Messing With Success: Victoria's Puzzling Turn to Austerity

By Troy Henderson and Jim Stanford
Centre for Future Work at the Australia Institute

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Introduction and Summary

In recent years, the State of Victoria has enjoyed an enviable period of dynamic growth and rising prosperity. Its economy has consistently been the strongest in Australia: with the most new jobs, the fastest growth in wages, and the biggest expansion in output. The Victoria state government has been both a key cause of that growth, and a major beneficiary of it. New expenditures on expanded public services and infrastructure have been crucial engines of the state's growth. In turn, that strong growth generated huge fiscal dividends for the state government, through a robust, diversified and growing revenue base.

In short, Victoria provides an encouraging example of the potential success of a mixed, partly planned, inclusive economy: one in which the public sector plays an active, leading role in both fostering growth, and ensuring that its benefits are shared. The state government was rewarded for this success with a strong electoral mandate in 2018.

Given this positive history, it is utterly inexplicable that the state government would now choose to mimic some of the most ill-advised and unsuccessful tools of fiscal austerity that have been implemented, with negative and unintended consequences, in other Australian jurisdictions. Specifically, the government has recently announced the imposition of a stringent cap on public sector wage increases: 2% per year over the coming four-year period. That is well below all relevant benchmarks: including continued growth in the state's economy, growth in state revenues, wage growth in the overall state labour market, and the Reserve Bank's targets for both wage and price inflation. It also falls far below what the state's elected representatives will receive in their own wage increase this year.

The wage cap, if it stands, would artificially suppress total state public sector compensation by over $3 billion over the coming four years – compared to normal compensation patterns. It would short-circuit the badly-needed recovery in wage growth that is just taking hold in Victoria's broader labour market. It would damage consumer spending, exert a chilling impact on private sector wage settlements, and do particular damage to regional communities which depend especially strongly on public sector jobs and incomes.

The impact of the wage cap would be exacerbated by a secondary, equally puzzling austerity measure announced in the state's 2019-20 budget: an increase in the so-called "efficiency dividend," to take effect form 2020-21, that would impose an effective and homogeneous budget cut on departments and programs. This expanded “efficiency dividend” is justified as a tool for eliciting greater efficiency in service delivery; in practice it amounts to a simple, mindless, across-the-board cut in expenditures, service delivery, and potentially employment.

There is no fiscal problem that justifies either of these austere measures. The state government is not experiencing a deficit; it plans to generate consistent annual operating surpluses over the next four years. Its total revenues will continue to grow strongly. The downturn in Melbourne property prices, which undermined one component of state revenues (land transfer duties), now appears to be reaching bottom; and even in its worst stages, the fiscal impacts of that property downturn were modest, never interfering with the ongoing strong growth in overall state revenues. Moreover, while gross debt has grown (boosted by the state’s historic infrastructure investment program), financial analysts and debt rating agencies are unanimous that the state’s net debt and interest payments are fully manageable, and the government’s net worth remains strongly positive. In sum, the Victoria state government enjoys a healthy and enviable fiscal position; there is no fiscal argument at all for the imposition of these unnecessary forms of fiscal austerity. The government’s flirtation with austerity, despite the proven success (both economic and political) of its previous, more expansive approach, is puzzling and concerning.

This paper is organised as follows. First it reviews the economic and fiscal context for the state government’s wage policies. It assembles evidence on Victoria’s nation-beating economic and labour performance – highlighting the positive role played by the state government’s own investments in both service delivery and infrastructure in recent years. Secondly, the paper considers the overall fiscal outlook facing the state government. In particular, it shows the strength and stability of the government’s diversified revenue base; the current decline in land transfer duties resulting from the downturn in the Melbourne property market is temporary, and had only a small effect on overall state revenues (which continued to grow anyway). The third section of the report describes the disproportionately important role that state public sector jobs play in regional communities in Victoria. State public sector jobs make up a significantly larger share of total employment in regional Victoria, compared to greater Melbourne. Moreover, they constitute some of the only positions in many regional communities available for well-educated, mobile, younger workers. Hence any retrenchment in public sector hiring and compensation will have a particularly negative impact on regional communities – which already struggle to maintain jobs, population, and services. The final section of the report challenges the logic of fiscal austerity: including restrictive measures such as wage caps and “efficiency dividends.” The experience of other jurisdictions in Australia confirms that these measures are neither necessary nor effective; instead they have contributed to broader wage stagnation, macroeconomic weakness, deterioration in service quality, and growing inequality.

The state government in Victoria faces no fiscal challenges that could justify either of these forays into the realm of austerity. Instead of belatedly aping austerity measures that have been tried, and found wanting, elsewhere in Australia, the government should recognise that its past rejection of these simple-minded tactics has in fact been important to the state's nation-leading economic success. To that end, the paper concludes with five key recommendations:

1. The state government should abandon the imposition of a wage cap on state public sector workers.
2. Instead, the state government should enter into normal negotiation of enterprise agreements in all broader public sector enterprises and agencies. The state's fiscal outlook is obviously a relevant and important factor in those negotiations, but it does not justify the imposition of direct wage controls.
3. The state government should abandon the proposed increase in the annual "efficiency dividend," which has proven to be a blunt and ineffective budgetary strategy.
4. Instead, the state should undertake an open-ended program review of departments and agencies. The goal of this review should be enhancing genuine efficiency – defined as improving the effectiveness and quality of public service delivery – rather than attempting to attain a target budget cut.
5. Finally, the state should commit to no forced redundancies during the course of that program review. Any identified redeployments (motivated genuinely by improving service and better allocating existing resources) should be attained through relocation, retraining, and voluntary severance.

1. The Economic and Fiscal Context for Public Sector Work and Wages in Victoria

The State of Victoria has enjoyed robust economic and labour market conditions in recent years. The state has led all Australian jurisdictions according to a range of core indicators: including economic growth, job-creation, and income growth. Victoria's network of public services has been a central factor in that expansion and prosperity. Growth in public services in Victoria has made an important and disproportionate contribution to broader economic growth and job-creation. And by the same token, the state's leading economic performance has solidified the economic and fiscal foundation that underpins the continued provision of those services. At the same time, these essential services delivered by the state government and public sector agencies contribute directly to the improved standard of living for Victorian residents.

In short, a mutually reinforcing "virtuous cycle" connects the expanded provision of public services in the state, with broader economic and social progress, and the state's fiscal health. More public services contributes to broader economic and fiscal expansion, stimulating spillover benefits (including in the private sector), and further strengthening the economic and fiscal foundation for the continued expansion of those public services. The jobs created through health care, education, community services, public administration and safety, culture, and other publicly-supported programs have strengthened family and community incomes, underpinned consumer spending, and benefited thousands of private businesses.

Communities want and need more of those public and caring services – and they require a well-resourced and high-skill public sector (including the support and administration functions that are critical to effective front-line service delivery) to deliver them. International and Australian evidence suggests that people naturally desire proportionately more of these caring services as income levels rise, the population ages, and technology advances (expanding the possibilities for health care and other services).[1] In this context, the continuing expansion of public sector activity

[1] In economic theory the tendency for government to provide more public services over time (relative to GDP) is termed "Wagner's Law" (see Musgrave, 1969, for a classic interpretation). Public services like health care and education are considered "superior goods," meaning that demand for them rises at a

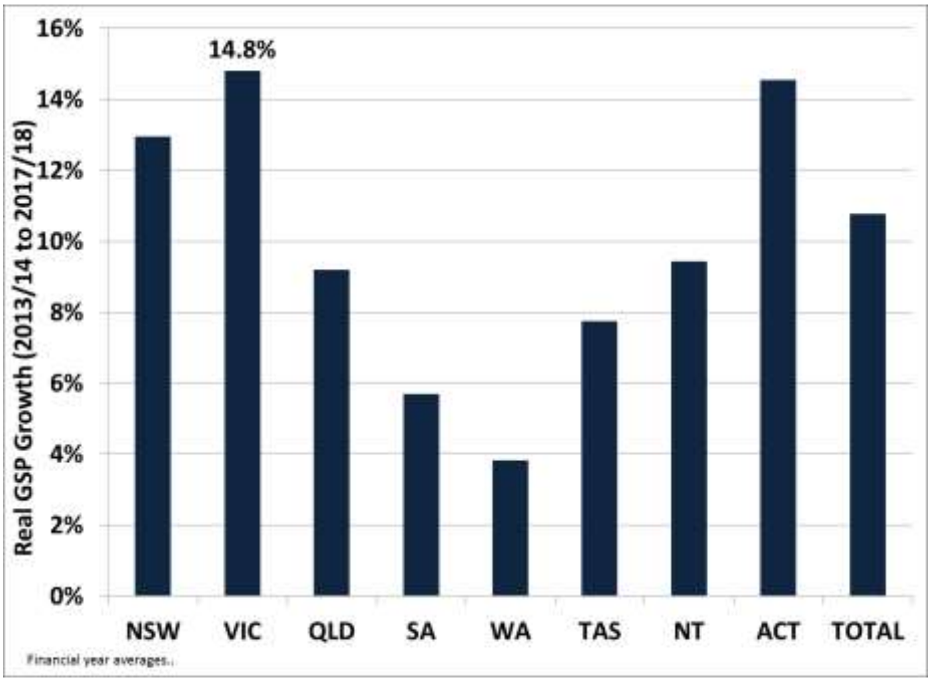
is a natural and healthy development; it is consistent with both social preferences and the productive capacity of the economy.

However, despite these positive outcomes, some commentators and political leaders still portray the expansion of public sector activity as some kind of “drain” or cost burden on society as a whole. Claims that the growth of health care, education, and other human services will somehow lead to the ultimate bankruptcy of governments are used to ratchet down public expenditure – including attacks on job security and compensation for the public sector workers who deliver these services. Despite Victoria’s robust economic and fiscal situation, these arguments for fiscal austerity remain powerful. Perhaps they influenced the state government’s recent surprising adoption of austere wage guidelines.

This section will review the broad economic and fiscal context for public service provision in Victoria. It will show that recent growth of expenditure and employment in the public sector has occurred in the context of growing economic capacity and growing public demand for those services. Relevant indicators confirm this expanded expenditure is well within historical norms, and is both economically and fiscally sustainable.

Victoria’s Economy has been the Strongest in Australia

Figure 1: Economic Growth by State, 2013-14 to 2017-18



Source: Authors’ calculations from ABS Catalogue 5220.0, Table 1

faster rate than incomes. See Lamartina and Zaghini (2011) and Magazzino et al. (2015) for recent empirical evidence.

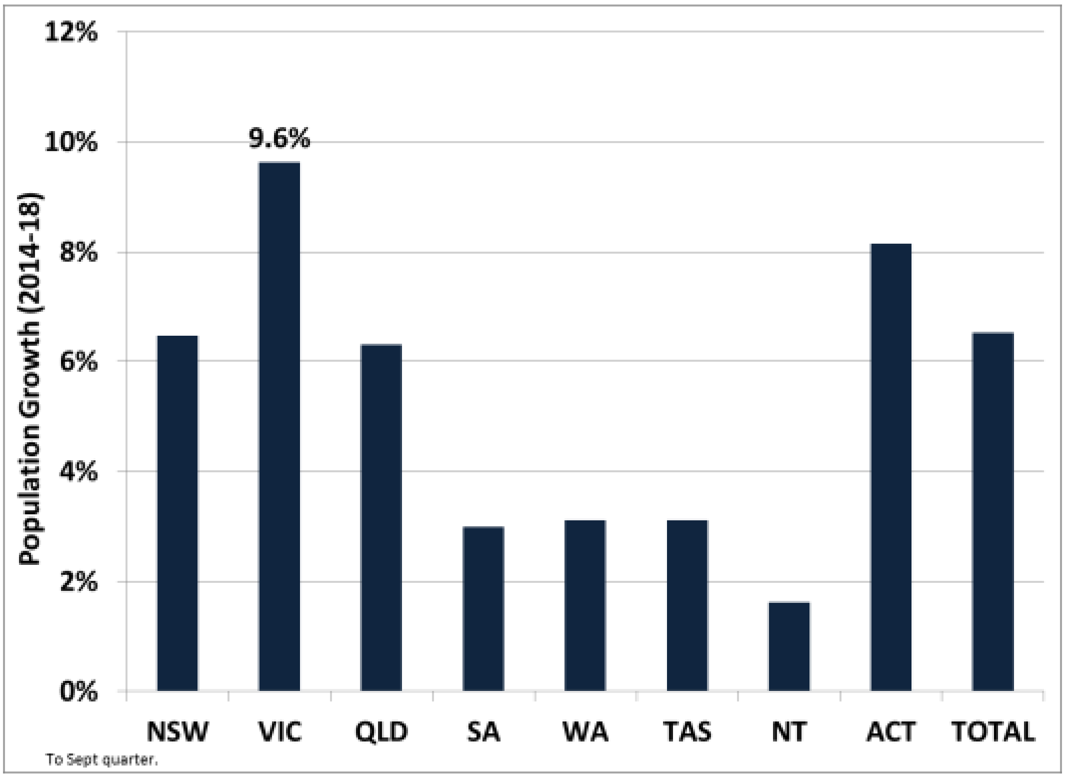
During the first four financial years after the election of the Andrews government in 2014, Victoria's real Gross State Product (GSP) expanded by a cumulative total of almost 15% – representing an annual average growth rate of 3.5% per year. This was the fastest economic growth experienced by any state or territory in Australia during this time.

Victoria's cumulative economic expansion since 2013/14 has been almost 40% faster than for Australia's national economy as a whole.

Relative to population, real GSP per capita grew by 5% over this period – at an annual average rate of 1.2% per year. This steady and significant growth in real per capita income provides a solid economic foundation for greater consumption of all goods and services – including public services.

<u>Victoria's Population has Grown Faster than Any Other State</u>

Figure 2: Population Growth by State, 2014-2018



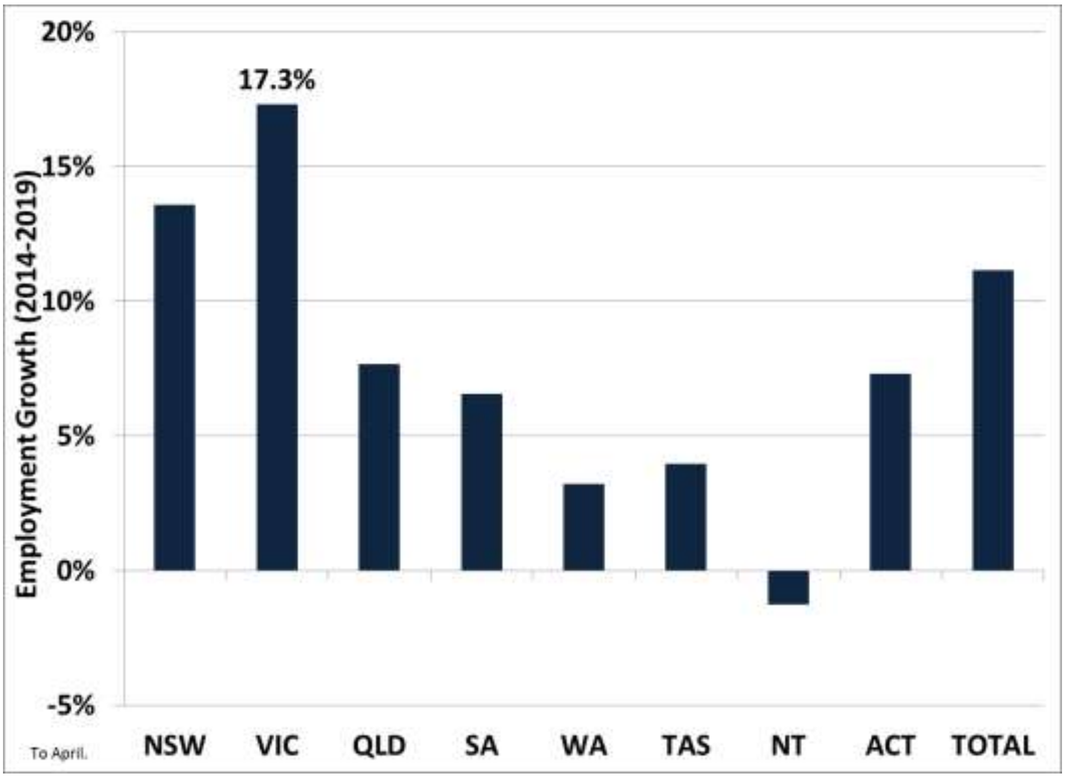
Source: Authors' calculations from ABS Catalogue 3101.0, Table 4.

Attracted by strong economic and employment opportunities, and by the high quality of life in Victorian communities, the state's population has grown robustly in recent years. During the first four years after the election of the Andrews government, the state's total population grew almost 10%. Once again, that is faster than any other state or territory – and half again as fast as the rate of population growth in Australia as a whole.

Needless to say, the rapid expansion of Victoria's population has led to growing demand for public infrastructure and public services. Thus the expansion of total state spending in these areas in recent years is quite appropriate to meet the needs of a growing (and ageing) population.

Victoria has the Strongest Labour Market in Australia

Figure 3: Employment Growth by State, 2014-2019



Source: Authors' calculations from ABS Catalogue 6202.0, Table 12.

Victoria's superior economic performance relative to the rest of Australia is strikingly evident in a comparison of job-creation performance. Over the past five years (based on most recent data to April 2019), total employment in the state expanded by over 17%. That is by far the strongest job-creation record of any state or territory, and represents a rate of employment growth more than 50% faster than the national average. And a higher proportion (close to two-thirds) of the new jobs created in Victoria were full-time, compared to the national average.[2]

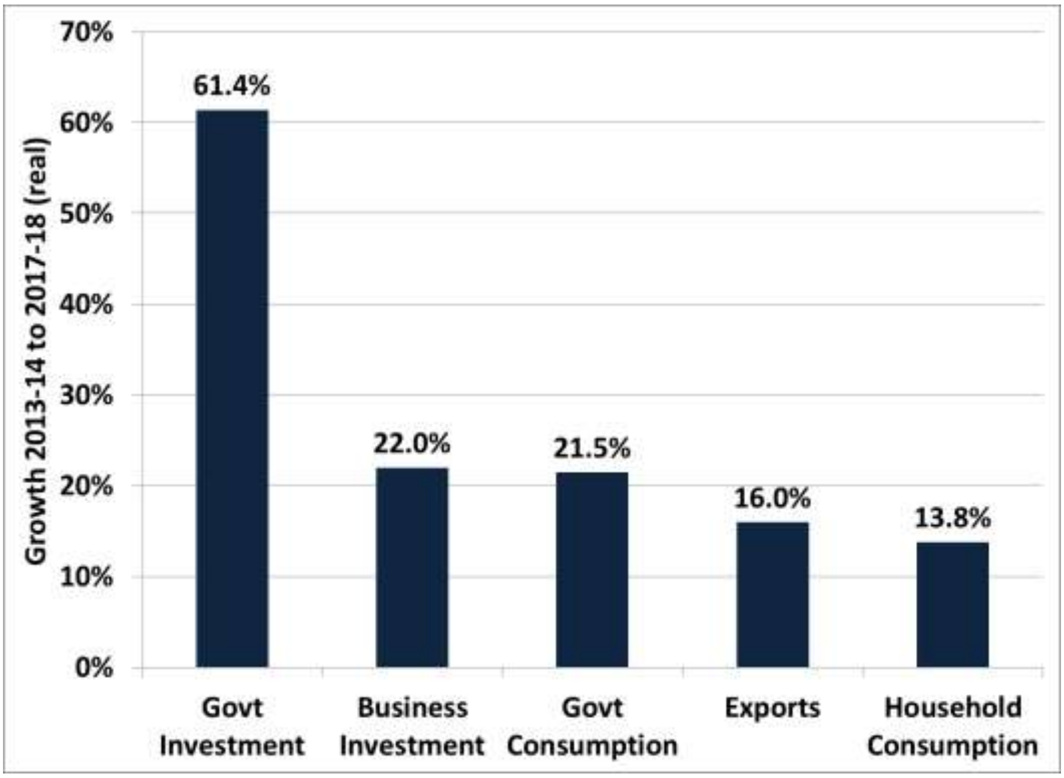
[2] The proportion of total employment in part-time jobs in Victoria increased slightly over this period, to 31.7% in the first part of 2019, compared to 31.5% in the similar period in 2015. The national average

The relatively robust expansion of total employment in Victoria over this period is relevant to the present discussion for two reasons. First, the rapid growth of total employment puts the expansion of public sector employment in Victoria in context: yes, public sector employment increased (by 16% in full time equivalent terms between fiscal years 2013-14 and 2017-18[3]). But that growth was broadly in line with rapid expansion in both population and employment in the state's labour market.

