



AUSTRALIAN CAPITAL TERRITORY

2016 Update

ACT Comments on Commonwealth Grants Commission Staff Discussion Paper

CGC 2015-03S

Wage Costs Assessment

September 2015

**Chief Minister, Treasury and
Economic Development Directorate**

“...PM&C was no longer advertising jobs by classification but in terms of issues and would select staff based on capability.

Public servants should move in and out of the private sector for years at a time, rather than just on short-term secondments. The APS needed to open the doors to the private sector, think tanks, universities, research centres, state and overseas government, and be open to the better use of data.”

Mandarins map path in Age of Malcolm¹,

Australian Financial Review, 1 October 2015

¹ The article covers a speech made by Michael Thawley, Secretary of the Department of Prime and Cabinet at the inaugural annual conference of the ACT division of the Institute of Public Administration.

EXECUTIVE SUMMARY

CONCEPTUAL CASE

The ACT has considered all of the arguments put forward by both the States and the CGC staff on whether the assessment should be continued. We have concluded that this assessment is supported by reliable evidence and it should be continued to ensure fiscal equalisation between States and Territories.

Relationship between private and public sector wages

The ACT agrees with CGC staff that there is a strong linkage between State public sector wages and the wages paid to the broader community and that each of these will at some time need to respond to the underlying drivers that cause differences in the cost-of-living in different locations. In stating this, however the ACT considers that non-State government wages, that is the combination of Commonwealth and private wages, is the most suitable proxy.

Factors influencing public sector wage determinations

State public and private labour markets inherently different

The ACT considers that this point of criticism from some States appears to be based on a general misinterpretation of the reason for using private sector wages in the assessment. Private sector wages are used as a proxy for public sector wages to remove policy influence, and it is a relative differences between States that matter. The current assessment is not predicated on an assumption that State Governments attempt to maintain parity of public sector wages with private sector wages.

National market for labour and wage convergence

The ACT agrees with the CGC staff position that there is no evidence to suggest a convergence of State public sector wages. Rather, the data indicate that there are persistent differences in nominal wage levels between jurisdictions.

Dominant employer

The ACT agrees with the CGC staff position that States respond to regional labour market influences even in those occupations for which the State government is a major employer. CGC staff compared annual salaries of comparable nurses, police officers and teachers in each State which showed public sector wages are not equal across States, even in occupations where States are a major employer.

The ACT considers that in responding to these regional market influences, State governments react to wage pressures similar to those experienced within the private sector. Moreover, while State governments may be dominant employers in some occupations within their own State, they compete to some degree with other State governments within particular occupations, and must have regard for wages in those occupations in other States, allowing for differences in factors such as cost of living and amenity. Thus, real wages (broadly defined) will align fairly closely across States, while nominal wages may diverge due to factors which are not subject to significant influence by State governments.

State policy influence

The ACT considers that no substantive evidence has been provided in previous reviews, or in the current literature, of significant and persistent differences in relevant State policy which may have impacted on private sector wages. Given the increased openness of the Australian economy and the move to enterprise based wage setting over the last two decades, it seems likely that the influence of State government policy over private sector wage setting has diminished over that time.

Alternatives to private sector wages as a proxy

The ACT considers that the best available measure of the wage cost disability is non-State government wages (ie: the combination of Commonwealth and private wages). A second best option, if such a measure cannot be developed, would be private sector wages.

Productivity differences

The ACT considers that, while productivity is a significant driver of differences in wage rates, the evidence does not support a claim that wage differences between States are accounted for solely by differences in productivity. Moreover, the literature indicates that productivity is largely determined by the job rather than individual characteristics – that is, structural factors are most relevant². These factors are related to the industry and occupation variables, which are controlled for in the CGC’s regression model.

At the level of the individual worker, there is no logical argument in our view which supports the view that there are differences in productivity across States which are consistent and persist over time. In addition, the regression model used by the CGC controls for differences between States in variables such as educational level, duration of employment and work experience, which are factors likely to influence productivity differences between individual workers.

² Thurow, L.C. *Generating Inequality*, 1975.

Technical aspects

Omitted variable bias

The ACT considers that there is no evidence that any reliable factor that drives wages has been omitted from the regression.

Simplification

The ACT supports the CGC staff position that simplification is unwarranted at this point in time if it were to significantly compromise the statistical accuracy of the model.

Discounting

The ACT considers that, if the new Characteristics of Employees (CoE) dataset, premised on a significantly larger sample size than the Survey of Education and Training (SET) and produced annually rather than quadrennially, produces a more reliable and accurate outcome than the data previously used, the discount currently applied to this assessment should be removed.

KEY ISSUES FOR THE ACT

Commonwealth sector influence on the ACT

The ACT considers there is a compelling conceptual case as to the influence of the Commonwealth government on wages paid by the ACT Public Service (ACTPS). We have argued in the submission that the nature of the ACT labour market differs markedly from that of other jurisdictions, in that our private sector is much smaller relative to the public sector than in other States, and within the public sector the Australian Public Service (APS) is three times larger than the ACTPS.

