High salary inflation: The downside to moving up in the world

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In October 2012, truck drivers returned to work after a three-week strike, having secured a three-year wage deal that will see nominal annual salary increases of 9%. If inflation remains within the 3% to 6% target band, this means a real increase of at least 3% per year.

According to Member WatchTM data, where salary inflation reflects both promotional and inflationary increases, retirement fund members have been enjoying high real salary increases, particularly at younger ages and in the last two years. The analysis below is based on a sample of members that depends on the demographics of those included. It does, however, illustrate that overall periods, salary increases have on average been well above inflation. For example over the past two years, the real increases have been over 9%[1] for members in the age band 25 to 35 years and just under 6% for members in the age band 55 to 65 years.

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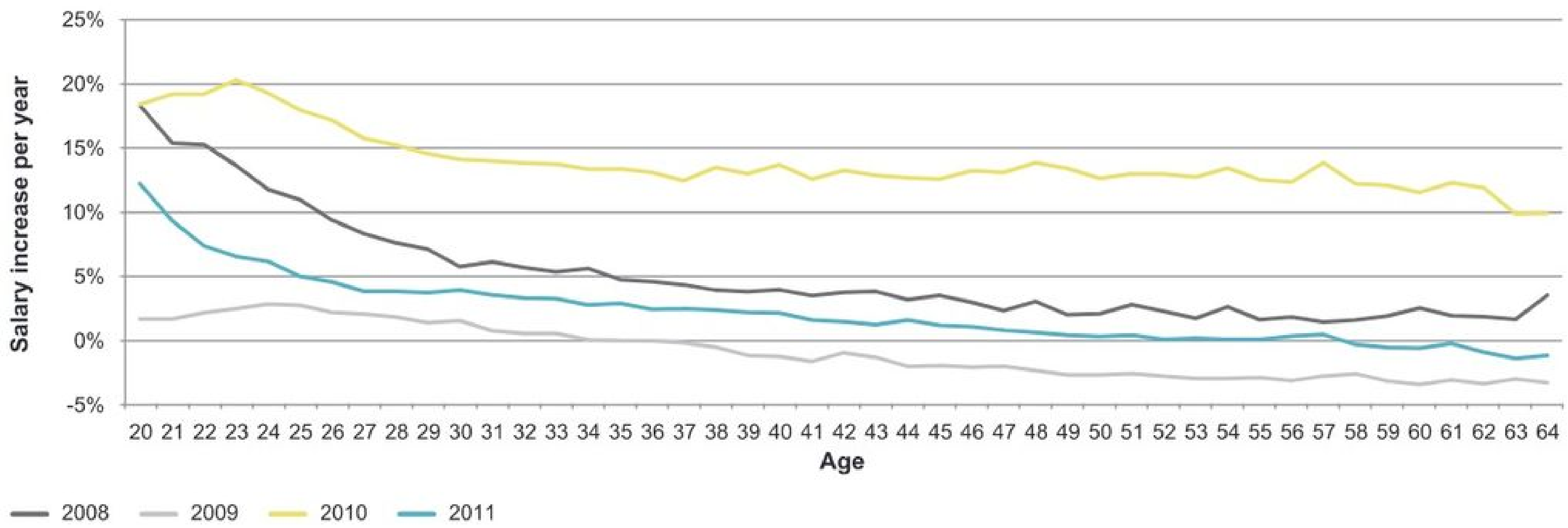
High real salary increases pose more of a challenge in certain industries than others. Cyclical industries such as construction may have high salary increases in certain years and lower increases in others. On the other hand, industries such as mining, security and transport may be adjusting wages upwards in real terms to secure a living wage and may face consistently high increases for a number of years.

AVERAGE REAL INCREASE IN PENSIONABLE SALARY



Source: Member WatchTM 2012 data set

Can we expect it to continue?

It is generally accepted that for South Africa to be a better place for all, we need to invest and accelerate the improvement of living standards of the poor, including the lowest earners. Some of the arguments for higher increases include the impact of petrol and electricity prices. Recent food and fuel inflation has hit lower earners hardest and this has influenced wage negotiations.

