EQUITY ECONOMICS

Economic Analysis of NSW Local Government Wage Agreement

June 2020

About Equity Economics

Equity Economics was established in 2013 as an Australian based economic consultancy committed to providing quality economic analysis and policy advice to the not for profit, corporate and government sectors.

Our expertise includes economic analysis, policy advice, research, advocacy and strategy on some of Australia's most complex economic and social policy challenges.

Drawing experienced economist and policy analysts from across the most senior levels of the Australian Government, including the Federal Treasury, Department of Finance and Department of the Prime Minister and Cabinet, Equity Economics combines original economic analysis, insights into the distributional impact of economic policy choices and a commitment to more inclusive growth.

Introduction

As NSW faces the impacts of the COVID-19 pandemic the economic benefits of the proposed increase in local government employee wages under the *Local Government State Award (2020)* substantially outweigh the costs.

The proposed wage increases of 1.5 per cent in 2020-21, 2.0 per cent in 2021-22 and 2.0 per cent in 2022-23 represent a real decline in wages in 2020-21 but a maintenance of the real value of wages over the period if RBA inflation forecasts are achieved. This will be an important component of the NSW recovery from the economic recession.

While local government employs fewer people than the NSW Government, and around half the number of the Commonwealth Government across NSW it remains an important employer in regional and rural NSW. Providing a wage increase to local government employees will help these local economies.

The OECD has highlighted the secondary effects of public sector wage increases which are likely to assist the economic recovery, such as increasing the purchasing power of a large number of employees and the increasing the morale of public employees.[1]

On 19 June the Fair Work Commission increased the minimum wage by 1.75 per cent in part recognition of the need to balance the weak employment market with the positive impact of wages on aggregate demand.

We provide a range of evidence and original analysis to support an increase in local government wages including:

- Analysis of the economic and inflation outlook;
- Evidence on the impact of local government wages on demand in regional areas;
- A detailed exploration of the importance of public sector wage growth on aggregate demand, including original analysis showing the importance of public sector wages in driving wage growth across the economy.

[1] OECD (2012), Public Sector Compensation in Times of Austerity, OECD Publishing

The current recession will have a significant impact on local government budgets, with a decline in revenue and an increase in expenditure. These are standard fiscal stabilisers that, if allowed to operate, will help the local economies traverse the recession, minimising job losses and the scale of the economic contraction. Budget consolidation in the form of a local government sector wage freeze in the middle of an economic contraction would prolong the recession and the return to balanced budgets in the medium term.

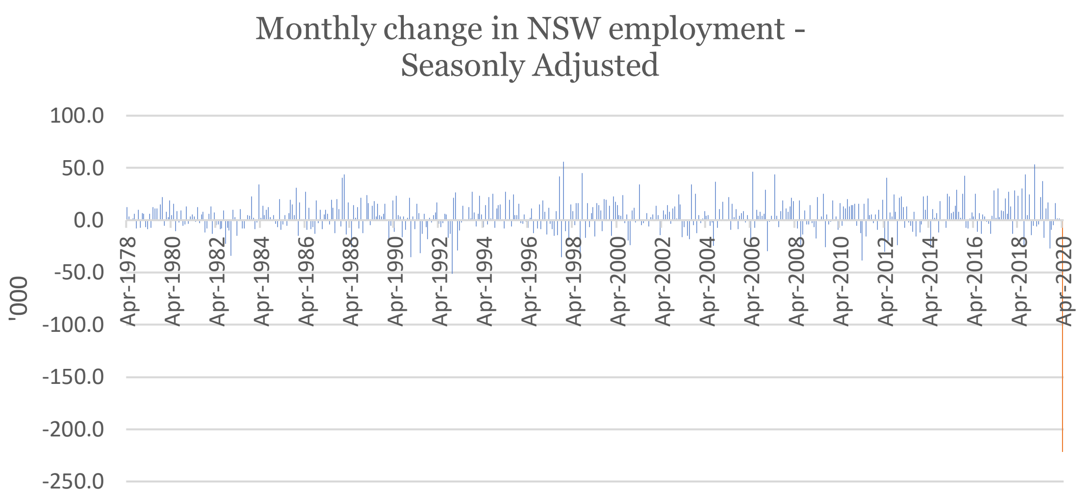
Economic Context

NSW is experiencing its first recession since 1990 due to COVID-19 and the economic shutdown to control the pandemic. In the March Quarter 2020 the Australian economy contracted 0.3 per cent in the March Quarter 2020, and is forecast to contract by around a further 10 per cent in the June Quarter 2020.[2]

