Category: Undergraduate

South Africa's Public Sector Wage Bill and its impact on fiscal sustainability

(1897 words)

Introduction

Over the past several years South Africa's public debt burden has risen rapidly and has been further affected by the economic shock brought on by the Covid-19 pandemic (National Treasury, 2021, p2). With the National Treasury projecting that national debt as a percentage of GDP could reach 140.7 percent by 2028/29 under their passive scenario (National Treasury, 2020, p30), several economists have begun to argue that South Africa's debt is fiscally unsustainable (Burger and Calitz, 2021, p3). The National Treasury has identified reducing the public sector wage bill as the primary tool to control expenditure and ensure fiscal sustainability (National Treasury, 2021, p5).

This paper will examine the concept of fiscal sustainability and why it is of economic importance. Subsequently, the paper will use insights from the fiscal reaction function in order to determine whether the reduction in the public sector wage bill proposed by the government will be sufficient to produce a primary balance that leads to fiscal sustainability. It concludes by suggesting that the reduction in the public sector wage bill on its own is unlikely to lead to fiscal sustainability as the magnitude of reduction required would be politically unpalpable. Therefore, additional expenditure reductions will be necessary to achieve fiscal sustainability.

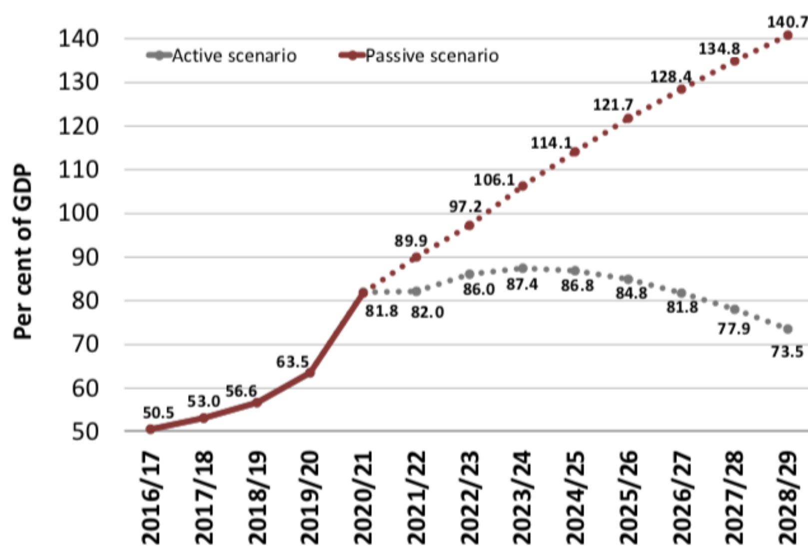

Figure 1, Debt Outlook Scenarios (National Treasury, 2020, p30)

Brief overview of fiscal sustainability

At its most basic level, fiscal sustainability can be viewed as the solvency of the government (Debrun, Ostry, Willems and Wyplosz, 2020, p151). Burnside (2005, p3) argues that the concept of solvency when referring to fiscal sustainability entails examining whether the

government can maintain its current spending plans without defaulting on its debt. Fiscal sustainability can be determined by modelling the effects of different spending plans and other variables on a country's primary balance through a fiscal reaction function (Bohn, 1998, p949). The equation below illustrates the rule defining the primary balance/GDP ratio required to keep to such a debt/GDP target, given that the current debt levels are deemed to be tolerable (Burger, Stuart, Jooste and Cuevas, 2012, p212).

$$(B/Y) = ((r - g)/(1 + g))(D/Y)$$

Where B/Y is the primary balance as a percentage of GDP, r is the real interest rate, g is the real economic growth rate and D/Y is public debt as a percentage of GDP. From this equation a fiscal reaction function can be estimated to determine how governments can reacted to the increase in debt to ensure fiscal sustainability (D'Erasmo, Mendoza and Zhang, 2016, p2494).