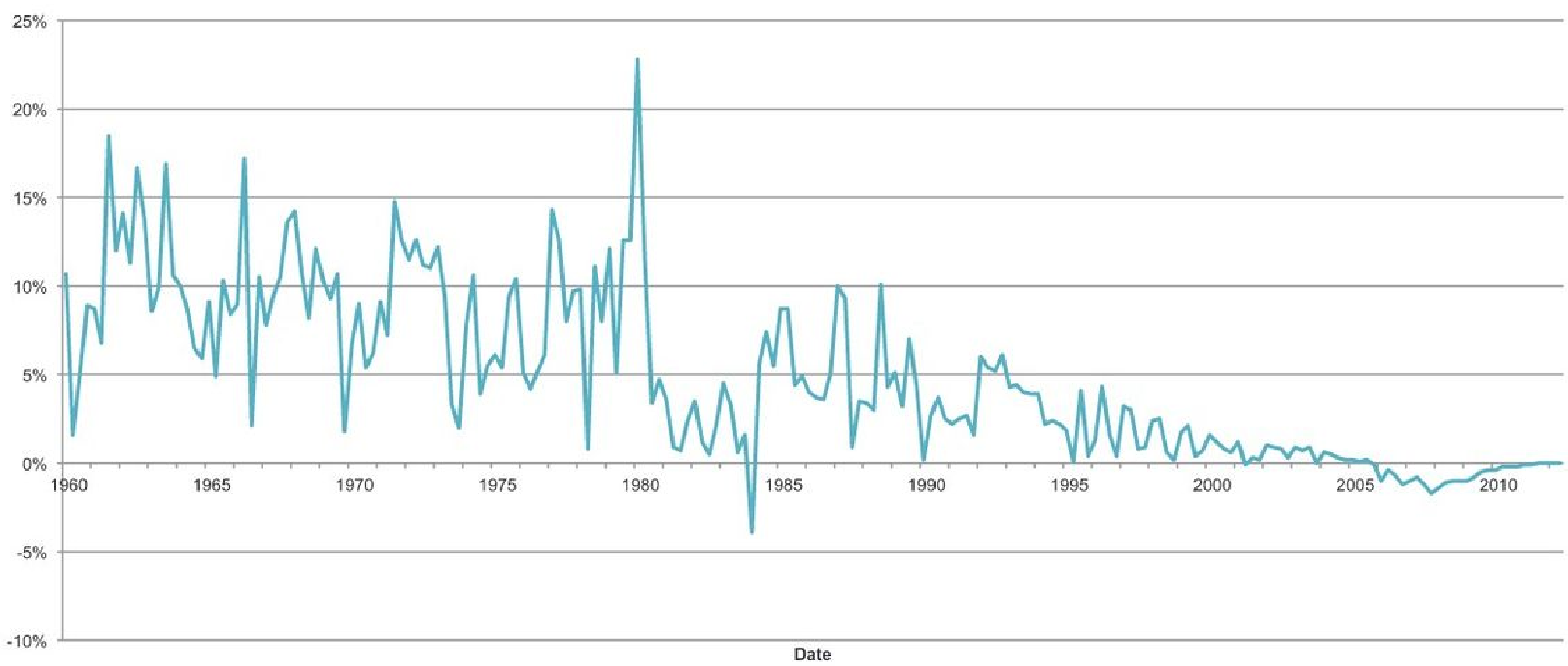
A second factor is skills shortages, such as in the construction sector during the construction of the Gautrain and the building boom in the lead up to the 2010 FIFA™ World Cup. Skills shortages can result in wages being driven up outside the annual salary review. For example, a new hire may cost more than a previous hire or an employer may be forced to grant a salary increase to retain skills. The higher turnover rates that many employers have experienced in recent years may be in part responsible for higher real salary inflation Given that skills shortages remain a feature of many industries, this trend is expected to continue.

The downside of upsizing salary

Unfortunately, while salary increases might increase take-home pay, they may not necessarily have a positive impact on overall financial health. Perhaps surprisingly, increasing take-home pay does not necessarily reduce financial distress[2].