Between March and May this year 259,000 jobs were lost across NSW.[3]

This represents the largest two-monthly fall in employment on record[4] (see Exhibit A).

EXHIBIT A



As restrictions to control the pandemic are lifted economic growth is expected to return in the September Quarter 2020, and the recovery will commence. However, there will be constraints on economic growth due to the ongoing global COVID-19 pandemic and underlying weaknesses present in the economy prior to the lockdown.

[2] Reserve Bank of Australia (2020), *Statement on Monetary Policy – May 2020*, https://www.rba.gov.au/publications/smp/2020/may/pdf/statement-on-monetary-policy-2020-05.pdf
[3] Australian Bureau of Statistics, 6202.0 - Labour Force, Australia, May 2020
[4] Australian Bureau of Statistics, 6202.0 - Labour Force, Australia, May 2020

There is a high risk of a second or double dip recession starting in the December Quarter 2020 or the March Quarter 2021. As a result support from government will be important to economic growth, due the lack of private demand.

Specifically, ongoing travel restrictions will continue to directly impact NSW's two largest service exports, international tourism and international education. Combined these sectors accounted for 3.5 per cent of Gross State Product (GSP) in 2018.[5]

In addition, the global recession caused by the first wave of COVID-19 and a potential second wave before the end of 2020[6], will reduce demand for many of NSW's goods exports, including coal, which combined contribute almost 9 per cent to GSP.[7]

A combination of high levels of household debt and low wages growth before COVID-19 were presenting significant risks to the Australian economy, which prompted the RBA to cut interest rates throughout 2019 to record lows.[8]

The economic recovery will be negatively impacted by weak consumer demand and consistent with advice from the RBA Governor in August 2019 Government policy should support wages growth and therefore consumer expectations.[9]

COVID-19 and the drop in oil prices has led to a temporary fall in prices, with the RBA forecasting inflation to rebound during 2020-21 to 2.75 per cent.[10] This is

[5] Authors own calculations using Australian Bureau of Statistics (2019), 5220.0 Australian National Accounts: State Accounts, 2018-19; Australian Bureau of Statistics (2020), 5368.0 International Trade in Goods and Services, April 2020 and Australian Bureau of Statistics (2019), 5368.0.55.004 International Trade: Supplementary Information, Calendar Year, 2018
[6] OECD (2020), OECD Economic Outlook, June 2020
[7] Authors own calculations using Australian Bureau of Statistics (2019), 5220.0 Australian National Accounts: State Accounts, 2018-19 and Australian Bureau of Statistics (2020), 5368.0 International Trade in Goods and Services, April 2020
[8] Reserve Bank of Australia (2019), Statement by Philip Lowe Governor: Monetary Policy Decision, 1 October 2019
[9] House of Representatives (2019), Standing Committee on Economics Hansard, Friday 9 August 2019
[10] Reserve Bank of Australia (2020), *Statement on Monetary Policy – May 2020*, https://www.rba.gov.au/publications/smp/2020/may/pdf/statement-on-monetary-policy-2020-05.pdf

within the target band of the RBA, however there is a risk that inflation will fall to be outside the target band.

Sustained deflation due to poor wages growth and excess spare capacity in the economy represents a risk to the recovery as it incentivises consumers to save rather than spend, prolonging the economic downturn. The proposed wage increase for Local Government employees would help mitigate this risk.

