THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: State Sector Wages

Date:	28 January 2005	**Treasury Priority:**	High
Security Level:	IN-CONFIDENCE	**Report No:**	T2005/84

Action Sought

	Action Sought	Deadline
Minister of Finance	a **note** that the size of the State sector wage bill has increased significantly over the last five years and that continued increases in the size of the State sector wage bill will significantly constrain Ministers' ability to fund new policies in the near future; b **note** that reprioritisation of resources is the most appropriate response to managing these pressures; c **agree** to a range of processes to assist in reprioritisation in the Budget 2005 process.	Wednesday, 2 February 2005
Associate Minister of Finance (Hon Trevor Mallard)	**Note** the contents of this report	Wednesday, 2 February 2005
Associate Minister of Finance (Hon David Cunliffe)	**Note** the contents of this report	

Contact for Telephone Discussion (if required)

Name	Position		Telephone	1st Contact
Withheld under s. 9(2)(a)				
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Enclosure: No

28 January 2005 SH-2-2-5-2

Treasury Report: State Sector Wages

Executive Summary

Over the last five years the size of the State sector wage bill has increased significantly (across the core public service, health and education sectors we have seen an increase of about 8% per annum)**.** This increase has been due to:

- a 14% increase in the number of people employed across the non-trading State sectors;
- increases in wages funded through injections to baselines, rather than reprioritisation of resources; and
- implementation of the first tranche of the State Sector Retirement Scheme (SSRS).

Commensurate increases in outputs do not appear to have been achieved as a result of this increase in costs. Furthermore, increases appear to largely have been provided across the board, which suggests that they have not always aligned with government priorities.

Looking forward, key pressures on the wage bill in the core public service, health and education sectors will continue over the next three to five years as:

- the size of the State sector continues to grow;
- wage pressures increase, either in response to 'key' settlements **[withheld under s. 18(d)]** or as the market struggles to address labour shortages; and
- regulatory changes are implemented – specifically the Holidays Act, the pay and employment equity policy, and a potential expansion of the SSRS.

This situation poses a significant problem because spending amounts are limited, yet (without intervention) the costs related to capability and wages will most likely continue to increase at a level higher than anticipated economic growth. Ultimately this has the potential of significantly constraining the ability of Ministers to progress new policies.

[Withheld under ss. 9(2)(f)(iv), 9(2)(g)(i)]

The wider macroeconomic impacts of increased wages in the State sector are likely to be limited in the short term. However, they will place pressure on the Government's fiscal strategy, and therefore have the potential to impact adversely on macroeconomic stability.

Reprioritisation of resources is the only sustainable means of managing the fiscal risks that have been identified. **[Withheld under ss. 9(2)(f)(iv), 9(2)(g)(i)].** In the medium and long term this will mean putting processes in place to better support Ministers in making reprioritisation decisions on an on-going basis.

[Withheld under ss. 9(2)(f)(iv), 9(2)(g)(i)]

In the medium to longer term reprioritisation will only succeed if Ministers are able to access good information about the performance and / or productivity of particular policies or agencies. A range of projects, considering ways in which Ministers can be supported in making reprioritisation decisions, are currently in progress and the paper identifies these.

Recommended Action

We recommend that you:

a **note** that the size of the State sector wage bill has increased significantly over the last five years and that continued increases in the size of the State sector wage bill will significantly constrain Ministers' ability to fund new policies in the near future;

b **note** that reprioritisation of resources is the most appropriate response to managing these pressures;

[Withheld under ss. 9(2)(f)(iv), 9(2)(g)(i)]

Medium to long term options

c **note** that central agencies are currently working on a range of projects that should provide better information to assist Ministers to reprioritise resources, and that the results of these projects will be reported to Ministers over the coming year; and

[Withheld under ss. 9(2)(f)(iv), 9(2)(g)(i)]

Treasury Report: **State Sector Wages**

Purpose of Report

1. This report provides an outline of current and future pressures faced by government in the management of employment relations issues, proposals for management of immediate pressures, and a work programme designed to provide ongoing responses.

