The Treasury

Advice on Public Sector Pay Adjustment (PSPA) Information Release

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[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment;

[36] 9(2)(h) - to maintain legal professional privilege

[38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

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TE TAI ŌHANGA
THE TREASURY

Reference: BM-3-6-1

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To: Prime Minister (Rt Hon Jacinda Ardern)
Minister of Finance (Hon Grant Robertson)
Minister for the Public Service (Hon Chris Hipkins)

Aide Memoire: The macroeconomic implications of Public Sector wage growth

In considering future public sector wage negotiations you will recognise the need to balance a number of competing risks. On one hand, supporting public sector wage growth to help arrest recent declines in real incomes, cost of living increases, attract and retain people in the public service needs to be balanced with some restraint to meet the Government's fiscal objectives and avoid protracting wage-price inflation that could prompt a stronger monetary policy response.

In order to identify where the balance between these competing risks currently lies, Treasury has analysed the general macroeconomic implications of public sector pay proposals that are consist with the Public Sector Pay Agreement (PSPA) proposals. You should consider this analysis alongside the more detailed costings in (T2022-2102). Public sector wage increases could be funded in four ways:

- Use of existing contingencies (little macro-economic impact):
- A reduction in real government services or other forms of savings/ efficiencies (little macro-economic impact).
- An increase in revenue to fund cost increases.
- Or by increasing the budget deficit and therefore debt. (tends to increase inflation pressure and interest rates).

Consistent with the detailed costings, this paper looks at scenarios that compare a modest wage increase (which can largely be funded using existing contingencies) over the first two years with that of incrementally larger ones (which are assumed to require additional deficit/debt financing to be taken up). All assume a further two years wage growth consistent with that presented in the interim economic outlook completed last month (T2022/1816), which we have used as a baseline for this analysis.

[33], [38]

Irrespective of the specific form of public sector pay agreement (centralised, or agency by agency as per status quo) these types of cost pressures will present a fiscal management challenge regardless.

The Treasury will provide advice on these fiscal management challenges, including for your cost pressure envelopes and Budget allowances, as part of the pre-Budget Policy Statement fiscal strategy road check report on 20 October.

Interest rates are set to increase as price pressures remain

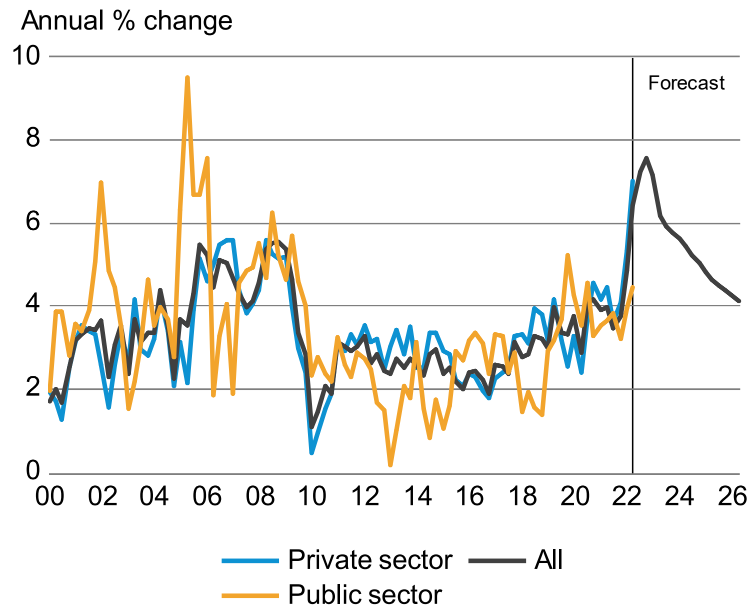
Since Budget, price pressures have intensified, monetary policy is tightening in response, and wage rates have started to climb. Inflation has peaked higher than anticipated, reaching 7.3% in the June quarter compared to a Budget forecast of 6.7%, with inflation expected at 6.9% in the September quarter. The Reserve Bank has signalled that **interest rates are likely to rise faster and to higher levels, than forecast at Budget**. Market pricing has now moved beyond that signalled by the Reserve Bank in the August MPS, with the OCR expected to peak nearer to 4.5% by the end of 2023. With higher interest rates to reduce demand, the Treasury expects to see a more rapid increase in unemployment, although its peak (at 4.9 percent) remains modest by historical standards. Economy-wide wage growth is expected to reach 6.2% in 2022/23 and 5.4% in 2023/24.

The labour market remains tight, and this has started to flow through to wages across all sectors. To date more of this wage growth has been in the private sector. This is consistent with the nature of bargaining in the public sector, which likely has more inherent lags in it when responding to changes in current economic conditions.

The pickup in recent wage growth is also likely to reflect and a degree of catch up in real wages, which have fallen over the past 12 months as inflation accelerated, although given the nature of a supply shock of this magnitude, the impacts will be unevenly felt and not everyone can be fully compensated. Furthermore, since the Global Financial Crisis (GFC) nominal wages rose by around 54% and real wages are around 15% higher, having grown by around 1% per annum. During this period, the labour market gradually recovered during a sustained period of economic growth that was supported by strong migration that peaked over 90,000 prior to the COVID-19 pandemic. With activity and net migration expected to be softer over the next couple of years and inflation easing from a very high rate, we may expect more modest real wage growth.