Economic forecasting in the current environment is fraught due to the uncertainty around the course of the COVID-19 pandemic, including whether there is a second wave and when a vaccine may become available.

Assuming a vaccine for COVID-19 is found and distributed in late 2021, we would expect a return to previous levels of economic activity in NSW no sooner than the first half of 2022. Without public investment and spending (of which wages is the largest component in NSW), and failing to allow automatic fiscal stabilisers to operate, the economic downturn will be more protracted and severe.

Inflation Outlook

The outbreak of COVID-19 and Commonwealth Government policies, including the provision of free childcare, are expected to have reduced inflation in the March Quarter 2020.

The Reserve Bank of Australia has noted that "a sharp drop in demand for some goods and services will lead to lower inflation for many components of the CPI such as fuel and rents. Oil price declines are putting downward pressure on fuel prices. The sharp decline in oil prices earlier in the year led to a 6 per cent decline in automotive fuel prices in the March quarter."[11]

The Reserve Bank of Australia has forecast 2.75 per cent inflation in the year to June 2021, 1.25 per cent inflation in the year to June 2022 and 1.5 per cent inflation in the year to June 2023.

This inflation outlook means that the proposed wage increase for local government employees would result in a maintenance of the real value of wages over the three years of the agreement.

[11] Reserve Bank of Australia (2020), *Statement on Monetary Policy – May 2020*, https://www.rba.gov.au/publications/smp/2020/may/pdf/statement-on-monetary-policy-2020-05.pdf

Public sector pay increases are an effective stimulus to support economic recovery

The IMF, the OECD and the World Bank have all issued advice to governments to provide fiscal support to economies in the wake of COVID-19.[12]

The case for fiscal support in times of recession has been well established, including in an IMF study of 118 episodes of systemic banking crisis in advanced and emerging market countries between 1980–2008. The study finds that "timely countercyclical fiscal measures contribute to shortening the length of crisis episodes by stimulating aggregate demand".[13] As a result they improve government finances in the medium term by strengthening the economy, which increases revenue and reduces expenditure.

While the decision to increase wages of local government employees will not have the same macro-economic impact as spending by other levels of government, it will still have a positive economic impact through increasing consumption – especially in local areas.

The Role of Consumption

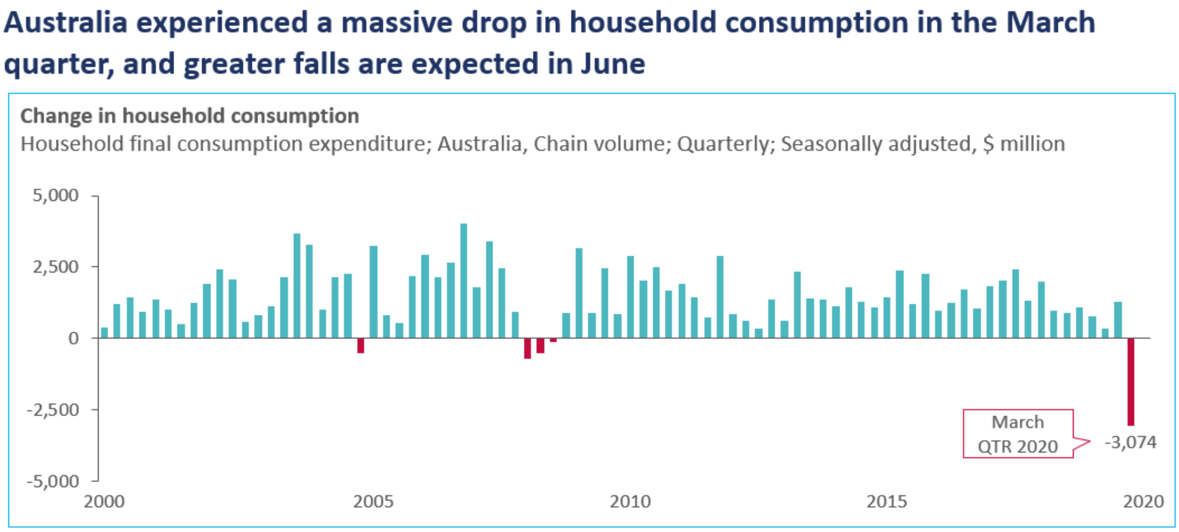
Recognising the central role of consumption in the Australian economy (and the livelihoods of households), the Commonwealth Government has implemented a number of support measures for households including new income support measures, expanded unemployment benefits and targeted stimulus. In addition, banks and other large businesses have implemented hardship measures including loan deferrals and extended payment plans.