Secondly, the fact that the total labour market is performing so positively provides a strong economic and fiscal underpinning for the corresponding (and necessary) expansion of public services. The growing population of employed workers in Victoria needs a stronger network of public services to support their continued economic and social success. And the incomes generated in those jobs, and the taxes paid as a result, fiscally validate the expansion of public services.

Public Sector Activity has been a Key Driver of Victoria's Growth

Figure 4: Major Components of Economic Growth, Victoria, 2013-14 to 2017-18



Source: Authors' calculations from ABS Catalogue 5220.0, Table 3.

part-time share of employment grew 4 times as quickly over the same period. Authors' calculations from ABS Catalogue 6202.0, Tables 2 and 5.

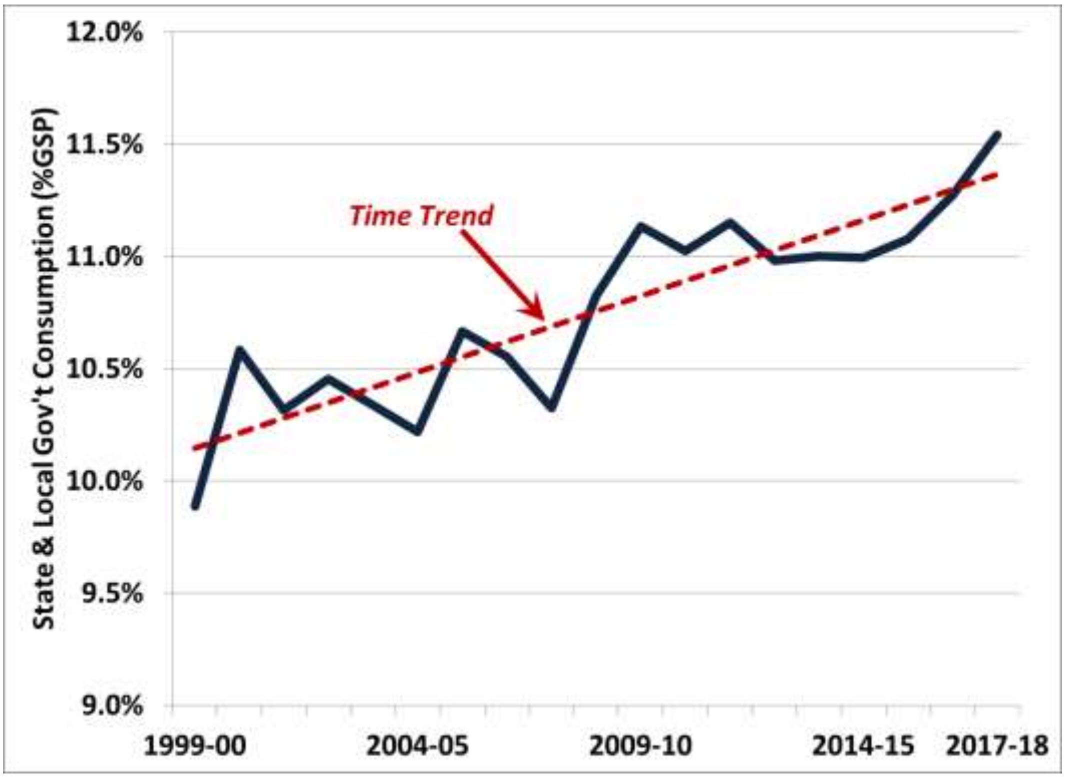
[3] Authors' calculations from Victorian Public Sector Commission (2019), Table 6.

The expansion of government activity has been a key factor driving Victoria's superior economic and job-creation performance over the last four years. Figure 4 presents the cumulative expansion over that period in the major categories of aggregate demand in the state (measured in real, after-inflation terms). Recall from Figure 1 that the state's total real output increased by just under 15% during this period – significantly faster than any other state.

Figure 4 confirms that government made an outsized contribution to this successful expansion. The enormous and important increase in government capital spending – on infrastructure projects ranging from transportation to utilities to housing to cultural facilities—has been the biggest driver of Victoria's strong growth.[4] Real public capital spending increased by over 60% over those four years.

The expanded provision of current public services (measured in economic statistics as "government consumption") also reinforced Victoria's strong growth trajectory. Government consumption at all levels (national, state and local) increased by 22% in that 4-year period. This matches an equally strong increase in private business

Figure 5: Share of State/Local Service in GSP, Victoria, 2000-2018



Source: Authors' calculations from ABS Catalogue 5220.0, Table 3; current values.

[4] Treasurer Tim Pallas himself has emphasised the important role of public spending in fueling Victoria's nation-leading economic growth; see Public Accounts and Estimates Committee (2019), pp. 1-2.

capital spending, which also grew 22% over the same period.[5] Government services grew half-again faster than personal consumption during this period; this reflects citizen demands for expansion in public and human services, within their overall bundle of consumption.[6]

The economic importance of expanded spending on public services is visible in other indicators, as well. Figure 5 portrays the share of state and local public services[7] in total economic output in Victoria (measured by GSP). An increase in this measure is visible after 2014, as the newly elected Andrews government responded to growing public demand for services with important improvements and support for state and local service delivery. By 2017-18, those services accounted for 11.5% of total Victorian GSP – up by about one-half percentage point of the total state economy since the 2014 election.

However, that post-2014 upturn in provision of state and local services was actually consistent with longer-term relative growth of that part of the state's economy. Over the previous 15 years, state and local services had also increased relative to GSP, by a cumulative total of over 1 full percentage point of GSP. This further confirms the long-run structural growth of public services provision (discussed above). In short, the public's growing demand for high-quality public services – the lion's share of which are delivered or funded through the state level of government – reflects a fundamental underlying trend that is both natural and desirable.

Another perspective on the importance of public service provision to Victoria's superior economic performance is provided by a sectoral disaggregation of total employment growth. Figure 6 illustrates the composition of new employment in Victoria since the election of the Andrews government, by broad industrial sector.

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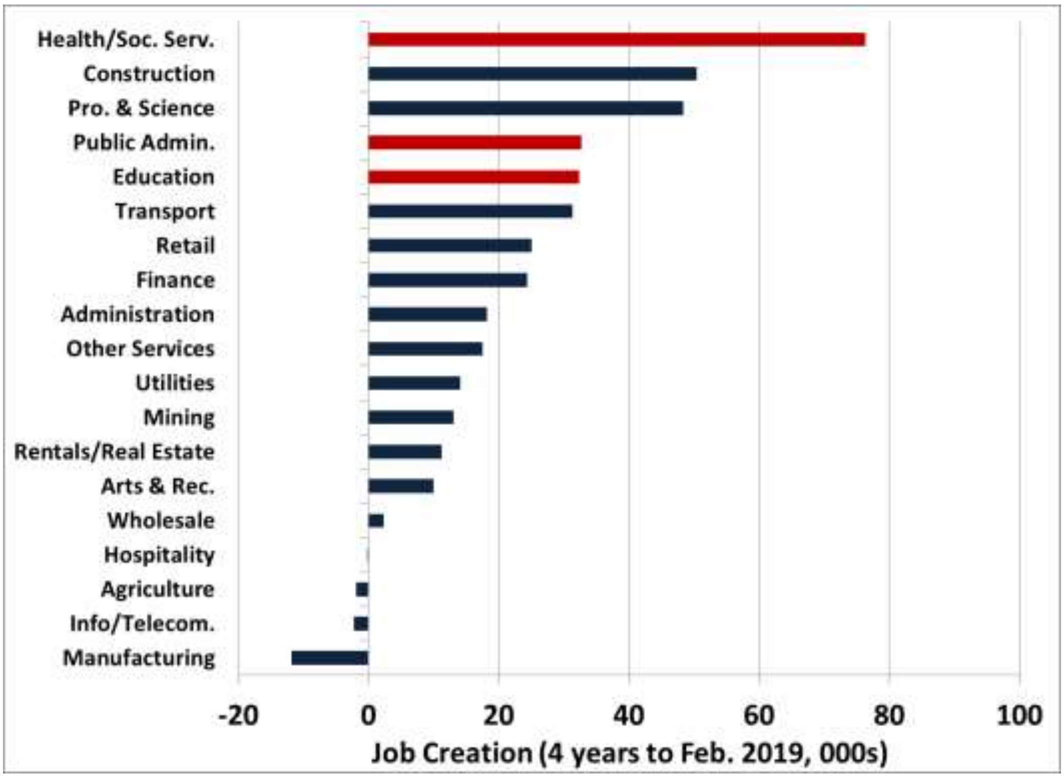
[5] Victoria's strong business investment performance in this period contrasts dramatically with the overall weakness of business capital spending in Australia as a whole. In the same 4-year period, real business investment in Australia declined by 17% (authors' calculations from ABS Catalogue 5204.0, Table 2). The better business investment record in Victoria reflects the attraction of a growing population and strong demand conditions, as well as the fact that Victoria's economy is less dependent on resource and mining projects.

[6] The strong electoral support expressed for the current government in 2018 reaffirms the public's support for expanded public and human services.

[7] ABS data do not disaggregate state and local services in its national income accounts; and at any rate, local services depend on fiscal transfers from the state level of government. So the combined value of services provided by both levels is a valid indicator of the commitment to services expansion on the part of the state government.

Figure 6: Employment Growth by Sector, Victoria, 2015 to 2019



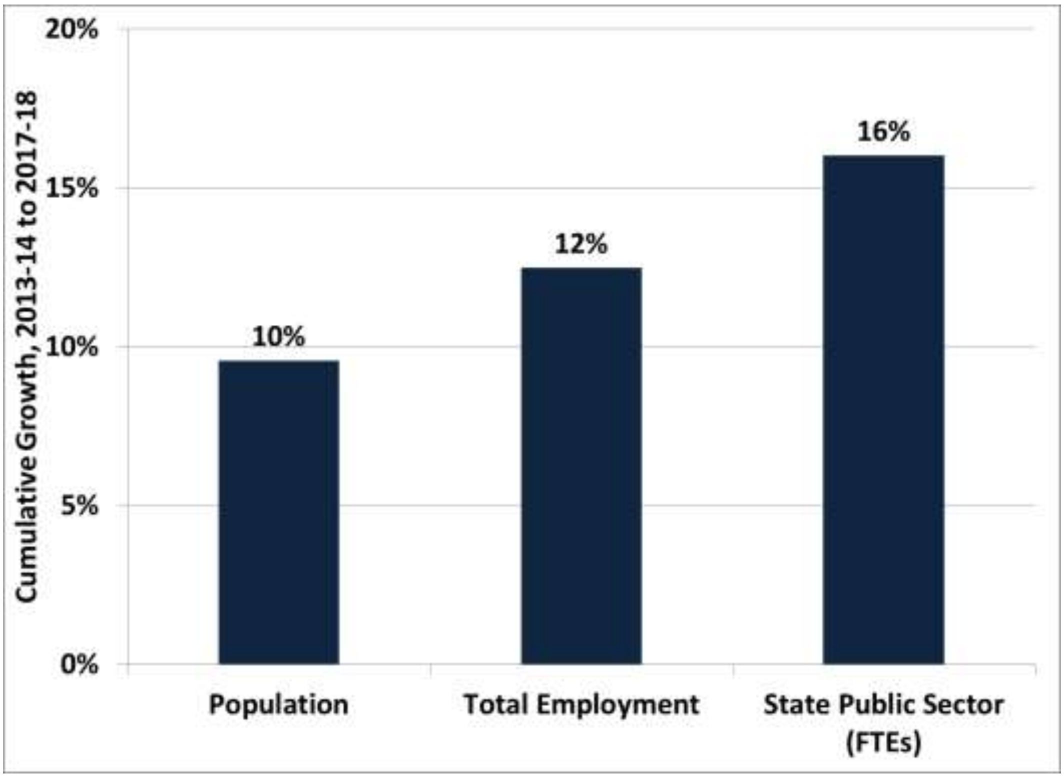
Source: Author's calculations from ABS Catalogue 6291.0.55.003, Table 5.

The rapidly-growing health and community services sector led all industries in job-creation in the state, adding over 75,000 new jobs in the last four years. Two private sector industries (construction and professional & technical services) ranked second and third in job-creation. But two more mostly public-sector industries (education and public administration & safety) ranked next in job-creation: adding about 33,000 jobs each. Together, three primarily public-sector industries (health care & community services; education; and public administration & safety – all indicated in red in Figure 6) accounted for over 140,000 new jobs in Victoria, representing 36% of all new positions created in the state's economy in that period. We can just imagine the enthusiasm of conservative commentators if any *private*-sector industry (whether it be mining, finance, retail or hospitality) created 140,000 new jobs in Victoria in four years. Yet just as much enthusiasm should greet the vibrant job-creation that has occurred in these vital human and caring services.

The reality is that Victoria's strong investments in expanding human and caring services have been a vital engine of growth for the state's economy. Whether measured by output, incomes, or employment, public services have injected tens of billions of dollars of spending power, contributed disproportionately to the strength of labour markets and economic growth – and reinforced the positive effects of growth on the government's fiscal position. The positive, mutual relationship between growing public services and a strong state economy should be celebrated, not suppressed.

Strong Population Growth has Driven Expanded Public Sector Hiring

Figure 7: Employment and Population, Victoria, 2013-14 to 2017-18



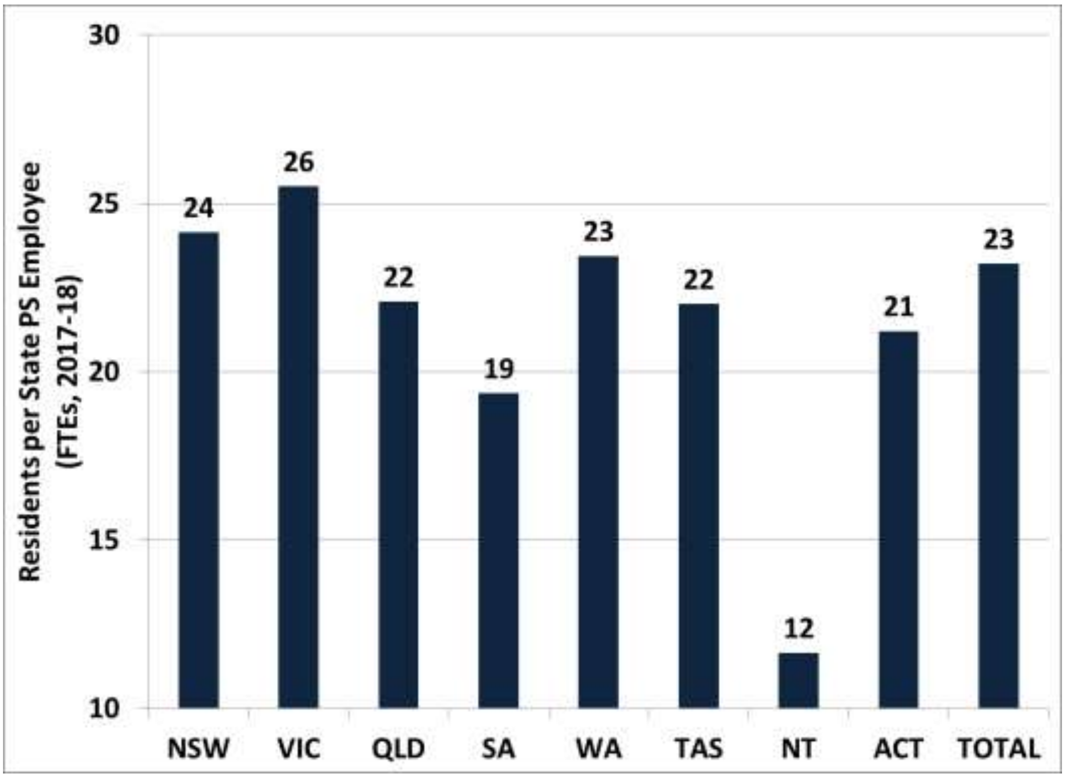
Source: Authors' calculations from ABS Catalogues 3101.0, Table 4, and 6202.0, Table 12, and Victoria Public Service Commission (2019), Table 6.

The relatively rapid expansion of Victoria's population and labour market has created pressing demands for more public infrastructure and services. Indeed, most of the additional hiring in public service delivery that has occurred since 2014 was necessary just to keep up with population and employment growth – let alone allowing for improvements in the quantity or quality of services relative to population.

As indicated in Figure 7, most of the increase in state public sector employment (on a full-time equivalent basis) was necessary just to match the state's rising population. Similarly, over three-quarters of the growth in state public sector payrolls would have been required just to keep pace with the expansion in overall employment (thus maintaining a constant share of state public sector employment as a proportion of total employment). State public sector employment has grown somewhat faster than both those benchmarks, facilitating improvements in the availability and quality of public services and infrastructure. But most of the expansion in state public sector employment was necessary just to keep pace with Victoria's overall growth.

Relative to Population, Victoria's State Public Service is the Smallest in Australia

Figure 8: Ratio of State Population to State Public Sector Employment, 2017-2018



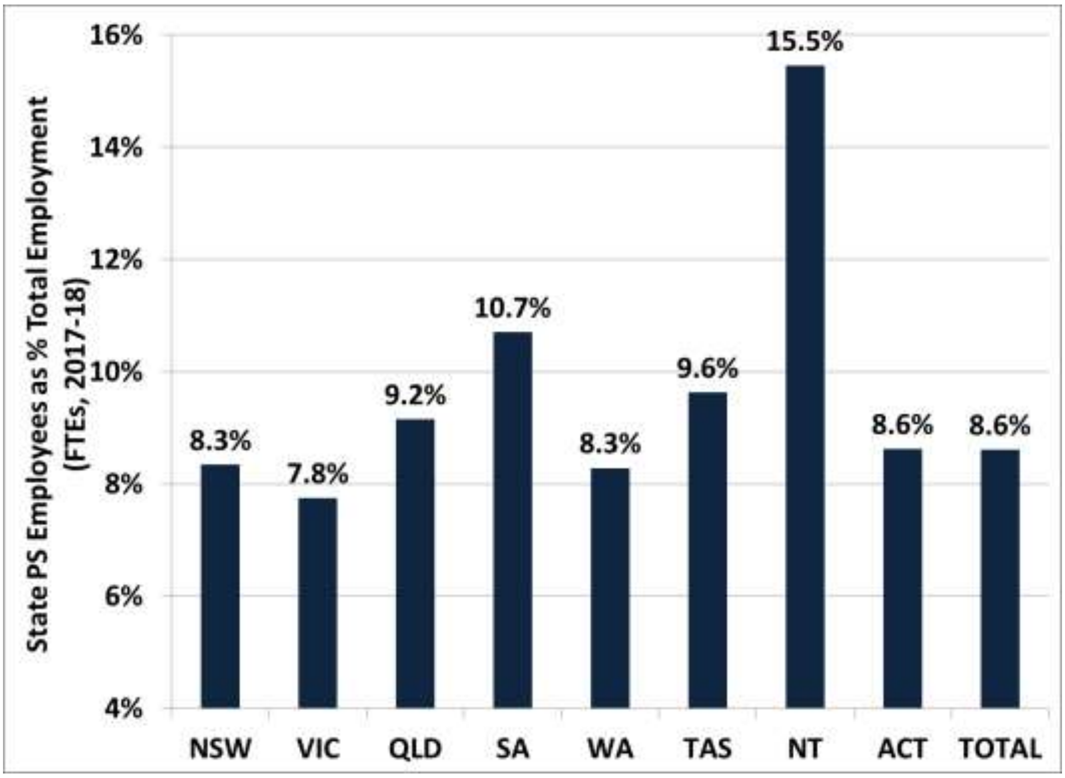
Source: Authors' calculations from Victorian Public Service Commission (2019), other state government public service reports, and ABS Catalogue 3101.0, Table 4.

Indeed, relative to the total size of the population served by the state's public sector, Victoria's public service workforce remains lean by comparison to other jurisdictions in Australia. In fact, on average each Victoria state employee (on a full-time equivalent basis) services a larger quota of state residents than in any other state or territory.

In financial year 2017-18 there were 26 residents of Victoria for every (full-time equivalent) state public sector employee. That ratio has declined modestly over the last four years (down from 27 residents per employee in 2013-14), thanks to healthy hiring in public services. However, the ratio of population to state public sector employment is higher in Victoria than any other state or territory – and 10% higher than the average for all states and territories.

This confirms both the high productivity and the heavy workloads of Victoria's state employees. And it certainly refutes the claim made by some critics that the state's public sector is somehow "bloated" or inefficient.

Figure 9: State Public Sector Employment as Share Total Employment, 2017-18



Source: Authors' calculations from Victorian Public Service Commission (2019), other state government public service reports, and ABS Catalogue 6202.0, Table 12.

