

# *False Economies*

*The Unintended Consequences of  
NSW Public Sector Wage Restraint*

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

July 2017

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This report was prepared for the NSW Branch of the Health Services Union.

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# Summary

This Report outlines the negative effects of the 2.5 percent annual cap on public sector remuneration on economic growth, employment, government budgets and labour rights in NSW. The wages cap is the cornerstone of the NSW Public Sector Wages Policy.

The declining labour share in national income and stagnant wages in Australia reduce national living standards and undermine the economic goals and fiscal objectives of state and federal governments.

RBA Governor Phillip Lowe recently acknowledged the ‘crisis...in real wages growth’ and argued forcefully that higher wages for Australians ‘would be a good thing’ (Hutchens, 2017).

Even Federal Treasurer Scott Morrison has admitted that weak wages growth poses a threat to the Commonwealth’s budgetary goals (Heath, 2017). And the NSW government itself identified soft wages growth as one of the two key risks (along with uncertainty in housing prices) to the state’s economy in its most recent budget.

In this general context of weak wages, and the growing consensus among economists that they are holding back economic growth and fiscal repair, the NSW government’s continuing unilateral intervention to cap public sector compensation growth is both harmful and contradictory. The government of the nation’s largest economy should be implementing policies to boost wages, employment and economic activity. The 2.5 percent wage cap does the opposite.

This report identifies several specific ways in which the NSW state government’s wages policy, now six years old, is causing harm to the broader state and national economy – not just to the public sector workers whose incomes have been artificially suppressed. In particular, we document five “unintended consequences” of the NSW Public Sector Wages Policy, including:

1. Over the five years from 2011 through 2016, the state’s public sector wage suppression has reduced consumer spending in the state by a cumulative total of some \$3.4 billion, harming businesses large and small.
2. We estimate that Australia’s national GDP has been reduced by a cumulative total of almost \$8 billion over the 2011-16 period.

3. The NSW government's wage austerity has reduced its own revenue by an estimated \$1.2 billion over the 2011-16 period.
4. Each public sector worker's "workload" has increased by 7.5 percent in the last five years – yet the wages policy in fact suppresses *true* productivity growth in the public sector.
5. The NSW government's extraordinary interventions, removing normal wage bargaining rights from a significant and influential section of the state labour market, have contributed to the unprecedented stagnation of wages in the overall state labour market – that government admits is hampering both economic growth and fiscal well-being.

So while the state government boasts of its cost-cutting in public service delivery and the legislative restraint it has imposed for years on its own workforce, the policy is actually harming the state economy. And the longer it is kept in place, the larger the damage becomes. The supposed savings generated by the government's authoritarian intervention into normal free collective bargaining are neither legitimate nor sustainable, and are generating a litany of growing consequences for all residents of New South Wales – not just public sector workers.

The report is divided into four major sections:

Section 1 situates the public sector wages cap within an ideological context that seeks to justify attacks on the public sector and workers' rights more generally. It debunks the 'big government' myth that has been invoked as the rationale for wage austerity, before outlining the specific features of the NSW Public Sector Wages Policy.

Section 2 enumerates the benefits of increased public sector compensation in an environment of stagnant wages. Paying well-trained, productive public servants to deliver high-quality public services is not a "waste," nor merely a "cost." The incomes of public sector workers are legitimate and essential compensation for their work; moreover, they constitute an important source of income and spending power for the broader economy. The report cites modeling of the potential positive effects of boosting public sector pay to illustrate the negative effects of artificial public sector wage restraint in NSW.

Section 3 examines how the NSW Public Sector Wages Policy has damaged the broader NSW economy, identifying five major negative side-effects of the Policy on the broader economy: including reducing consumer spending, reducing economic growth, undermining state government revenues, suppressing public sector productivity growth, and contributing to the damaging stagnation of overall wage rates.

Section 4 reminds readers that public sector workers are no different from other employees: they should be entitled to the same workplace bargaining rights as other workers in NSW, and enjoy the same opportunity to boost their real incomes over time (including through productivity and efficiency gains). The NSW wages policy is a violation of those rights. It suggests, incredibly, that real compensation for public sector workers should be frozen for as long and the policy remains in place. This arbitrary and punitive approach needlessly singles out public service workers, who perform essential services that boost the quality of life in communities across the state.

# The Cap in Context: The NSW Public Sector Wages Policy

The 2011 NSW Public Sector Wages Policy, including the 2.5 percent annual cap on compensation growth, can be understood as part of a general conservative strategy of downsizing government, cutting public services, restricting public service compensation and attacking workers' rights. This approach is an important part of a broader policy stance to enhance the power and freedom of business, at the expense of other stakeholders in society.

These ideological attacks on public service have been justified over the years by many conservative academic theories, including "trickle-down" economic theories and public choice theory. Public choice theory asserts that the self-interest of bureaucrats and politicians, coupled with insatiable public demand for government services, leads to 'runaway government expansion' unless 'responsible government takes the reins and cuts public expenditure' (McCauley and Lyons, 2015: 20-21).

These arguments found a receptive audience in right-wing think tanks and powerful economic agencies (like departments of treasury and finance). The private sector was assumed to be the leading force in the economy and society, and "big government" became the enemy. But is "big government" really a problem in Australia? And did "runaway" public spending in NSW, including on public sector compensation, require the draconian restrictions on normal collective bargaining that the state government has invoked?

## BUSTING THE BIG GOVERNMENT MYTH

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Australians are used to hearing about "budget black holes", governments "living beyond their means" and the need to "trim the fat" in the public sector. But the truth is that public sector spending in Australia, and in NSW in particular, is modest by international standards. And public sector employment has declined significantly as a share of total employment.

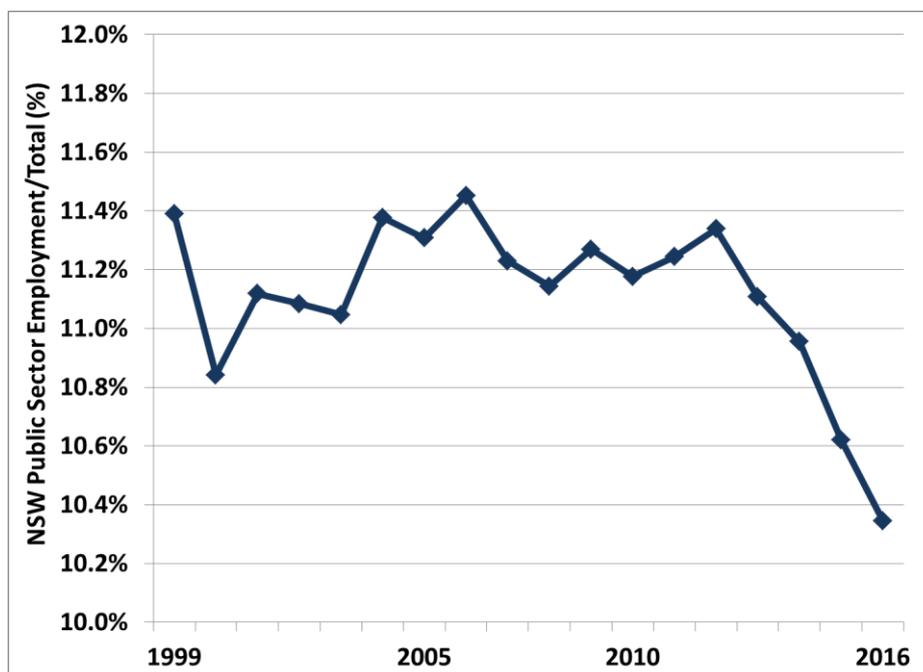
Australia is one of the lowest-tax, smallest-government jurisdictions in the industrialised world. In 2014 Australia ranked 30th of 35 wealthy OECD countries with a tax-to-GDP ratio of 27.8 percent (compared to the OECD average of 34.3 percent). While the average OECD tax-to-GDP ratio was stable between 2000 and 2014, Australia's ratio fell by over 2.5 points of GDP during that period (OECD, 2016: 1).