However, each of these measures is temporary and will be progressively withdrawn over the next six months. If large numbers of workers begin running out of these benefits, consumer confidence could falter and put the recovery at risk.

[12] IMF (2020), Special Series on Fiscal Policies to Respond to COVID-19: Expenditure Policies in Support of Firms and Households, April 2020; OECD (2020), OECD Economic Outlook, June 2020 and World Bank Group (2020), Protecting People and Economies: Integrated Policy Responses to COVID-19, 2020
[13] IMF (2009), How Effective is Fiscal Policy Response in Systemic Banking Crises? Sanjeev Gupta; Carlos Mulas-Granados; Emanuele Baldacci, IMF Working Paper, July 1, 2009

One of the largest hits to the Australian economy has been the fall in consumption, which experienced the largest fall in more than two decades in March (and will fall even further in June) (See Exhibit B).

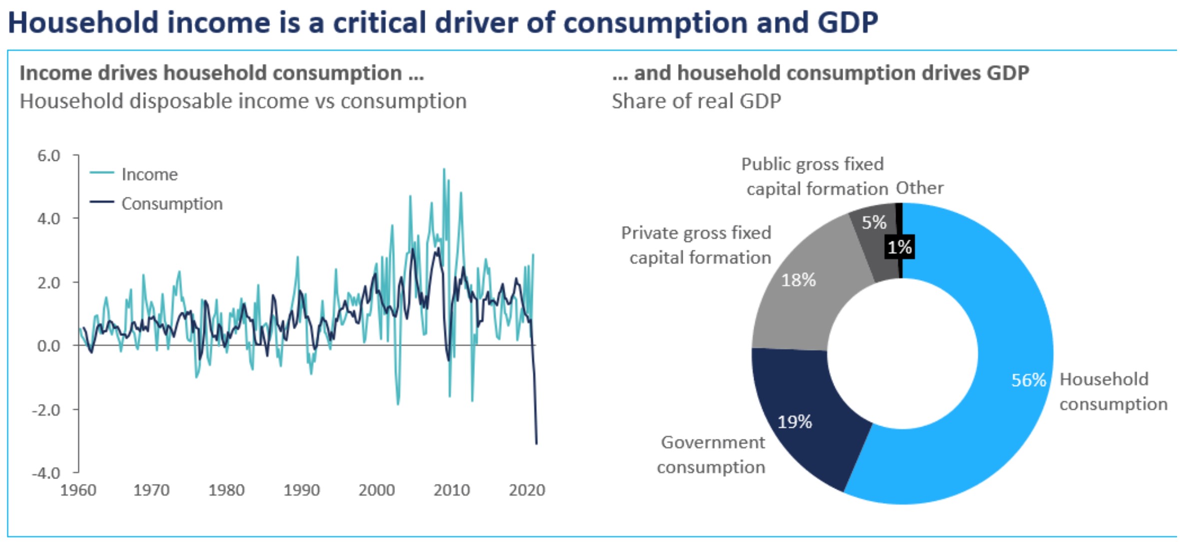
EXHIBIT B



SOURCE: ABS, Equity Economics

Household income is a critical driver of consumption. Exhibit C shows a strong correlation between household consumption and household income. Further, household consumption is the largest component of the economy, accounting for more than half (56%) of GDP.