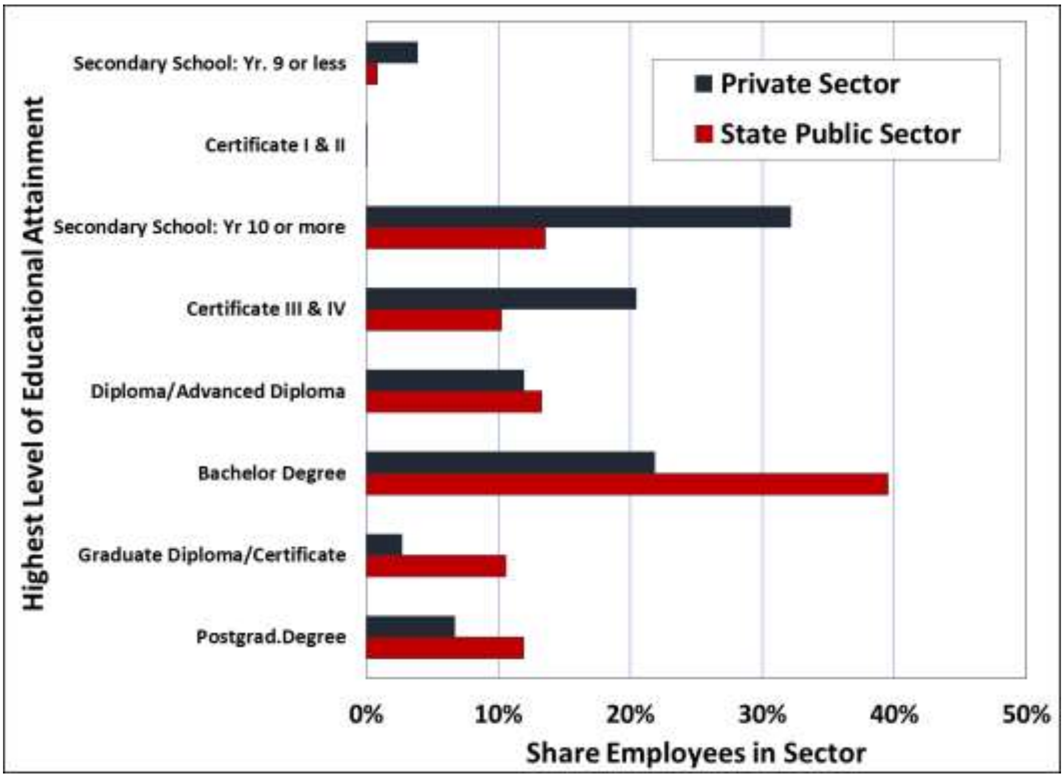
Another perspective on the leanness of Victoria's state public sector is provided by comparing the share of total employment in each state or territory accounted for by state public employment. Here, too, Victoria is an outlier.

In fiscal 2017-18, employees on the state's public sector payroll (in full-time equivalent terms) accounted for less than 8% of total employment in the state. That was a smaller ratio than in any other state or territory. Victoria's state public sector employment share is about one-tenth lower than the average for all of Australia. By this measure, too, the state's public sector workforce remains relatively small, despite growing public sector employment since 2014.

<u>Public Sector Workers Have Superior Education and Training</u>

The nature of their work in specialised human and caring services, and related functions such as administration and technology, requires Victoria's public servants to acquire more education and training than is typical of the state's workforce as a whole.

Figure 10: Employment by Level of Highest Education, Victoria, 2016



Source: Authors' calculations from ABS Census data.

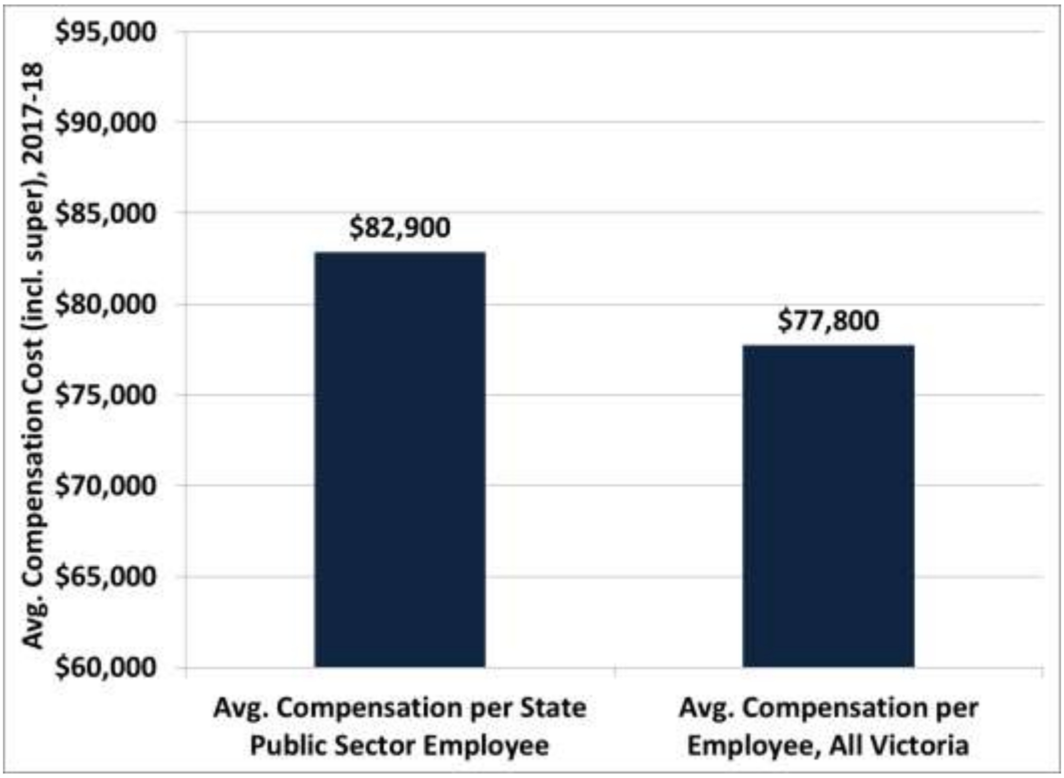
Figure 10 illustrates the proportion of employed workers according to highest level of education – comparing workers in state public service functions, with workers in the private sector. The chart indicates that over 60% of the state's public sector workforce possess a bachelor's degree or higher – twice the proportion among private sector workers. Public sector and private sector workers are about equally likely to possess a diploma or advanced diploma. A much smaller share of public sector workers has completed Certificate IV or lower levels of qualification: less than 25% of public sector workers in 2016, compared to 57% of private sector workers.

The advanced training and education demonstrated by Victoria's public sector workforce underpins the quality and efficiency of their service delivery. It also underpins the compensation they receive.

Public Sector Compensation is Comparable with Broad Labour Market Trends

Despite the demanding educational requirements, licensing and regulatory requirements, and heavy workloads associated with state public sector jobs, overall compensation for workers employed in public service delivery is certainly within the range demonstrated by Victoria's overall labour market.

Figure 11: Average Compensation, Victoria, 2017-18



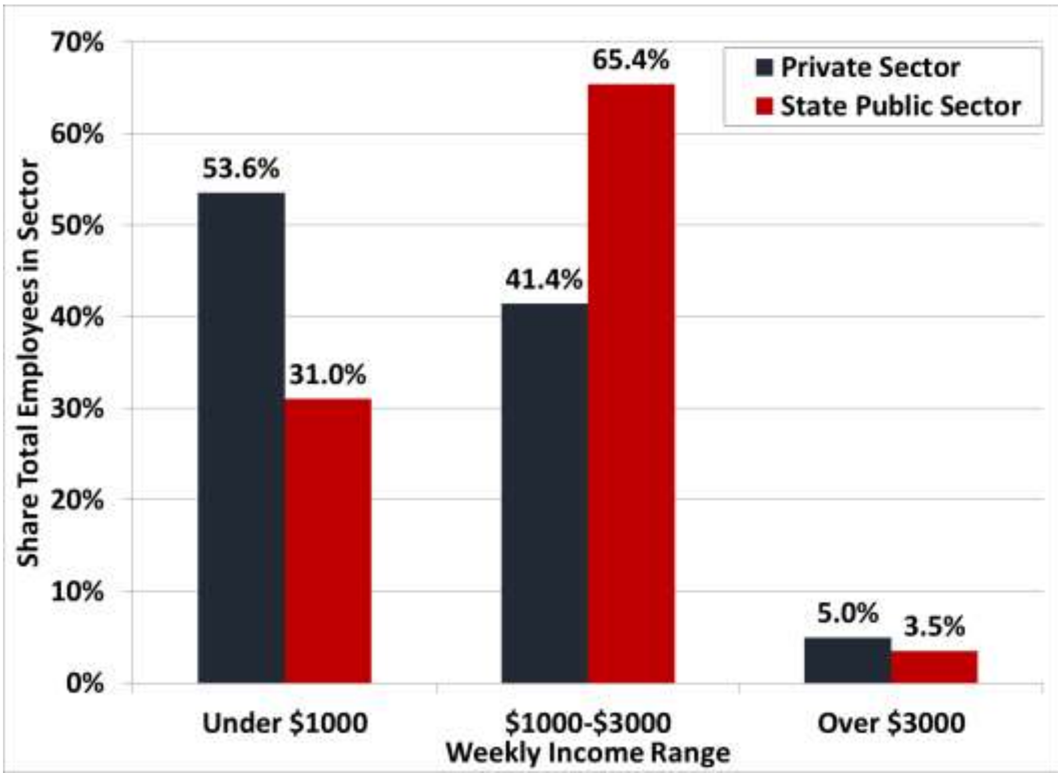
Source: Authors' calculations from Department of Treasury and Finance *(2019), Victoria Public Service Commission (2019b), and ABS Catalogues 5220.0, Table 3, and 6291.0.55.001, Data Cube EM6a.*

It is difficult to obtain comparable data on employee compensation for different groups of workers, but Figure 11 provides one broad and representative comparison of compensation between the public sector and the rest of the labour market. Average compensation (including superannuation contributions) per state public sector employee is estimated by comparing the state's total employment and superannuation expense with administrative data on state public sector employment. Average compensation per employee in the broader labour market (again including superannuation contributions) is estimated by comparing total labour compensation paid to workers in the state (from ABS economic accounts) to the number of employees in each financial year.

By this method, average total compensation (including super) per employee in the state public sector is estimated at $82,900 for the 2017-18 financial year. That is about 6% higher than for the overall state labour market. The difference reflects the superior education of state public sector workers (who are twice as likely to possess a bachelor's degree or higher qualification as private sector workers); it may also reflect somewhat lower reliance on lower-earning casual positions (discussed further below).[8]

Public Sector Jobs are More Likely to Pay Middle Incomes

Figure 12: Victoria Employment by Income Category, 2016



Source: Authors' calculations from ABS Census data.

While overall average levels of compensation are comparable between state public sector workers and other segments of the Victorian labour market, there are clear differences in the distribution of compensation and inequality. Compensation for state public sector workers is concentrated within a broad band of "middle income" workers, whereas compensation patterns in the private sector indicate great polarisation between very low and very high incomes.

The reduced level of inequality in public sector jobs is starkly visible in Figure 12, which compares total employment in state public services with the private sector of

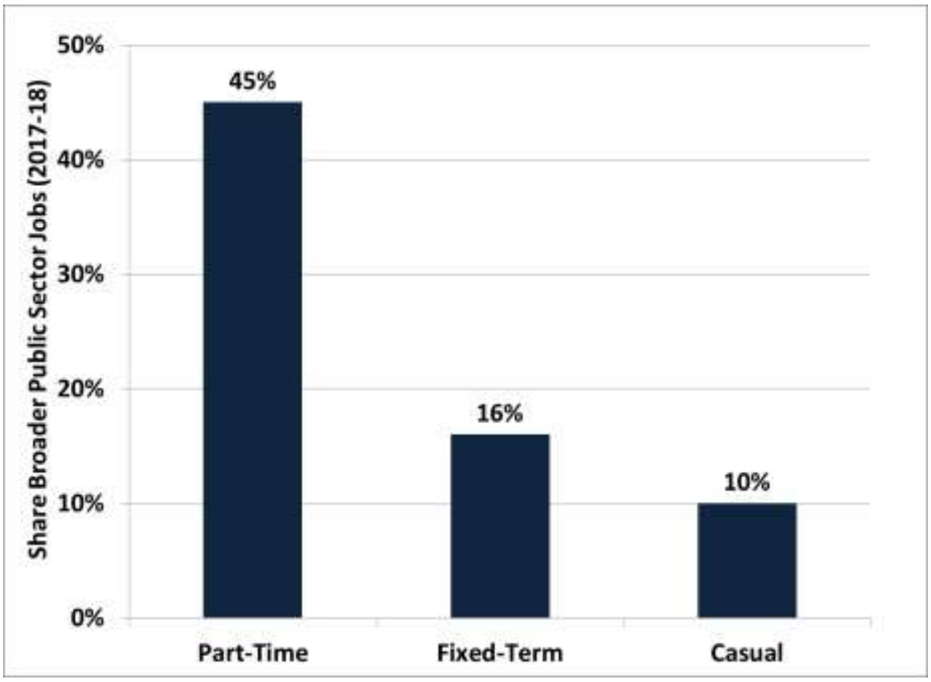
[8] Another measure of overall compensation levels in the Victorian public sector is provided by the Victorian Public Services Commission (2019b), Figure 10, which reports median annual base salary for non-casual employees as $81,260. A strictly comparable figure for the overall state labour market is not available. However, ABS Catalogue 6306.0, Data Cube 3, Table 10 reports median annual earnings for adults in full-time positions as $78,000 per year; the ABS catalogue does not provide state-specific data, but Victorian incomes tend to be slightly higher than national averages. Therefore, by this measure, too, public sector compensation is broadly comparable with the overall labour market.

Victoria's labour market. Employment in each segment is disaggregated into three broad income categories: low income (below $1000 per week), middle income (between $1000 and $3000 per week), and high income (above $3000 per week). Almost two-thirds of state public sector workers are paid in the middle-income band – versus only 41% of private sector workers. In contrast, over half of private sector workers are paid low incomes (under $1000 per week), compared to less than one-third in the state public sector. Finally, the share of private sector workers making high incomes (above $3000 per week) is half-again as large as the share of state public sector workers in that category.

Abundant research has documented the negative economic and social consequences of growing inequality, and the erosion of middle-income jobs in Australia's labour market.[9] It is evident that employment in public service delivery constitutes an important bulwark against the negative polarisation of incomes evident in other parts of the economy. Public sector jobs, more often, are decent, relatively stable, "middle-class" jobs. The growing share of public sector work in Victoria in recent years has thus made a crucial contribution to offsetting the growth of inequality in the state that would otherwise have prevailed.

Many Public Sector Jobs are Insecure and Non-Standard

Figure 13: Non-Standard Employment in Victoria's State Public Sector, 2017-18



Source: Victoria Public Services Commission (2019b), Tables 8 and 9.

[9] See, for example, the findings compiled in Australian Council on Social Service (2018).

While average incomes in state public sector jobs in Victoria are somewhat higher, and much less unequal, than pay in the overall state labour market, it should not be inferred that public sector jobs have been fully insulated from the negative trends which are undermining the quality of employment in the broader labour market. To the contrary, public sector jobs have experienced many of the same shifts toward non-standard and precarious forms of employment that are visible across the labour market.

Figure 13 illustrates the significant proportion of workers in the broader public sector who are employed under some non-standard arrangement: including part-time, fixed-term (temporary) and casual work. Fully 45% of all state public sector workers in Victoria are employed on a part-time basis; that is higher than the incidence of part-time work in the state's labour market as a whole.[10] Public health care, TAFEs, and state schools have the greatest reliance on part-time work. Part-time opportunities can be an important option for meeting service delivery requirements in a flexible and effective manner, and many employees prefer part-time arrangements to assist in balancing work and family responsibilities. However, many part-time workers would prefer more hours of work, and the overuse of part-time work is a symptom of growing precarity in employment practices.

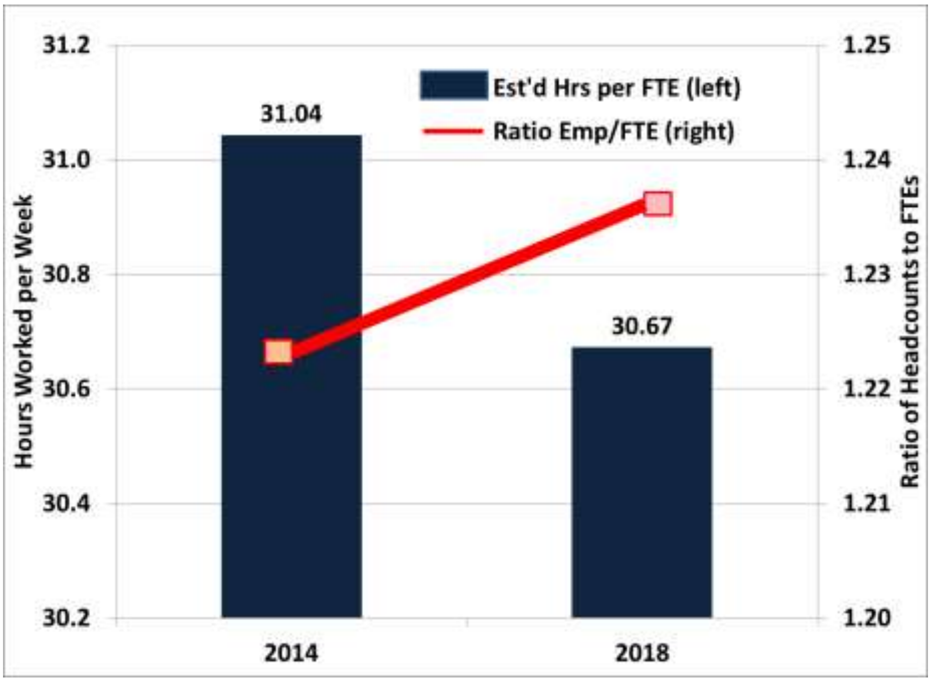
Temporary positions are also becoming more common in the Victorian public sector, mirroring the similar trend in the overall labour market. Over one-quarter of all state public sector employees work either on a casual or a fixed-term basis. Considering all of these forms of non-standard work (part-time, temporary, and casual), only around half of state public sector employees in Victoria are employed in traditional full-time, permanent positions.[11] Again, this parallels the growing precarity of private sector employment arrangements: only half of employed Australians now fill a "standard" full-time permanent position (see Carney and Stanford, 2018).

The growing reliance on non-standard work in Victorian state public service delivery can be further confirmed by analysing data on total employment and full-time equivalent employment. The greater is the reliance on part-time and other non-standard employment forms (which tend to demonstrate lower working hours), the greater will be the *difference* between these two measures (since headcounts will exceed FTE measures by a growing margin when part-time and temporary jobs become more common).

[10] In 2018 32% of all employed people in Victoria worked part-time; author's calculations from ABS Catalogue 6202.0, Table 5.

[11] Only 55% of state public sector workers are employed full-time, and some of them are employed under fixed-term or casual arrangements; the specific share of workers in full-time permanent positions is unavailable from state government publications, but it will be around one-half.

Figure 14: Total versus Full-Time Equivalent Employment, Victoria State Public Sector



Source: Authors' calculations from Victoria Public Services Commission (2019b).

Figure 14 indicates that the total number of employees on the payroll has grown faster in the last 4 years than FTE employment, and hence the ratio of the former to the latter has increased (from 1.22 to 1.24). This implies a corresponding reduction in average hours worked per week per employee. We estimate that average weekly hours have declined by about one-third of an hour over that same period – from 32 to 31 and two-thirds hours per week.[12] The increasing reliance on non-standard employment practices within the state public sector workforce must therefore be taken into account along with salary levels, in evaluating the relative position of public sector workers within an increasingly precarious broader labour market.

Victoria has Experienced a Wage Slowdown, Although Less Severely

Wage growth across Australia's economy has experienced several years of unprecedented slowdown. In contrast to wage increases that typically averaged 4% per year or even faster through the 1990s and 2000s, wage growth decelerated markedly after 2012. Since then, annual wage increases have averaged barely 2% per year. This development has sparked concern from many economic and social

[12] On the assumption that a standard full-time position requires 38 hours per week of work, the average hours worked per employee (on a headcount basis) can be inferred by the ratio between total and FTE employment.

commentators – including business leaders, economists, and the Governor of the Reserve Bank of Australia.[13] Factors contributing to the wages slowdown include:

- High levels of underutilisation in the labour market, including underemployment (people working fewer hours than they desire) and disguised unemployment and non-participation. The chronic existence of excess labour supply has undermined workers' wage demands.
- The growth of precarious, insecure, and non-standard employment, including in forms (such as labour hire, casual work, and 'gigs' with digital platforms) in which workers have very little bargaining power.
- The erosion of institutions that traditionally supported stronger wage increases, including the minimum wage (which has declined relative to prevailing wages in the overall labour market), the awards system, and collective bargaining.[14]
- The failure of price inflation to match the Reserve Bank's 2.5% inflation target. Since mid-2014, realised consumer price inflation has remained consistently below the RBA target. This contributes to a mutually reinforcing disinflation whereby prices and wages "chase" each other downward.