This unique ACT labour market underlines the need to recognise that non-State government wages are a more appropriate proxy for public sector wages than private sector wages alone. This offers a benchmark that is “unaffected by State government policy and reflect(s) the general levels of wages with which State governments compete” as noted by the CGC in its 1999 Review³.

³ Commonwealth Grants Commission, *Report on General Revenue Grants Relativities 1999, Volume II Methods, Assessments and Analysis*, 1999, para 116, pg. 72.

While the ACT understands that this distinction may not be readily available when the Characteristics of Employees (CoE) survey⁴ is released, we have identified ways in which CGC staff could split the data between Commonwealth and State public sector employees so that a non-State government wage can be reinstated into the assessment.

Capital City versus Whole of State Wages

The ACT supports the CGC staff position that States generally use whole of State agreements and therefore that public sector wages are more homogeneous between capital cities and the rest of the State than private sector wages.

While there is some theoretical validity to States setting wages based on capital city levels, no evidence has been presented in any of the literature examined that adequately supports this proposition. While a benchmark is required to measure against in the assessment, the fact that a whole of State approach to wage setting is used does not dictate that the benchmark must be capital city wages. In contrast, we contend that whole of State private sector wages are a better proxy than capital city private sector wages for the State public sector.

⁴ The CGC intends to use the CoE survey upon its release in October 2016 to replace the existing dataset used in this assessment, the Survey of Education and Training, which has been discontinued by the Australian Bureau of Statistics.

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INTRODUCTION

The Commonwealth Grants Commission (CGC) is undertaking a review of the wage costs assessment as part of the 2016 Update on GST Revenue Sharing Relativities. The CGC had previously deferred its review of the assessment in the *Report on GST Revenue Sharing Relativities 2015* Review (which recommends the 5 yearly methodology framework) until new data became available.

As part of this 2016 Update review, the CGC staff subsequently released a CGC Staff Discussion Paper CGC 2015-03S, *Wages Costs Assessment*. This paper has framed the discussion to be had on the review of this assessment. In addition CGC staff released Information Paper CGC 2015-04 *History of the Wage Costs Assessment* which provided the relevant background to the development of the current assessment.

The ACT has made every attempt to address all aspects of the assessment raised by the CGC staff in this submission. In doing so we have made a number of approaches to CGC staff during its development.

In general, the ACT considers that CGC staff have accurately captured the essence of each State's past arguments, certainly in the case of the ACT, in each of these documents.

In responding to this review, the ACT has segmented its approach, and our submission is structured accordingly. The initial discussion follows the CGC's usual approach when considering if differences between States should affect assessed fiscal capacities and thus the GST distribution in asking:

- is there a conceptual case supported by evidence that, putting aside policy differences, States face different costs in the delivery of services, and
- can a reliable assessment of those costs be developed from the available evidence, and if so what is the most appropriate methodology?

The ACT has addressed this consideration in the first half of this submission under the heading of the "Conceptual Case".

The second half of this submission focuses on the CGC staff proposal to base the assessment on private sector capital city wages. It also considers the specific or unique attributes of the ACT labour market which gives rise to special considerations.

CONCEPTUAL CASE

Relationship between private and public sector wages

The CGC currently observes that public sector employees in the same occupation⁵ in different States are paid different wages. The CGC is concerned about interstate differences in the cost of delivering State services. The focus of this assessment is on differences in the wage costs of State employees which are beyond the policy control of States.

The CGC staff paper considers that there is a continuing linkage between the wages paid by the State public sector and the wages of the larger community in which State Governments operate. They consider that if there are underlying location influences which put pressure on wages, then they will not be confined to the public sector but will also be evident in the wages of the general community. To this end, the CGC staff look for evidence of such influences on private sector wage levels, as measured by the wage received in each State by the average private sector employee.

This position does not imply or require any causal link between private and public sector wages. The fundamental point is that there is a relationship between the two and that they are responding to a common set of underlying drivers which differ between States in the size of their effect. Indeed, in the 2004 Review the CGC state that it is the differences in the nature and extent of non-tradeable services and ‘intangibles’⁶ such as transportation, education services, recreation and housing, that are the main drivers of differential location effects. In this context, it is neither private sector wages causing movement in public sector wages, nor vice versa, but rather that wage levels in the broader community are reacting to the same external influences.

There is substantial academic literature which supports the above view of wage determination. For example:

“The key to understanding potentially permanent regional wage differentials is to recognize that not all factors are mobile across regions. Workers and firms interact in regional labour markets, determining wages and prices. Although firms and their employees may respond quickly to changes in local market conditions, some factors that are unique to a region, such

⁵ Occupation refers to the role an employee performs, e.g. Construction and Mining Labourer, School Teacher. The CGC seek to compare the differences in the wage levels across jurisdictions between comparable employees by controlling differences in the workforce and personal attributes such as industry, occupation, qualifications, gender and marital status.