EXHIBIT C



NOTES: Household final consumption expenditure; Chain volume, Quarterly, Seasonally adjusted, $ million; Real household disposable income, Quarterly, Seasonally adjusted, $ million, Lagged 2 quarters
SOURCE: ABS, Equity Economics

The Role of Public Sector Wages

Fiscal Multipliers

A major challenge in the Australian economy over the last decade has been persistently low wages growth. Restraints on public sector wages are a significant restraint on private sector wages.

The RBA Governor directly raised this issue in August 2019 in his evidence before the Standing Committee on Economics where he indicated that it would be preferable to see Public Sector Wage increases with a 3 in front, rather than a 2[14]. This reflected the view of the RBA that wages constraint due to its negative impact on consumption hurts the Australian economy.

A relevant question for policymakers is: What interventions are most likely to support and sustain economic recovery. As Australian governments consider this question, a key criteria is the 'fiscal policy multiplier'.

The fiscal multiplier (i.e. the 'bang for buck' of government spending) is the ratio of change in national income arising from a change in government spending. Certain types of spending lead to greater second and third round effects, which enhance the economic benefits. We note that once you move past first round effects of spending the level of uncertainty surrounding the benefits increases substantially.

The fiscal multiplier is higher when less of the money 'leaks' from the economy through either saving, taxation, or imports. For example, if fiscal policy is used to fund a project for which many components are imported, then the fiscal policy multiplier may be low. Or if fiscal policy is directed to households who save the money rather than spend it, then the fiscal policy multiplier may also be low.
Estimate

The fiscal multiplier of increasing local government wages, requires consideration of a number of impacts:

- The immediate impact on disposable income;

[14] House of Representatives (2019), Standing Committee on Economics Hansard, Friday 9 August 2019

- The impact on the borrowing capacity of households; and
- The secondary impact on private sector wages.

Immediate Impact on Disposable Income

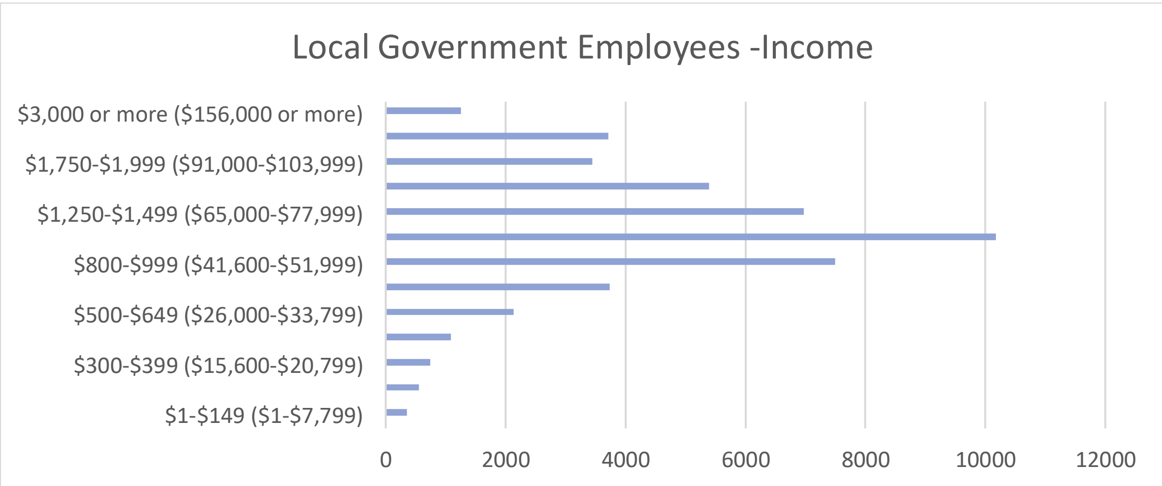
Increasing the disposable of income of households during economic crisis has shown to be an effective economic stimulus, with a high fiscal multiplier from previous recessions.