Victoria has navigated the slowdown in wages relatively better than other states. As indicated in Figure 15, wage growth in Victoria (as measured by the ABS's Wage Price Index[15]) has averaged 2.4% over the past 5 years – significantly higher than the national average (2.1% over the same period), and higher than any other state or territory. Several factors help to explain Victoria's relatively stronger wage performance:

- Stronger labour market conditions: including faster job-creation and lower unemployment and underemployment than national averages.
- A higher proportion of workers covered by enterprise agreements.
- The relatively strong growth in public service employment (discussed further below).

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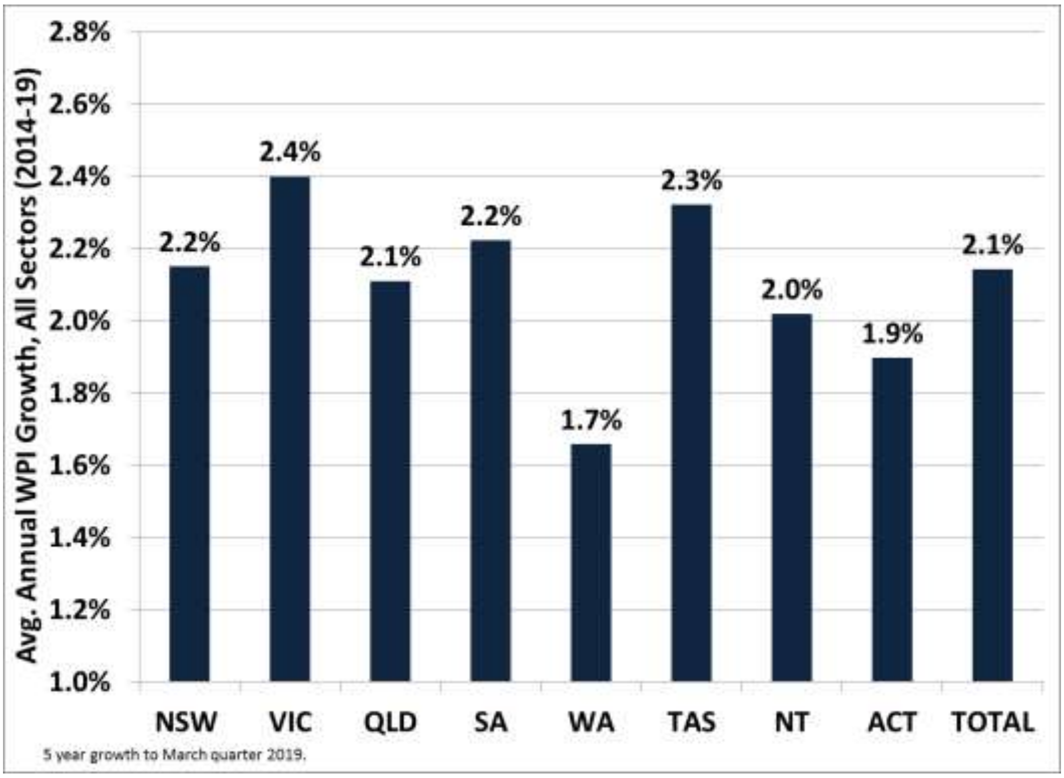
[13] See, for example, Turner (2017) and Greber (2017) for statements of concern over the wage slowdown from leading business and financial figures. Stewart et al. (2018) provide a comprehensive analysis of the causes and consequences of the wages slowdown – and potential solutions.

[14] Pennington (2018) describes the dramatic decline in collective bargaining coverage in the private sector of Australia's economy since 2013.

[15] The Wage Price Index is an indicator of hourly labour costs that measures inflation in the cost of an artificially constructed "basket" of jobs. It thus deliberately excludes changes in the average composition of employment, and the quality of jobs – in its efforts to obtain a measure of "pure" wage inflation that is independent of those structural trends. See Stanford (2018) for more discussion of the strengths and weaknesses of this methodological approach.

Figure 15: Wage Inflation by State, 2014-2019



Source: Authors' calculations from ABS Catalogue 6345.0, Table 2b.

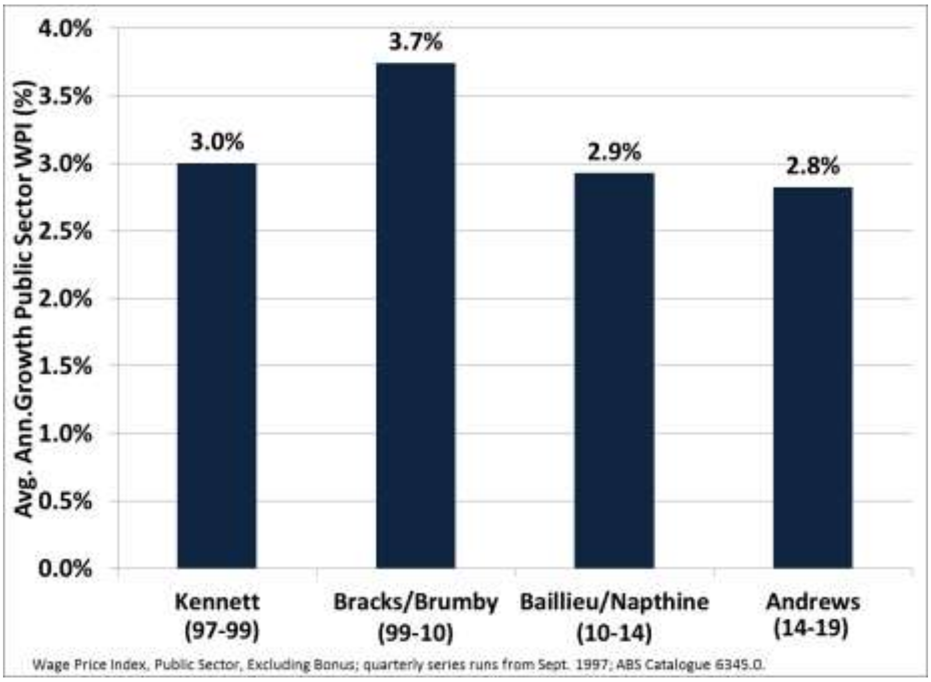
Victoria's stronger wage growth has been a major benefit for the state's economy. Faster wage growth supports consumer spending and household financial stability. It also supports faster revenue growth for governments at all levels – including the state government itself, through higher payroll tax revenue, and larger flows of income tax and GST revenues that are ultimately shared by the Commonwealth.

Public Service Wage Trends have been Below Historic Norms

Despite Victoria's better-than-average performance on wage growth over the past several years, the reality remains that wage growth in the state has been far below traditional norms. This is true of public sector wage increases, as well as private sector.

Figure 16 illustrates the average pace of wage increases (as measured by the WPI) in Victorian public sector workplaces. Average labour costs have grown somewhat faster in the public sector over the past 5 years than the overall labour market; a similar differential has prevailed in other states and territories. This reflects the fact that public sector wages are more subject to discrete policy actions (including collective bargaining and government wage policies), and less responsive to changing labour market conditions. WPI growth in Victoria's public sector[16] has averaged 2.8% per year over the last 5 years – modestly higher than the 2.4% average growth recorded in the state's labour market as a whole.

Figure 16: WPI Growth, Public Sector, Victoria



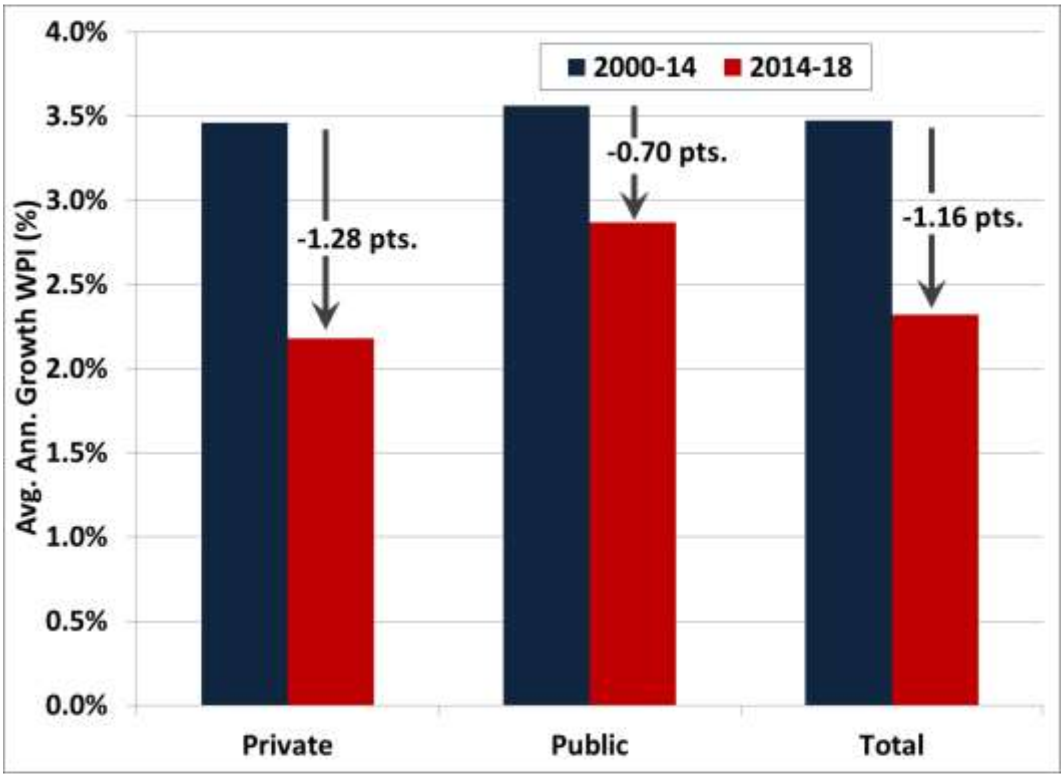
Source: Authors' calculations from ABS Catalogue 6345.0, Table 4b.

However, the impact of wage deceleration is also visible in public sector wage increases. Public sector WPI growth in Victoria has demonstrated the slowest pace since 2014 since the ABS first developed the index in 1997. In fact, public sector wage growth under the Andrews government has been slower than under any previous government (including Liberal governments) dating back to the advent of this ABS data (see Figure 16). The claim that wages are "out of control" under the current government is not supported by the empirical record.

[16] The data in Figure 16 refer to all public sector workers in Victoria, including all levels of government and public agencies – not just those employed in the state government and its agencies. Unfortunately there is no disaggregated data reporting WPI growth by level of government service. The majority of public sector employment in Victoria is accounted for by the state government public sector, and hence this overall public sector WPI data for Victoria will predominantly (though not exclusively) reflects compensation trends for state government and agencies.

<u>Public Sector Wage Growth Moderated Victoria's Wage Deceleration</u>

Figure 17: Deceleration in Private and Public Wages, Victoria, 2000 to 2018



Source: Authors' calculations from ABS Catalogue 6345.0, Table 4b.

Like other states in Australia, Victoria's labour market experienced a dramatic deceleration in wage growth after 2013. Compared to typical rates of wage growth of 3.5% per year or more, wage growth in Victoria slowed down by more than 1 percentage point after 2013.

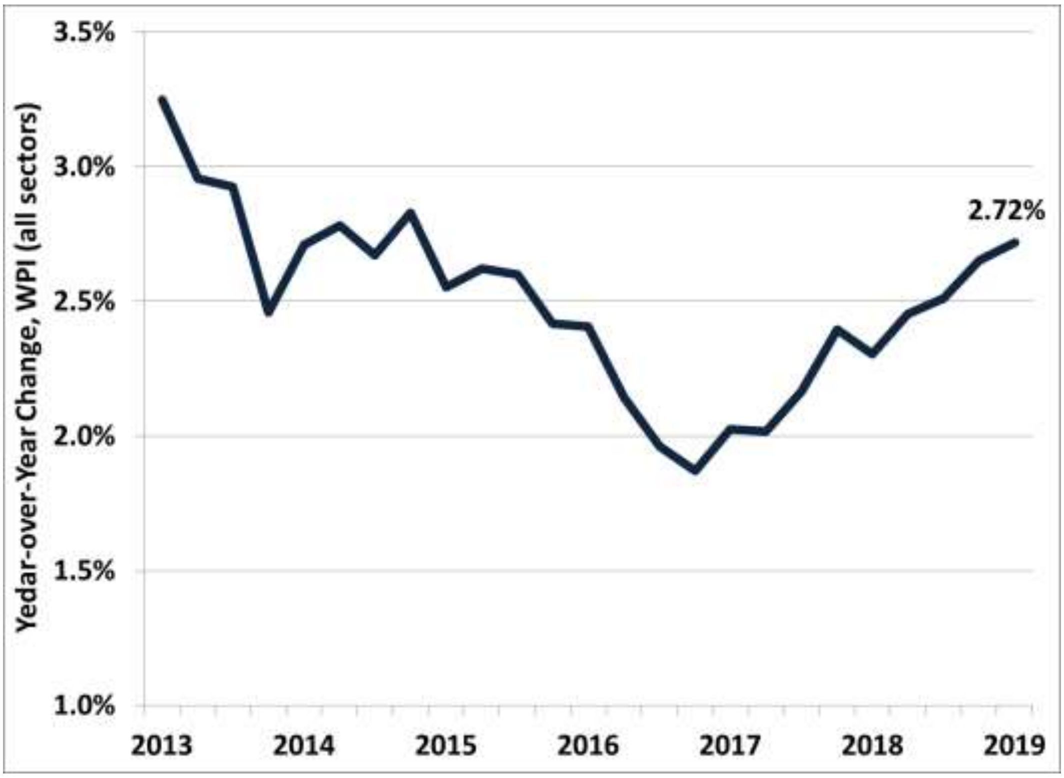
However, the better performance of public sector wages in the state played an important role in *limiting* the extent of wage deceleration in Victoria – and hence supporting continued growth in household incomes, consumer spending, and even government revenues.

Figure 17 illustrates "before" and "after" indicators of average wage growth in Victoria. The "before" period covers the period from the turn of the century through to 2014 (when wages first began slowing down dramatically), and the "after" period the years since 2014. Note that the "before" period includes the significant downturn associated with the Global Financial Crisis, when wage growth across Australia was very weak – but only temporarily. Hence the pre-2014 pace of wage increases illustrated in Figure 17, if anything, may actually understate "normal" wage growth (since it includes a period of unusually weak wage increases).

Overall wage growth in Victoria slowed from around 3.5% before 2014 to under 2.5% since then. However, the deceleration was more dramatic in private sector jobs: with a slowdown in wage growth of close to 1.3 percentage points. In the public sector, in contrast, wage growth slowed by about half as much (down by 0.7 percentage points). The relative stability of wage growth in public sector positions thus reduced the extent of the overall wage shock that was experienced in the state.

Overall Wage Trends are Gradually Recovering

Figure 18: WPI Growth, Victoria, All Sectors, 2010-2019



Source: Authors' calculations from ABS Catalogue 6345.0, Table 4b.

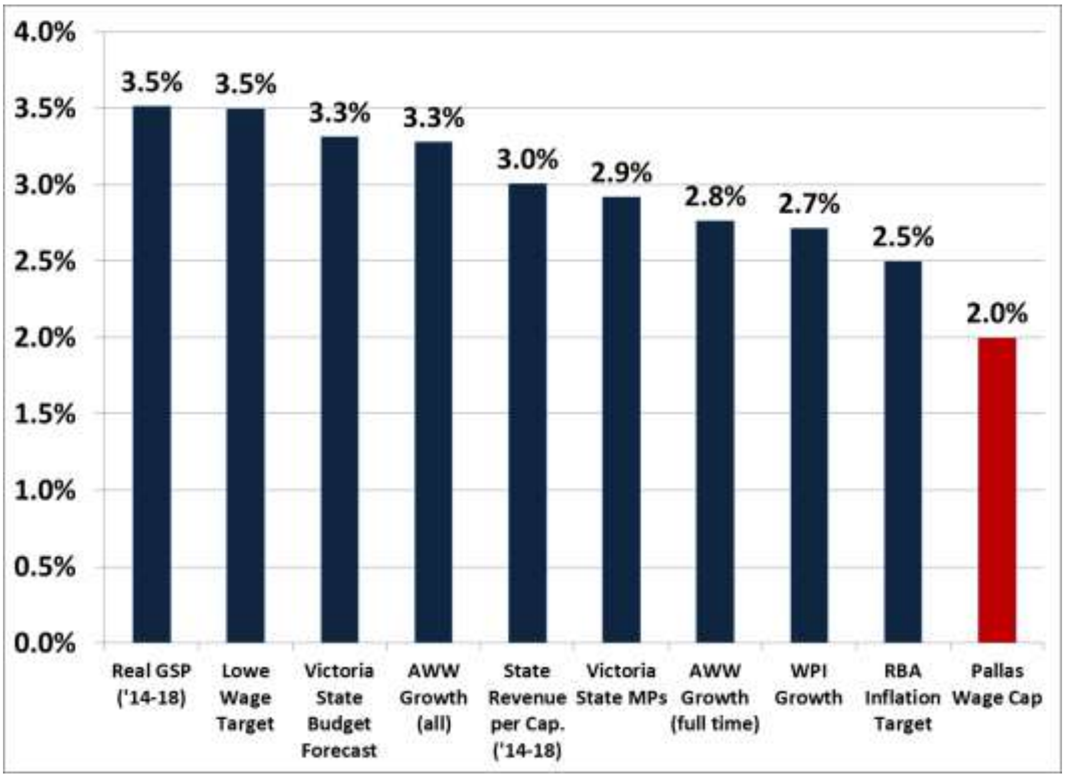
Figure 18 provides further detail on the pattern of wage deceleration that was experienced in Victoria after 2013. Year-over-year wage increases (as measured by changes in the ABS's Wage Price Index) slowed to below 2% for a time in late 2016 and early 2017.

Since bottoming out in early 2017, however, wage growth has gradually but steadily begun to recover. The most recent year-over-year reading of WPI growth in Victoria indicates wages (for all sectors) are now growing at over 2.7% per year.

Other statistical indicators provide an even more encouraging view of the rebound in wage growth in Victoria. For example, the ABS series on average weekly earnings[17] suggests an even stronger recovery in wage growth. Using most recent data (to November 2018), average weekly earnings for all workers (both part-time and full-time) had increased 3.3% over the year-earlier reading. For full-time workers only, average weekly earnings were up 2.8% on a year-over-year basis.

<u>The Proposed Wage Cap Falls Well Below Relevant Wage Benchmarks</u>

Figure 19: Growth in Prices and Wages: Potential Benchmarks



Source: Authors' calculations from ABS Catalogues 5220.0, Table 1, 6302.0, Table 11b, and 6345.0, Table 4b; and Dept. of Treasury and Finance (2019). GSP=Gross State Product; AWW=Average Weekly Wages; WPI=Wage Price Index.

Even as the state's economy continues to outpace the rest of Australia, and wage trends indicate an encouraging rebound, the Victoria state government has decided to suppress wage growth across the state's public sector to just 2% per year in the coming round of enterprise agreements. This stringent wage cap represents not only a marked departure from the government's previous commitment to genuine collective

[17] Unlike the WPI, ABS data on average weekly earnings includes the effects of changes in hours of work, job quality, and other structural factors. It is thus a more accurate measure of the actual flow of incomes realised by Australian workers.

bargaining with its employees. It also contrasts sharply with the more vibrant growth indicated by relevant wage comparators and benchmarks.