⁶ Non-tradeable services refers to services that cannot be traded between locations. For example the service provided by a local taxi provider, mechanic or hairdresser cannot be traded between locations without the person or business providing that services physically relocating. Non-tradeable ‘intangibles’ refers to such things as environmental assets, congestion and access to amenity.

as geographic and climatic characteristics, remain the same. Even for those areas that share common features, the quality and quantity of site-specific characteristics may differ. Therefore, firms and households may be willing to pay or accept different levels of compensation depending on the value they place on those attributes. These immobile, site-specific features are referred to here as amenities: consumptive amenities apply to households and productive amenities apply to firms.”

Eberts, R. W., and Schweitzer, M. E, *Regional Wage Convergence and Divergence: Adjusting Wages for Cost-of-Living Differences*, 1994

Similarly, So, Orazem and Otto⁷ apply a household utility maximising model to analyse residential and job location choices, under which households trade off housing and commuting costs for wages in deciding where to live. Other studies include less quantifiable aspects of amenity, such as climate and environmental aspects of different locations, as impacting on wage levels. We have listed some relevant references at the end of this submission. **The ACT’s view is that the conceptual case for the Wage Costs Assessment is clear and well established.**

Given that the conceptual case is established, attention must then turn to how best to measure the disability. **In our view, the use of private sector wages – or non-State government wages, as discussed below, offers the best available measure or benchmark for this purpose.** The only potentially viable alternative, which is canvassed later in this submission, is a spatial indicator or index which incorporates cost of living, commute time and other relevant locational amenities. However, reliable and comprehensive measures of this nature are not currently available.

We consider that the CGC staff should pursue data that would enable the assessment to be based on non-State government wages, that is the total of private sector and Commonwealth public sector wages as the benchmark, rather than on private sector wages alone. The CGC had previously used non-State government wages as the benchmark, but discarded this approach when the assessment moved to using the Survey of Education and Training dataset, which did not make the distinction between Commonwealth and State public employees.

The ACT considers that using non-State government wages as the benchmark would be more appropriate as it would more accurately reflect the influence of the Commonwealth public sector on wages in the ACT public sector, while not significantly changing the

⁷ So, K.S., Orazem, P.F. and Otto, D.M. *The Effects of Housing Prices, Wages and Commuting Time on Joint Residential and Job Location Choices*, American Agricultural Economics Association Annual Meeting, August 1998; Salt Lake City, Utah.

assessment for other States, where the Commonwealth public sector does not constitute a large component of employment. Such an approach would remove the need for a separate form of treatment or adjustment to reflect the peculiar circumstances of the ACT.

Factors influencing public sector wage determinations

The CGC seek indicators that are free of State policy choice and so they use the average private sector wages to determine the relative differences in wage costs across States.

States have differing views on the weight which should be placed on the observed relationship between public and private sector wages in deciding if there is a conceptual case which warrants an assessment. Arguments which have been used by States opposing the current basis of the assessment include:

- State public and private sector labour markets are inherently different from each other, and parity with the level of private sector wages has never formed an explicit part of the wage setting process in any State. Instead, it is argued that the primary focus when setting wages has been:
 - the wages paid to comparable employees in the other States,
 - cost of living increases within the State or region, and
 - State governments' budgetary constraints.
- State government wages are not impacted by regional influences, but rather States compete with one another in a national market for public sector employees.
- 'Material wage differentials do not exist in public sector occupations where States are the dominant employer and where local private sector employment opportunities are limited (teachers, nurses, police)'⁸.
 - CGC staff analysis indicates that there are significant differences across jurisdictions in the wages of these employees.
- Differences in State policy influence differences in private sector wages. For instance:
 - State governments can impact the amenity of areas, which may cause workers to accept higher or lower nominal wages.
 - Planning and land release policies may affect land prices.
 - State governments, through industry or environmental policy, may be able to impact the macroeconomic conditions in their State over the longer term.
 - States still have some role, although smaller than in the past, in wage setting and industrial relations in their State.

We address each of these major lines of argument below.

⁸ From South Australia's first submission to the 2015 Review (July 2013).

State public and private labour markets inherently different

The ACT considers that this point of criticism from some States appears to be based on a general misinterpretation of the reason for using private sector wages in the assessment. Private sector wages are used as a proxy for public sector wages to remove policy influence, and it is a relative differences between States that matter. The current assessment is not based on an assumption that States attempt to maintain parity with private sector wages. Rather, as CGC staff point out in para 10 of the Discussion Paper, there is a linkage between the wages paid by the State public sector and the wages of the larger community in which States operate. The distinction of there being a “linkage” is key here, as it does not imply that there is any causality either way. This is reflective of the research undertaken by CGC staff which informed the 1999 Review and is important as it indicates that, as the data suggests, public and private sector wages appear to respond to the same wage pressures over time.