Federal government spending, meanwhile, has oscillated within a narrow band between 23 and 27 percent of GDP since 1975 (McCauley and Lyons, 2015). Public sector employment in Australia fell from 20 to 13 percent of all employed workers between 2000 and 2015 (ABS, 2015).

The same trends can be observed within NSW. Since 2010-11 NSW general government expenditure has remained flat as a share of Gross State Product (GSP), at around 13 percent. While the state budget is currently in surplus, both revenues and expenditure are projected to decline further relative to the economy over the next four years. Expenditure is slated to fall from 12.9 percent of GSP in 2017-18 to 12 percent by 2020-21, based on constraining annual average nominal expenditure growth to 2.8 percent (compared to a 5.6 percent long-term average (NSW Treasury, 2017)).

Prior to 2011, public sector employment in NSW fluctuated in a narrow band slightly above 11 percent of total employment. There is no evidence that government was becoming “too big.” But since the current NSW Public Sector Wages Policy was introduced in 2011 (along with other restraint measures in spending and employment), public sector employment has flatlined in absolute terms, and declined markedly as a share of the NSW workforce (see Figure 1) to the lowest share in postwar history.

**Figure 1. NSW Public Sector Employment Relative to Total Employment, 1999-2016**



Source: Authors’ calculations from NSW Public Service Commission, 2016, and ABS Catalogue 6202.0, Table 4.

# THE NSW PUBLIC SECTOR WAGES POLICY

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Public sector wage restraint is an ideologically-driven policy that has been implemented by governments in many countries around the world. In Australia it was framed as a solution to the non-problem of “big government”.

The NSW Public Sector Wages Policy (see Box 1) is a specific example of this general hostility to public sector employment and compensation. The O’Farrell government implemented the current policy through the Industrial Relations Amendment (Public Sector Conditions of Employment) Act 2011 NSW (the Amendment Act).

In what Carabetta (2012:65) describes as ‘an unusual and highly controversial move,’ the Act requires the NSW Industrial Relations Commission (the commission) to subordinate the wage claims of public sector workers during the bargaining period to NSW government policy. Carabetta states: ‘Any award or order of the commission that is inconsistent with the government’s declared policy has no legal force.’

The Amendment Act is given effect via the Industrial Relations (Public Sector Conditions of Employment) Regulation 2011 (NSW) which ‘applies to a wide range of public sector employees.’ The ‘heart of the policy...is a requirement that any increases to employee-related expenses above a 2.5 percent per annum ‘cap’, including wages and conditions of employment, must be offset by employee-related cost savings’ (Carabetta, 2012: 65-66).

In other words, wages and salaries for public sector employees cannot grow faster than 2.5 percent, unless “extra” wage increases are offset by other concessions from the overall bundle of compensation and working practices. Public sector workers must, in effect, “buy their own wage increases,” above 2.5 percent. The 2.5 percent cap was justified with reference to the midpoint of the Reserve Bank of Australia’s target band for inflation (according to which the RBA is mandated to ensure that inflation remains between 2 and 3 percent per year). So in essence, on the (optimistic) assumption that the RBA meets this inflation target, the Public Sector Wages Policy freezes real wages for public sector workers indefinitely: that is, for as long as the policy remains in place. If inflation exceeds the midpoint of the RBA target band (as has occurred many times in practice), then the policy ensures real wage cuts for public sector workers.

In addition to suppressing public sector compensation (to the harm of public sector workers and their families), this policy also sacrifices the traditional independence of the Industrial Relations Commission in relation to public sector wage determination. Former commission President Justice Boland argued that the Amendment Act forced the commission ‘to rubber stamp the government’s wages policy regardless of what that policy dictates’ (cited in Carabetta, 2012: 67).

Not surprisingly, the NSW Public Sector Wages Policy met with strong opposition from public sector unions, Unions NSW, legal experts, and opposition parties (Carabetta, 2012, Unions NSW, 2013, Bhatt, 2014). In a submission to a Senate Inquiry, Unions NSW described the 2.5 percent cap as an arbitrary figure<sup>1</sup> that would lead to real wage cuts for workers anytime inflation rose above 2.5 percent (Unions NSW, 2013).

Another key criticism of the policy is that any pay increases above the 2.5 percent cap can only be achieved by trading away existing conditions. This is because employee-related cost savings are defined as involving ‘a significant contribution from public sector employees and are generally expected to involve direct changes to work

### **Box 1. NSW Public Sector Wages Policy 2011**

#### **3. The Policy**

3.1. The policy provides:

3.1.1. Public sector employees are entitled to guaranteed minimum conditions of employment, as defined in this policy.

3.1.2. Equal remuneration for men and women doing work of equal or comparable value.

3.1.3. Public sector employees may be awarded increases in remuneration or other conditions of employment that do not increase costs by more than 2.5 per cent per annum.

3.1.4. Increases in remuneration or other conditions of employment that increase employee related costs by more than 2.5 per cent per annum can be awarded, but only if sufficient employee related cost savings have been achieved to fully offset the increased employee related costs. For this purpose:

3.1.4.1. whether relevant savings have been achieved is to be determined by agreement of the relevant parties or, in the absence of agreement, by the IRC, and

3.1.4.2. increases may be awarded before the relevant savings have been achieved, but are not payable until they are achieved, and

3.1.4.3. the full savings are not required to be awarded as increases in remuneration or other conditions of employment.

3.1.5. Awards and orders are to resolve all issues the subject of the proceedings (and not reserve leave for a matter to be dealt with at a later time or allow extra claims to be made during the term of the award or order). However, this does not prevent further variations made with the agreement of the relevant parties.

3.1.6. Changes to remuneration or other conditions of employment may only operate on or after the date the relevant parties finally agreed to the change (if the award or order is made or varied by consent) or the date of the IRC’s decision (if the award or order is made or varied in arbitration proceedings).

3.1.7. Policies regarding the management of excess public sector employees are not to be incorporated into industrial instruments.