Figure 19 illustrates several of the economic, fiscal and labour market trends which might be considered logical benchmarks for public sector wage determination. Those benchmarks fall into the following thematic categories:

- *Wage Comparisons*: As noted above, overall wage growth in Victoria is proceeding at a pace significantly faster than the proposed 2% cap. Over the past year, average weekly wages (AWW) for all employees in Victoria grew by 3.3%. For full-time employees only, they grew at 2.8%. According to the Wage Price Index (WPI, which adjusts wage growth estimates to discount changes in job composition and working hours), wages rose 2.7% over the last year. Looking forward, the Victoria state budget projects annual wage increases in the state averaging 3.3% over the coming four years. Whether on a retrospective or a prospective basis, therefore, the 2% wage cap is badly out of synch with broader labour market trends.
- *Central Bank Policy*: The Reserve Bank of Australia is charged with managing Australia's inflation and monetary policy. Its mandate is to adjust interest rates and other variables to ensure that inflation fluctuates within a narrow band around 2.5% per year. While inflation has often fallen below that target in recent years (a problem exacerbated, in fact, by very weak wage growth), the Bank's goal remains unchanged – and in the long-run it should be assumed that inflation will match its target, on average. Any sustained rate of wage increase below 2.5% should therefore be expected to result in ongoing decreases in real wages. However, merely having wages "keep up" with consumer price inflation is itself neither a normal nor a positive economic outcome. In general, wages should increase *faster* than inflation, in order to generate real wage increases that broadly match ongoing growth in real labour productivity – which has been growing in Australia at an annual average rate of around 1%. For this reason, Reserve Bank Governor Dr Philip Lowe has indicated that a normal benchmark for nominal wage growth in Australia is approximately 3.5%: representing the sum of the Bank's inflation target (2.5%) plus an allowance for real wage gains to match productivity growth (1%).[18] Dr Lowe has indicated that returning to that "normal" pace of nominal wage growth is essential both for macroeconomic and social stability – to ensure that Australian workers share in the benefits of future economic and productivity growth.
- *Ability to Pay*: The economic and fiscal foundation for decent public sector jobs depends on continuing economic growth, and on the capacity of governments

[18] Dr Lowe has made this argument on several occasions; see, for example, Lowe (2018).

to collect a sustainable share of that growth in the form of public revenues. On both of these criteria, the ability of Victoria's state government to pay normal wage increases to its own employees, preferably in the context of normal and free collective bargaining, is not in question. Victoria's economy has expanded at an average rate of 3.5% per year since the election of the Andrews government in 2014 (after inflation). And state revenues have increased in step: even adjusted for Victoria's strong population growth, state revenues per capita grew at an average rate of 3.0% per year from 2013-14 through 2017-18. Of course, future trends in fiscal variables cannot be predicted with certainty. The fiscal outlook for the Victorian state government will be discussed in more detail in the next section; but there is no reason to expect that Victoria's economic and fiscal progress will suddenly stop in its tracks.

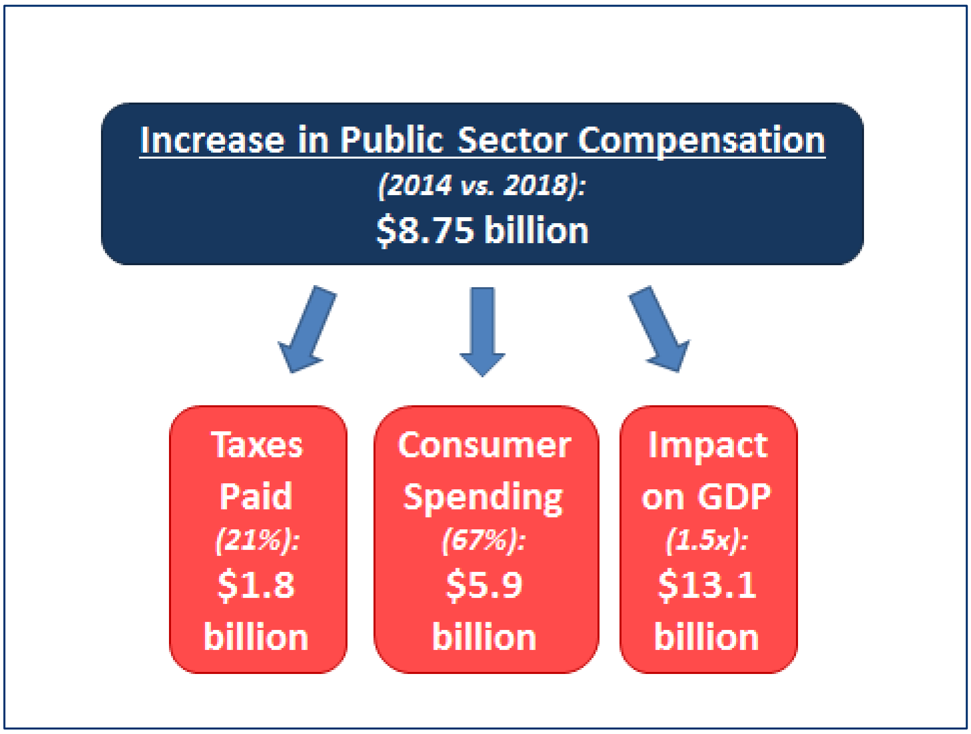
- *Compensation for Politicians*: A particularly galling contradiction exists between the government's determination to cap wage increases for public sector workers at 2%, and the most recent wage increase announced for elected state politicians. Based on a sensible formula that ties politicians' salaries to trends in the overall labour market, state MPs (including the Premier and the Treasurer) will receive wage increases this year of 2.92% (Baxendale, 2019). This formula is sensible and fair. But for those same politicians to then impose a much more severe form of wage restraint on its own employees is clearly unreasonable and hypocritical.

Compared to all of these measures, therefore, the state government's 2% wage cap is well out of the bounds of relevant benchmarks. The government's decision to impose such an austere cap on wage gains is out of line with other economic and labour market comparators; it is unjustified and arbitrary.

Public Sector Wages Strengthen Overall Macroeconomic and Fiscal Performance

Some commentators insist on seeing incomes for public sector workers as a "cost burden" on the rest of society – something to be minimised in the pursuit of small government and lower taxes. This approach assumes that public sector work is inherently unproductive or wasteful. But in fact public sector work makes at least as much of a contribution to GDP, income, and well-being as any private sector activity. The superior training and higher education of public sector workers, not to mention the high value of public services to the quality and safety of our communities, further attests to the real value-added in public sector activity.

Figure 20: Spillover Benefits of Growing Public Sector Incomes



Source: Authors' calculations from ABS Catalogue 5206.0, Tables 20 and 44.

In addition to its direct contribution to output, productivity, and incomes, public sector compensation supports other beneficial spillovers that are experienced throughout the economy – including by private sector businesses and their employees. Based on average household income flows in Australia (as reported in the ABS national income statistics[19]), the following broad parameters shape the extent of positive spillovers into the broader economy from public sector employment and compensation:

- Public services production accounts for about 15% of Australia's total gross domestic product (value-added).[20]
- About one-fifth of labour compensation received by public sector workers, on average, is paid back to government in direct taxes.
- About two-thirds of income received by public sector workers is reinjected into the economy in the form of spending on consumer goods and services.
- The recirculation of public sector incomes back into government finances and downstream consumer spending supports additional increases in economic activity, incomes, and tax revenues.

Total economic activity, including in the private sector, is higher as a result of government spending on public servants and the services they provide. Continuing

[19] Average spending parameters are based on ABS Catalogue 5206.0, Table 20.

[20] The contribution of public sector activity to total value-added is explored in detail in Stanford (2018b).

growth in public sector compensation generates positive spillover effects – also called multiplier effects – for the rest of the economy, boosting private sector confidence, investment, employment and economic growth. These spillover effects are particularly important during times of economic weakness. Conversely, the negative spillover effects of austerity can have severe negative effects during economic recessions. Economic models indicate that government expenditure multipliers under conditions of unemployment are typically in the order of 1.5: that is, increases in government purchases affect final GDP by a factor of $1.50 for every additional dollar in expenditure (and vice versa for spending cuts).[21] Multiplier effects will be stronger for purchases (like labour-intensive public services) which generate greater flows of direct income for domestic residents, as compared to more capital- or import-intensive purchases (for which more of the expenditure's effect is dissipated away from the state economy). Therefore, if anything, the assumption of a 1.5 multiplier effect is conservative for our examination of the macroeconomic benefits of public sector employment and compensation.

We can apply this standard macroeconomic analysis to better understand the incremental value of public service activity represented by the increase in public sector compensation in recent years. These effects are illustrated in Figure 20. Annual public sector compensation in the state of Victoria (for all levels of government) was a total of $8.75 billion higher in calendar year 2018 than in 2014. That new income, received by hundreds of thousands of households across the state, provided an important source of spending power.

Over one-fifth of that incremental income was paid back to government itself in direct taxes: representing a fiscal addition of $1.8 billion in 2018.[22] Two-thirds of the new public sector compensation was spent on additional consumer goods and services: representing an injection of consumer demand equal to almost $6 billion in 2018. Considering the expenditure and re-expenditure effects of that new income, and applying the traditional multiplier impact of 1.5, those increases in compensation supported an expansion in total value-added worth over $12 billion in 2018 – representing around 2.5% of Victoria's total GSP.[23]

[21] Weber (2012) uses 1.5 as a benchmark multiplier effect; similar multiplier estimates are discussed in Spoehr (2006), Cook and Mitchell (2009), and Australian Treasury (2009-10).

[22] Most of that direct tax revenue is received by the Commonwealth government, but some is received by the state government – and indirectly the state government benefits from growing Commonwealth revenues through GST sharing and federal grants.

[23] Not all of the stimulus from that additional expenditure by public servants stayed within the state economy, of course: some of it "leaked out" to other states, or the global economy, through purchases

Conclusion

This section of the report has provided a wider and more nuanced context for discussion of Victorian public sector wages. Public sector employment and compensation should not be interpreted as a "cost" to be minimised through economic policy. The value-added produced, incomes generated, consumer spending supported, and taxes paid by public sector workers contribute as directly and importantly to Victoria's overall well-being as any other form of activity.

More specifically, the growth since 2014 in public sector employment and compensation in Victoria must be considered in light of:

- Victoria's very strong economic growth, job-creation, and population growth – in every case the fastest in Australia. That growth both underpins the expansion of public service delivery, and has benefited from it.
- The leading role of public expenditure, on both infrastructure projects and expanded public service delivery, in contributing to Victoria's strong economic growth and job-creation.
- The generally higher quality of public sector jobs: including their payment of decent, and less unequal, incomes, and the superior education and credentials possessed by public sector workers.
- The important effect of public sector wage increases in moderating the damaging deceleration of wage growth in Victoria.
- The macroeconomic and fiscal spillover effects from expanded public sector employment and compensation, which benefit private sector activity throughout the state.

In this context, it is both surprising and puzzling that a state government which oversaw the strongest economy in Australia – an achievement due in large part to its own expansive approach to public infrastructure investment and public services – should suddenly abandon that successful recipe, and instead begin to priorise fiscal austerity as a central budgetary goal. The imposition of a very restrictive cap on wage growth for state public sector workers is not at all justified by fiscal or labour market trends in Victoria. It threatens to dismantle that virtuous circle of public and private growth which this government has so ably managed since 2014.

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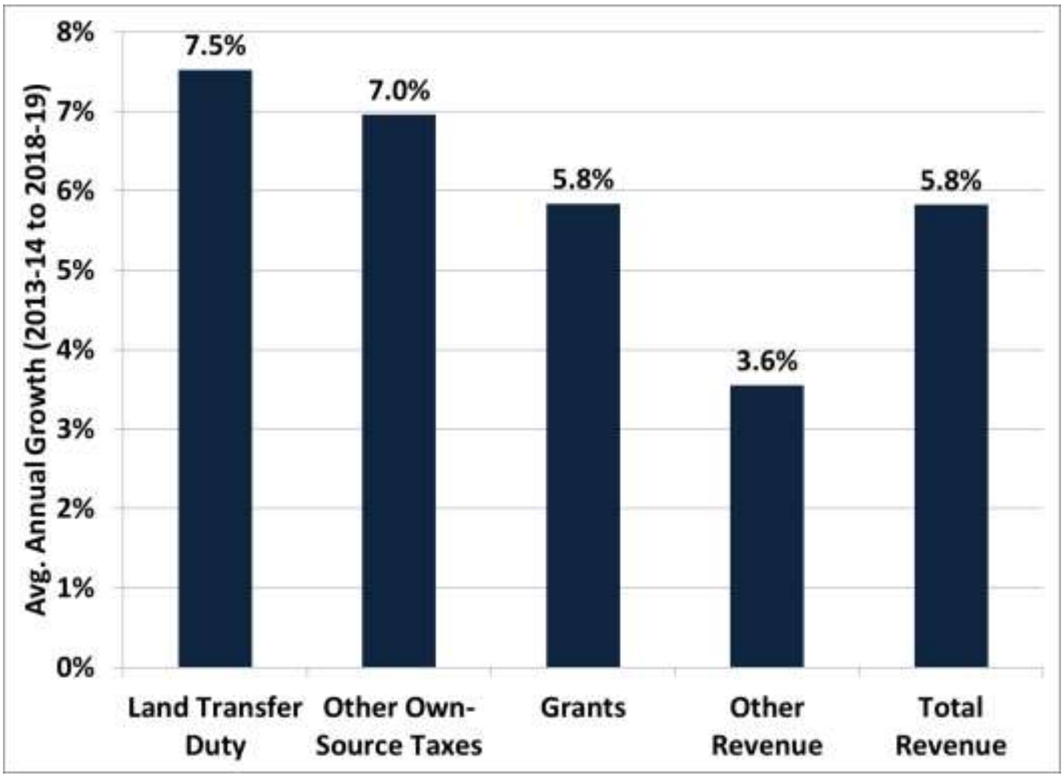
of goods and services from outside Victoria. The bulk of consumer spending, however, is allocated to purchases of domestic production (especially services, which tend to be produced at home).

2. Victoria's Fiscal Outlook

A Strong Revenue Position

One important spin-off benefit from Victoria's strong economic performance in recent years has been a robust fiscal condition for the state government. Strong economic growth and job-creation have fuelled steady growth in the state's own-source tax revenues – which grew at an average annual rate of over 7% per year from 2013-14 through 2018-19.[24] To be sure, the boom in Victoria's property market, and resulting increase in land transfer duty revenues, was one factor in that expansion in revenue – and that revenue component will diminish somewhat now,in the wake of the current property market downturn. However, the land transfer duty was not the only source of growing revenues; in fact, other own-source revenues grew almost as quickly. Land transfer duties grew at an annual rate of 7.5% during that period, while other own-source taxes grew at an annual rate of 7%.

Figure 21: Growth in Victoria State Revenue by Component, 2013-14 to 2018-19

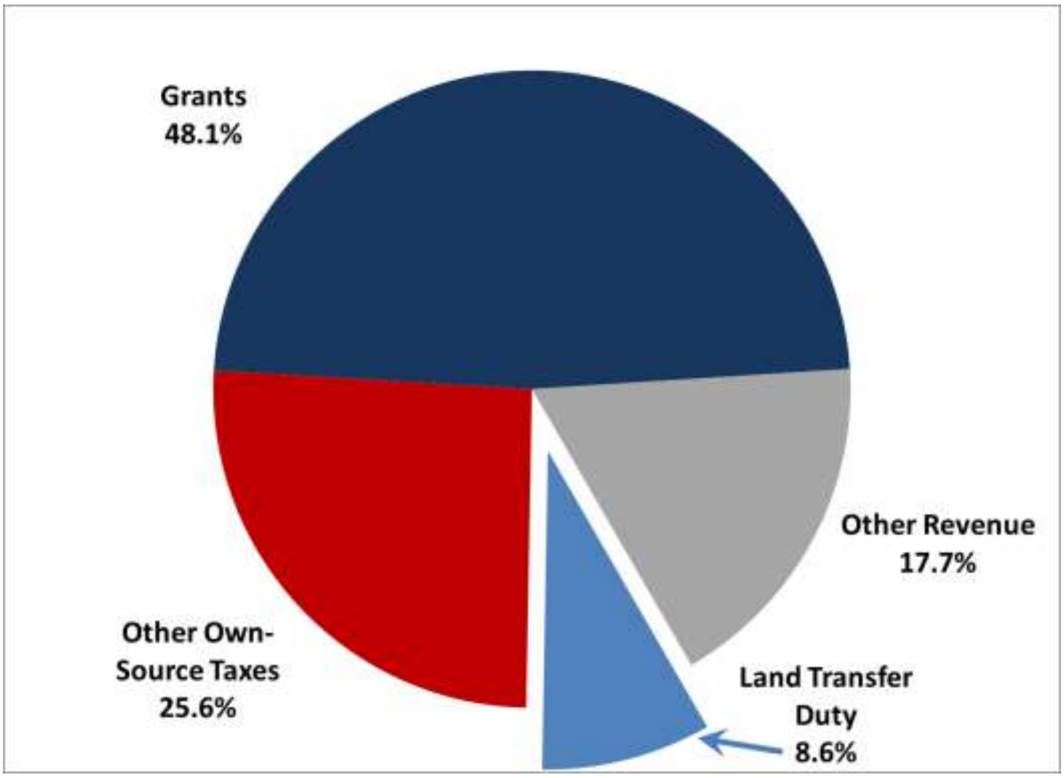


Source: Authors' calculations from Dept. of Treasury and Finance (2019).

[24] Authors' calculations from Dept. of Treasury and Finance (2019); 2018-19 data revised projection.

Grants from the Commonwealth grew at a somewhat slower pace: rising nearly 6% per year during this period. The weakest component of the state's revenue base was the set of smaller "other revenues": including interest and dividend income, user fees and sales revenue, and other sources. That diverse group of non-tax non-grant revenue streams expanded at 3.6% per year in the same period. Across all sources, overall state revenues grew at a strong annual rate of almost 6%.

Figure 22: State Government Revenue by Source, 2018-19



Source: Authors' calculations from Dept. of Treasury and Finance (2019). Revised estimate for 2018-19.

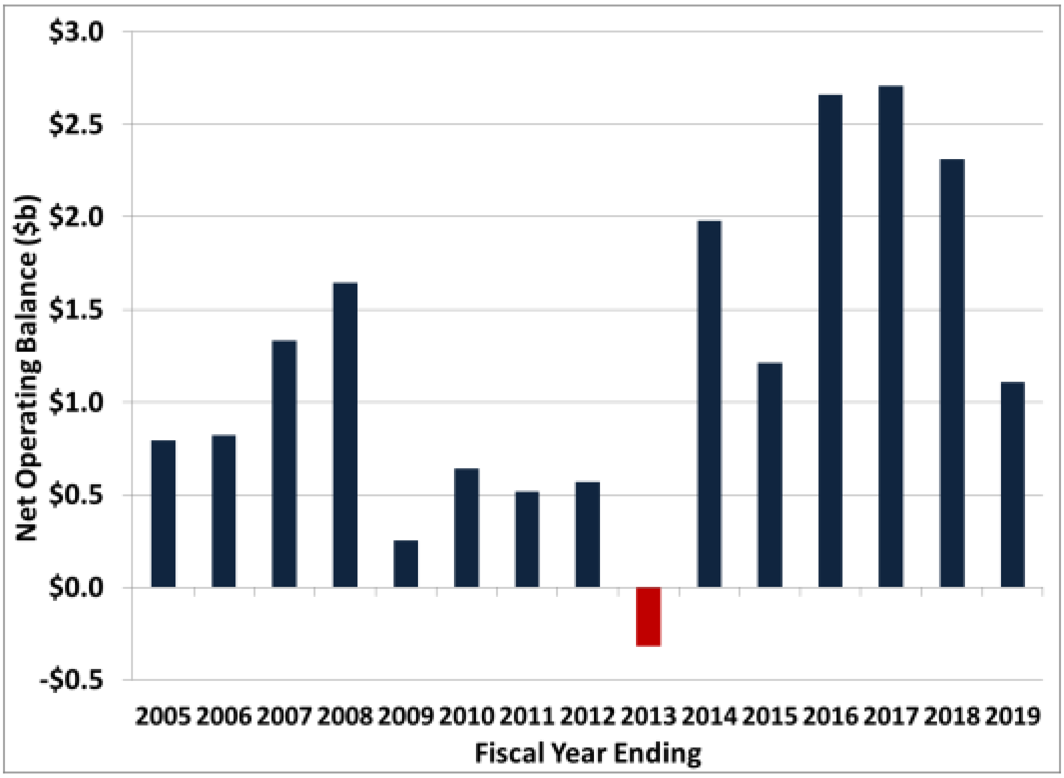
Following this period of robust expansion, the state government now enjoys a diverse and stable set of revenue sources. Grants from the Commonwealth account for almost half of all state revenues. All own-source taxes account for over one-third of total revenues; the land transfer duty represents just one-quarter of those own-source taxes (and less than 9% of total revenues). Other revenues (interest, dividends, sales, and other) account for the final 18%.