This has an important context for the argument that as no State aims to maintain parity with the level of private sector wages, then private sector wages are not an appropriate proxy for public sector wages. Again the point is not that State governments attempt to keep their wages at the level of the private sector, it is that at some stage they will need to respond to the same influences that are driving wage levels in the larger community in that region and the observed difference in wage levels that results from this. As a result we can expect to see that relative differences in wages across jurisdictions will be similar for the public and private sectors.

National market for labour and wage convergence

We agree with the CGC staff position that there is no evidence to suggest a convergence of State public sector wages. Rather the data illustrates that there are persistent differences in nominal wage levels between jurisdictions. CGC data indicates that between 1994 and 2014 the ACT, NSW and the NT have all typically had above national average wage input costs, while Victoria, SA and Queensland have had below average costs.

These sustained differences support the view that there are location based factors that affect wage determination in the public sector. These may relate to differences in cost of living or structural factors within different jurisdictions that lead to a sustained difference in the wage levels of comparable employees across jurisdictions. The key issue is the extent to which labour markets function like a competitive market, so that there would be an equalisation of net benefits in different sectors or States. The net benefits view of labour markets takes account not just of wages, but of other benefits and costs such as cost of living, travel time and environmental amenity. Thus, real wages (broadly defined) will align fairly closely across States, to the extent that there is labour mobility between States. That

allows for nominal wages to diverge between States, due to factors which are not subject to significant influence by State governments.

We note that the only State that has transitioned between low wage and high wage categories is WA, clearly as a result of the mining boom in that State. WA public sector wages display a lagged effect against the private sector wage over this period, which seems to suggest that State Government policy constrained public sector wages for as long it could before eventually having to allow for the same upward wage pressures experienced in the private sector.

In our view this is further evidence that the private sector wage level is a suitable proxy for the public sector wage level, while allowing for our preference to enhance the private sector data by the inclusion of the Commonwealth public sector, if the required data can be obtained.

Dominant employer

The 'dominant employer' effect was a key issue which arose in the 1993 Review, that is whether private sector data on relative wage levels could be "contaminated" by State policy in those occupations where States were the dominant employer e.g. teachers and nurses; or where for a particular State the public sector was a large employer relative to the private sector⁹.

The CGC staff position on the existence of linkage (and not causation) between private and public sector wage levels also has important implications for the dominant employer argument put forward by South Australia. This linkage suggests that when setting public sector wages, governments will respond to similar wage pressures as the private sector. There are common underlying drivers of both public and private sector wage differences across States, such as cost of living and amenity, rather than a direct causal relationship by which private sector wages drive public sector wages, or vice versa. The proposition is that a potential employee will assess the differences in these location costs relative to the wage level being offered.

Moreover, while State governments may be dominant employers in some occupations within their own State, they compete to some degree with other State governments within particular occupations, and must have regard for wages in those occupations in other States, allowing for differences in living costs. Thus, real wages, broadly defined, equalise, with nominal wages diverging from the common benchmark to account for non-wage costs and benefits.

⁹ CGC Information Paper CGC 2015-04, *History of the Wage Costs Assessment*, July 2015

These arguments were reflected by the CGC in the 1999 Review. It said that, even in the professions of teaching, policing and nursing where State governments are the major employers, wage levels are still subject to broad market forces. It recognised that, given the Australian industrial framework and the general absence of institutional barriers to labour mobility, it would be difficult for State governments to set wages for any professions without reference to the prevailing labour costs¹⁰.

The analysis undertaken as part of the 2004 Review also failed to establish a case for the ‘dominant employer’ effect. The Review concluded that this is “consistent with the conceptual view that, in a competitive setting, there was no basis for presuming that wages for these occupations should behave differently from those for other occupations, over the longer term.”¹¹

We consider the above arguments are also consistent with the national labour market argument of some States, in recognising generally free inter-State movement of labour, but allowing for the persistence of other differences between States such as housing costs which will drive nominal wage differences.

State policy influence

While State policy may in theory have some effect on private sector wages, there would, we consider, have to be evidence of significant and persistent differences in relevant policy between States over time. No substantive evidence has been provided to that effect in our view. Given the increased openness of the Australian economy and the move to enterprise based wage setting over the last two decades, the influence of State government policy over private sector wage setting has diminished over that time.

In addressing arguments put forward by WA in the 2015 Review that there should be discounting of the mining revenue assessment for the effect of policy differences in the support given to mining development, the Commission concluded that it was not feasible to separate policy influences from other factors impacting on mining revenue capability. We contend similar argument applies to the wage costs of States. The impact of policy differences cannot be separated from that of other factors, nor is there any reason to believe that higher wage costs in some States result from policies designed, or likely to have the effect of, generating higher wage rates, persisting over time, for comparable jobs than those in other States.