The OECD estimated that the fiscal multiplier from one-off payments made during the GFC in Australia were in the order of 0.4 in year one, and 0.7 to 0.8 in year two.[15]

Increasing the income of middle and lower income households is an effective form of support for the economy because they are more likely to spend the extra money in the economy (i.e. they have a higher marginal propensity to consume), lower tax rates and lower import shares than many other recipients of fiscal support. Fiscal support to lower and middle-income people has a high 'fiscal multiplier' which is an important consideration in designing fiscal policy.

Data from the 2016 Census highlights that many local government employees in NSW are low to middle income earners (Exhibit D).

EXHIBIT D



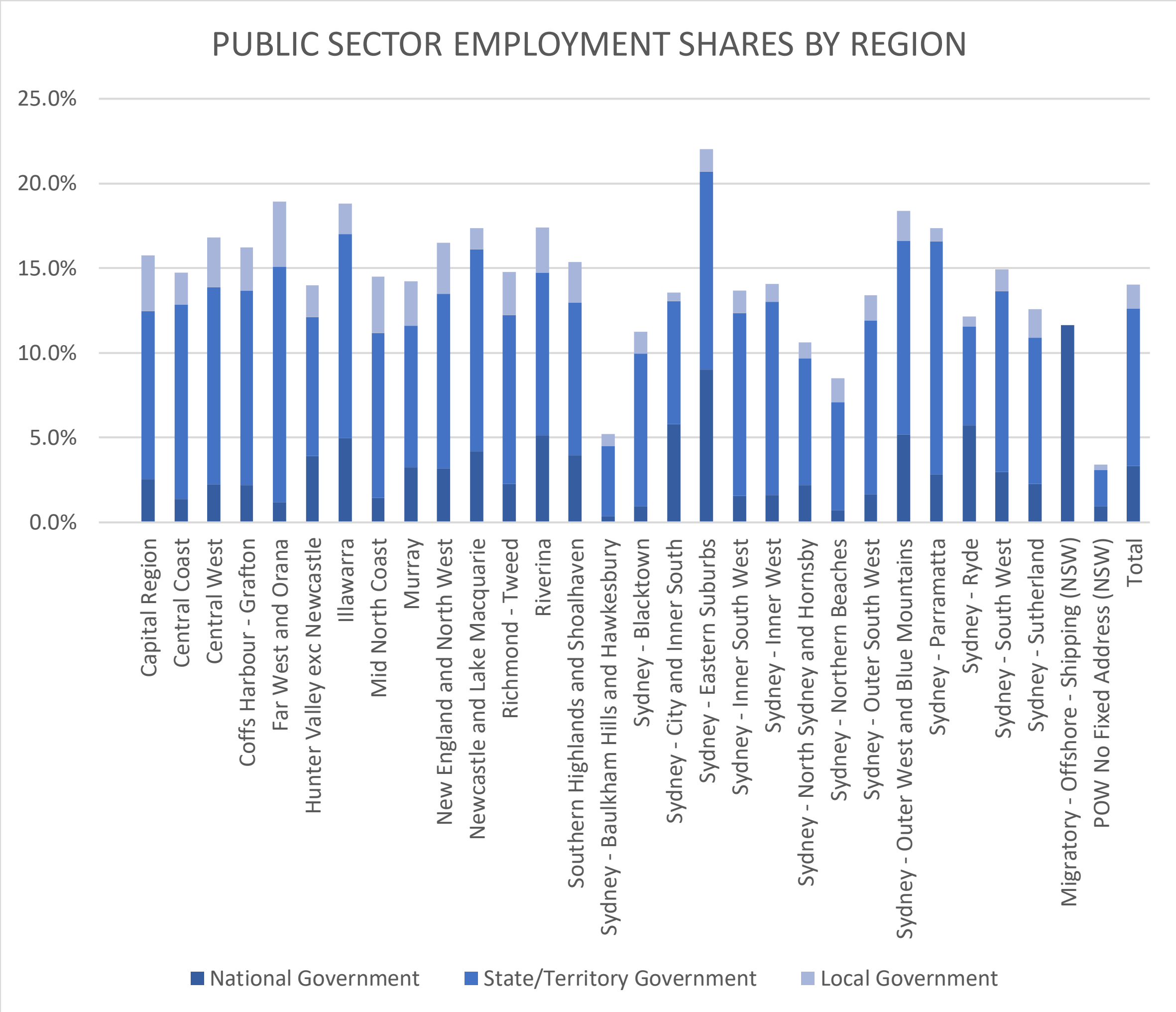
Source: Australian Bureau of Statistics Census Table Builder, 2016 Census.