In this context, concerns about the impact of the property market downturn on the state's revenue base, and hence on the government's ability to fund continued expansion of public services (and wage increases for the workers who deliver those services), have been clearly overstated. Revised budget estimates for 2018-19 project a 13.6% decline in total land transfer duties from the previous year. But given the small share of land transfer duties in the state government's total revenue base (just 8.6% of total revenues), that decline amounts to a loss of just over 1% of total state government revenues. That amount is easily outweighed by normal continuing growth in other revenue sources. Hence the state's total revenues are still expected to have increased in 2018-19 by over 7% – in line with recent history.[25]

Outlook for Operating Balance

This steady and multi-faceted expansion of the state government's revenue base has allowed the government to fully fund the expansion of public services that has contributed so much to Victoria's nation-leading economic performance – and been endorsed so enthusiastically by the state's voters.

Figure 23: Net Operating Balance, Victoria State Government, 2004-05 to 2018-19



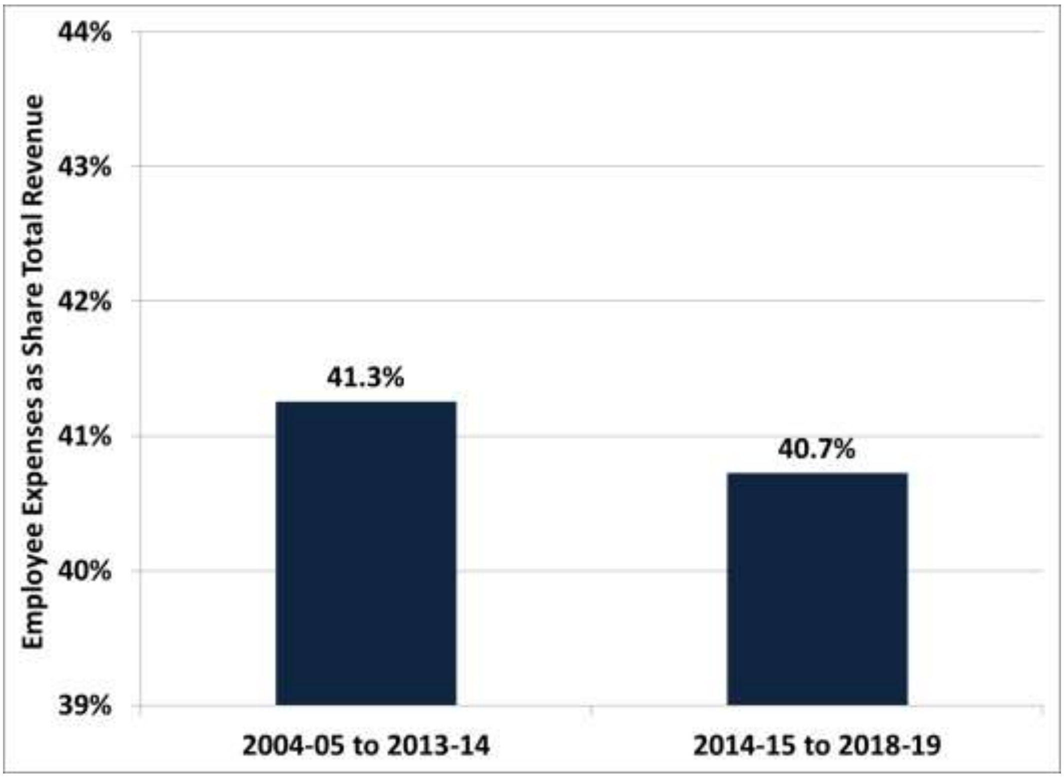
Source: Dept. of Treasury and Finance (2019).

Since the election of the Andrews government in late 2014, Victoria has recorded a string of five consecutive operating surpluses, totalling a cumulative total of $10 billion. Increases in current spending on service delivery and other public functions

[25] In fact, paradoxically, total state revenue growth actually accelerated somewhat in 2018-19 compared to the previous year: rising by an estimated 7.6% compared to 6.0% revenue growth in 2017-18 (a year when land transfer duty *increased* by 13%). This confirms that the impact of property values on state revenues is modest and easily outweighed by other determinants of revenue growth.

have been fully offset by the robust expansion of state revenues – which, in turn, was reinforced by the economic stimulus provided by strong government spending. The consistent operating surplus confirms that the expansion of state public services, and associated compensation costs for public sector workers, is entirely sustainable within the state's current fiscal framework.

Figure 24: Employee Expenses as Share Total Revenues, 2000 to 2019



Source: Authors' calculations from Dept. of Treasury and Finance (2019).

Another perspective on the sustainability of the state government's current service delivery and compensation practices is provided by comparing the government's total compensation costs (including wages, salaries and superannuation expenses) to the growth of total revenues. Since the election of the Andrews government in 2014, there has been no "explosion" of relative compensation costs by this measure. To the contrary, employee expenses have actually declined slightly as a share of total state revenues (as shown in Figure 24). This confirms that the expansion of employment and wages in the Victorian public sector was validated by the strong revenue growth enjoyed by the state government over this time.

Despite the downturn in property prices (which now shows signs of moderating[26]), the 2019-20 Victorian state budget projects continued overall revenue growth, and continuing operating surpluses. Highlights of the 2019-20 budget include:

- The budget's revenue forecast is very conservative: projecting revenue growth of only 2.2% in 2019-20, accelerating to around 5% in subsequent years. Given continued economic growth and job-creation in the state, that cautious revenue forecast for 2019-20 is almost certainly to be exceeded – despite an expected small decline (of less than 2%) in land transfer duty.
- Growth in operating expenses is also curtailed to just over 2% in the current year. This is partly due to a reduction in the inflation indexation factors applied to major program items. Operating expenses are expected to grow somewhat faster in the later years of the estimates (by an average of 3.3% per year between 2019-20 and 2022-23).
- An operating surplus of $1.05 billion is projected for 2019-2020, with larger surpluses in subsequent years.
- The budget plans for public infrastructure investments averaging $13.4 billion per year over the coming 4 years. That substantial injection of public capital spending (totalling over $50 billion over those 4 years) will continue to support economic growth and job-creation throughout the state. New infrastructure spending is directed primarily at major transportation projects, but will also include expansion of schools, prisons, and the new Footscray hospital.

Table 1: Forecasts of Major Economic Variables, Victoria State Budget, 2019-20

	2017-18 actual	*2018-19 forecast*	*2019-20 forecast*	*2020-21 forecast*	*2021-22 projection*	*2022-23 projection*
Real gross state product	3.5	3.00	2.75	2.75	2.75	2.75
Employment	2.8	3.25	2.00	1.75	1.75	1.75
Unemployment rate (b)	5.6	4.50	4.75	5.00	5.25	5.50
Consumer price index (c)	2.3	1.75	2.00	2.25	2.50	2.50
Wage price index (d)	2.3	2.75	3.00	3.25	3.50	3.50
Population (e)	2.2	2.10	2.00	1.90	1.90	1.80

Source: State of Victoria (2019), Budget Paper #2.

Table 1 summarises the key macroeconomic assumptions of the state budget. It anticipates a modest deceleration in economic growth and job-creation in the immediate future, with a subsequent rebound in later years. Real GSP growth is foreseen slowing to 2.75% per year throughout the forecast. Nominal GSP growth (the more relevant indicator for tax revenues and debt burden analysis) slows in 2019-20,

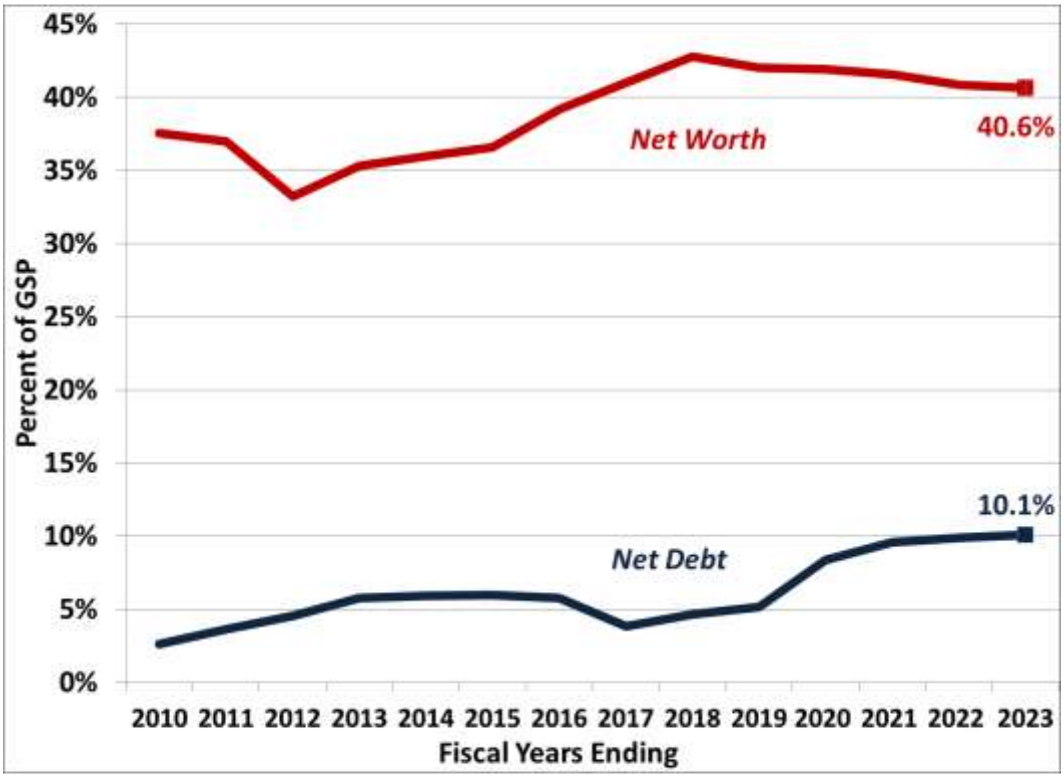
[26] Monthly declines in residential property prices in Melbourne bottomed out in December 2018; while prices are still declining, according to CoreLogic and ABS indicators, they are falling at a much slower rate; many property market observers expect prices to stabilise imminently.

rebounding to over 5% after 2020. The budget predicts that future growth in the Wage Price Index will accelerate to 3.5% per year by 2021-22 – consistent with the indicators presented above showing a recovery in the pace of wage increases. Given the government's expectation of accelerating wage gains across the state, its plan to suppress wage increases for the public sector workforce (to barely half the pace anticipated in the overall labour market) is both inexplicable and contradictory.

Debt and Borrowing

Considerable discussion and commentary has been devoted to the subject of Victoria's rising public debt. State government borrowing will indeed increase significantly in coming years: total gross borrowing will increase by almost $30 billion over the coming 4 years, from $39 billion at end of 2018-19 to $67 billion 4 years later. Measured as a share of GSP, this represents an increase of about half (with gross borrowing rising from 8.3% of GSP at present, to 12.5% by end 2022-23). This borrowing is being undertaken to fund rapid investments in public infrastructure (totalling over $50 billion in the same period). However, that new borrowing will fund only about 60% of new infrastructure spending in the coming four years; the rest will be funded from internal resources.

Figure 25: State Government Net Worth and Net Debt, 2010-2023



Source: Author's calculations from Dept. of Treasury and Finance (2019) and State of Victoria (2019).

Since the government has generated (and will continue to generate) operating surpluses, this borrowing does not reflect any inability to fund the cost of current programs and services (including compensation costs for public sector workers). Rather, the government's borrowing is tied directly to the construction of long-term public capital assets. As for any other economic stakeholder (including consumers and businesses), borrowing to finance long-term assets, especially those which support future economic and productivity growth, is a rational and responsible act. The benefits of this new infrastructure for Victoria's future employment, output, incomes, and tax revenues clearly validate this increase in public debt.

As indicated in Figure 25, the state's net debt[27] is expected to roughly double as a share of the state economy over the next four years, plateauing at 10% of GSP. This remains well below the state's self-proclaimed long-run maximum net debt target of 12% of GSP.[28] Moreover, throughout this period the state maintains a positive net financial position, with total financial assets exceeding total liabilities at the end of the forecast period by a margin equal to 5% of GSP.[29] And the state government's overall net worth (the difference between total assets, including non-financial assets, and its liabilities) remain strongly positive throughout the period. There is little change in the government's net worth position in coming years despite the large increase in borrowing; it remains above 40% of GSP throughout the forecast period. When borrowing is used to finance accumulation of lasting, valuable physical assets, then the net balance sheet position of government is not significantly changed. It accumulates new assets as well as new liabilities, with little change in the net position – but the addition of those assets to Victoria's physical and social infrastructure makes an important contribution to economic capacity and well-being.

Another crucial piece of context for the increase in state borrowing to finance infrastructure projects is the low and declining level of interest rates on public debt. The state enjoys a very strong credit rating: government bonds are rated 'AAA' by both the Moody's and Standard and Poor's agencies, with a stable outlook.[30] Interest

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[27] Defined as borrowings, deposits held and advances received less cash and deposits, advances paid, investments loans and placements and investments in GGS entities; see Dept. of Treasury and Finance (2019), "Historical and estimated consolidated balance sheet as at 30 June - General Government."

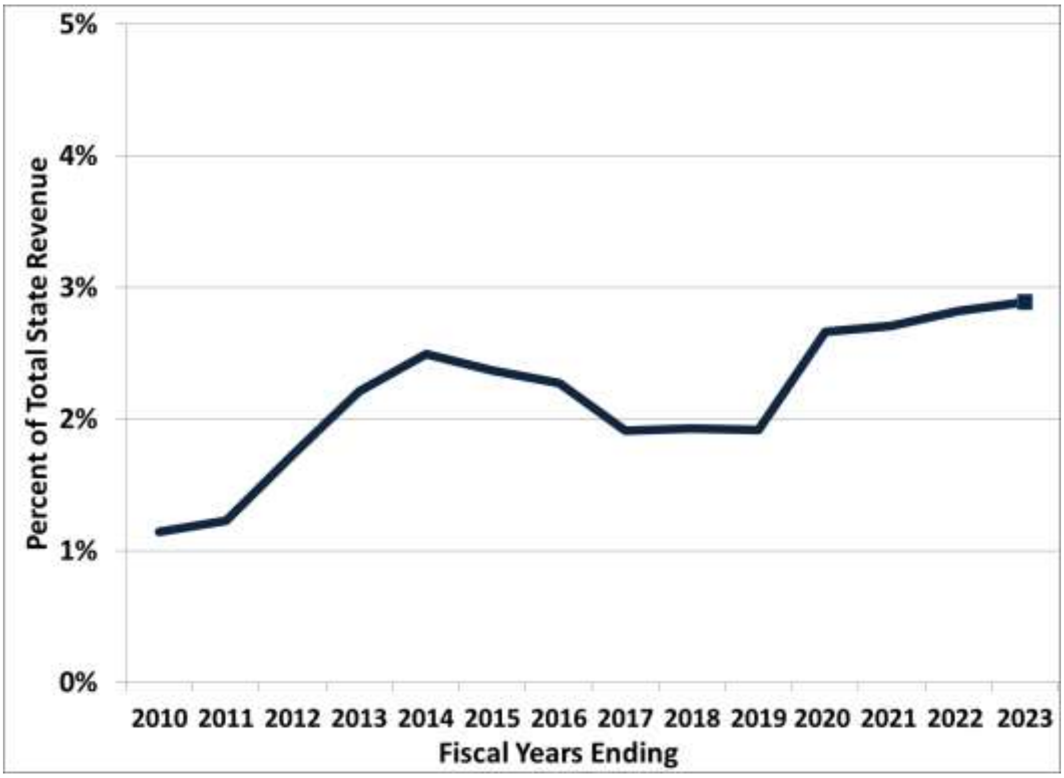
[28] And there is no particular economic logic underpinning that 12% target; in reality, state debt could grow much larger, so long as borrowings are used to finance lasting, productive assets, interest costs remain modest, and economic growth continues.

[29] The state reports a positive net financial position despite also reporting net indebtedness because many of the state's financial assets (most importantly investments in "other sector entities") are normally excluded when calculating the state's net debt.

[30] See Dept. of Treasury and Finance (2019b). Moody's reaffirmed the AAA rating after the recent state election; see Public Accounts and Estimates Committee (2019), p.2.

rates on the state's public debt (similar to other governments around the world) have fallen substantially in the years since the Global Financial Crisis, as financial investors seek safe instruments for their funds, and global central banks (including the Reserve Bank of Australia) keep interest rates low in an effort to stimulate recovery from the long post-GFC stagnation. Current yields on State of Victoria 10-year bonds are in the range of 2.25%. Given the Reserve Bank of Australia's inflation target (2.5%), this implies zero or even negative real interest rates on state borrowing. In other words, the state can borrow money with virtually no real interest burden – and then put that money to work in the construction of lasting, productive infrastructure assets which enhance both economic growth and the quality of life in Victoria. This is not "imprudent," it is a sensible and responsible strategy that generates short-term and long-term benefits. With very low interest rates paid on the state's new borrowing, as well as interest savings resulting from rolling over previous state bonds at new, lower interest rates, total interest payments by the state are expected to remain quite stable as a share of total revenues – despite the significant increase in net debt. Net interest payments are forecast to account for under 3% of total state government revenue in 2022-23 (Figure 26), despite new borrowing. That is only modestly higher than the 2.5% recorded in 2013-14 (when the Andrews government took office).

Figure 26: Net Interest Payments as Share Total Revenues, Victoria, 2010-2023.



Source: Authors' calculations from Dept. of Treasury and Finance (2019).

Conclusion

In sum, the fear that Victoria is somehow sliding into a fiscal “hole” is not credible. Revenue growth has been strong, supported by the state’s superior economic growth and job-creation. The state’s own-source revenues are diversified and stable. The current downturn in property market activity and valuations in Victoria will temporarily undermine revenues from land transfer duties; but the loss in revenue from that source is more than offset by continued expansion from other sources. Growth in total revenues remains robust.

The state more than pays for its current expenses on programs and services from current revenues. Operating surpluses have been consistent and significant, and are expected to remain so.

The state government has made a deliberate and prudent decision to undertake new borrowing to fund a historic expansion in public infrastructure investment. That investment will stimulate job-creation and purchasing power in the short-run (with consequent flow-back benefits to state revenues), and enhance productivity, economic capacity, and quality of life in the long-run. The new borrowing has little impact on the government’s bottom-line fiscal condition: it retains strong positive net worth and a positive financial balance, and interest costs relative to revenues are both stable and sustainable.

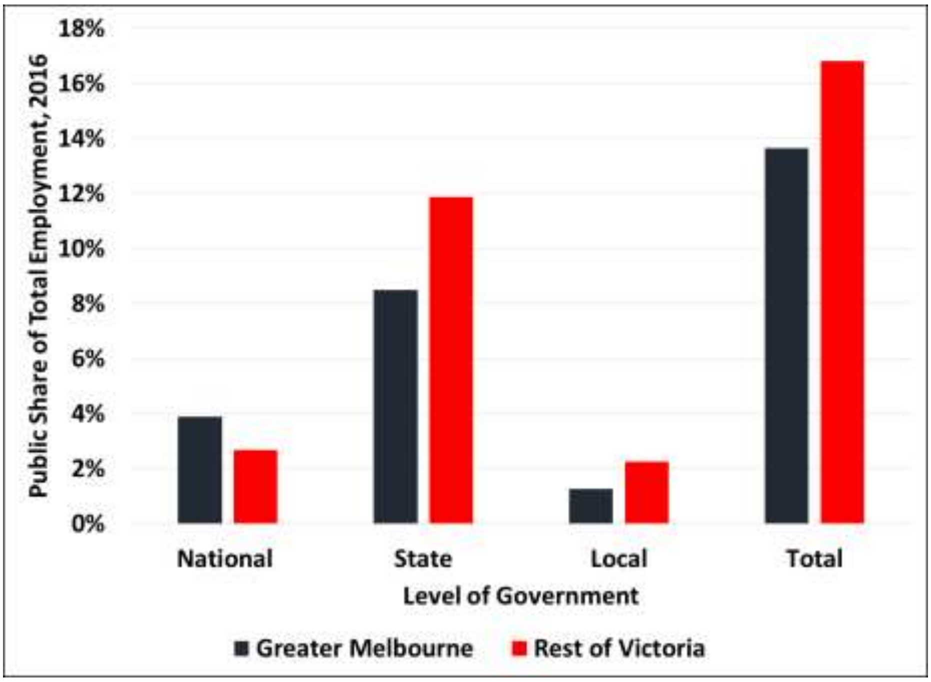
This positive fiscal outlook is acknowledged by global rating agencies, as well as reflected in interest rates on the state’s long-run bonds that remain close to zero in real terms.

In short, Victoria’s fiscal situation is strong and stable. The government has wisely mobilised new resources for important investments that will benefit Victoria’s economy and society. No credible argument can be made that the state faces some kind of fiscal “emergency” or “crisis.” In such a positive fiscal environment, the state’s decision to impose arbitrary and unprecedented constraints on pay increases with its own workforce seems all the more unnecessary and damaging.