¹⁰ CGC Information Paper CGC 2015-04, *History of the Wage Costs Assessment*, 2015

¹¹ Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2004 Review: Working Papers 1998-99 to 2012-13 Volume 7 – Expense Issues: Major Factors and Other Issues*, 2004, pg. 445

Alternatives to private sector wages as a proxy

Victoria has proposed that ‘The Commission ... investigate the use of a broad spatial cost of living indicator to provide a simple, transparent proxy measure for the underlying wage differentials between States.’¹²

While the ACT is open to the idea of a more direct measure of the wage cost disability, we are not aware of any cost of living indicator that could reliably measure the wage differentials between jurisdictions. The key issue to consider when determining an appropriate cost of living indicator is the extent to which labour markets function like a competitive market, so that “there would be an equalisation of net benefits in different sectors or States”¹³. The net benefits view of labour markets takes account not just of wages, but of other benefits and costs such as cost of living, travel time and environmental amenity. Thus, “real” wages, broadly defined, equalise, with nominal wages diverging from the common benchmark to account for non-wage costs and benefits.

Cost of living is not the only driver of location costs, which could also include such measures as congestion and travel time to work. In theory, a composite index of such factors could be developed as an alternative to using private sector wage levels as a benchmark. We agree that an assessment focused on only one of the drivers of location costs (cost of living) is unlikely to deliver a more robust outcome - and in any case there is not currently a reliable spatial cost of living measure for Australia. **Therefore, the ACT considers that private sector wages is the best available measure of the wage cost disability, all be it one expanded to using non-State government wages.**

Productivity differences

South Australia and Queensland have argued that differences in State productivity may account for all of the differences in wages observed in both the public and private sectors across States. They argue that it is not sufficient to observe wage differences if it is not established that the differences are between genuinely comparable employees.

CGC staff consider that while there could be productivity differences between the public sectors of different States, it is less clear what impact those differences should have on the equalisation process. The staff view is that:

- To the extent those productivity differences are likely to be influenced by State policy choice on how they organise the delivery of services, they should not be recognised in the equalisation process, as is the Commission’s usual approach.

¹² From Victoria’s first submission to the 2015 Review (July 2013).

¹³ Cobb-Clark, D. and Junankar, P. N. *Input Costs and Fiscal Equalisation: Report to the ACT Government*, 1996, pg. 23

- To the extent productivity differences are due to other influences outside State control, they should be recognised and, in the case of administrative scale and service delivery scale differences between States, they are.

The issue of productivity differences has featured heavily in criticisms from some States of the current approach taken by the CGC. In the 1993 Review, a key conceptual issue was:

Whether observed differences in nominal community wages reflected productivity differences, and if so whether those differences applied equally to public sector employees¹⁴.

In research work carried out as part of the 1999 Review the CGC found that average wage levels in each State were strongly correlated with a State's average productivity, measured by average gross State product at factor cost per employee in selected industries. This study focused on industries dominated by the private sector and by its nature could not control for the influence on wages of factors other than productivity. Although the study indicated that industry-level productivity differences are a key factor driving wage differentials, it did not control for differences in industry composition between States. Results from the regression model used by the CGC, in our view, support the proposition that industry is a significant variable affecting wage levels, but this is controlled for in the model so as to remove its impact before assessing location-related differences.

CGC staff have raised the question of whether differences in private sector productivity which are reflected in the estimate of wage differentials for comparable private sector employees among States should be incorporated into the assessment of public sector wage costs. We contend there is a case to say that private sector productivity is not subject to any significant policy influence from State governments, and is an important driver of community wage levels which arguably should be accounted for in the assessment of public sector wage costs. However, it is not clear to what extent such differences between States reflect differences in industry composition or other structural factors, rather than differences in the productivity of workers in comparable roles. The ACT's view is that it is preferable to apply the current approach of the CGC in controlling for all other factors likely to impact on wage levels, thus enabling the influence of locational factors to be clearly identified.

Some States, in particular SA, have argued that:

Differences in productivity between the workers in a State account for most or all of the observed differences in wages; effectively, all Australian workers are being paid commensurate with their individual productivity¹⁵.

¹⁴ CGC Information Paper CGC 2015-04, *History of the Wage Costs Assessment*, July 2015; p.4.

We consider the evidence cannot support a claim that wage differences between States are accounted for solely by differences in productivity. While the research work undertaken as part of the 1999 Review did suggest there was strong correlation between State productivity and average wage levels, it also notes that the analysis experienced “major data limitations” and that “caution is needed in drawing any implications”¹⁶. Even so, the analysis found a correlation of 0.8 between States’ wages and productivity which would appear to still allow scope for locational factors, such as cost of living differences, to play a role also. This would be entirely consistent with the current assessment approach.

