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# Victorian response to CGC 2025 Review consultation

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Wages cost consultation paper

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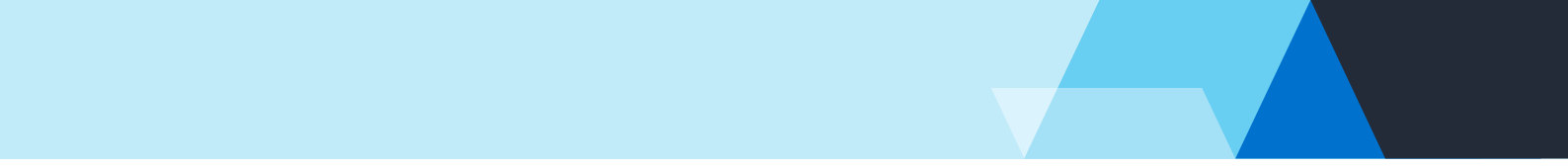
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# Contents

1. Introduction	3
2. Conceptual concerns with the wages cost assessment	3
3. Private sector wages as a policy neutral proxy for public sector wages	5
3.1 Maintaining the private sector as a proxy for the public sector	5
3.2 Restricting the sample to only use female private sector employees	5
4. Characteristics of Employment Survey data	6
5. Hourly wages rather than weekly wages as the dependent variable	7
6. Usual hours of work	8
7. Imputed work experience	8
8. Control variables and model complexity	8
8.5 Criteria for including control variables	8
8.6 Removing industry variables and gender interactions	9
8.7 Statistical testing for potential overfitting	9
9. Combining years of data	10
10. Discount applied	11
11. Wage to non-wage costs	12
11.1 Including other component expenses	12
11.2 Calculation of wage cost proportion for housing, roads and transport	12



# 1. Introduction

States were provided an initial consultation paper on the wages cost assessment on 20 June 2023. The expert consultant's final report was provided on 4 September 2023 and an updated CGC consultation paper was provided on 27 September 2023. This response provides Victoria's views on the both the initial and updated CGC consultation paper, informed by the consultant's report.

Victoria's preference is for a simple and readily explainable method to distribute the GST, as noted in the introductory comments to its response to the CGC's tranche 1 consultation papers. Overall, Victoria considers the current wages cost assessment does not meet these aims.

Victoria is broadly supportive of the consultant's recommendations for the wages cost assessment, which aim to simplify the approach. Victoria supports many of the CGC's suggested changes in the consultation paper that respond to the consultant's recommendations to reduce the complexity of the model.

Victoria's view is that this can be taken further and that there are still questions around the conceptual basis and applicability of the model, as well as its technical specification. Victoria's specific suggestions to improve the assessment, along with responses to the CGC's consultation questions, are provided below.

Victoria appreciates the CGC engaging the expert consultant to review the wages cost assessment. Victoria considers this has led to a thorough examination of the assessment, and a strong conceptual and technical basis for the CGC and states to engage with. As noted in its response to the tranche 1 consultation, Victoria would have preferred if more assessments were given the same rigorous examination on a regular basis, including the engagement of expert consultants. Victoria reiterates its request for the CGC to work collaboratively with states to improve its methods and address any uncertain or proxy data used, including in the justice assessment or in health for culturally and linguistically diverse people.

## 2. Conceptual concerns with the wages cost assessment

Victoria is generally concerned with the conceptual basis and interpretation of the wages cost assessment.

Over time there has been limited information on what the wage cost assessment attempts to measure in practice, how accurately it measures this, and to what extent the measured effect is "beyond states' control" (or policy neutral).

The CGC's initial consultation paper states that "the wage costs assessment recognises that comparable public sector employees in different states are paid different wages, partly due to differences in labour markets beyond the control of state governments."

The geographic factors outlined by the CGC are:

- Local amenities
- Climate
- Attachment to state
- Cost of migration.