15 OECD 2009, Interim Economic Outlook, Chapter 3: The Effectiveness and Scope of Fiscal Stimulus, OECD, Paris.

Another advantage of raising the incomes of local government workers is that they are geographically dispersed.

While NSW local government employees only account for 1.5 per cent of the entire NSW labour market, they account for more than double this amount in some rural and regional areas (Exhibit F).

EXHIBIT F



Source: Australian Bureau of Statistics Census Table Builder, 2016 Census.

One of the challenges with fiscal policy stimulus is ensuring that the support reaches all parts of the economy and isn't concentrated in one geographic region. Local government workers are spread across almost every community and increasing their income adds activity to every corner of the state.

EXHIBIT F

Increasing the income of lower and middle-income people is one of the most effective ways to stimulate the economy

How can governments spend money to create maximum economic stimulus?

The fiscal multiplier (i.e. the '**bang for buck**' of government spending) is the ratio of change in national income arising from a change in government spending. The fiscal multiplier is higher when less of the money 'leaks' from the economy through either **saving**, **taxation**, or **imports**.

$$Fiscal\ multiplier = \frac{1}{f(saving, tax, imports)}$$

Providing additional income to lower and middle-income people has a high fiscal multiplier because:

- **Saving** rates are lower for low income people
- **Tax** rates are lower for lower income households
- **Imports** are lower for households

Public sector wage rises are an effective stimulus because, when the government provides money to lower and middle income people, less of that money 'leaks' from the domestic economy

SOURCE: Equity Economics

Impact on Borrowing Capacity of Households

Wage increases are different to a one-off payment to households because they represent a permanent increase in income.

The wage increases will permanently increase the wages of local government employees. Assuming local government employees earn equivalent median salry of state public servants ($87,926) then the value of the salary increases in each year of the agreement will be:

- 2021-22: a 1.5 per cent pay increase equates to an additional $1,319 per year
- 2022-23: a 2.0 per cent pay increase equates to an additional $1,785
- 2023-24: a 2.0 per cent pay increase equates to an additional $1,821

Over the three years the increase equates to an additional $4,924, but an increase of $93,620 in future income over the next twenty years[16]. An increase will also have an impact on compulsory superannuation savings, which will decrease other forms of saving and increase consumption. This is useful to understand because it explains why the impact on spending today is greater than the value of the wage freeze in each year.

[16] NSW Public Service Commission (2019), State of the NSW Public Sector Report, 2019 and authors own calculations – comparator is not increase in wages over twenty years.

Households will factor in the extra $1,319 they receive this year, and next year and so forth and their increased future superannuation savings into their borrowing and spending decisions today.

This increases the stimulatory impact of the wage increase above any direct fiscal multiplier, and therefore its importance to the economy of NSW. Public servants will not just spend a portion of the additional $4,924 they receive over the next four years; they will also borrow more than this on the basis of the permanent increase in their wages.

Impact on private sector wages

A major challenge in the Australian economy over the last decade has been persistently low wage growth. Restraints on public sector wages are a significant restraint on private sector wages.

Over the last ten years, both private and public sector wage growth in NSW has fallen. NSW private sector wages growth fell from 3.8 per cent per annum between 2006 and 2011 to just 2.0 per cent p.a. between 2011 and 2016. In the public sector the slowdown was even steeper as a result of the introduction of the NSW public sector wage cap in that period. Public sector wage growth decreased from 4.7 per cent p.a. between 2006 and 2011 to just 1.3 per cent p.a. between 2011 and 2016.