While industry-based productivity differences may play a significant role in private sector wage differentials, no assertion has been made about productivity in relation to public sector wage differentials. No argument has been developed, for example, that such differences can be ascribed to policy choice of State governments, or why there are consistent differences in average public sector wage levels across States which persist over time. It could perhaps be argued that State governments have consistently pursued different policies (e.g. in relation to capital investment in new technology; staff training and development) which have driven underlying productivity differences. However, such arguments have not even been stated, let alone supported by evidence. Nor, in our view, has any clear distinction been made between public and private sector productivity at State level – no evidence has been presented that differences in private sector productivity are subject to significant influence by State governments, nor that substantially different policies of this nature have been pursued by States over time.

At the level of the individual worker, there is no logical argument in our view to support the view that there are differences in productivity across States which are consistent and persist over time. The literature indicates that productivity is largely determined by the job rather than individual characteristics – that is, structural factors are most relevant¹⁷. In addition, the regression model now used by the CGC controls for differences between States in variables such as educational level, duration of employment and work experience, which are factors likely to influence productivity differences between individual workers.

¹⁵ CGC Information Paper CGC 2015-04, *History of the Wage Costs Assessment*, July 2015; p.9.

¹⁶ Commonwealth Grants Commission, *Reports on Research in Progress, Volume I*, 1995, pg 21.

¹⁷ Thurow. L. *Generating Inequality*, 1975; quoted in Cobb-Clark & Junankar op cit p.25.

Technical aspects

Omitted variable bias

Queensland has previously proposed that there are variables contained within the Survey of Education and Training (SET) dataset, such as self-reported health, that should be used in the regression. The ACT does not support the inclusion of this variable as there is no evidence that this would impact on the salary received by an employee.

As highlighted above, at the aggregate level it is more the characteristics of the job itself than the characteristics of the worker that drive productivity. In addition, the wage a worker receives does not solely reflect output or productivity, but a range of other factors.

The ACT considers that there is no evidence that any reliable factor that drives wages has been omitted from the regression.

Simplification

CGC staff now consider that any simplification is not warranted. If variables suggested by States that represent an employee characteristic that could reasonably impact on wages are found to be significant, staff are inclined to include them in the model, provided the information is available in the CoE data.

The ACT supports the CGC staff position.

Proportion of wage expenses in each category

CGC staff consider it unnecessary to update the proportion of wages expenses in each assessment category, as these proportions have been relatively stable over time.

The ACT is seeking CGC staff to clarify this position and to provide an explanation for their reasoning.

Discounting

In the 2015 Review the ACT presented its position on the general principle of discounting. We stated that discounting should be used to address concerns over reliability of data, not to deal with conceptually unsatisfactory approaches to assessment, or to meet objectives other than equalisation.

We agree with the current CGC approach, where if the CGC determines that data are not sufficiently reliable, but is confident that the data signals the direction but not the size of the effect, then a discount is applied. The discount is applied in a manner that reflects

either the lower confidence in the outcome of an assessment or the greater uncertainty attached to the information underlying the assessment.

CGC staff note the CoE will have a substantially larger sample size than the SET and will be conducted annually. These two improvements will increase the model's accuracy and reduce volatility.

The ACT considers that, if the new CoE dataset produces a more reliable and accurate outcome than the data previously used, CGC staff should consider the removal of the discount currently applied to this assessment.

KEY ISSUES FOR THE ACT

Commonwealth sector influence on the ACT

The impact the Commonwealth has on wages paid by the ACT Government is critical and should be reflected in the assessment. CGC staff have acknowledged that if the upcoming, or future, CoE survey shows the ACT's public sector wages (primarily Commonwealth public servants) relative to other States were significantly higher than its private sector wages relative to other States, there would be an argument that wage costs facing the ACT government are higher than those reflected by private sector wages alone.

Notwithstanding, we consider that a more robust measure of this influence may be available, in the form of non-State government wages.

As stated above, the CGC did use non-State government wages prior to the adoption of the SET dataset. Following this the CGC considered that private sector wages understated the influence that Commonwealth Government wages had on the wages paid by the ACTPS. As part of the 2004 Review the CGC made some judgement-based adjustments to the model, including an upward adjustment for the ACT to reflect the impact of Commonwealth government wage levels. This adjustment was discontinued in the 2011 Update following the release of the 2009 SET survey as the data showed that the private sector had relative wage levels that were broadly consistent with those in the public sector.

The ACT's economy is strong as illustrated by its gross state product per capita of more than \$92,000 between 2012 and 2014, far greater than the national average of around \$66,000 over the same period¹⁸. The ACT is a single-city territory, bounded entirely within the State of NSW. As the national capital and the seat of parliament, Canberra is the eighth most populous city in Australia, representing 1.6% of the national population, while being responsible for 2% of GDP.