Victoria is concerned with this description of the drivers of policy neutral wage differences between states. Climate is a clear and independent geographic driver of wages differences. However, Victoria questions the other factors noted. Local amenities could be the result of decisions from state policy makers as all states implement policies to improve amenity for their residents. Victoria also questions the strength of ‘attachment to state’ and ‘cost of migration’ as influences over states’ wage pressures. Victoria questions the implicit assumption in these factors that states significantly compete between each other for workers. The CGC’s wages draft assessment paper as part of the 2020 Review noted:

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*“Analysis of Census data showed that 60% of people joining the State public service between 2006 and 2011 moved from the private sector in their State, **while only 3% moved from the State public service in another State.** The Commission concluded that the direct **impact of competition for labour from other sectors within a State appeared to be stronger than the impact of a national labour market** for State public service employees.<sup>1</sup>”*

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Of the 10 per cent or so of workers that change jobs in a year, data from the Household Income and Labour Dynamics in Australia (HILDA) survey suggest that only around 1 in 20 relocate interstate as part of the job change (less than 1 per cent of all workers).<sup>2</sup>

Victoria requests the CGC provide supplementary evidence to support its description of the drivers of wages cost differentials. For example, evidence to support that local amenity, climate, attachment to state and the cost of migration significantly influence the wage cost pressures states face.

An additional interpretation is provided by the consultant’s report which notes: “the geographic controls capture factors such as compensatory wage premiums (e.g. the additional monies that individuals may require to compensate for cost-of-living costs in particular regions) as well as wage pressures linked to local labour markets (e.g., skills shortages).”

Victoria requests the CGC provide an intuitive description of how the results of its model relate to these underlying drivers. This should include how these drivers relate to the differences in the state wage factors produced by the model – for example, why some states have higher or lower wage requirements due to these factors.

For example, the various models in the consultant’s report and the CGC’s consultation paper produce coefficients that suggest WA and ACT have the highest wage cost factors. Victoria would appreciate a description of how the geographic factors noted relate to this general result. For example, it is unclear why climate, a factor clearly outside states’ control, would mean WA and ACT need to pay a wage premium compared to Qld or the NT.

A simple interpretation may suggest the effect of specific high wage non-state industries – the mining industry in WA and Commonwealth public sector in ACT – could explain why those states face higher wage pressures. The impact of industry on the wage pressures of these states is pronounced, as shown in the consultation paper (Figure B-1) where both WA and the ACT’s wage coefficients are significantly impacted by the introduction of the industry variable. It is possible the model is not accounting for this impact completely. This interpretation does not align with the CGC’s suggested drivers however, and as such Victoria requests the CGC’s interpretation of the coefficients and their differences.

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<sup>1</sup> [https://www.cgc.gov.au/sites/default/files/2021-11/R2020%20-%202018-01-22-S%20-%20Draft%20assessment%20paper%20-%20Wage%20Costs\\_0.pdf](https://www.cgc.gov.au/sites/default/files/2021-11/R2020%20-%202018-01-22-S%20-%20Draft%20assessment%20paper%20-%20Wage%20Costs_0.pdf)

<sup>2</sup> <https://www.rba.gov.au/publications/bulletin/2012/dec/pdf/bu-1212-1.pdf>

### **CGC consultation questions and Victoria's positions**

- Victoria requests the CGC provide an intuitive interpretation of the wages cost model and its conceptual basis when presenting results. Victoria requests the CGC provide supporting evidence to establish the conceptual case for the identified drivers of the wages differences between states.

## **3. Private sector wages as a policy neutral proxy for public sector wages**

### **3.1 Maintaining the private sector as a proxy for the public sector**

Victoria supports the continued use of private sector employees as a proxy for public sector wage pressures in the absence of an appropriate alternative. However, the lack of closeness of this proxy raises concerns that the CGC's model is not able to accurately delineate the policy neutral wage differences between states.

In the consultant's analysis, geographic wage relativities between the private and public sector are not consistent for all states. While WA private sector employees earn significantly more than their NSW counterparts, WA public sector employees earn significantly less. The consultant suggests that this could mean that private and public labour markets are separate in WA, and that using private sector wages to proxy the public sector may not be equally valid for all states.

In addition, the consultant's report shows differences in the wages differentials between the private and public sectors for Victoria and NSW. Private sector males in Victoria earn less than in NSW, however there is little to no difference in the public sector. This calls into question the proxy, if identified differences are only present in the private sector and do not translate to the public sector.

Private sector wages in Australia are influenced by the dynamics of the public sector, impacting the policy neutrality of the private sector as a proxy. The public sector employs a substantial portion of the workforce across Australia. State governments alone provide employment to approximately one in ten Australian workers, and when considering all levels of government, including local and federal, they collectively account for 15 percent of the national workforce. However, this varies significantly from state to state with the ACT and NT standing out as prime examples of the public sector's substantial impact on private sector wages.