Analysis

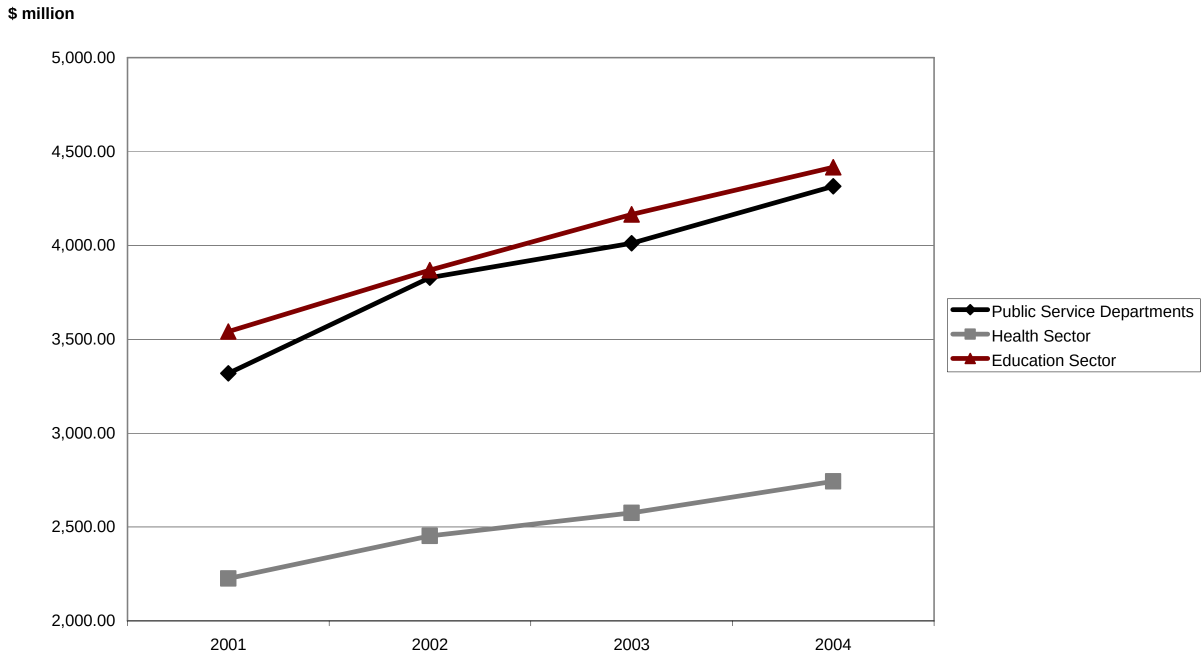
Increased wage and capability costs will make Budget tradeoffs harder within available spending

2. The size of the State sector wage bill has increased significantly over the last five years. As figure 1 illustrates, in the core public service, health and education sectors alone, we are currently looking at increases in the order of $750million to $1billion per budget to meet the costs associated with both wage and employment growth. This does not reflect any other increases in capability or wages funded from within baselines.

3. Whilst the identified increase only equates to approximately 2% per annum of total government spending, the impact on total personnel expenses across these sectors is an increase of about 8% per annum.

4. This increase has largely occurred in response to: an increased focus on the effectiveness and capability of the State sector; the promotion of equitable employment relationships in the State sector; and the macroeconomic environment having led to labour shortages, which in turn have increased wage pressures.

Figure 1 - Personnel Expenses



NB: This graph does not reflect the impact of recent settlements – the nurses settlement will provide for a further increase in the health sector line.

5. This is not a static increase. Any future wage increases, even if they are in line with movements across the wider labour market, will have a significant fiscal impact. This will be compounded by costs associated with implementation of a range of employment policies (for example, pay and employment equity). Further, the State sector labour market is likely to remain very tight for at least another twelve months, with the potential for some level of labour shortages over the next two to four years.

6. The combination of these trends represents a significant problem for the future because spending amounts are limited but the costs related to capability and wages will continue to increase at a level higher than anticipated economic growth (for example, we saw an increase in the total wage bill – representing increases in numbers employed and wage increases – of 12% in the year to June 2004). Ultimately this trend has the potential of significantly constraining the ability of Ministers to progress new policies.

[Withheld under ss. 9(2)(f)(iv), 9(2)(g)(i) and 18(d)]

7. In the short term, the wider macroeconomic effects of increased wages in the State sector may be limited by New Zealand's strong economic growth. However, if these trends continue they have the potential to impact adversely on macroeconomic stability:

- on the fiscal side, the wage bill will continue to put pressure on future Budgets at the same time as longer-term expenditure pressures come to bear, which could mean needing to reconsider the Government's fiscal strategy;

- on the monetary side, increasing labour market demand and rising wages in the public sector will put pressure on inflation outcomes and may lead to rising interest rates. They are also likely to reinforce demands for higher wages in some parts of the private sector; and

- in terms of economic growth, rising wage costs in the sectors of the economy not exposed to international competition such as the public sector will reduce competitiveness and choke off growth. This phenomenon has been a major reason for the end of the period of rapid growth in Ireland.