¹⁸ ABS, 5220.0 *Australian National Accounts: State Accounts, Table 1. Gross State Product, Chain volume measures and current prices.*

As the home of the Commonwealth Government, the economy is concentrated around the provision of public administration, which accounts for around 30% of economic output. The ACT's reliance on public administration offers both benefits and disadvantages. The Territory's strong economic growth over the past decade has surely been aided by a high level of public employees resulting in a wealthy and well-educated population, with a typically high degree of job security. However, the nature of the ACT economy means that the Territory is disproportionately impacted by fiscal consolidations on the part of the Commonwealth Government policy. In essence, the ACT's economic performance is directly impacted on by the policies of the Commonwealth government more so than any other jurisdiction.

It is within this setting that the labour market in the ACT takes its unique structure. The ACT has a relatively small proportion of workers employed in the private sector compared with other States. On the other hand, it has a much larger proportion employed by the Commonwealth Government¹⁹; the Canberra-based APS workforce is around three times the size of the entire ACTPS workforce²⁰.

While the ACT considers there is a compelling conceptual case as to the influence of the Commonwealth government on wages paid by the ACTPS, data availability is constrained. The ACT has made every attempt to analyse the data available through the ABS on Commonwealth and State public wages including the Average Weekly Earnings²¹ and the Employment and Earnings, Public Sector²² series. The ACT also attempted to make use of data available through the Australian Public Sector Commission (APSC) and the Community and Public Service Union.

The data that is available typically either does not make a distinction between Commonwealth and State employees or does not control for other factors such as the industry, the job type or the level of experience. For example, while the Average Weekly Earnings series makes a distinction between the private and public sector and offers data on industry and State, it does not make the distinction between Commonwealth and State public employees.

The ABS Employment and Earnings, Public Sector dataset does make the distinction between Commonwealth, State and Local government employees. In 2013-14, the average

¹⁹ Cobb-Clark. D. and Junankar. P. N. *Input Costs and Fiscal Equalisation: Report to the ACT Government*, 1996

²⁰ O'Shea. T. *ACT Public Service Classification Review Element 2: Report Market Basis for salary levels for the ACT Public Service*, 2012, Black Circle Pty Ltd

²¹ ABS, 6302.0 - *Average Weekly Earnings, Australia*

²² ABS, 6248.0.55.002 - *Employment and Earnings, Public Sector, Australia, 2013-14*

weekly earnings of a Commonwealth employee in the ACT were \$1,813, considerably higher than the national average of \$1,602. This however does not control for the fact that Canberra is home to the central offices of most Commonwealth agencies and so a larger proportion of Commonwealth employees in the ACT are management executives compared with other States.

The significance of the Commonwealth is illustrated in the findings of the ACTPS Classification Review in 2011 which found that for a number of specific occupations, particularly within the professional, managerial and administrative, operations of Government, the most significant employer in Canberra is the public sector. These 'white collar' occupations included economists, auditors, accountants, finance officers, business officers, corporate services officers, statisticians, procurement and contracts officers, policy development officers, generalist managers, program and project managers, librarians and archivists, business analysts, systems analysts, programmers, database and network engineers and administrators, web designers, journalists, editors, public relations officers, customer service officers, pay clerks and human resource specialists.

The APS is a significant competitor for labour in several segments of the "white collar" workforce within the public sector in the ACT, with the APS comprising more than 100 separate agencies, most of which are represented in Canberra. Between 1996 and 2007, wage fixing in the APS developed under a decentralised model resulting in a marked dispersion in salary rates and employment conditions. As a result, the APS can be seen not as a single competitor, but as several competitors in the same market. Competition for skilled labour is as strong between the APS agencies as it is between the ACTPS and the APS in general.

The significance of this competition within the public sector in Canberra is further supported by a paper commissioned by the ACT in 1996 on the wage costs assessment (see [Attachment A](#)) which claimed that "the skills required by the ACT and Commonwealth Governments are much the same and there is a great deal of mobility between the two governments. This suggests that the ACT Government is more likely to be in competition with the Commonwealth Government than the private sector when hiring workers"²³.

The ACT is in the process of identifying data on the proportion of ACTPS employees moving to the APS. The ACTPS Classification Review (2011) (see [Attachment B](#)) pointed to the Canberra-based APS being highly active in the local labour market and found that the most significant APS recruitment activity takes place in the same range of classifications where

²³Cobb-Clark. D. and Junankar. P. N. *Input Costs and Fiscal Equalisation: Report to the ACT Government*, 1996, pg. 17

ACTPS experiences most staff turnovers²⁴. The ACT has also attempted to use the data on engagements in the APS from the Australian Public Service Employment Database (APSED). The data available suggest that 54.8% of APS engagements in 2013-14 were from the ACT.