In the case of the ACT and NT, public sector workers constitute a significant proportion of all workers, with the NT at 30 percent and the ACT at 44 percent. The high shares of public sector employment in the territories could have a substantial ripple effect on the overall economic landscape. When public sector workers command a significant share of the labour market, it could impact wages in the private sector.

### **3.2 Restricting the sample to only use female private sector employees**

The consultant recommended using only female private sector employees as a substitute for public sector workers to assess wage costs. This suggestion stemmed from the fact that many state sectors, particularly in healthcare and education, predominantly employ female workers.

Victoria agrees in principle with the suggestion to make the private sector proxy a closer match to the public sector. Victoria also agrees in principle that taking only female private sector workers would be a closer proxy than all private sector employees. Victoria is generally concerned that due to the inaccuracy of the proxy the CGC's model may misattribute private sector wages pressures which are not present in the public sector.

However, Victoria agrees with the CGC's conclusion that excluding male employees from the model would likely impact its statistical accuracy. The sample size of the Characteristics of Employment Survey (COES) is already a concern for the CGC's use and creates some uncertainty and volatility. The CGC seeks to address these issues with its other recommendations. The consultant has presented a trade-off between the closeness of the proxy and statistical accuracy, and in this case Victoria favours accuracy. Despite the majority of public sector staff being women, a significant number of men also hold public service positions.

In light of these concerns, the CGC should not exclusively rely on female private sector employees as a proxy for the entire public service workforce. Victoria notes this approach does not resolve the issue identified by the consultant of the mismatch between public and private sector wages, and considers it may suggest the continued need for a discount on the assessment.

Another approach noted in the consultation paper could be to consider only wages in specific private sector industries closer to the public sector like health and education. While considering the use of private sector healthcare and education data could provide a better match for the industries of interest, Victoria agrees with the CGC's conclusion that it would raise further concerns around reflecting each state's unique policy decisions and so is not recommended.

### **CGC consultation questions and Victoria's positions**

#### **Q1. Do states agree on continuing to use private sector wages as a policy neutral proxy for the market pressures faced by public sector employers?**

- Victoria agrees to continue to use private sector wages as a proxy for public sector wage pressures, however, notes the inaccuracy of this proxy suggests a rationale to continue the discount on the assessment.

#### **Q2. Do states agree that the Commission should continue to use all private sector employees to proxy for public sector drivers of costs?**

- Victoria agrees the CGC should continue to use all private sector employees in its wages cost model, however notes the issues raised around the applicability of this proxy to public sector wages supporting a discount.

## **4. Characteristics of Employment Survey data**

Victoria considers that the COES data are appropriate to use for the wage costs analysis. However, Victoria also recommends the CGC test its results against alternative data sources such as the HILDA survey or the Commonwealth Multi-Agency Data Integration Project (MADIP).

While the COES has robust data collection methods, it is important to recognise that there are untapped opportunities in alternative data sets that have not received consideration. Alternative sources could serve as valuable tools to validate or strengthen the CGC's model. For example, in situations where external events have the potential to impact data collection, alternative data sets could play a crucial role in maintaining the integrity and continuity of the analysis.



In recent years, there have been adjustments made to the CGC's modelling approach due to external events, notably in the 2022 and 2023 Updates due to the impacts of COVID-19 and JobKeeper payments. The COES is conducted during the two weeks beginning 5 and 11 August annually. According to the ABS, the information which is obtained relates to the week before the interview. Given the narrow scope of data collection, significant events in the future such as another pandemic, economic shocks, natural disaster or infrastructure failures could all impact the data collected and compromise the wage costs assessment.

The CGC should aim to reduce its exclusive reliance on the COES as the primary data source for critical information. This is especially relevant in light of the impacts of COVID on data collection. The CGC should explore alternative data sources that can validate the COES survey insights, particularly during periods when state-specific events may affect data collection to enhance the accuracy and reliability of findings. The Review offers an excellent opportunity to test these alternative sources and determine their effectiveness in ensuring a more comprehensive and accurate analysis.

If other sources are also found to produce robust results, in future these could be incorporated into the assessment. For example, it is common modelling practice to blend or average results from equivalent models where there is uncertainty around the best approach.

### **CGC consultation questions and Victoria's positions**

#### **Q3. Do states support the continued use of the Characteristics of Employment survey data?**

- Victoria supports the use of the COES for the wages cost model, however requests that the CGC validate its results against other data sources, including HILDA and/or MADIP.