Increasing costs can be attributed to three factors …

8. The increase in the State sector wage bill can largely be attributed a combination of: an increased number of positions across the State sector[1]; increased wage levels; and an increase in costs associated with responding to regulatory changes.

Employment growth

9. As table 1 illustrates, since 1999 the number of positions funded across the non-trading parts of the wider State sector has increased from around 220,000 to 246,000, reflecting an increase of around 12% in total non-trading State sector employment. This increase has largely been driven by:

- policy decisions centred on shifts in the 'quality' dimension of services currently delivered – for example, decreased class sizes and reduced contact hours for teachers has lead to an increased demand for teachers;

- policy decisions leading to an increased or new role for Government – for example, the government has decided to place a higher focus on biosecurity

1 This does not directly equate to an increase in full-time equivalent staff.

management, and has therefore increased capacity and capability in Biosecurity New Zealand;

- increasing supply to respond to increased demand for services – for example, increasing numbers of inmates eventually requires an increase in the number of prison guards employed by the Department of Corrections.

TABLE 1: QUARTERLY EMPLOYMENT SURVEY[2]

Total Filled Jobs in the Central Government (State) Sector

Year	*Public Service*	*Health Services*	*Education Services*	*Other State Sector Non-Trading*	*NZDF Regular Force Numbers*	*State Sector Non-trading*	*Trading Enterprises*	*Central Govt/State Sector Total*
May								
1999	30,702	49,400	105,900	25,298	9,301	220,601	24,600	245,201
2000	30,040	49,200	106,600	25,860	9,343	221,043	25,100	246,143
2001	31,440	50,900	103,700	24,500	9,097	219,637	23,800	243,437
2002	32,837	52,300	104,400	27,465	8,739	225,741	34,200	259,941
2003	34,445	53,300	108,400	29,655	8,660	234,460	33,300	267,760
2004	37,869	54,400	113,400	28,531	8,731	242,931	31,600	274,531
2004 (Sept)	38,270	55,300	116,200	27,630	8,731	246,131	32,700	278,831

10. This expansion of the State sector can in turn create wage pressures, particularly in those occupations where demand outstrips supply and creates recruitment and retention pressures.