*Source: NSW Treasury, 2014: 2 .*

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<sup>1</sup> The official justification was that 2.5% lies at the mid-point of the RBA’s inflation target band.

practices or other conditions of employment' (Carabetta, 2012: 72). Carabetta (2012: 72) argues further that: 'These two factors combined have led to claims that important conditions (working hours, loadings, leave entitlements and allowances), will inevitably have to be traded off for wage and salary increases beyond the 2.5 percent "cap".' Critically, these cost savings have to be delivered (and certified by the commission) before any remuneration increases above the 2.5 percent cap are actually paid.

# Purchasing Power Matters: The Economic Value of Public Sector Compensation

Australia managed to largely avoid the most disastrous economic and social consequences of Global Financial Crisis and subsequent austerity policies, such as those implemented in Europe. This can be explained by a combination of good policy (including the Rudd government's quick and ambitious stimulus package) and good fortune (the side-effects of the Chinese-led resources boom).

But the current economic picture is far from rosy. Slowing economic growth, stagnant wages, unaffordable housing and rising household debt threaten to derail Australia's economic trajectory. In this context, austerity measures such as the NSW Public Sector Wages Policy can only exacerbate these worrying trends. The NSW public sector wages cap is precisely the wrong policy for conditions of macroeconomic stagnation. Far from being akin to throwing "money down the drain," as often stereotyped by fiscal hawks, the compensation paid to public sector workers plays a crucial economic function: it ratifies the skills and productivity of public services work, and provides a solid foundation for the purchasing power and consumer spending that is essential for ongoing economic growth.

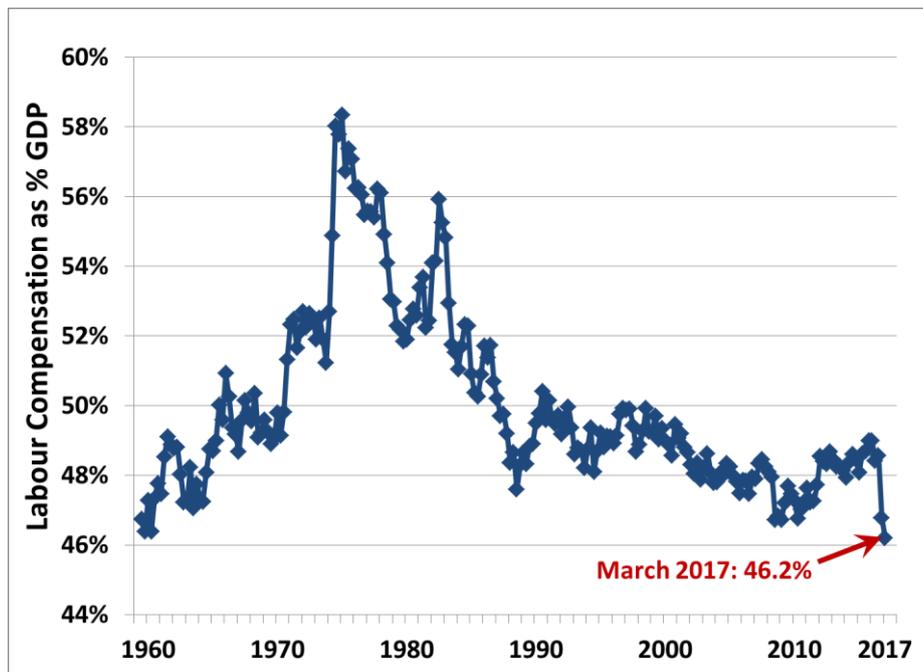
## AUSTRALIAN WORKERS NEED A PAY RISE

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RBA Governor Phillip Lowe recently urged Australian workers to claim a bigger slice of the economic pie, by stepping up their wage demands (Greber, 2017). He argued that the record-slow growth of wages was undermining economic growth and leading to distortions in the pattern of income distribution and spending. Indeed, in the March quarter of this year, the labour share of GDP (measured by total wages, salaries, and other compensation including superannuation contributions) reached the lowest level at any time since the ABS began collecting quarterly national income data in 1959 (see Figure 2). Workers' real wages have lagged well behind productivity growth since the early 2000s (Cowgill, 2013). A recent analysis of household living standards between 1990 and 2016 concluded that 'living standards in Australia peaked in June 2012' and have since 'declined by 0.6 per cent to March 2016' (Phillips, 2016). The same study found that 'growth in living standards...between 2010 and 2015' was 'even lower than the growth experienced during the last major recession in the early 1990s' (Phillips,

2016). Stagnant wages are a key factor in this persistent and damaging income slump. Continued policy interventions to restrain and suppress wages, such as the recent decision by the Fair Work Commission to cut penalty rates for hundreds of thousands of workers in the retail and hospitality sectors, only compound the problem.

**Figure 2. Labour Compensation as Share of Nominal GDP**



Source: Authors' calculations from ABS Catalogue 5206.0, seasonally adjusted.  
Employee compensation includes wages, salaries, and employer super contributions.

Federal and state governments understand that slow wages growth directly undermines their own broad economic goals and specific fiscal objectives. The federal government has relied on heroic assumptions regarding strong wages growth to underpin their official projection of returning the budget to surplus by 2020-21 (see Table 1). But those assumptions directly contradict the same government's active measures to *suppress* wage growth and weaken the institutions (like trade unions and free collective bargaining) that support wage growth – including the Commonwealth government's endorsement of the cuts in penalty rates. Similarly, the 2017-2018 NSW budget acknowledges 'wages growth has remained soft in recent years,' with 'Annual WPI growth...now close to 2 per cent for both New South Wales and Australia...the weakest since the WPI series began in 1997.' The budget also predicts that 'soft wages growth will continue to be a drag' on housing and other consumer spending (NSW Treasury, 2017, 2017: 3:9, 3:7). How contradictory, then, that the same government continues an arbitrary and interventionist strategy to deliberately *suppress* wage

**Table 1**  
**Labour Market Assumptions in 2017-18 Commonwealth Budget**

	2016-17 (current fiscal year)		June 2017 Budget Assumptions			
	Assumption in last budget (June 2016)	Actual	2017- 18	2018- 19	2019- 20	2020- 21
<b>Total employment</b>	1.75%	1.1%	1.5%	1.5%	1.5%	1.5%
<b>Wage price index</b>	2.5%	1.9%	2.5%	3.0%	3.5%	3.75%
<b>Total wages and salaries</b>	4.0%	1.5%	3.5%	4.25%	5.0%	5.25%

*Source: Authors' calculations from budget papers & ABS Catalogues 6345.0, 6202.0, 5206.0. Actual based on most recent year-over data for each series.*

growth among public sector workers, and short-circuit normal wage determination processes in this crucial sector of the state's labour market.

This data lays bare the contradiction between policies that deliberately constrain public sector wages, such as the NSW wages cap, and stated economic policy goals of higher economic growth, more jobs and increased government revenues.

## **THE ECONOMIC BENEFITS OF PUBLIC SECTOR PAY**

Other countries have attempted to eliminate deficits and generate fiscal surpluses on the backs of public sector workers, including through the imposition of restrictions on free collective bargaining. The disastrous experience in Europe of such measures should serve as a cautionary tale for Australian politicians and policymakers at all levels of government. Government spending cuts there only worsened the underlying weakness in purchasing power that had caused stagnation in GDP, lower business and consumer confidence, and escalating debt ratios.