Fiscal sustainability is of economic importance for several reasons. There is substantial evidence to suggest that after the ratio of public debt to GDP surpasses a certain level, it begins to act as a drag on economic growth (Reinhart, Reinhart and Rogoff, 2012, p84). Sustained increases in public debt can lead to the crowding out of private borrowing by public debt and an increased risk premium demanded by investors due to the increased default risk which further erodes fiscal sustainability (Ağca and Celasun, 2009, p17). Fiscal sustainability is vital to ensure governments avoid default which can have serious adverse consequences. Sovereign defaults often lead to spill overs into the private sector leading to banking crises as well as currency crises (Laeven and Valencia, 2020, p251). Mendoza and Yue (2012, p889) have found that in the 23 cases of sovereign default they observed in the period 1977 to 2009, on average countries GDP decreased by 5 percent. The cost of a sovereign default may be more serve if a significant portion of government debt is held by domestic financial institutions (Borensztein and Panizza, 2008, p18) as is the case for South Africa where domestic banks hold 23 percent of total government bonds and domestic pension funds and insurers hold a further 29 percent (South Africa Reserve Bank, 2020, p15)

South Africa's fiscal sustainability

The sustainability of South Africa's public debt can be assessed using the fiscal reaction function as set out by Bohn's framework (1998, p949). Bohn (1998, p950) contends that primary balances can be used as fiscal tools to ensure public debt has a fiscally sustainable path. A fiscal reaction function can be employed to chart the reaction of the primary balance

to changes in outstanding debt, whilst controlling for other variables (D'Erasmo, Mendoza and Zhang, 2016, p2494). Therefore, should public debt rise, the government should increase the primary balance to counteract the increase in public debt (Bohn, 1995, p258).

The National Treasury has undertaken to improve the primary balance by reducing current expenditure, predominantly through the reduction in the public sector wage bill (National Treasury, 2021, p5). It is worth noting that in the past South Africa has been relatively successful in ensuring that its public debt remains sustainable by appropriately adjusting the primary balance (Burger, Stuart, Jooste and Cuevas, 2012, p222). Moreover, it has been found that South African often ran primary balances higher than the level required to achieve fiscal sustainability (Burger, Stuart, Jooste and Cuevas, 2012: p225).

The National Treasury's focus on the public sector wage bill is prudent as Alesina and Perotti suggest that OCED countries that attempted reductions in fiscal deficits primarily through the cutting of the public wage bill realized more sustainable and permanent reductions in their deficits than those countries that raised taxes to reduce their deficit (1997, p211). Furthermore, Kemp (2020, p30) suggests that large and negative tax multipliers exist for South Africa and the burden of fiscal consolidation should rather rely on spending reductions. In addition to this, public sector compensation is one of the government's largest expenditure items, with public sector compensation taking up 41 percent of government revenue in 2019/20 and over 47 percent in 2020/21 (National Treasury, 2021, p6). Thus, making it a prime target for spending reductions.

National Treasury plans to narrow the main budget primary deficit from 7.5 percent of GDP in 2020/21 to 0.8 percent of GDP in 2023/24 to stabilise public debt (National Treasury, 2021, p2). To achieve this the National Treasury proposed compensation reductions of R160.2 billion for 2020/21 to 2022/23, relative to the pre-Budget baseline (National Treasury, 2021, p53). An additional decrease in compensation was proposed in the 2020 MTBPS amounting to R143.2 billion for 2021/22 to 2023/24 (National Treasury, 2021, p31). This is to be achieved by limiting salary increases, encouraging early retirement, natural attrition, and the elimination of non-critical positions (National Treasury, 2021, p31). Burger and Calitz (2021, p15) have calculated that for the Treasury to achieve the primary balance target of their active scenario as set out in the special adjustment budget they would need a fiscal adjustment of 8 to 9 percent. That is more than double the average adjustment of an IMF program of 4 percent (Lanau, Castellano and Khan, 2019). An adjustment of this size would be extremely improbable and near impossible politically (Burger & Calitz, 2021:16). Burger and Calitz (2021, p16) create an alternative scenario where a more politically realistic adjustment of 4 percent is used,