In the South African context, this is due to our high levels of credit spending. This is evident from the net of debt savings rates of South Africans as seen in the graph below.

HOUSEHOLD SAVINGS RATE AS A PERCENTAGE OF DISPOSABLE INCOME



Source: South African Reserve Bank, KBP6287L, Household Savings Rate as a Percentage of Disposable Income, Seasonally Adjusted Data

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Instead of using the additional growth in earnings to increase savings, South Africans have continued to spend the additional income.

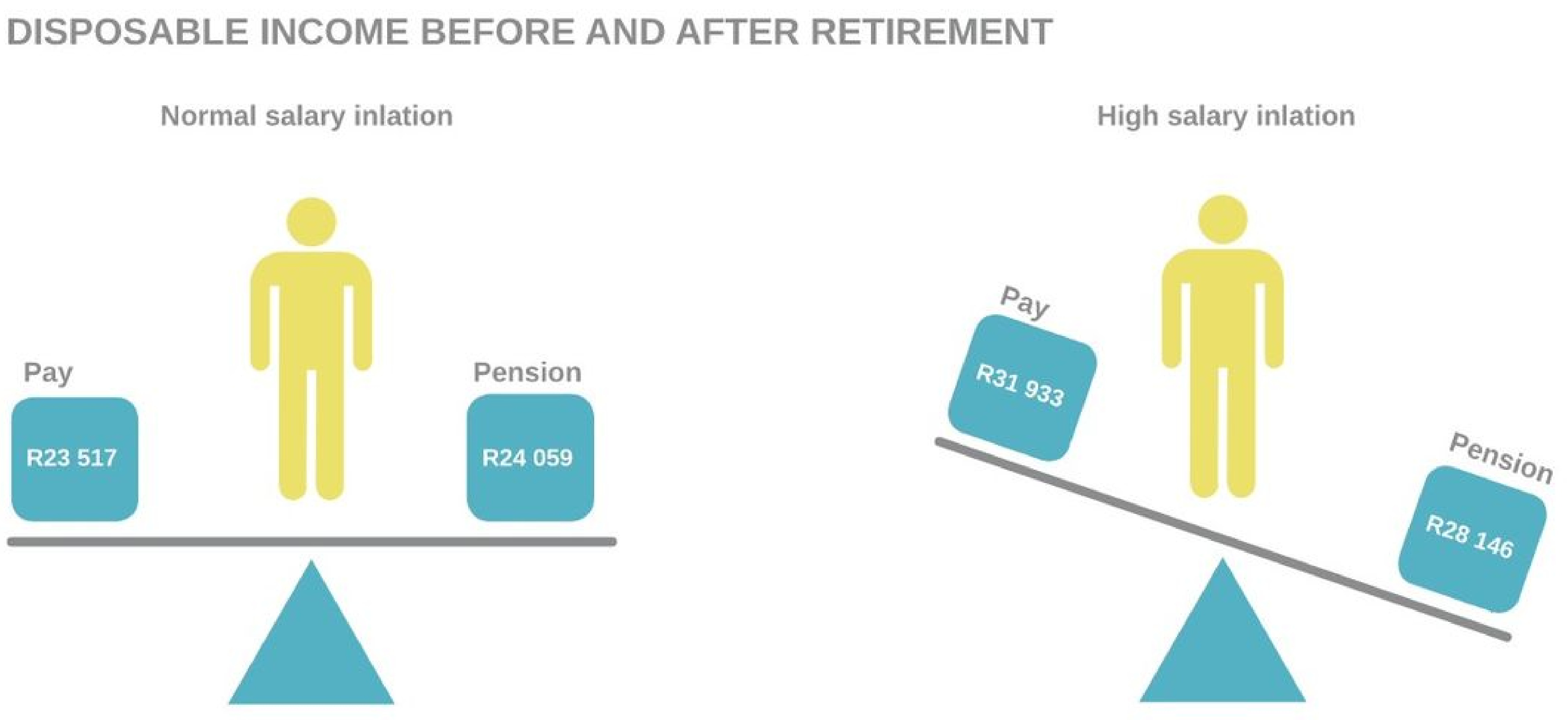
This has significant implications for retirement savings. The high real salary increases are taking place during a period of low expected returns on accumulated savings. And both the high increases and low returns are expected to continue for the foreseeable future.