## **5. Hourly wages rather than weekly wages as the dependent variable**

Victoria has no initial concerns with the CGC's proposal to use hourly wages as the dependent variable. The consultant stated that the empirical literature typically uses weekly wages as the dependent variable where no information on hours worked is accessible. Given hours worked are available from the COES, the consultant suggested using hours worked as the dependent variable.

The preference for hourly or weekly wages is context specific. In industries where employees are paid on an hourly basis, like retail, hospitality, and manufacturing, using hourly wages is a relevant and logical choice. It accurately reflects the compensation structure and work patterns in these sectors. On the other hand, weekly wages align more appropriately with salaried positions, where employees receive a consistent, fixed amount of compensation each week regardless of the hours worked, making it a more suitable measure for this category of workers.

### **CGC consultation questions and Victoria's positions**

#### **Q4. Do states agree the Commission should use hourly wages rather than weekly wages as the dependent variable?**

- Victoria agrees to the CGC's proposal to use hourly wages as the dependent variable for the wages model.

## 6. Usual hours of work

Victoria has no initial concerns with the CGC's approach to use three categories for usual hours of work, rather than the current set of hours worked variables. This approach removes a number of variables from the previous model and assists to simplify the model, which Victoria supports.

### CGC consultation questions and Victoria's positions

**Q5. Do states support including usual hours of work in the model as 3 categories, part-time, full-time and more than full-time hours?**

- Victoria supports including usual hours of work in the model as three categories.

## 7. Imputed work experience

Victoria has no initial concerns with the CGC's proposal to include age in 5-year categories as an independent variable, rather than using potential experience and potential experience squared. This approach introduces a more straightforward and easily understandable model specification.

In contrast, the suggestion to add interactions with the highest level of education, while enhancing the overall model fit, has minimal impact on state coefficients. Victoria supports the CGC's recommendation that prioritises simplicity over unnecessary complexity.

### CGC consultation questions and Victoria's positions

**Q6. Do states support replacing imputed work experience and imputed work experience squared with 5-year age groups?**

- Victoria agrees with the CGC's proposal to use imputed work experience squared with 5-year age groups.

## 8. Control variables and model complexity

Victoria agrees with the consultant's conclusions that the CGC should simplify the model. Victoria agrees with the proposed approach of using the model as a starting point, and only adding in additional variables if they improve it. Victoria considers that the CGC should seek simplicity across its assessment methods, particularly where it does not impact the ability to achieve HFE.

### 8.5 Criteria for including control variables

Victoria strongly supports the consultant's recommended approach on including control variables and reducing model complexity. Victoria suggests the CGC consider consultant's questions for testing the inclusion of each variable: whether they improve model fit, if the improvement to fit is worth the increase in complexity and whether there is an impact on the state variables?

The four criteria that the CGC has outlined that a variable must meet in order to be included follow the consultant's recommendation and make logical sense. However, Victoria has concerns with the

implementation of the criteria for a “strong conceptual case” which may not be concretely defined and subject to judgement, and the practical realities of a material impact to state coefficients.

Victoria would like to see the final model proposed by the CGC, including additional explanation of how included variables meet the four criteria, as well as how the excluded variables no longer meet the criteria.

## **8.6 Removing industry variables and gender interactions**

Victoria supports the CGC’s suggestions to reduce the complexity of the model by reducing the number of granular variables, including the industry categories and gender interactions. Victoria agrees with the consultant’s conclusion that the detailed and complex variables in the model could be simplified without impacting the variables of interest which are the state coefficients.

Victoria supports the removal of the gender interaction terms in line with the consultant’s analysis finding that while potentially improving some technical aspects of the model, the trade-off with simplicity is not warranted. This is particularly the case as there is minimal impact on the variables of interest.

Victoria supports the CGC’s recommendation to replace the current detailed industry variables with the higher-level industry divisions of the Australian and New Zealand Standard Industrial Classification (ANZSIC). However, the CGC has proposed retaining the occupation variable at the Australian and New Zealand Standard Classification of Occupations (ANZSCO) ‘minor group’ level (3-digit), rather than raising to the ‘major group’ level (1-digit).

Victoria recommends the same approach is applied to the occupation variables as is applied with the industry variables and that the CGC use the occupation ‘major groups’ (1-digit) rather than the ‘minor groups’ (3-digit).