For example, the UK experience clearly highlights the economic risks of fiscal austerity; government program budgets there were slashed during the Great Recession, and public sector workers were among the hardest hit. Between 2010 and 2015, public sector real wages fell by a cumulative 17 percent as a direct consequence of very tight limits imposed on public sector hiring and compensation (Reed, 2014: 1). Economists

have argued that economic recovery and job-creation would be strengthened by maintaining or expanding public spending, rather than through further austerity.

One study, prepared by Landman Economics, outlined more specifically the economic benefits that would flow from increasing public sector pay; this analysis holds important lessons for Australian governments. The UK study used a microsimulation model of the UK tax and transfer system to estimate the effect on economic growth, job creation and the UK budget balance of increases in public sector remuneration. Table 2 summarises the simulation results for a 3 percent increase in public sector compensation.

<b>Table 2</b>		
<b>Overall Economic Impacts of a 3% Increase in Public Sector Pay</b>		
<b>Initial (direct) impacts</b>		
<b>Change in overall wage bill (£m)</b>	4,140	
<b>Initial amount recouped by government through increased tax and lower benefit/tax credit payments (£m)</b>	1,750 (42% of outlay)	
<b>Additional impacts (from multiplier effects)</b>		
	Minimum Case	Maximum Case
<b>Extra amount recouped by government through increased tax and lower benefit/tax credit payments (£m)</b>	380 (9% of outlay)	710 (17% of outlay)
<b>Total net expense (£m)</b>	2,010	1,680
<b>Number of extra jobs created (assuming full-time at median wages)</b>	29,000	55,000
<i>Source: Reed, 2014: 2.</i>		

The UK forecast predicted that public sector pay increases would boost economic growth (thanks to the re-spending of salary increases by public sector workers), creating an additional 29,000 to 55,000 jobs.<sup>2</sup> Private sector businesses which expand thanks to the spending stimulus from public sector workers include consumer goods, food, housing, transportation, recreation, and many others. The UK government would itself recoup between 50 and 60 percent of the gross cost of the wage increase through higher taxation receipts (Reed, 2014: 2, 11) – obtained directly from the higher pay of public servants, and indirectly through increased economic activity. The study noted that additional revenues to fund higher public sector pay could be

<sup>2</sup> Depending on the size of the multiplier.

obtained, if desired, through progressive taxation measures that do not dampen consumption – such as a higher corporations tax, land tax or a financial transactions tax. These arguments apply equally to Australia, where austerity in public sector employment and wages policy has been imposed alongside planned company tax cuts, and continuing fiscal losses from regressive tax concessions (such as arising from large superannuation contributions, negative gearing and capital gains). Australia's stronger public finances and lower tax-to-GDP ratio provide even more scope for boosting public sector pay than is the case in the UK.

This section has identified record low wages growth as a significant threat to Australia's economic prosperity – and this threat has only been exacerbated by the NSW public sector wages cap. We have also highlighted the inherent contradictions between state and federal governments' economic and fiscal objectives (based on assumptions of accelerating wage growth), and their continued interventions aimed at suppressing public sector wages. The next section describes in more detail the negative side-effects of the NSW Public Sector Wages Policy on consumer spending, economic growth, government revenues, public sector productivity and broader wage trends.

# False Economies: The Unintended Consequences of Public Sector Wage Restraint

The NSW Government's Public Sector Wages Policy is an arbitrary and unjustified violation of normal free collective bargaining practices. For six years, it has artificially suppressed compensation for hundreds of thousands of highly skilled, productive public sector employees across the state, and caused significant hardship to those workers and their families. Initially the government attempted to justify the policy through a phony sense of fiscal "emergency" – which was never credible even when the state was experiencing budget deficits. Yet the government now boasts of substantial annual budget surpluses, and announces funding for new projects with great fanfare. So any arguments about the wages policy being "necessary" to address fiscal challenges have long been abandoned. Now the policy is automatically replicated year after year, since it provides such a convenient (if illegitimate) method for the government to restrain normal operating expenses and accumulate fiscal room for other, more politically expedient spending announcements. In essence, the public sector workers of NSW are being forced to subsidise the government's other fiscal priorities, through this ongoing violation of their rights to normal collective bargaining.

But the damage done as a result of this continuing policy extends well beyond the direct financial losses experienced by public sector workers and their families – not to mention the damage done to the legitimacy and independence of the state's industrial relations system. The government's continuing knee-jerk suppression of public sector compensation is imposing other significant costs on the state's overall economy. These "unintended consequences" arising from the artificial cap on public sector compensation are felt by everyone in the state, not just public servants. And those costs get larger, the longer this unnecessary and illegitimate policy is maintained in force.

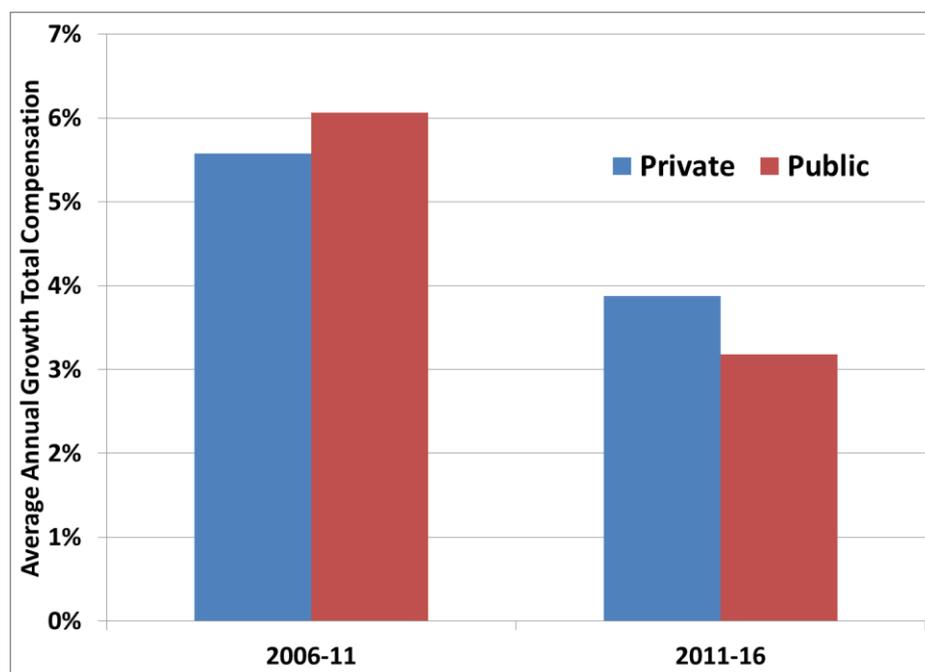
This section will consider and estimate five painful unintended consequences of the NSW Public Sector Wages Policy: consequences that are borne by all residents of the state.