3. The Importance of Public Sector Employment in Regional Communities

Even in a state with a strong and diverse economy, like Victoria, regional communities face distinct challenges in relation to economic opportunity and the provision of social services. Therefore, the economic and social importance of the public sector is even more significant in those parts of the state outside of greater Melbourne. Public services are of critical importance in regional communities. Public hospitals, schools, social workers, courts, water authorities, parks officers, and other public institutions and services provide a concrete demonstration of Victoria's commitment to providing adequate services to all of its residents. The public sector also plays a vital economic role in "anchoring" employment and incomes in regional communities. In many cases a major hospital, public university or VET institution, government agency, public prison, or other institution functions as an economic centre of gravity for entire towns and regions: anchoring steady employment and incomes in communities where alternative job opportunities may be scarce, seasonal (such as tourism, agricultural) or cyclical (natural resources).

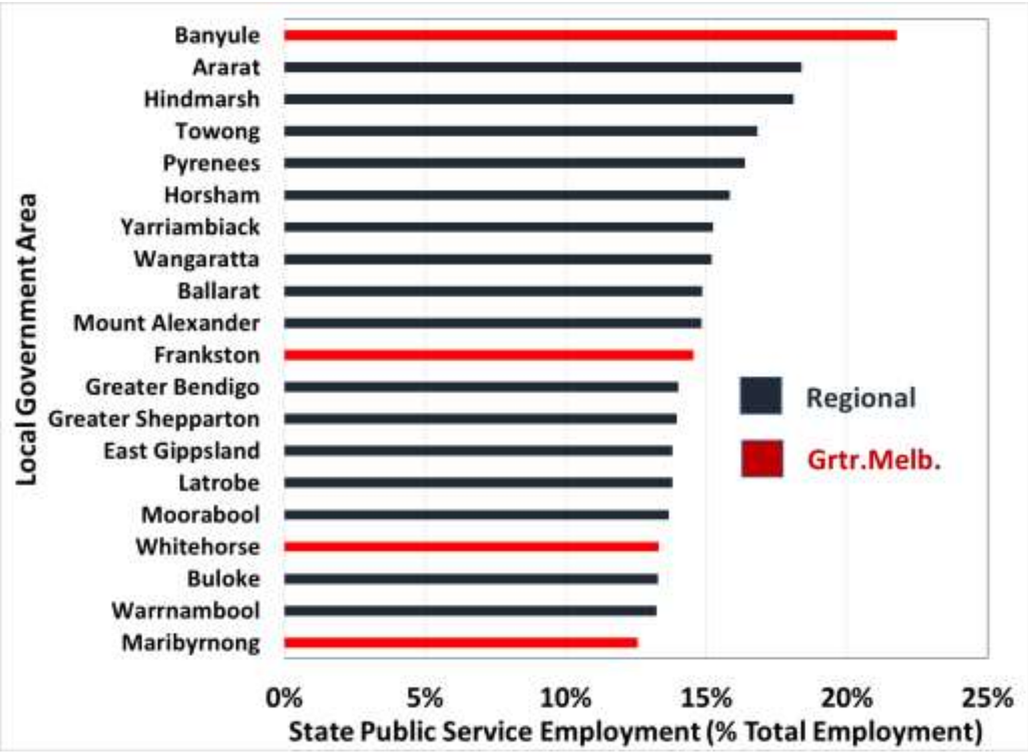
Figure 27: Share of Public Sector in Melbourne and Regional Victoria Employment



Source: Authors' calculations from ABS Census data.

Figure 27 provides an illustration of the heightened importance of public sector services and employment in regional Victoria. It depicts the share of total employment accounted for by public sector jobs (including all levels of government: federal, state and local) in two parts of the state: greater Melbourne and regional Victoria. Public sector employment accounts for a significantly larger share of jobs in regional communities: about 3 percentage points higher as a proportion of total employment. Public sector work (across all levels of government) constitutes almost 17% of all jobs in regional communities, compared to under 14% in greater Melbourne.[31] State government programs and services are the main reason for that greater proportional presence of public sector jobs: state-level public sector jobs account for almost 12% of employment in regional Victoria, compared to just over 8% in Melbourne. In contrast, national-level public sector positions are disproportionately concentrated in greater Melbourne; local government services, meanwhile, account for only a slightly higher share of employment outside of Melbourne. Clearly, therefore, state public services are vital to the continuing economic and social viability of regional communities. Continued job-creation in these services, and regular improvements in compensation for the workers who deliver public services, are thus disproportionately important to the future prosperity and viability of regional communities.

Figure 28: State Public Sector Employment, Top 20 Local Government Areas, 2016



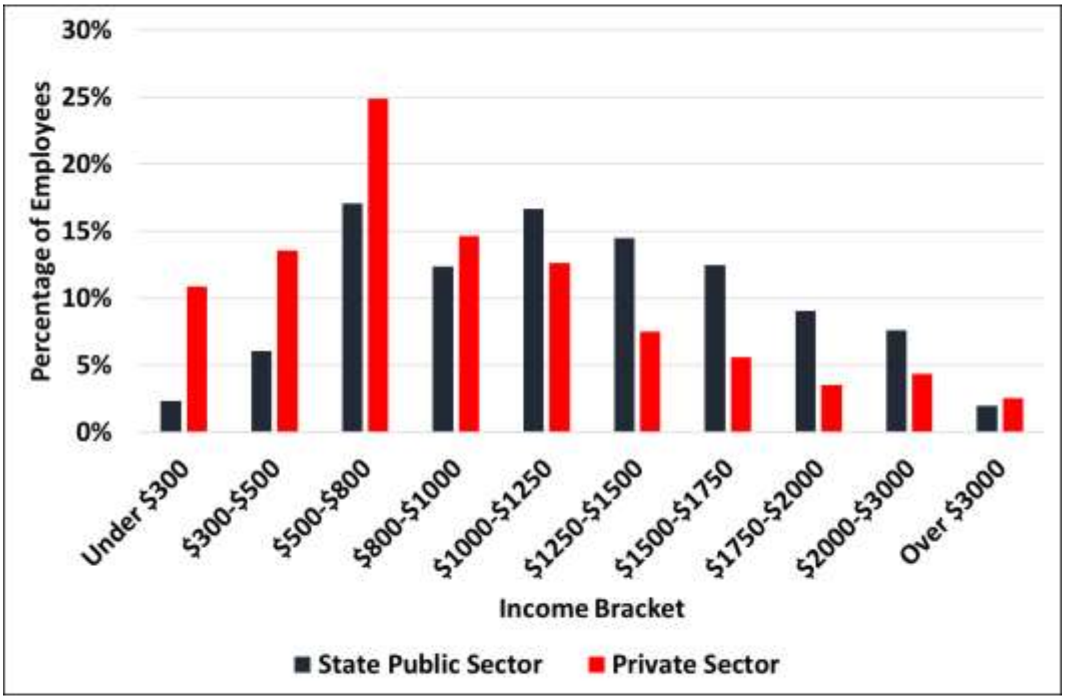
Source: Authors' calculations from ABS Census data.

[31] Of course, the absolute number of public sector jobs is larger in greater Melbourne by virtue of the city's majority share of the total state population.

The greater relative importance of state-funded public services in regional communities is further detailed in Figure 28. It shows the 20 local government areas (LGAs) in Victoria with highest proportional reliance on state public sector employment, measured as a share of total employment. In these 20 communities, state public sector jobs account for a larger-than-average share of total local employment: ranging from 13% up to 22% (compared to a state-wide average of under 10%). Of those 20 communities especially reliant on state public sector jobs, 16 are located outside of greater Melbourne. Only Maribyrnong, Whitehorse, Frankston and Banyule shires (illustrated in red in Figure 28) fall within greater Melbourne. In fact, Banyule has the largest concentration of state public sector jobs of any LGA in Victoria, mostly because of the unique concentration of public hospitals and related health facilities in that community. But it is the only greater Melbourne district included within the top 10 communities listed in Figure 28; all other members of the "top ten" are communities in regional Victoria.

In sum, communities in regional Victoria are disproportionately dependent on state-funded public services for local employment and income-generating opportunities. Any policies which artificially restrict either employment or wage increases in the state public service, therefore, will have a disproportionate impact on regional communities. They already face an uphill battle creating new jobs, and encouraging younger residents to stay and build their careers there. Retrenchment in state public sector employment or compensation would only make matters worse.

Figure 29: Employment by Income Category, Regional Victoria, 2016

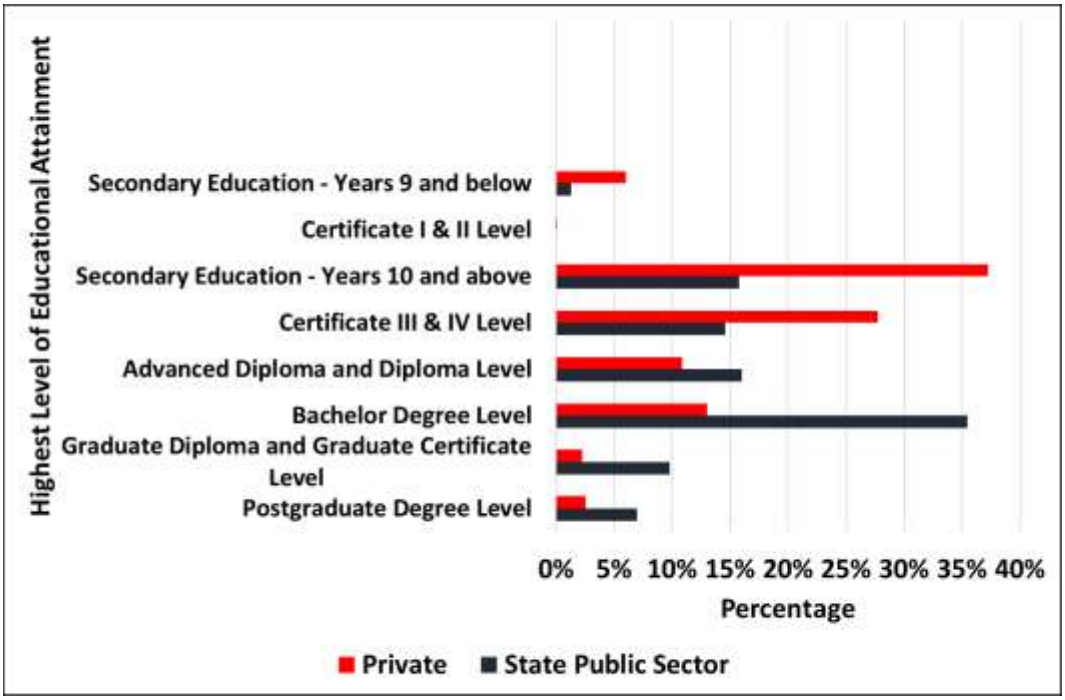


Source: Authors' calculations from ABS Census Data.

It is not just that state public sector jobs make a disproportionate contribution to the quantity of total employment in regional Victoria. They are even more important as a source of relatively secure, well-paying jobs in those communities – especially for workers with further education and higher credentials.

Recall from Figure 12 above that jobs in the state public sector are far more likely than private sector positions to offer compensation that falls in the broad "middle income" range – defined as paying between $1000 and $3000 per week. The importance of public sector jobs in supporting a local "middle class" is all the more evident in regional communities, as illustrated in Figure 29. Barely one in three private sector employees in regional communities falls within that middle-income group (even lower than the 41% middle-income share demonstrated by private sector jobs across the state). And almost two-thirds of private sector employees (64%) in regional communities report incomes of less than $1000 per week (worse even than the 53% of private sector jobs paying low incomes in Victoria as a whole). The decent middle-class incomes enjoyed by most state public sector employees are thus especially important in regional communities – where decently-paid private sector jobs are rare. In regional communities, over 60% of state public sector employees have incomes between $1000 and $3000 per week; only 38% report incomes below $1000 per week. Without public sector jobs in regional communities, and without a continuing commitment by government to fair compensation for those jobs, labour market prospects for regional Victorians would be even more discouraging.

Figure 30: Educational Attainment, Employees in Regional Victoria, 2016



Source: Authors' calculations from ABS Census data.

The greater incidence of decent middle income compensation among public sector workers in regional communities is validated by their superior educational attainment and credentials. The more advanced educational attainment of public sector workers was evident in the state-wide data portrayed above in Figure 13. But it is even more striking in regional communities, as indicated in Figure 30. Very few private sector employees in regional Victoria possess a Bachelor's degree or higher qualification: just 18% in total. The share of state public sector workers with at least a Bachelor's degree is almost *three times higher*, at 52%. In contrast, some 71% of private sector employees in regional Victoria possess a Certificate IV or lower level of qualification. The corresponding share among state public sector workers is 31%. In short, jobs in state-financed public sector positions are some of the only positions in many regional communities for university graduates and others with higher education. These communities face an ongoing challenge to retain younger and better-educated workers, many of whom are naturally tempted to move to Melbourne (or other large cities in Australia) in pursuit of jobs where they can apply their education. Clamping down on either the quantity or compensation of jobs in state public service delivery, therefore, would have a devastating impact on the job opportunities available to younger, educated residents of regional Victoria.

The positive spillover effects of public sector work on the broader economy are also more evident, and easier to identify, in regional communities. As illustrated in Figure 20, public sector employment provides a stimulus for expanded private sector activity. The incomes paid to public sector workers are re-injected into the economic cycle: via taxes paid by public sector workers (thus helping to fund public services where they live), and via consumer spending (which supports sales, profits and employment in the myriad of private sector businesses which cater to those customers). Both of these spin-off effects are strategically more important in regional communities – given the relative scarcity of decent private sector jobs outside of greater Melbourne.

Major public sector institutions (like schools, universities, TAFEs, hospitals, water authorities, transportation maintenance facilities, prisons, research facilities, and others) play a vital role in anchoring broader regional economies. Without those centres of economic activity and income, the decline of local populations and gravitational pull of Melbourne would be even more overpowering. In some cases, public facilities support much or most of the private sector positions in their respective communities: because without the decently-paid, stable jobs in a local hospital or educational institution, there would be nothing to anchor local activity in retail, housing, transportation, business services, and other domestic activity. The input purchases of public facilities are another channel through which public sector activity supports broader regional economies; public sector facilities are more sensitive to the needs and capacities of local businesses, and hence more willing to source their own supplies and input purchases locally.

In sum, regional communities in Victoria receive tremendous economic and employment benefits from the decentralised provision of state-financed public services across the state. State public sector jobs are located disproportionately in regional communities – more so than for either of the other two levels of government. Regional jobs in the state public sector are far more likely to require advanced education, and far more likely to pay decent middle incomes, than jobs in the private sector. Regional communities already face daunting challenges to remain viable, attractive places for younger, more mobile and more educated residents. Continued commitment to job-creation and fair compensation in the state public sector is thus vitally important to the long-run sustainability of regional communities.

4. The Self-Defeating Failures of Austerity

Dabbling in Austerity

As described above, Victoria's economy has surpassed every other state and territory in Australia in recent years, measured by economic growth, population growth, and job-creation. That strong record reflects a positive conjuncture of underlying factors – not the least being the state government's ambitious approach to funding expanded public service delivery and historic investments in public infrastructure. As shown in Figure 4, growth in public services and public investment were among the strongest drivers of the state's economic expansion since 2014. In turn, the state government's fiscal situation benefited from the strong economy, enjoying an impressive and diversified growth in revenues (at an average pace of almost 6% per year since 2014). Key fiscal indicators have remained positive throughout this time: including annual operating surpluses, stability in the share of employee expenses (relative to total revenues), and net worth.

Moreover, the government's expansive strategy delivered political, as well as economic dividends: its commitment to expanding services, investing in infrastructure, and stimulating growth was strongly endorsed by voters in the 2018 election. Given this positive record, one would wonder why any government would tamper with what has obviously been a winning recipe. Yet in its 2019-20 budget, and accompanying statements regarding the application of new austerity measures to the public sector workforce, that is exactly what the government has chosen to do.

In particular, the government has announced two fiscal measures which mark a stark and surprising departure from the successful approach followed during its first term in office:

1. In April the government announced a new "Wages Policy and Enterprise Bargaining Framework." This framework includes a new cap on wage increases for public sector workers of just 2% per year over the life of any enterprise agreements negotiated after this time.[32] This represents the first time that this Labor government has implemented such a wage cap: a restrictive practice that has

[32] The Framework includes a "secondary pathway" according to which wages in certain collective agreements (expiring before 30 June 2020) can be extended by one year with a 2.5% wage increase. See Victorian Government (2019c).

unfortunately become common in other states and at the Commonwealth level. Until now Victoria had bucked the trend of subjecting public sector workers to this top-down interference in normal collective bargaining.

2. In its 2019-20 State Budget, unveiled on 27 May 2019, the government also announced an increase in its so-called annual “efficiency dividend,” which will be boosted from 2020-21.[33] This policy imposes a top-down annual budget saving target on departments and programs. In theory this prods them to identify more efficient ways of delivering services (and hence reducing costs, typically through reductions in staffing levels). In practice it more often amounts to a straightforward budget cut. The state budget does not specify the extent of the increase in the efficiency dividend, nor for how long it would remain in place.

The suppression of wage increases for public servants to 2% per year would result in significant savings for the state budget – but at the expense of reduced incomes for state workers, greater financial stress in hundreds of thousands of households, and reduced consumer spending across the state. In 2018-19, the government spent just under $28 billion on total compensation (including superannuation costs) for the state public sector workforce. Suppressing growth in that compensation below traditional norms (and, indeed, suppressing it below current prevailing trends in Victoria’s overall labour market[34]) will strip billions of dollars from state workers’ incomes over the budget’s planning horizon.

Table 2
Reduction in Compensation Under a 2% Wage Cap
($ billion)

	2019-20	**2020-21**	**2021-22**	**2022-23**	**4-Year Total**
Starting Employee Expenses (2018-19): $27.9 billion[1]					
At 3.25%[2]	$29.211	$30.598	$32.051	$33.574	
At 2%[2]	$28.862	$29.872	$30.918	$32.000	
Reduction	$0.349	$0.726	$1.134	$1.574	**$3.782**

Source: Authors’ calculations from Dept. of Treasury and Finance (2019).
1. Includes superannuation expenses.
2. Assumes 1.5% annual increase in FTE employment.

[33] Victorian Government (2019a), p.44. The current efficiency dividend for budget planning in non-frontline operations is 2.5% per year; see Public Accounts and Estimates Committee (2019, p.10).
[34] As noted in Figure 19 above, year-over-year wage increases in the broader Victorian labour market are currently running at 2.7-3.3% (depending on precise measure selected).

As indicated in Table 2, reducing the rate of compensation growth to 2% from an assumed benchmark of 3.25%[35] reduces employee expenses (including wages and superannuation contributions) by almost $350 million in the first year of the budget. Those cuts in compensation swell quickly in subsequent years – because of the compounding effect of successive years of below-normal wage improvements. By the fourth year of the budget forecast, compensation costs are $1.5 billion lower under the wage cap compared to normal wage increases. Over the four years, compensation is reduced by a cumulative total of $3.8 billion. This represents a significant fiscal transfer from state public sector workers to other budgetary priorities. Over those four years, the policy would reduce cumulative compensation by an average of over $14,000 for each full-time equivalent public sector worker.

Projected savings from the increased efficiency dividend are smaller, and harder to predict (given the lack of detail provided in the budget about the dividend and its method of application). The government incorporates savings from the efficiency dividend within a budget line item titled “Whole of Government efficiencies.” That line item also includes savings resulting from the application of a lower rate of indexation to program budgets, in light of the budget’s assumption of lower inflation (projected to equal 2.0% for 2019-20 and 2020-21, instead of the usual 2.5%[36]). The budget also specifies another separate line item of savings, reducing expenses by an additional $50 million per year throughout the forecast period. These savings were promised by the ALP in its 2018 election campaign; the government claims they can be achieved by reducing its use of outside consultants and labour hire services.[37]

Table 3: Projected Savings Measures, Victoria State Budget, 2019-20 ($ million)

	2018-19	*2019-20*	*2020-21*	*2021-22*	*2022-23*
Labor's Financial Statement savings	..	50.0	50.0	50.0	50.0
Whole of Government efficiencies	..	201.3	462.8	524.2	584.6
Total savings [(a)]	**..**	**251.3**	**512.8**	**574.2**	**634.6**

Source: Victorian Government (2019b), p. 126.

As indicated in Table 3, the combined savings from reduced inflation indexation and a higher “efficiency dividend” after 2020-21 amount to around $1.8 billion over the four years of the budget forecast; the savings promised in the election financial statement would add another $200 million over the same time. The enhanced efficiency dividend would seem to account for a relatively small portion of these total savings. The process

[35] 3.25% is chosen as a benchmark for illustrative purposes only; it broadly corresponds to the average pace of wage increases for state public sector workers under the time covered by the previous (now expired) enterprise agreement.