Victoria considers the same rationale for simplifying the industry variables applies to occupations. Leaving more granular occupation variables makes occupation inconsistent with the level of detail used for the industry variables. The consultant also notes the case for simplifying both industry and occupation variables and uses the highest-level industry and occupation variables (1-digit) in their analysis.

## **8.7 Statistical testing for potential overfitting**

Victoria requests the CGC undertake further testing for overfitting of the models selected and publish the results of this and any testing it has already done. The proposed model specification contains multiple variables with many classifications. However, no formal test results have been published comparing the information criteria of the models with and without restrictions. Publishing Likelihood Ratio test results comparing model specifications with different restrictions would provide conclusive evidence in response to overfitting concerns in the model. Other statistical inference like the Akaike information criterion or Bayesian information criterion could also be helpful to select the most informative model specification, while retaining parsimony.

## CGC consultation questions and Victoria's positions

### Q7. Do states agree with the Commission's proposed criteria for including control variables in the model?

- Victoria agrees that the model should be simplified, however would like further clarity, including the proposed model and how each variable meets or fails the criteria before agreeing to the approach, noting a concern with the criteria relating to a strong conceptual case.

### Q8. Do states support using a less complex model by replacing industry group categories with industry division categories and removing the interaction terms with gender and every other independent variable?

- Victoria supports replacing industry groups with divisions and removing the gender interaction terms.
- Victoria recommends the occupation variables are replaced with the occupation major groups (ANZSCO 1-digit classification).
- Victoria requests the CGC undertake further testing for overfitting of the models selected and publish the results of this and any testing it has already done.

## 9. Combining years of data

Victoria generally supports combining multiple years of data to reduce volatility in the model results. Victoria considers that combining multiple years of data may reduce the volatility in the model and resolve some issues around significant events that impact the regression, such as with COVID-19 and JobKeeper. By aggregating data from multiple years, the model may be more resilient due to incorporating a broader perspective of trends and patterns.

The preferred option from the CGC is to use three years of data, the Wage Price Index (WPI) and standard errors to create combined estimates of relative differences between states. Victoria supports this approach in principle and considers it deals with concerns such around structural breaks and aligns with the CGC's goal of producing a more robust model.

However, further clarification is needed regarding how this approach functions in practice relating to model specification and the data source.

Victoria notes this approach is contingent on the assumption that WPI applies in a similar manner to all wages across the states, and is not influenced by, or inclusive of public sector wages. The CGC should be clear on this assumption if it implements this approach.

The consultant recommended a simpler approach of pooling data from recent years, noting the potential for complexity and volatility in the CGC's preferred approach. As noted throughout Victoria's submissions to the review, Victoria's position is that some assessments, including the wages cost assessment, are overly complex and would benefit from being simplified. Pooling data from different years provides a simpler approach to an already significantly complex assessment.

Victoria considers there is a trade-off presented between simplicity achieved through the consultant's suggested approach (pooling previous years data), and the potential greater accuracy delivered by the CGC's approach (indexing using the WPI). Echoing the consultant's position, Victoria suggests the CGC undertake further volatility testing to establish whether the trade-off between simplicity and accuracy is warranted. It may be the case that there have not been substantial structural changes in

states' wages to motivate the WPI based approach. Victoria requests the CGC undertake this testing and present the results to states before concluding its approach.

### **CGC consultation questions and Victoria's positions**

#### **Q9. Do states agree with the proposed approach to combine estimates of relative differences in states' wages across years?**

- Victoria agrees the CGC should implement an approach to combine estimates across years. Victoria considers both approaches presented have merit. Victoria requests the CGC provide the results of further volatility testing to determine whether the additional complexity of the WPI approach is warranted, otherwise Victoria recommends it adopt the pooling approach.

## **10. Discount applied**

Victoria supports retaining the current discount applied to the assessment. Victoria is supportive of the findings of the consultant's report and some of the CGC's recommended changes which improve the model and potentially reduce the need for a discount. However, on balance Victoria considers these changes do not fully address the underlying issues that motivate a discount and recommends it is maintained.

The expert engagement with the CGC has highlighted some existing shortcomings in the CGC's existing model that motivate a discount. These were both independently identified by the expert in its analysis and acknowledged by the CGC in the consultation paper. These reasons are sufficient evidence to maintain the discount to the model.

First, the consultant's proposal that female private sector wages are a more suitable proxy than all private sector wages signifies that there are issues using the private sector as a proxy of public sector wage pressures that are not resolved.