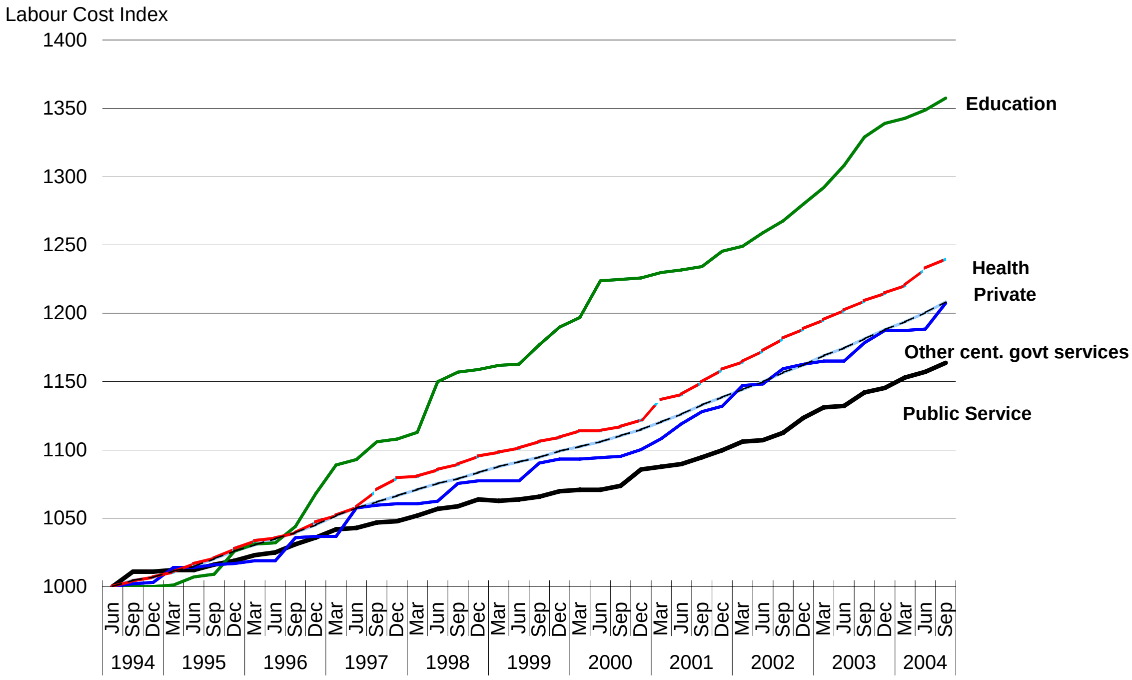
Calls for increased wages

11. Wage pressures across the State sector have largely been driven by, or at least argued for on the basis of, recruitment and retention issues and/or relativity shifts. In the short to medium term, it is likely that the compounding effect of recruitment and retention concerns coupled with a flow-on of settlements (to maintain relativities) is likely to continue to exert significant pressure on wage levels across the State sector.

12. Data suggests that aggregate State sector wages have, over the last ten years, increased at a rate higher than that of increases in the private sector. However, this overall trend masks very different wage tracks in differing parts of the State sector, depending upon the nature of different occupations and portability of skills, as figure 2 illustrates.

[2] Data provided by Statistics New Zealand

Figure 2: Pay Movement 1994 – 2004 (Sept), all salary and wage rates[3]



Regulatory changes

13. Regulatory changes in the wider labour market, or with specific regard to the State sector, also have a fiscal impact. Key areas of regulatory change that the State sector has had, and will have, to respond to include:

- amendments to the Holidays Act - **[Withheld under ss. 9(2)(f)(iv), 9(2)(g)(i)]**;
- pay and employment equity policy - **[Withheld under ss. 9(2)(f)(iv), 9(2)(g)(i)]**; and
- the State Sector Retirement Scheme (SSRS) - **[Withheld under ss. 9(2)(f)(iv), 9(2)(g)(i)]**.

14. Regulatory changes can also impact on the institutional arrangements that govern bargaining in the State sector. These arrangements are largely designed to operate in a bargaining environment characterised by organisation-based employment agreements, with delegations to individual chief executives in the case of bargaining for collective agreements. Where regulatory changes start to promote an environment characterised by multi-employer employment agreements, these institutional arrangements may be less successful at managing fiscal risks, unless other strategies are put in place to support individual employers.

which have differing impacts on different parts of the State sector …

15. The core public service, the health sector and the compulsory education sector are the component parts of the wider State sector most susceptible to the drivers identified above. They are also the sectors where fiscal sustainability risks are most obvious. The influence of each driver differs depending on the sector in question and the institutional arrangements that surround wage setting in each sector.

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3 Data provided by Statistics New Zealand

16. Institutional arrangements around bargaining in the New Zealand public management system have tended to be decentralised, with financial control exerted through an expectation that costs will largely be met from within baselines. However, in practice, agencies often receive additional funding to assist in meeting the costs of increased wage bills – particularly where settlements have been significant (for example, the health and education sectors or for 'uniformed' occupations) or where a shift in services to be delivered or capability requirements has occurred.

17. These institutional arrangements have tended to most effectively manage the fiscal risks identified above where: Ministerial expectations are clear and do not conflict with each other; 'costs' associated with settlements tend to rest with chief executives; and central agencies have a level of influence over the bargaining agencies.

18. Our analysis suggests that the health sector poses significant risks in both the short and long term; the core public service is likely to pose most employment growth risks in the short term; and the compulsory education sector poses a sustainability issue in the medium to long term.

[Withheld under ss. 9(2)(f)(iv), 9(2)(g)(i)]

Health sector

19. The health sector poses significant fiscal risks in the management of wage costs. This is because:

- as table 1 shows, the number of positions in the health sector have increased by about 12%;
- recent wage settlements have provided for shifts in salary over and above that in the wider labour market (and the risks of flow-ons from these settlements are high); and
- the cost of implementing regulatory change is high, in part because of the large number of staff employed across the sector.

[Withheld under ss. 9(2)(f)(iv), 9(2)(g)(i)]

20. Institutional arrangements in the health sector are not particularly robust when it comes to management of fiscal risks. There are few incentives on the chief executives or DHB chairs to manage back costs. The recent nurses' settlement has potentially set a precedent for costs associated with bargaining to be met by central Government.