[36] See Public Accounts and Estimates Committee (2019), p.10.

[37] See Australian Labor Party, Victoria Branch (2018).

of implementing the efficiency dividend was not specified in the budget; it merely commits the government to undertaking a "comprehensive program of expenditure base reviews" to identify the promised savings (Victorian Government, 2019a, p. 44).

The Unintended Consequences of Austerity

Public sector austerity has been become a hallmark of public policy in most Australian jurisdictions in recent years. Austerity involves a familiar suite of specific policy measures implemented reflexively by governments of all political stripes. Typical tools of austerity include: the privatisation and marketisation of public services, the outsourcing of roles traditionally performed by the public sector, downsizing public sector employment, the imposition of so-called "efficiency dividends" on government agencies, and the introduction of arbitrary public sector wage caps. The decision by the government of Victoria to begin pursuing some of these measures, despite its strong fiscal position and the state's strong economy, is both puzzling and concerning.

Attacking public sector employment and compensation, under the guise of a supposed commitment to efficiency and responsible financial management, is a symptom of lazy and ineffective policy-making. The imposition of annual "efficiency dividends" on government departments and agencies, first introduced at a federal level in the 1980s, in reality constitutes an unimaginative, recurrent budget cut – one that does not account for the actual funding requirements of various programs, nor is effective in fostering genuine innovation and efficiency (as opposed to budget-cutting). Top-down imposition of these annual cutbacks reduces employment and undermines quality of service.

Numerous criticisms have been made of the practice of routinely imposing annual budgetary reductions on departments and programs, in the guise of "efficiency."[38] Evidence suggests that the imposition of these blunt, uniform budget cuts across all programs has many uneven and unintended consequences. Smaller programs and departments are affected more severely (due to indivisibilities in operations); perversely, more efficient departments can actually be punished by the application of across-the-board cuts. Far from fostering innovation in program delivery, efficiency dividends can inhibit it: most genuine operational innovations require up-front investments in new systems and technologies, which can become impossible under steadily-shrinking budgets. One ANU economist bluntly summed up the evidence against this simplistic budgetary strategy as follows: "What governments call efficiency

[38] See Joint Committee of Public Accounts and Audit (2008) for a detailed and critical review; see also Stone (2014) and Feltes (2016) for critical accounts.

dividends are simply budget cuts. Using the term efficiency is at best misleading and at worst harmful."[39]

Public sector wage caps are an equally unimaginative instrument in the toolkit of austerity. The state government in NSW was the first in Australia to use this strategy in modern times, introducing a 2.5 percent public sector wage cap in 2011 – purportedly to address a supposed "crisis" in the state budget. Eight years later, with NSW's budget deficits replaced by large surpluses, the cap is still in place; the current government has even toyed publicly with now lowering the cap further, to just 2%. The 2% wage cap has been aped by the Commonwealth government, and state governments in Tasmania and the Northern Territory. South Australia introduced a 1.5% cap in 2016, while WA capped public sector wage increases to a maximum of $1,000 per person.

Wage caps are often enforced by legislative measures that limit or eliminate normal collective bargaining processes and labour rights. Even when the wage cap is enforced without new legislation (as in Victoria's case), the government can count on other legal and regulatory powers to effectively dictate its desired wage outcome: including routine prohibitions on industrial action for public servants, and the acquiescence of arbitrators to the government's stated goals.[40] Either way, this heavy-handed approach subverts normal wage-setting processes; the top-down imposition of wage caps by government on its own employees contradicts both traditional practice and international norms. In most cases wage caps have been implemented during times of budget deficits, and thus justified as a fiscal necessity; they usually remain in effect long after fiscal pressures ease. In Victoria's case, however, the cap is being introduced despite a long-standing and continuing budgetary surplus. The case for implementing this extraordinary measure is thus even weaker than in other jurisdictions.

The use of wage caps is especially damaging given that Australia is in the midst of a pronounced and prolonged slowdown in wage growth: the worst since the end of the Second World War. To some extent, Victoria has avoided the worst effects of that slowdown, thanks to its stronger macroeconomic and labour market conditions. As noted in Figure 15, Victoria has enjoyed the fastest wage growth of any state since 2014. Victoria did not have a public sector wage cap during this time. Strong wages and resulting strong household incomes in Victoria further reinforced positive trends in consumer spending, government revenues, and economic growth. The state government's decision to now suppress future wage gains for its own workforce will

[39] Dr Maria Racionero, cited in Feltes (2016).

[40] Recent Fair Work Commission proceedings which accepted government-specified public sector wage caps as legitimate and important factors in wage determinations include its 2013 determination on industrial action by Parks Victoria workers (FWCFB 950), and its 2018 determination on industrial action by workers at the Commonwealth Department of Home Affairs (B2016/1232).

inevitably have a dampening effect on incomes, spending, and consumer and business confidence across the state. As noted above, those impacts will be especially painful in regional communities, which are more dependent on state public sector jobs and incomes than greater Melbourne. And the wage cap could undermine broader wage growth – just as overall wage indicators are finally showing signs of recovery.

A warning of the potentially self-defeating impacts of wage caps is provided by the perverse experience in NSW, which (as noted) imposed one of the country's first public sector wage caps in 2011. At the time, overall wage growth in the state was running at between 3.5 and 4%, having rebounded quickly after a temporary slowdown during the worst years of the Global Financial Crisis. However, almost as soon as the state government imposed a 2.5% cap on its own workforce (the largest single group of employees in the state), overall wages began to decelerate sharply – even among private sector employers.

Figure 31: Wage Growth in NSW, Before and After Wage Cap, 2005-2019

Source: Authors' calculations from ABS Catalogue 6345.0, Table 2b.

As illustrated in Figure 31, within a year of the implementation of the state cap, overall wage growth in the state (including in the private sector) began to decelerate sharply, falling below 2.5% by early 2013. Wage growth in NSW since then has remained significantly weaker than in Victoria (even though NSW's job-creation was second-fastest in Australia). Indeed, the most recent data show a renewed downturn in NSW wage growth in 2019 (in contrast to the accelerating rebound in Victoria[41]). The imposition of an arbitrary and restrictive wage cap on NSW's large public sector workforce has played an undeniable role in undermining overall wage growth throughout the NSW labour market.

Henderson (2018) argues that austerity measures by the Commonwealth government had a similar impact on national wage trends. The Commonwealth government imposed large "efficiency dividends" (as much as 4% per year) and then 2% wage caps in the years after the Global Financial Crisis. Those actions contributed to the deceleration of broader wages, with national wage growth falling below 2% per year in the wake of those Commonwealth measures.

Why does a wage cap on public sector workers spill over into slower wage growth in the overall economy? There are at least three transmission channels that can explain the connection between public sector wage caps and broader wage stagnation: a 'composition effect,' a 'demonstration effect,' and a 'macroeconomic effect.' We will briefly consider each of these channels in turn.[42]

The 'composition effect' reflects the direct impact of lower public sector wage growth on the overall weighted average wage growth of the total labour market. With lower wage increases being offered to the roughly 15% of the total labour force employed in the public sector, overall average wage growth is reduced accordingly (by a proportional fraction of the reduction imposed on public sector workers).

The 'demonstration effect' refers to the impact of public sector wage caps on wage trends among private sector employers. Public sector wage caps establish a highly visible benchmark for wages; they are automatically influential since they are implemented by the largest single employers in the country (governments and public sector agencies). Private firms that supply government quickly invoke the wage cap as justification for their own wage restraint, in order to 'stay competitive' with this major customer. But even firms that do no direct business with public agencies will also invoke the government's highly visible wage target as a convenient guide for their own efforts to restrain wage growth. The seeming legitimacy which is imparted to wage restraint by the actions of government – often backed up with extraordinary legislative intervention – imparts further (undeserved) moral force to this effort to restrain wage growth.

[41] All-sector WPI growth in NSW slowed to 2.35% year-over-year in the March quarter of 2019, whereas in Victoria it picked up to 2.72%.

[42] This discussion is adapted from Henderson (2018).

Finally, there is a negative ‘macroeconomic effect’ arising from public sector wage austerity. Suppressing wage growth undermines overall incomes and consumer spending; public sector wage restraint therefore damages aggregate demand conditions and the vitality of private-sector activity (including in retail trade and other consumer-sensitive ‘downstream’ industries). This negative impact on aggregate demand is experienced directly via the significant section (around 15%) of the total workforce that is employed in the public sector; but it is also experienced indirectly via private sector workers whose own employers have mimicked restrictive public sector wage benchmarks.[43] Less money in the pockets of over 300,000 workers in Victoria inevitably implies reduced sales opportunities for thousands of businesses across the state – and this in turn undermines their own employment decisions and wage offers.

For all these reasons, the imposition of a 2% wage cap on state public sector compensation growth will have a significant and negative impact on overall wage trends in Victoria’s economy – cutting short a nascent and badly-needed wage recovery after years of wage stagnation. It is unfathomable that a state government enjoying annual budgetary surpluses would suddenly shift to adoption of this blunt, ineffective, and self-defeating instrument of austerity. The 2% wage cap falls well below all relevant benchmarks for wage growth: including growth in overall wages, inflation targets, and continuing growth in state revenues. There is no fiscal or moral case for this punitive, arbitrary, and interventionist measure.

The Consequences of Wage Stagnation

The Victorian state government’s sudden decision to endorse the concept of public sector wage caps (and bigger “efficiency dividends”) is further contradicted by an emerging consensus among economic policy experts that governments should be acting to spur wage growth, not suppress it. In response to the unprecedented slowdown in Australian wage growth since 2013, a growing number of economists, policy-makers, and even business leaders have acknowledged the economic and social damage being done by years of stagnant wages, and the resulting polarisation of income distribution.

For example, the Governor of the Reserve Bank of Australia, Dr Philip Lowe, has highlighted in numerous interventions the negative effects of weak wage growth on macroeconomic outcomes, monetary policy, and social cohesion.[44] Weak wage growth undermines consumer spending and economic growth, it makes it impossible for the

[43] For example, in the case of New South Wales, Henderson and Stanford (2017) estimated that between 2011 and 2016 public sector pay restraint reduced consumer spending by $3.4 billion, GDP by over $8 billion and state government revenue by $1.2 billion.

[44] See, for example, Greber (2017), Bagshaw (2017), Hutchens (2018), and Lowe (2017, 2018).

Bank to attain its inflation target (with implications for long-run confidence in the inflation targeting system), and it undermines the implicit social contract that is essential to ongoing innovation, productivity growth and economic reform. Other leading policy-makers have also spoken out about the dangers of stagnant wages.[45]

Recently, members of the Reserve Bank's Monetary Policy Committee explicitly acknowledged the role of public sector wage caps in forestalling the national recovery of wage growth to normal rates. In its most recent meeting, the committee noted the impact of public sector wage caps in restraining national wage trends:

> "New private sector enterprise bargaining agreements had incorporated slightly faster wages growth than agreements reached a year earlier. However, wages growth for workers on existing enterprise bargaining agreements had remained subdued, and there was little prospect of a near-term pick-up in public sector outcomes given the ongoing wage caps." (Reserve Bank of Australia, 2019)

Another important intervention into the Australian debate over wages was a recent joint public statement by 124 labour policy experts – including economists, labour lawyers, and other policy specialists – highlighting the dangers of wage stagnation, and calling on governments to take several concrete measures to reinvigorate wage growth.[46] Importantly, the experts' policy recommendations prominently included relaxing or eliminating wage caps on public sector workers as one of the most important and immediate actions governments could undertake to lift wage growth.

Similarly, a recently published volume of Australian academic research on the causes, consequences, and remedies for wage stagnation also highlighted the role of public sector wage restraint in setting a negative example for wage behaviour through the rest of the labour market.[47] Indeed, the editors of that volume listed the abolition of arbitrary public sector wage caps as the *first* among five crucial policy recommendations for addressing wage stagnation:

> "We are proposing an end to public sector wage suppression as our first category of proposed reforms because it is something that governments at every level can do immediately, without any need for bigger structural or legislative changes. Governments should indicate, through their actions as well as their rhetoric, that reigniting wage growth is

[45] See ACOSS (2018), Heath (2017), McManus (2018), Turner (2017), and Yeates (2017) for examples.

[46] See Remeikis (2019). The full statement is available at https://assets.nationbuilder.com/theausinstitute/pages/2972/attachments/original/1553100722/Open_Letter_on_Wages_Full_List.pdf?1553100722.

[47] See Stewart *et al.* (2018).

considered a positive and central goal of economic and fiscal policy." (Stewart *et al*., 2018, pp. 285-286)

The consequences of wage stagnation are pervasive and long-lasting. Major implications of weak wage growth include:

- Negative impacts on consumer spending, which is held back by weak household incomes. Compensation of employees constitutes about two-thirds of total personal income in Australia. If wages are not growing, it is difficult for consumers to spend more. Wage stagnation has been a major factor in the recent weakness in consumer spending in Australia,[48] which in turn has contributed to the sharp recent slowdown in national economic growth (which has slowed to its weakest pace since the Global Financial Crisis).
- Wage stagnation has a longer-lasting negative impact on household financial stability, by constraining Australians' ability to service and eventually repay personal debt. Australian households are among the most heavily indebted of any in the world, with personal debt equal to 200% of disposable income. By slowing down growth in personal incomes (the denominator of that debt/income ratio), stagnant wages both spur more household borrowing (as consumers sustain consumption levels through borrowing) and exacerbate the fragility of household finances.
- Stagnant wage growth also undermines innovation and continued productivity growth in the economy, by reducing the incentive for workers to participate in and support those processes. In economic theory, real wages are supposed to broadly keep pace with productivity growth – thus ensuring that workers receive a proportional share of increases in total real output, in line with their contribution to productivity growth. In practice, real wages have lagged far behind productivity growth through most of the last generation; since the turn of the century, for example, average real wages have increased only half as quickly as realised labour productivity.[49] Making matters worse, since 2013 real wage growth has stopped in its tracks, even as labour productivity continues to incrementally improve. This severing of the traditional, healthy link between productivity growth and rising living standards has major implications for continued innovation, workplace relations, and social cohesion.
- Public finances, as noted above, are also damaged by the unusually weak growth of wages in recent years. Weaker wage growth implies weaker income and payroll tax streams; weaker consumer spending undermines GST revenues;

[48] In the year ending in the March quarter of 2019, real consumer spending in Australia increased by just 1.8%, its weakest growth in 6 years; authors' calculations from ABS Catalogue 5206.0, Table 2.

[49] See Stanford (2018a) for detailed comparisons of wage growth and productivity growth.

slower superannuation accumulation ultimately result in a larger call on the Age Pension and other public income programs; weaker overall growth undermines property values and hence land tax and land transfer duty revenues. The 2019-20 Victoria state budget assumes that wages will increase by 3.0% in the current financial year, rising to 3.5% for 2021-22 and after. That assumption is critical to the budget's targets for many revenue streams – including own-source revenues (like payroll taxes), but also shared revenue flows from the Commonwealth.[50] The state government thus undermines its own fiscal plan with its decision to suppress wage increases for a large segment of workers in the state, to far below what it anticipates in its own budget.

- The slow growth of wages imposes deeper and lasting damage to inclusion and cohesiveness in Australian society. Even as overall wages have grown slowly (hurting overall personal income growth), inequality across households has widened considerably. That is because only a fortunate minority of employed workers is able to achieve more robust wage increases; and the shift in overall national income from wages to capital incomes (including interest, dividends, and capital gains) disproportionately benefits the minority of households with large investment holdings.[51] Growing inequality, in turn, imposes a wide set of economic and fiscal costs – including higher costs for health care, policing, and income supports; reduced educational outcomes; poorer income and productivity results; and more.[52]

A government committed to inclusive growth, greater inequality, and stronger wages should be sensitive to these risks, and resist the temptation to so forcefully and arbitrarily suppress incomes for its own workforce in the interests of short-term budget savings.

Ignoring clear advice from numerous policy experts, rightfully concerned about the long-run consequences of wage stagnation on Australia's economic performance and social fabric, the Victorian government seems intent on implementing severe and unnecessary restrictions on compensation growth for its own employees. It is jumping on a bandwagon that long ago departed – and which labour policy experts now understand is traveling in the wrong direction.

[50] Slower wage growth will negatively affect Commonwealth income tax and GST collections, which will be partly reflected in reductions in transfers to the state level.

[51] The link between the changing factor distribution of incomes, and growing inequality in personal income distribution, is considered further in Stanford (2018c).

[52] New scientific evidence regarding the huge range of negative impacts of inequality is usefully assembled by Pickett and Wilkinson (2009).

Conclusions and Policy Recommendations

This report has provided extensive empirical evidence for several key hypotheses relevant to the Victoria state government's future policy stance on public sector wages. These key factors include:

- Victoria's economy is strong – the strongest in Australia. The state's impressive growth underpins and validates job-creation, rising wages, and the expansion of public services and infrastructure.
- The strong expansion in both public services and infrastructure investments in recent years has reinforced the positive trajectory of the state's overall growth. Expanded public sector activity has been a key driver of Victoria's economic progress – not to mention the social benefits arising from greater availability of services and infrastructure.
- The past practice of respecting free collective bargaining with public sector workers produced decent wage increases – though still below historical norms. Those gains in public sector compensation were fully consistent with continued progress in state government finances: they were implemented in concert with regular operating surpluses and a slight fall in employee costs relative to total state revenues.
- The state's general fiscal outlook remains healthy, despite the downturn in the greater Melbourne property market which has modestly reduced revenues from land transfer duties. Overall state revenues are still growing; operating surpluses will be maintained; and state public debt (undertaken solely to finance important and necessary improvements in public infrastructure) is entirely manageable (within a continuing context of strong credit ratings and near-zero real interest rates).
- Relevant benchmarks for evaluating the future trajectory of public sector wages all indicate they should be growing much faster than the 2% cap being imposed by the state government. Real economic growth; growth in per capita state revenues; wage and inflation targets from the Reserve Bank; and wage increases paid elsewhere in the Victorian labour market (including wage increases for elected state politicians!) are all trending well in excess of the 2% marker which the state government wants to impose on its own employees.
- The imposition of public sector wage caps by governments has had demonstrable negative impacts on overall wage trends, via a range of causal

channels: including negatively influencing private sector wage settlements, and undermining aggregate demand and spending conditions.

- The needless continuation of Australia's presently weak wage patterns will cause escalating damage to macroeconomic conditions, household financial stability, innovation and productivity growth, and social cohesion.

In this context, the decision by the Victorian government to impose stringent and intrusive wage caps, and dispense with normal collective bargaining, seems ill-advised and destructive. And the imposition of annual budget cuts in the name of increased "efficiency dividends" would do additional damage to public sector employment and aggregate compensation. Given the disproportionate importance of state public sector jobs in regional communities in Victoria, these consequences will be especially damaging outside of greater Melbourne – in communities that already face an uphill battle to retain jobs, population, and services.

There is no fiscal necessity for the state government to adopt these hackneyed hallmarks of fiscal austerity. They have not worked in other jurisdictions. Indeed, the fact that Victoria did not follow this recipe in recent years helps to explain why its economy has been consistently the strongest in Australia. In addition to its negative economic effects, the imposition of wage caps which short-circuit normal free collective bargaining rights and practices curtails the fundamental rights of public sector workers to organise and negotiate, and violates international labour norms.

For these reasons, we recommend that the state government of Victoria:

1. Abandon the imposition of a 2% cap on wage increases for state public sector workers.
2. Enter into normal negotiation of enterprise agreements in broader public sector enterprises and agencies; the state's fiscal constraints obviously constitute a relevant and important factor in those negotiations, but do not justify the imposition of direct wage controls.
3. Abandon its proposed target for increased "efficiency dividends," which have proven to be a blunt and ineffective budgetary strategy.
4. Undertake instead an open-ended program review of departments and agencies with the goal of enhancing genuine efficiency – defined as improving the effectiveness and quality of public service delivery, rather than attaining a target budget cut.

5. Commit to no forced redundancies during the course of that program review; any identified redeployments should be attained through relocation, retraining, and voluntary severance.[53]

Victoria enjoys an enviable situation, given its strong growth, expanding network of public services and infrastructure, and relatively strong incomes. The state government's approach to public sector employment and wage policies has been an important element of that success. This is not the time to jeopardise that success with a belated and unjustified leap into failed policies of austerity.

[53] Treasurer Tim Pallas has indicated that he believes the expenditure review can be implemented without forced redundancies (see Public Accounts and Estimates Committee, 2019, p.14), and hence it should be straightforward for the state government to commit to this important goal.

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