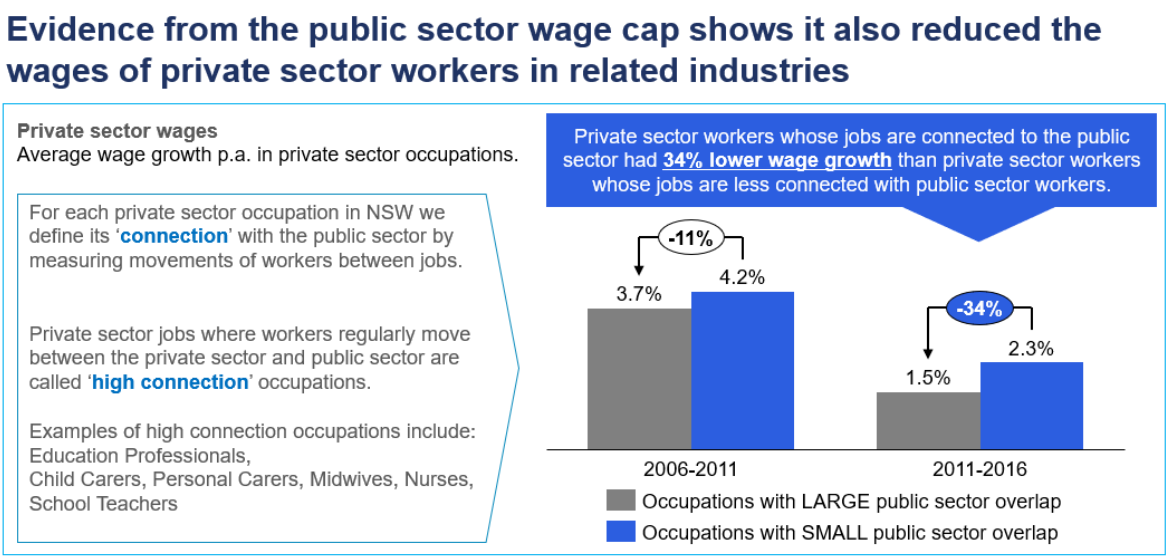
One question is whether the large reduction in the public sector wages growth (caused in part by the Public Sector wages cap that was in place over this period) contributed to the decline in private sector wages growth. To analyse this question we used information from the ABS Census to analyse data on wage growth for detailed occupations. For each private sector occupation in NSW, we define its 'connection' with the public sector by measuring movements of workers between jobs. Private sector jobs where workers regularly move between the private sector and public sector are called 'high connection' occupations. Examples of 'high connection' occupations include education professionals, personal carers, midwives, nurses and teachers.

Private sector workers in occupations with 'high connection' to the public sector had 34 per cent lower wage growth than private sector workers whose jobs are less connected with public sector workers. Private sector workers in occupations with 'high connection' to the public sector saw their wage growth fall 59 per cent (from 3.7 per cent per annum between 2006-2011 to 1.5 per cent between 2011-2016). Over the same period, private sector workers without 'high connection' to the public sector saw their wages fall less (a total fall of 45 per cent, from 4.2 per cent to 2.3 per cent).

A possible explanation for this result is that the wage restraint in the public sector 'spilled over' into wages for private sector workers. Private sector workers in 'high connection' occupations – such as nurses, teachers, child care workers – are hired from the same 'labour market pool' as public sector workers and are eligible in many cases for similar roles. If private sector employers of these occupations know that the alternative public sector roles for these people involve slow wages growth, they will feel less pressure to increase their wages.

The potential for public sector wage constraints to negatively affect private sector wages is another reason not to impose a freeze on the public sector (see Exhibit G).

EXHIBIT G.



SOURCE: ABS Census Tablebuilder

Conclusion

The proposed agreement will maintain salaries for thousands of local government employees across the state. This will have a direct impact on the spending by these employees, due to an increase in disposable income and borrowing capacity. In addition, it will have a positive impact on private sector wages, which also increases aggregate demand. This will support the economic recovery.

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