Secondly, the distinction between some states' private and public sector wage markets raises questions about their interplay and how they may diverge. This suggests the wage costs regression may not be appropriate to apply to some states' expenses. For example, the consultant identified a difference in wage differentials between WA's private and public sectors.

Finally, the extent to which state wage policies impact private sector wages introduces another layer of uncertainty to the assessment. The significant relative size of the public sector in some states and impact on private sector wage outcomes cannot be ignored. This highlights that the model may not accurately measure wage costs independent of the public sector.

### **CGC consultation questions and Victoria's positions**

#### **Q10. Do states agree that a 12.5 per cent discount remains appropriate?**

- Victoria supports retaining the 12.5 per cent discount.

## 11. Wage to non-wage costs

Victoria considers that the CGC needs to recalculate the wage to non-wage costs split, and remove the adjustment to the average share of wage to non-wage expenses for housing, roads and transport.

### 11.1 Including other component expenses

Victoria's understands the CGC makes a determination on which expenditures are included in the wage to non-wage split based on GFS data and Economic Type Framework (ETF) codes. Victoria considers there is not sufficient transparency for states on how this categorisation is determined and requests the CGC provide further detail on its approach.

Victoria is specifically concerned with the exclusion of additional costs classified as "other component expenses". These expenses largely relate to grants and subsidies which, particularly in recent years, contributed substantially to government expenditure.

For example, spending on the services to industry component has shifted recently. Due to the incidence of COVID-19, states faced unique challenges in supporting business via grants and other direct financial contributions.

A large proportion of spending under services to communities also forms direct grants to remote communities for electricity and water subsidies, which are paid directly to service providers to pass on to these communities.

It is unclear why grant expenses are excluded from the wage to non-wage share calculation. It is Victoria's understanding that excluded expenses under 'other component expenditures' are captured in expenses that the wages assessment is applied to, implying a mismatch.

For example, the wages cost assessment is applied to the business development component of the services to industries category, which largely comprises grants to businesses. The wage to non-wage split should accurately reflect that the majority of this spending does not incorporate a state wage component.

Victoria recommends the CGC rebase this calculation, re-considering relevant other component expenses to determine the proportion of recurrent spending that should attract a wage adjustment, and provides states with its methodology for making this determination.

### 11.2 Calculation of wage cost proportion for housing, roads and transport

Currently the CGC adjusts the housing, roads and transport expenses wage cost proportion to equal the average proportion for all other categories. Victoria considers state spending on these components does not have a significant nexus with wages and should not be apportioned at the average of all components.

Victoria considers the current approach essentially takes the average of labour-intensive components and applies it to capital intensive components. The CGC has assumed that spending on these industries has a similar wage related component as other expense categories such as schools and health.

The CGC's roads assessment considers higher costs for states with longer road networks, more traffic, heavy vehicle use, and longer bridge and tunnel length. While maintenance and administration

of roads have wages components, 63 per cent likely overestimates the contribution to these activities. Data from the Commonwealth Bureau of Infrastructure, Transport and Regional Economics (BITRE) suggests that, on average, site-based labour comprises 26.7 per cent of spending, while office-based labour makes up 7.3 per cent for a total of 34 per cent labour and 66 per cent non-labour.<sup>3</sup> This indicates that the CGC's assumption of the average of labour-intensive categories overstates wage related spending.

Public transport and housing are similarly capital-intensive areas of state service delivery which may also have lower shares of associated wages costs. Victoria requests that the CGC removes the adjustment to the average wage cost proportion for housing, roads and transport. If the CGC is not satisfied with the results from the Government Finance Statistics data, it should present alternative data sources to provide evidence for an alternative calculation.

### **CGC consultation questions and Victoria's positions**

- Victoria requests the CGC provide states with further detail on how it determines which expenses are 'wages', 'non-wages' and 'other component expenses for the wages cost assessment. Victoria recommends the CGC reconsider the inclusion of some other component expenses in this calculation, particularly if they include expenses that wage costs are applied to.
- Victoria recommends the CGC recalculate the wage to non-wage costs split and removes the adjustment to the average for housing, roads and transport. If the CGC finds the results from the ABS Government Finance Statistics inappropriate, it should provide alternative data to support any adjustment.

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<sup>3</sup> [https://www.bitre.gov.au/sites/default/files/is\\_083.pdf](https://www.bitre.gov.au/sites/default/files/is_083.pdf)