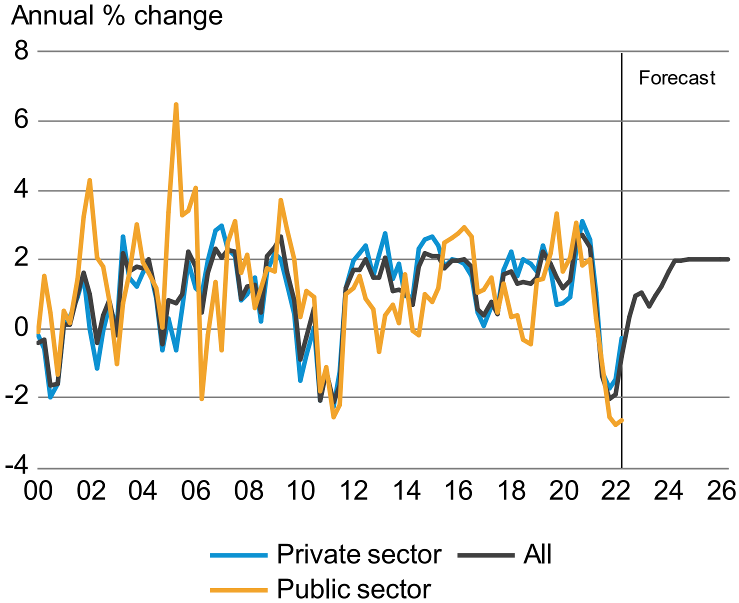
The difficulty for policy makers is that wage growth can contribute to increased inflationary pressure through a combination of increased consumer spending (demand pull) and firms needing to increase prices as wage costs increase (cost push).

Figure 1: Nominal wage growth (QES)



In our interim economic update, we outlined that inflation will begin to ease and nominal wage growth pick up over the next 12 months, and real wage growth will accelerate, reaching 2.0% by 2024. Nominal public and private sector wage growth averages around 5.5% over the four year forecast period.

Figure 2: Real wage growth (QES)



Economic implications of public sector wage growth

We consider alternative public sector wage growth scenarios, each consistent with alternative PSPA proposals for two years, with a further two years wage growth consistent with that presented in the interim economic update. We also include progression commitments so as to assess the overall macroeconomic impacts of public sector wage growth. The inclusion of a further two years wage growth reflects the prospect of on-going wage growth following the end of the two year PSPA irrespective of the nature of public sector wage bargaining. [33], [38]

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Higher government allowances would lift wage incomes both directly for employees covered by the PSPA and indirectly as the higher wage inflation under the PSPA spills over to the wider public sector and the private sector. Higher wage income in turn would boost private consumption and generate further inflationary pressure requiring additional monetary policy tightening, [38]

The following charts highlight the differences between each scenario for key macroeconomic variables.

[38]

Tax implications of proposals

The direct cost of the PSPA will vary according to the scale of each proposal, although the net cost will be less given the tax implications. There will be a tax clawback associated with these proposals both in terms of GST and PAYE, the latter of which will also generate some fiscal drag.

However, there are some additional offsetting impacts at an economy-wide level to consider, which are also likely to increase in scale to the size of the proposal. Stronger wage growth is likely to lead to higher unemployment as monetary policy reacts to higher aggregate demand and inflation.

Using QES wage growth to assess PSPA proposals

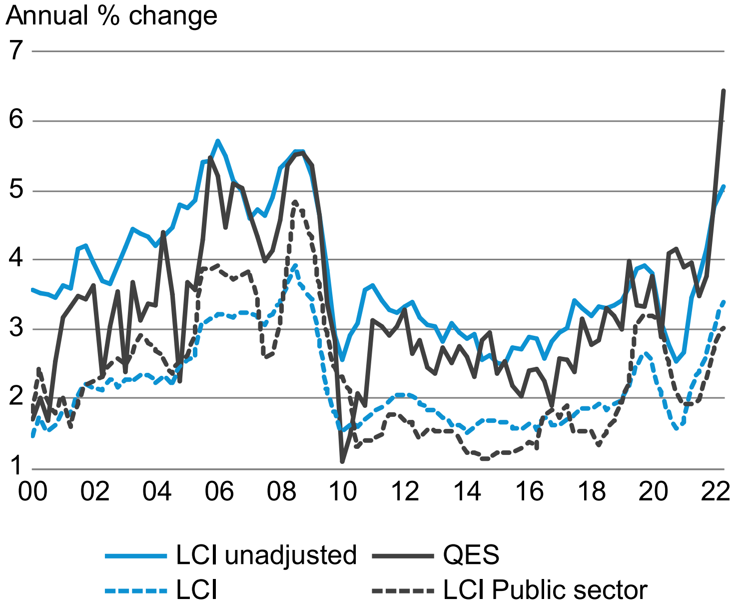
To quantify the macroeconomic impacts of public sector wage growth we focus on the QES measure. This is relevant for analysing the broader impacts on increased consumer spending (demand-pull) resulting from a PSPA. It is also used in the Treasury forecast models.

Nonetheless, QES wage growth is not the best measure for assessing other potential macroeconomic risks, such as cost-push inflation, because it is not quality adjusted and therefore combines many different influences on wages e.g., compositional changes in employment between high (or low) wage sectors, occupational mix changes, productivity growth within occupations, and wage increases for existing jobs.

The adjusted LCI, which better reflects pure wage inflation in existing jobs, is a more useful measure to assess PSPA proposals themselves. The adjusted LCI increase is currently 3.4% in the private sector and 3.0% in the public sector. [33], [38]

[33], [38]

Figure 7: Wage growth: LCI vs QES



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