Core public service

21. Over the last five years, the key driver to increased wage bills in the core public service has been the 25% increase in total numbers of people employed (one fifth of which represents a shift in employees from the Crown entity sector). Whilst, this increase reflects some large increases within a handful of agencies, across the board approximately 80% of public service departments have experienced some level of employment growth. The available data suggests that the agencies that have experienced the most growth are not necessarily those working in areas that closely align with the Government's priorities.

22. Wage pressures and regulatory changes have had a limited impact on agencies in the core public service – with the exception of the 'uniformed' agencies. This environment may change over the next twelve months as labour shortages in particular occupations become more apparent, the nurses' settlement impacts on specific departments, and

agencies move to implement the Holidays Act and the pay and employment equity process.

23. Information provided by the State Services Commission suggests that 20 departments will be involved in bargaining over the next calendar year[4], and that unions and employees have a high level of expectations around pay increases. These expectations will be driven by the nurses' settlement, and shifts / demands in the private sector.

24. Institutional arrangements in the core public service tend to be robust. It is relatively easy to send clear signals to chief executives about Ministerial expectations and fiscal risks have tended to be well managed by the practice of fixed nominal baselines. However, the increased number of capability bids suggests that this approach may need to be revisited to provide chief executives and Ministers will some certainty about the sustainability of future funding.

25. The key driver of wage bill pressure in the core public service is employment growth. Anecdotal information, and an initial assessment of budget bids, suggests that the significant increase in funded positions is also leading to labour shortages in specific occupations (e.g. policy analysts, corrections officers and senior social workers). Over time this could lead to demands for wage increases to assist in the management of recruitment and retention risks.

Compulsory education

26. Wage costs in the compulsory education sector escalated over the 1990s, with large settlements provided to teachers to address parity issues, and because of the relative bargaining power exercised by the unions and their members. The long term impact of these increases has been a quantifiable shift in the base cost of employing teachers.

27. Over the last five years, the increasing wage bill has been driven by a further substantial increase in wages, and employment growth (created by responses to demographic changes, and reductions in class sizes). The 2004 settlements provide further staged increases over the next two years, and a process for discussing other issues (including workloads).

28. In the medium term, the wage bill in the compulsory education sector should diminish, as demographics will lead to a decrease in the number of teachers employed. However, there is a risk that the wage bill could plateau due to continuing pressures driven by changes in workload policies.

Potential responses

29. Inevitably, State sector capability will need to increase in some areas to meet the Government's policy objectives. However, the fiscal trends show that such increases cannot be provided for across the whole State sector. This means that reprioritisation of resources will be the primary response to managing back the fiscal risks identified above.

[Withheld under ss. 9(2)(f)(iv), 9(2)(g)(i)]

4 Involving about 13,000 employees.

30. In the medium to long term, reprioritisation should also provide for an increased focus on increased performance and productivity across the State sector.

[Withheld under ss. 9(2)(f)(iv), 9(2)(g)(i)]

Medium to long term options

31. In the medium to long term the risks associated with significant increases in the wider State sector wage bill will best be managed by ongoing reprioritisation of resources – either through standard policy processes or the budget process – to ensure that they are aligned with Ministerial priorities.

32. Armed with information about 'what works' Ministers should be better positioned to make reprioritisation decisions within portfolios or within allocations, with a further goal of providing for increased performance and / or productivity across the State sector.

33. With improved reprioritisation it should also be possible to target employment and wage growth to the government's priority areas. This will allow the government to limit overall net employment growth and ease pressures across the State sector.

Information

34. Ministers currently have limited information available to assist them in making reprioritisation decisions. However, agencies should be able to provide advice on ways in which the nature of services can be amended to better achieve the outcomes sought by Ministers, or where services may no longer be appropriate and should cease to be delivered in order to free up resources required elsewhere.

35. Ministers will also be supported in reprioritisation decisions if they are able to access robust information about the effectiveness of particular policies, or the productivity of specific sectors or agencies. Central agencies are currently working on a range of projects that should provide such information. These projects include the promotion of evaluative activity in the public sector, baseline reviews, and an empirical investigation of productivity outcomes for a sample of agencies.

[Withheld under ss. 9(2)(f)(iv), 9(2)(g)(i)]