# 1. THE PUBLIC SECTOR WAGES POLICY REDUCES NSW CONSUMER SPENDING

As described above, since 2011 public sector employment has been shrinking steadily as a share of NSW’s total employment. And the state’s compensation payouts have also been declining relative to state GSP, total employee compensation, and state government budgetary aggregates. The declining relative size of the state’s public sector payroll gives the lie to the claim that public sector employment is somehow “out of control.” Nevertheless, the artificial limits on overall public sector compensation – arising from both the 2.5 percent wage cap, and the concurrent downsizing of public services – cut significantly into overall purchasing power in the New South Wales economy.

Figure 3 indicates that under the government’s wages policy (and its other austerity measures), the average annual growth of public sector compensation in the state has been cut almost in half since 2011: from an average expansion of just over 6 percent per year in the period 2006-11 (when wages were rising more vibrantly, and public services were expanding) to barely 3 percent per year since 2011. Moreover, in the last five years public sector total compensation has been growing significantly more slowly than total compensation in the private sector – despite generally weak employment conditions and wage growth in the private sector.

**Figure 3. Compensation Trends, NSW, 2006-2016**



Source: Authors’ calculations from ABS Catalogue 5206.0, Table 44.

As noted above, a growing chorus of economic commentators has identified stagnant wages and the resulting weak state of consumer finances as significant constraints on Australian economic growth, and the situation in New South Wales is no different. The artificially slow growth of public sector payrolls in NSW since 2011, reflecting the impact of both the wage cap and downsizing of the public sector workforce, has reduced potential consumer spending in the state by many billions of dollars per year – and that gap is growing.

We estimate the impact of public service wage austerity on consumer spending as follows. If total compensation in the state’s public sector had grown at the same rate since 2011 as in the private sector (reflecting both the maintenance of free wage bargaining and a similar proportional rate of overall hiring), total payrolls would have been \$1.8 billion larger in 2016 – and a cumulative total of \$5.3 billion higher over the five-year period from 2011 through 2016. On average, Australian consumers spend over 65 percent of their gross personal income on personal consumption of goods and services (authors’ calculations from ABS Catalogue 5206.0, Table 20). This suggests that over the past five years, the state’s public sector wage suppression has reduced consumer spending in the state by a cumulative total of some \$3.4 billion.

The longer the policy remains in place (despite the significant budget surpluses expected in coming years), the larger is its negative impact on consumer spending. Over the next five years (2016 through 2021), if the same gap is maintained between the annual average growth of public and private sector compensation,<sup>3</sup> then the loss in relative public sector compensation resulting from the post-2011 shift in policy will equal a cumulative total of \$16.5 billion (reaching over \$4 billion per year by 2021). This results in a reduction in consumption expenditure (using the same assumed consumer spending ratio) of \$10.7 billion over the next five years.

Consumer spending is the largest source of aggregate spending power in the NSW economy. Private sector businesses, large and small, depend on consumers having disposable income to support their sales, their capital expansions, and their hiring. One important and direct side-effect of the NSW government’s wage austerity, therefore, has been to reduce the consumer market for NSW businesses by billions of dollars.

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<sup>3</sup> The NSW State Budget for 2017-18 forecasts a slight acceleration in the growth of the government’s total employee-related expenses, to an average of 3.5 percent over the forward estimates, driven mostly by new hiring (since the 2.5 percent wage policy is unchanged); see “Budget Paper No.1, Budget Statement,” Table 6.3. But the budget also forecasts an acceleration of private sector employment and wage growth, and so the gap between public and private compensation, if its forecasts of both measures are accurate, will remain stable.

## 2. THE PUBLIC SECTOR WAGES POLICY REDUCES NSW ECONOMIC GROWTH

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Because of its negative impact on overall spending conditions in the state economy, the government's wage austerity also imposes a contractionary influence on aggregate economic growth in the state. As noted, many billions of dollars have been diverted from consumer spending because of the artificial suppression of public sector wages, and declining public service headcounts. That reduced spending, in turn, reduces business incomes, profits, and investment – since the private sector will adjust its level of activity to reflect the loss of potential demand. That retrenchment in turn generates additional contractionary impacts in the other firms which supply those businesses with inputs, services, capital equipment, and other purchases. The spillover impacts of the loss of several billion dollars of consumption spending are ultimately experienced broadly throughout the economy.

Economists model these spillover effects arising from an initial loss of purchasing power through their estimates of the expenditure multiplier on government spending. This multiplier captures the ultimate flow-through effects on final spending (and hence economic activity) of an initial change in government spending. When the economy has unutilised resources (including unemployed or underemployed labour), more government spending helps to draw those resources into production, sparking a chain-reaction of production, income, and spending that cycles through various sectors. Australian and international evidence in the wake of the stagnant macroeconomic conditions which have prevailed since the GFC indicate that government expenditure multipliers are stronger than many economists traditionally expected (Weber, 2012; Quiggin, 2013; IMF, 2012: 41-43). If resources were fully occupied anyway (due to very strong macroeconomic conditions and full employment), then expenditure multipliers are less potent – or, under extreme assumptions, non-existent. But clearly the state of NSW's economy today is far from that ideal: official unemployment is substantial, underemployment is at record levels, and other pools of non-employed people (such as discouraged and “marginally attached” workers) sit idly by instead of being integrated into productive activity. In these conditions, increased government spending – including on wages and salaries to public sector workers – will certainly contribute to economic growth. Spending cutbacks, in contrast, exacerbate the stagnation.

Economic models indicate that government expenditure multipliers under conditions of unemployment are typically in the order of 1.5: that is, changes in government purchases affect final GDP by a factor of \$1.50 for every additional dollar in

expenditure.<sup>4</sup> 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 like infrastructure investments (for which more of the expenditure's effect is dissipated away from the state economy). So if anything, the assumption of a 1.5 multiplier is conservative for our examination of the macroeconomic effects of public sector wage restraint.

Using the estimates developed above of the cumulative reduction in public sector compensation resulting from the 2.5 percent wage cap and associated public sector wage austerity, we estimate that Australia's national GDP has been reduced by a cumulative total of almost \$8 billion over the 2011-16 period.<sup>5</sup> And as above, this loss will grow in coming years as the gap between restrained public sector payrolls, and what would have been experienced under normal wage and employment policies, continues to grow. If the current trajectory is maintained, then the cumulative loss of national GDP would increase to an additional \$25 billion over the coming five years.

These figures refer to the loss of national GDP, not just the GDP of New South Wales – since some of the loss expenditure results in a contraction of output for goods and services purchased from other states. However, NSW's economic and fiscal outlook is not independent from the economic conditions experienced elsewhere in Australia – not least because of the importance of fiscal transfers from the Commonwealth government (which depend crucially on national GDP growth) for the fiscal performance of NSW.

### 3. THE PUBLIC SECTOR WAGES POLICY UNDERMINES GOVERNMENT REVENUES

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Perhaps the most ironic and self-defeating of the unintended consequences arising from the state government's wage-suppressing policies is the negative blowback of this austerity onto the state government's own budget. Most obviously, public sector employment generates its own stream of tax revenues: income taxes on wages and salaries,<sup>6</sup> payroll taxes, and GST on public sector workers' own purchases.<sup>7</sup> A government which tries to "save money" by suppressing its own wage payouts, must

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<sup>4</sup> Weber, cited above, uses 1.5 as his benchmark of standard multiplier effects.