But why is this a problem? In general, retirement fund contributions are expressed as a percentage of pensionable salary, so the rand amounts being contributed increase with the higher salaries. However, the issue comes in that accumulated savings need to keep pace with salary inflation and then provide an additional return. This is because as you upgrade your lifestyle, the level of income you need to sustain it in retirement increases. So your retirement goal moves further out of reach. To accumulate enough by retirement age to meet this goal, you would either need to save more as a percentage of your salary or earn more investment returns. If the contribution rate is fixed, the only way you could achieve this goal is through increased investment returns.

However, future investment returns are expected to be muted at best. A retirement fund member with a 70% equity (shares) allocation, 20% bond allocation and 10% cash allocation is only expected to earn 3.8% annually above inflation over the next 10 years. If historic levels of salary inflation continue, the investment returns will hardly be enough to cover the salary increases, let alone provide growth. In other words, the higher standards of living funded by high salary increases cannot be supported in the generally lower investment return environment.

This can best be illustrated by an example shown alongside[3]. Let's take a 25-year-old member who earns R10 000 per month now. He contributes 26% of his earnings to his retirement savings. By the time he gets to retirement, his final salary after tax and saving for retirement would be R23 517 per month. His after-tax pension is estimated at R24 059 per month.

If the member's salary inflation is 1% higher in real terms over his working life, the picture is quite different. His final salary after tax and saving for retirement would be R31 933 per month and his after-tax pension is now R28 146 per month. This example is illustrated in the infographic below.



As a result, even though higher salary inflation leads to larger pensions, it also leads to a larger drop in income at retirement. The higher the salary inflation, the bigger the drop. Although the retiree is obviously better off in rands and cents terms following higher salary increases, economising may prove difficult. To reduce the fall in income at retirement, the overall contribution over the member's lifetime would need to increase. In practice, this could be phased in over a period of time, using a portion of each subsequent salary increase to fund the additional contributions.

The appropriate contribution structure would also need to take taxation into account. Given current conditions, allowing tax-deductible contributions of over 30% over an individual's lifetime may be required.

Every time you receive a salary increase above the return earned in your retirement fund, it means that your accumulated savings have not kept pace with your living standard change. If accumulated savings continually lack behind rising living standards, you will need to reduce your expected living standard at retirement unless you make a plan to close the shortfall.

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Implications

For defined benefit (DB) funds, high salary increases relative to investment returns may translate into additional strain on the funding levels. This, in the absence of any other factors, is likely to lead to increased contribution rates.

For defined contribution (DC) arrangements, high salary increases relative to investment returns result in a larger gap between actual retirement incomes and pre-retirement living standards. One response to address this would be to defer retirement, which is discussed in 'Longevity'.

The other response in DC arrangements would be to change the mindset on remuneration. Every time a person receives a salary increase, they need to understand that they are building both their current and future lifestyle. So, the more they spend of their increases, the less they will have to live on in retirement.

Perhaps it's time to start looking at defaults that start a person off at a pre-determined contribution rate, which then automatically increases at the salary increase date each year to a maximum level. This approach has shown to increase savings rates in the United States[4] and is one way to overcome some of the behavioural problems involved in increasing the amount people save.

Lastly, these issues illustrate the importance of improving the financial literacy of South Africans. This is desperately needed to stimulate a savings culture that would turn salary increases into increased savings and decreased debt.

References

1 Wendell, R. South African Truckers Sign Wage Deal, Strike Off. Reuters http://www.reuters.com/article/2012/10/12/us-safrica-strikes-trucks-idUSBRE89B07920121012 12/10/2012
2 O'Neill et al (2006)
3 Performed using Alexander Forbes Houseview assumptions as at 30 September 2012
4 Thaler & Benartzi (2004)

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