clear that if public sector wage talks are "business as usual," the Treasury's fiscal targets for public sector compensation in the upcoming fiscal year and the two outer years of the Medium Term Expenditure Framework look somewhat too low. Public sector pay continues to risk further crowding out of other current and capital expenditure.

A strike in the public sector could save the government money on the "no work, no pay" principle

The opposition Democratic Alliance has proposed a public sector pay freeze, arguing that that this would save ZAR50bn. This seems somewhat of an overestimate to us, since National Treasury's 2018 Budget documentation pencilled in an increase in total public sector compensation of just ZAR38bn in 2018/19, but perhaps the Democratic Alliance is also factoring in some cost savings for the government from the strike that would likely result from any attempt to freeze civil service pay, since presumably the "no work, no pay" principle would apply. With total public sector compensation of about ZAR459bn in FY 2017/18, a one week strike would save the government a little less than ZAR9bn, assuming the entire public sector went on strike, but of course some parts of the public service are deemed to be essential services, and thus the ZAR9bn figure is very much an upper bound. Nonetheless, what the calculation illustrates is that the government may find some beneficial fiscal side-effects in taking a hard-line stance in the wage negotiations if it leads to a strike. Government typically tries to negotiate a multi-year pay deal, but there might be some benefit in a different approach at this particular fiscal juncture. For example, the government might try to capitalize on the goodwill that broadly exists for the new leadership with a one year partial pay freeze in exchange for a promise to negotiate with labour again in a year's time, when the economic outlook might be more favourable, especially if the government can make a sufficiently fiscally stringent deal this year that boosts confidence and growth.

Government seems unlikely to go down the path of forced retrenchments

Obviously, efforts to contain the burden of public sector pay can focus on headcount as well as pay restraint. However, we think the government is unlikely to go down the path of forced retrenchments, especially not in a pre-election year. Instead it will likely continue to rely on natural attrition, strict hiring freezes, voluntary retrenchment programs, and early retirement incentives to shrink the public sector. These programs are not generally particularly controversial, but unfortunately they are slow. From its 2012/13 peak of 1,326,120 full time equivalent public sector workers at the level of national and provincial government the government has shed only about 26,000 – around 0.4% net per year. Moreover, relying on attrition can over time lead to misallocation of human resources, with the most able and skilled leaving and the wrong people in the wrong departments. A robust performance management system in the public service sector could help mitigate this malign outcome, but the government has struggled to implement such a system to date.

Public sector employment (and hence the largest chunk of public sector compensation) is heavily concentrated in a few key national and provincial government departments

As regards headcount, a key point to note is that the bulk of government employment comes in a few national and provincial departments, and this preponderance of employment drives the distribution of compensation costs. Containing compensation costs is therefore likely to require efforts targeted very specifically at these labour intensive departments, but some of them are the very front line departments – police, teachers, health care professionals – where South Africa is facing the greatest social and developmental challenges. Vigorous steps to contain costs in these departments could thus have major negative repercussions on South Africa's ability to deliver safety, education and health. However, one department stands out markedly as costly, with arguably less apparent upfront benefit to South African society: defense, which had 77,350 full time equivalent employees (ie, soldiers and civilian employees) in 2016/17 costing some ZAR27bn, about 0.6% of GDP. Given the absence of any significant military threat to South Africa, this could seem a logical place to look to start downsizing the public sector, were the government to consider some more aggressive retrenchment strategies.

Obviously, much is still uncertain. But one thing is clear: National Treasury has sounded a warning about the risks to fiscal consolidation from public sector pay trends, and as yet the South African government has not offered a clear answer. Investors and rating agencies are likely to monitor the outcome of the negotiations carefully.

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