<sup>5</sup> This equals the estimate of total foregone compensation from 2011 to 2016 times the 1.5 assumed multiplier.

<sup>6</sup> And public sector workers in full-time, permanent positions pay income tax at relatively high marginal and average rates.

<sup>7</sup> The state government does not directly collect income and GST revenue, but depends on the health of those flows indirectly through the transfer payments received from the Commonwealth.

take account of the immediate impact of that austerity back on its own revenues. The direct loss of tax revenue flowing back to government negates a not-insignificant share of the supposed fiscal “savings” of the wage policy.

But the final impact on the government’s own budget is much larger than just this direct effect, by virtue of the flow-through impact of reduced income and consumption expenditure on the overall trajectory of GDP in the broader economy. The overall effect of wage restraint on national GDP was estimated above to total in the tens of billions of dollars over the coming five years. That will have an inevitable and significant effect on state tax revenues (again, experienced both directly, and indirectly via transfers from the Commonwealth).

In aggregate, state governments in Australia collect over 15 cents of each dollar of GDP: consisting of 9 cents of its own-source revenue and 6 cents in the form of fiscal transfers from the Commonwealth level of government (authors’ calculations from ABS Catalogue 5206.0, Table 19). By that measure, the NSW wage austerity has reduced its own revenue by 15 percent of the final flow-through contraction in GDP which has resulted from its artificial suppression of public sector payrolls.<sup>8</sup> This translates into a loss of state revenue of \$1.2 billion over the 2001-16 period – and a loss of \$3.7 billion over the next five years if the current trajectory of public sector payrolls relative to private sector payrolls is sustained.

## 4. THE PUBLIC SECTOR WAGES POLICY SUPPRESSES PUBLIC SECTOR PRODUCTIVITY

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In theory, the goal of the NSW Public Sector Wages Policy is to freeze real compensation levels for public sector workers in perpetuity. The 2.5 percent benchmark was chosen to correspond to the mid-point of the Reserve Bank of Australia’s target band for its inflation-targeting policy (NSW Treasury, 2014). Of course, inflation may or may not correspond to that RBA target – and the inflation indicator chosen to operationalise the bank’s target will not perfectly correspond to the prices paid by NSW public sector workers in their daily expenditures. (This latter issue is especially concerning in regards to the incomplete incorporation of housing

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<sup>8</sup> Of course, the loss in state revenues arising from the NSW wage policy via the associated contraction in Australian GDP is also shared by other states (since the transfer payments to states from the Commonwealth are not tied to specific state-level GDP performance). In this sense it could be argued that NSW is “free-riding” to other states, by shifting some of the negative fiscal side-effects from its own policies to the rest of the country. But unfortunately several other states have mimicked the NSW wage austerity with their own measures, and hence NSW can be expected to experience a proportional share of the broader fiscal blowback from overall public sector wage austerity.

costs in conventional CPI measures; in reality, the soaring cost of housing in NSW, and Sydney in particular, is not fully reflected in the growth of the CPI used by the RBA as its price target, and hence real wage trends for public sector workers in practice have been worse than implied by real wage indices calculated according to the CPI.)

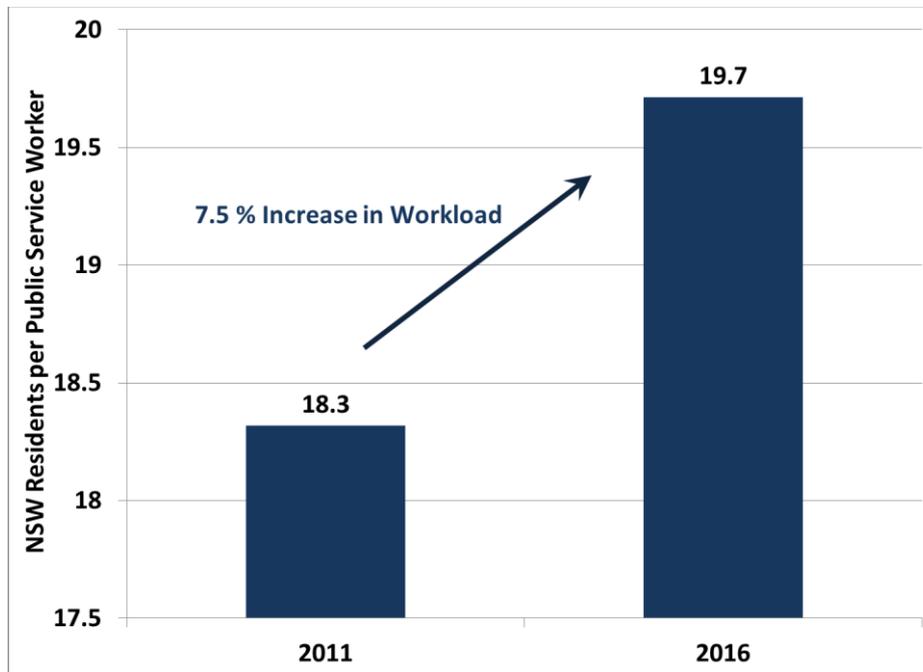
But even if the RBA inflation targeting system worked perfectly, and its target measure perfectly reflected the actual cost of living in NSW, the implications of a perpetual freeze on real compensation for public sector workers are perverse and economically damaging. Economic theory suggests that labour compensation should rise in step with labour productivity. Of course, in recent history this relationship has been disrupted, by several different factors – not the least being the aggressive efforts of governments to suppress collective bargaining, minimum wages, and pay across the economy (including for their own employees). Nevertheless, ultimately labour compensation must grow with productivity in order to provide a fair return to workers for their efforts to enhance productivity (including accumulation of skills and education, efficiencies in work practices, and other measures), and to support the expansion of purchasing power necessary to ratify the increased potential output of the economy. The notion that the state government, by fiat, can simply ignore this fundamental economic relationship in perpetuity is absurd.

In fact, the productivity of public sector workers in NSW has been growing steadily in recent years, despite the Wages Policy. Indeed, the government is determined for this to occur: it has imposed arbitrary “efficiency dividends” on departments and services, averaging 1.5 percent per year in recent years – and now scheduled to accelerate to 2 percent per year starting in 2018 (NSW Treasury, 2017: 6-4). It enforces productivity growth through often punitive and arbitrary measures (such as reductions in staffing, leaner work practices, longer hours, etc.), yet denies through legislative dictate the right of affected workers to at least capture a proportional share of those gains in the form of higher real wages and salaries.