suggesting that the debt/GDP ratio stabilises at 100 percent in 2025/26. Under this scenario, Burger and Calitz (2021, p16) estimate that a reduction of 3.5 percent of the public sector wage bill as a percentage of GDP is needed along with a 1 percent reduction in the goods-and-services budget as a percentage of GDP. A freeze on public sector wage increases would make some head way in achieving this, which National Treasury has committed to for the next three years; yet this has not been agreed to by the public service union (National Treasury, 2021, p31).
However, it is unlikely that public sector unions would agree to a reduction in the public sector wage bill of up to 30 percent that is required to reach the 3.5 percent target (Burger and Calitz, 2021, p19). This risk was highlighted in the Budget with the Treasury's current plans stating that there is a significant risk that the upcoming wage agreement leads unaffordable salary increases. (National Treasury, 2021, p6). Therefore, due to insufficient reductions in the public sector wage bill, the government will be unable to achieve their primary balance target and thus undermine their ability to achieve fiscal sustainability (National Treasury, 2021, p6).

Another vulnerability in the National Treasury's plan to ensure fiscal sustainability is the assumptions that underlie their active scenario. The active scenario assumes growth of 1.5 percent in 2023/24, increasing to 2 percent for the next two years and finally reaching 2.5 percent for the remaining years to 2028/29 (National Treasury, 2020, p30). These growth rates would only be feasible if South Africa can ensure a reliable electricity supply as well as increase its generation capabilities (Wright and Calitz, 2020), something South Africa has been unable to do in the past. Therefore, it is highly likely that the reduction in the public sector wage bill will be insufficient to ensure fiscal sustainability because the magnitude of the cut would prove politically unmanageable with public sector unions. Furthermore, there is little room in the National Treasury's plans for deviation from expenditure plans and changing growth assumptions. Thus, further expenditure reductions may have to be found.

Additional expenditure reductions and alternative proposals

Further reductions should be focused on consumption expenditure rather than government investment as Kemp (2020, p2) suggest that reductions in consumption expenditure are more successful at stabilising public debt than reductions in government investment. The National Treasury has seemly followed this suggestion with a reduction of R24.2 billion of goods and services over the medium-term expenditure framework (National Treasury, 2021, p55). This approach coincides with the observations of Alesina and Perotti (1997, p211), who in their

study of OECD countries found that the most successful fiscal adjustments rely on reductions in current expenditure and government transfers and are more likely to be expansionary. Tax rises could be an alternative to further spending reductions; however, Kemp (2019, p445) suggests that any further increases in marginal income tax rates are unlikely to yield increased tax revenue, especially amongst high-income earners. An increase in consumption taxes could be a considered as the negative multiplier is significantly smaller than that of income taxes, though it is a regressive tax Kemp (2020, p30). Although, fiscal adjustments that rely on cuts to public investment and tax increases are less successful and are more likely to be contractionary (Alesina, et al. 1997, p211). Public debt management could also be used to help reduce debt costs through the optimization of the debt's maturity structure (Pascal, 2011, p576). However, it is most likely that further spending reductions will have bear most of the burden should deviation from the Treasury's current spending plans occur.

Conclusion

While a major reduction in the public wage bill would have a significant impact in improving South Africa's primary balance and putting South Africa on the path to fiscal sustainability, the magnitude of the cut required would be politically unachievable. The National Treasury admits that any breach of compensation ceiling for public servants would be unaffordable and undermine debt stabilisation. Furthermore, the Treasury's active scenario for debt management depends on several underlying assumptions, including growth rates of above 2 percent which may not materialise, further undermining debt stabilisation. Therefore, the size of the reduction in the public sector wage bill that is likely to take place will fall short of what is necessary to ensure fiscal sustainability. Thus, without additional expenditure cuts in other areas or an increase in consumption taxes South Africa is unlikely to achieve fiscal sustainability.

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