One simple aggregate measure of the productivity and intensity of public service work in NSW is provided by the overall “caseload” which public sector workers must handle in the course of their work. The nature and measurement of workloads will vary widely, of course, across specific occupations. A convenient proxy is the number of state residents who must be “served” (in a generic sense) by each public sector worker (see Figure 4). In 2011, when the government initiated this policy of wage restraint and other austerity measures, there was one public servant for every 18.3 state residents. That ratio grew to 19.7 over the next five years: with a slight decline in total public service employment contrasting with a significant expansion in the state’s population. By this measure, each public sector worker’s “workload” has increased by 7.5 percent

in the last five years.<sup>9</sup> Yet the government’s official policy aims to break the normal link between improving productivity and growing compensation, by freezing real public sector compensation for as long as the policy is in effect.

**Figure 4. NSW Residents per Public Sector Worker, 2011-2016**



*Source: Authors’ calculations from ABS Catalogue 3101.0, Table 4, and NSW Public Service Commission, Workforce Profile Report, 2016.*

Higher productivity combined with flat real compensation arithmetically implies ongoing reductions in unit labour costs. This is verified by the declining share of employee expenses in the state government’s total revenue and expenditure profiles. The artificial suppression of wages, despite growing productivity, is fiscally convenient for the government. But for how long does it really expect to be able to sever the link between productivity and incomes – and freeze real compensation for public sector workers (even as employees in the private sector have at least a fighting better chance of capturing the gains of improved productivity in the form of higher real wages)?

The most perverse dimension of this policy is its likely impact in creating a major disincentive to enhanced productivity performance in the public service. There is no opportunity for public sector workers to benefit from improved productivity in their workplaces, since government policy crudely freezes real pay for every function across the public service. This inhibits the normal adjustments in relative compensation, and

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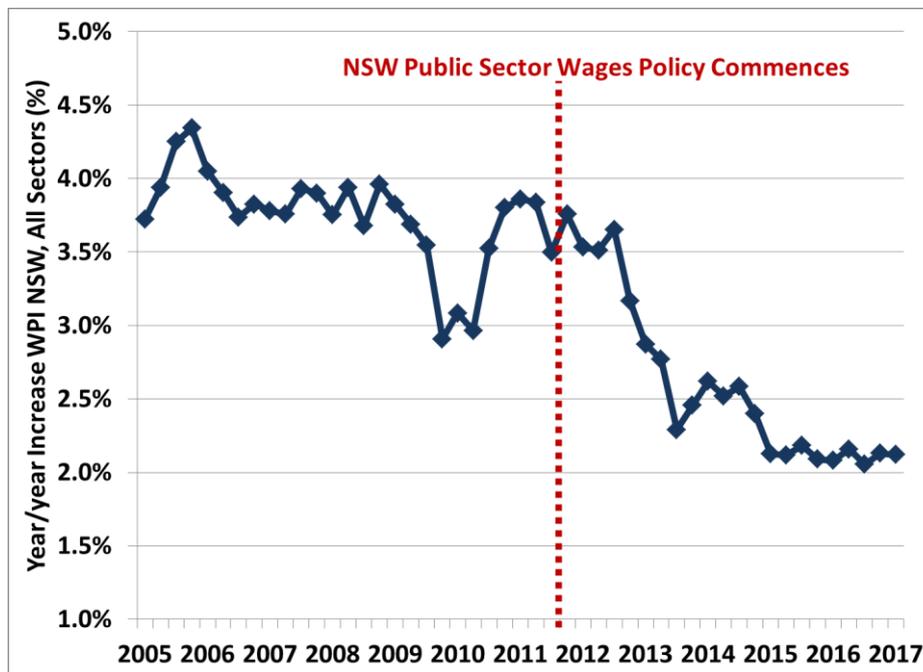
<sup>9</sup> Perhaps by coincidence, this cumulative growth is very similar to five years’ worth of 1.5 percent annual “efficiency dividends.”

ongoing symbiosis between productivity and pay, that are central features of a normal, healthy labour market. Why should either managers or workers in the public sector strive for higher productivity, when there can be no material reward for their efforts? The government’s policy is clumsy and inefficient.

## 5. THE PUBLIC SECTOR WAGES POLICY CONTRIBUTES TO BROADER WAGE STAGNATION

A final unintended irony of the NSW government’s wage suppression policy, is that it has likely played an influential role in contributing to the broader stagnation of wages that has proven so damaging to Australia’s (and NSW’s) macroeconomic performance. As noted above, commentators from major bank economists to the RBA Governor to the Commonwealth Treasurer have all acknowledged that the record-slow pace of wage increases is substantially undermining spending conditions, growth, job-creation, and fiscal repair across Australia’s economy. Workers are capturing a record-low share of national GDP in the form of wages, salaries, and other compensation. This maldistribution of the economic pie creates a lopsided and precarious economic environment, in which the normal mechanisms of self-sustaining growth (based on a virtuous cycle of employment, income, and expenditure) are short-circuited.

**Figure 5. Public Sector Wage Cap and Overall Wage Trends, NSW, 2005-2017**



Source: Authors’ calculations from ABS Cat. 6345.0, Table 2a, excl. bonuses.

Ironically, private sector wage growth in the NSW labour economy has declined largely in step with public sector wage restraint (see Figure 5). While total private sector compensation has grown substantially faster than in the public sector, average incomes for individual workers in the private sector have also been growing at a record-slow pace. We are confident that these two outcomes – legislated wage suppression in the public sector, and a corresponding deceleration of wage growth in the private sector – are not unrelated. Within two years of the NSW state government imposing a cap of 2.5 percent on annual wage increases in the public sector, annual wage growth in the *private* sector had decelerated to the same level – or even lower (Figure 5).

The NSW government’s wage policies have undermined private-sector incomes via several channels. First, the broader weakness in purchasing power caused by the artificial suppression of public sector payrolls undermines labour demand and hence wage pressures facing private employers. Moreover, the high-profile “signal” sent to all economic stakeholders by the NSW policy – namely, any wage increase above 2.5 percent is somehow exorbitant and illegitimate – can have unintended repercussions in private sector wage determination. Employers are encouraged to hold the line all the more in their own wage negotiations, seeing the state government take extraordinary measures (even developing custom-made new laws to restrict wage growth) in its own approach to managing compensation. And workers in the private sector, notwithstanding RBA Governor Lowe’s exhortation to ask for more money, probably feel even less confident in doing so, seeing the determination of their government to suppress wages in perpetuity. This chilling impact on expectations in the private-sector labour market has certainly reinforced the deflationary impact of other economic factors (such as stubborn unemployment and underemployment, and the growing precarity of jobs) that explain the erosion of wage bargaining power throughout the labour market.

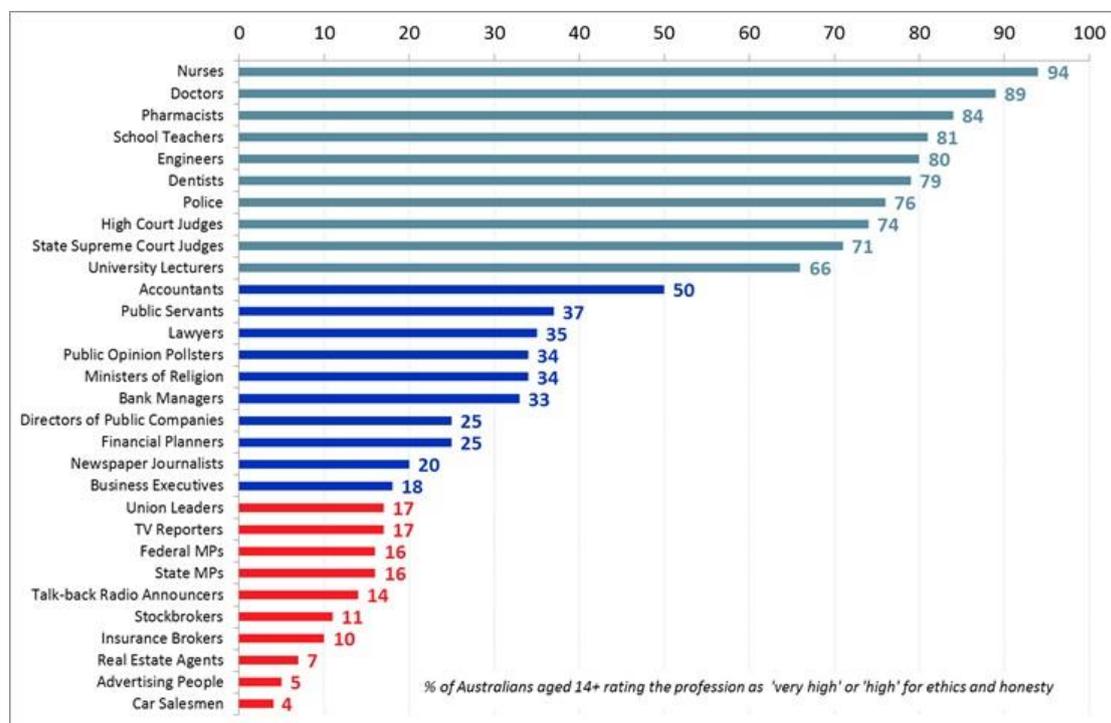
In this regard, the NSW government’s extraordinary interventions, removing normal wage bargaining rights from a significant and influential section of the state labour market, have certainly contributed to the broader stagnation of wages that it admits is hampering both economic growth and fiscal well-being.

# People Just Like You: Equal Rights for Public Sector Workers

On the ACTU’s 90th anniversary Secretary Sally McManus (2017) launched a campaign to “change the rules” that presently rig the economic and industrial relations systems against working people in Australia. The NSW public sector wages cap is an obvious example of this kind of arbitrary and unjust rule.

Public sector employees work in a wide range of occupations that are absolutely essential to the welfare of the residents and communities of NSW. Paramedics, teachers, allied health workers, nurses, police officers, social workers, judges, planners, engineers, fire fighters and bus drivers do work that enables our complex society and economy to function, safely and efficiently. Public sector workers play a critical role in supporting regional and remote areas of NSW (38 percent of them work outside of Sydney), and public sector employment even helps to reduce the gender pay gap (NSW Public Service Commission, 2016).

**Figure 6. Image of Professions, 2017**



Source: From Roy Morgan Research, 2017

It is therefore no surprise that so many of the occupations that dominate the public sector score so highly when it comes to public trust (see Figure 6). Nurses, doctors, teachers, police and judges are all ranked in the top ten professions for ethics and honesty. Even the general category of “public servants,” so often attacked by the media and politicians, is trusted far more than the politicians who themselves impose draconian policies such as the NSW Public Sector Wages Policy.

Public sector workers, like most workers in NSW, face growing financial pressure due to rising housing costs – especially in the greater Sydney area. The high cost of housing forces workers to take longer and longer to pay off mortgages. One recent study found that: ‘For home owners aged 45-54 years, the incidence of mortgage debt has nearly doubled from 36 percent to 71 percent. Among those aged 55-64 years, this incidence has more than tripled from 14 percent to 44 percent’ (Ong *et al.*, 2017). Obviously, policies that deliberately suppress wages will only make this problem worse. Australians already spend over 20 percent of their disposable income on housing, compared to 8 percent in 1960, and highly indebted households are extremely vulnerable to any upward movement in current record-low interest rates (Irvine and Wade, 2017).

Essential service workers on modest wages are struggling to afford housing in greater Sydney. For example, 95 percent of Sydney suburbs would be out of reach for a mid-range medical professional (like a paramedic or registered nurse) looking to buy her/his first home (Ting and Wade, 2017). Researchers found that they would need ‘a two- or three-fold jump in pay to live in the North Shore, around Lindfield or Beecroft, for example’ (Ting and Wade, 2017). The lack of affordable housing options is forcing more essential service workers into longer commutes to and from work. A NSW Nurses Association survey found ‘more than 35 per cent of members having moved home or changed jobs in the past 12 months because of housing affordability issues’ (Hutchinson, 2017). The dramatic rise in housing costs in NSW is not fairly or fully reflected in the traditional CPI indicators that are used to guide the RBA’s inflation-targeting policy; hence the real incomes of public sector workers have likely fared even worse than conventional indicators would imply.

These cost of living pressures affect most NSW workers and their families – but what sets public sector workers apart from their private sector colleagues is the unjust removal of their legitimate right to bargain for pay and conditions commensurate with their skills and circumstances. As Unions NSW put it (2013: 4) in its submission to a Senate Inquiry, the NSW Public Sector Wages Policy has left ‘public sector employees in New South Wales with less rights than any other worker in the state as it enables executive government, which serves dual roles as both employer and regulator, to dictate the wages and conditions of public sector employees.’ In a similar vein, the

CPSU argued that the policy 'effectively removes for public sector workers the basic right that should be enjoyed by all workers to be able to collectively bargain with their employer over wages and conditions' (Bhatt, 2014: 11). Public sector workers have earned the trust of the people of NSW, but not the respect of the NSW government. The NSW Public Sector Wages Policy is a denial of the equal rights that all NSW workers should enjoy. This, in addition to the broader macroeconomic and fiscal consequences which it is imposing on the state economy, is why the policy must change.

# Conclusion

This report has outlined the negative effects of the NSW Public Sector Wages Policy, and in particular its 2.5 percent annual cap on compensation increases. Neither Australia in general, nor NSW in particular, suffers from a problem of “big government.” There is no economic, fiscal, or moral justification for the extraordinary suppression of public sector remuneration – particularly at a time of record low wages growth in Australia, and particularly when budget surpluses are being generated in the state. The report has highlighted five unintended consequences of the NSW Public Sector Wages Policy in the period 2011-2016. These include: a \$3.4 billion cumulative reduction in consumer spending, an \$8 billion cumulative loss in GDP, \$1.2 billion in lost state government revenue, the severing of the normal link between productivity and incomes, and an exacerbation of overall wage stagnation across the labour market. The longer this policy remains in place, the higher these costs will become. With record housing prices, public sector workers cannot afford this perpetual and heavy-handed public sector wages cap. Public sector workers deserve the same workplace rights as all other NSW workers. The NSW Public Sector Wages Policy is an ideologically-motivated intervention that damages the state’s economy, disrespects its public sector workforce, and harms the residents of NSW.

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