As a result of the unique structure of the ACT labour market **the ACT considers that non-State government wages are a more appropriate proxy for public sector wages than private sector wages alone**. Given both its size and the comparability of its occupation/industry profile with that of the ACTPS, the inclusion of Commonwealth public sector wages in the non-State government wage is better able to reflect the location effects in the ACT that impact on the wages paid by the ACTPS. Non-State government wages as a benchmark also has the benefit that Commonwealth public sector wage setting is not subject to any significant control or influence from State governments and reflecting the general wage levels with which State governments compete²⁵. Thus, Commonwealth public sector wages are a policy neutral indicator. The adoption of a non-State government wages proxy would enable all States to be treated symmetrically without the need for judgements to be made about adjustments for particular jurisdictions.

Past analysis has shown that the use of non-State government wage levels rather than private sector wage levels is likely to have a minimal impact on other jurisdictions compared with the current assessment, while producing a significantly different result for the ACT²⁶. This would suggest the non-State Government approach offers the benefit of a robust assessment that treats all States in the same fashion, while providing clear recognition of the impact that Commonwealth Government wages have on the labour market within the ACT.

In framing the question to the ACT on presenting this case, CGC staff did pose that “the ACT would need to explain why Commonwealth wages would not exert an influence on the wider community wages but would affect the public sector”²⁷. However it is important to note that the ACT is not claiming that the Commonwealth public sector does not influence broader community wage levels. Rather we contend that non-State government sector wages are a better measure of community wage levels in the ACT than private sector wages alone, and thus a more appropriate proxy in the assessment. Indeed, the CGC agreed with

²⁴ O’Shea. T. *ACT Public Service Classification Review Element 2: Report Market Basis for salary levels for the ACT Public Service*, 2012, Black Circle Pty Ltd

²⁵ Commonwealth Grants Commission, *Report on General Revenue Grants Relativities 1999, Volume II Methods, Assessments and Analysis*, 1999

²⁶ Table 3 and 4, Cobb-Clark. D. and Junankar. P. N. *Input Costs and Fiscal Equalisation: Report to the ACT Government*, 1996

²⁷ CGC Discussion Paper CGC 2015-03S, *Wage Costs Assessment*, July 2015; Attachment A, para 83, p.21.

this view in the 1999 Review where the use of non-state government sector wage proxy was upheld. However, unlike NSW and WA, the ACT is not claiming that differences in labour market structure should not be standardised for.

Whilst we are aware that the CoE dataset will not contain splits between Commonwealth and State public sector wages, **the ACT considers that the CGC staff should investigate ways in which the assessment could be returned to the use of non-State government average wages.** The ACT understands that there may be a data marker against individual survey participants that would indicate the organisation an employee works for and could be used to identify Commonwealth and State public employees. The ACT considers the CGC staff are in the best position to pursue provision of the relevant data by the ABS.

The ACT has also approached the CGC staff for assistance in gaining full access to the APSED. The APSC commissioned Mercer to undertake the comprehensive *2010 Australian Public Service Remuneration Survey*, in which the Commonwealth government mandated that all agencies participate in the survey for that year. The APSC has continued to conduct this survey annually since and the census provides participating APS agencies with agency-specific and APS-wide data that informs their remuneration practices. In particular the Report on the survey includes data on geographic and locality allowances by classification. This may imply that there is data available within the survey on the location of Commonwealth employees that could be used to either analyse the impact these employees have on ACTPS wages, or to reliably split the Commonwealth and State public employees within the CoE dataset.

Capital City versus Whole of State Wages

CGC staff have suggested that State governments generally negotiate and set wages on a State-wide basis, so regardless of where a State public sector employee resides within a jurisdiction, they generally earn the same salary (location loadings notwithstanding). The CGC staff have argued that if private sector wages vary within a State, but public sector wages do not, it is worth considering whether the private sector wage level for the entire State or for some subset of the State best reflects the pressure on public sector wage levels.

CGC staff contend that States set their wages at a level which allows them to recruit and retain staff in most locations i.e. at a level competitive with capital city private sector wages. The assertion is that setting wages at a level lower than the capital city level is likely to mean a State will face difficulty recruiting staff in the capital, although it may still be easy to attract staff in lower wage areas.

Centrelink has been given as an example, as it is said to set its wage rates at levels that enable it to recruit staff in most areas. In some areas, Centrelink could fill all available positions at a lower wage, but it chooses to have a national wage rate. In some regions, it is easier to fill positions than in other regions. This has some impact on where it locates

services. Centrelink may choose to relocate one of its national call centres to a lower cost location. This relocation may not lower its wages bill, but would make it easier to fill positions. In order to recruit and retain staff in most areas Centrelink presumably sets a wage at, or close to, that of the highest wage region. By doing so, Centrelink has competitive or attractive wages in most areas. CGC staff have assumed States follow a similar process to determine and maintain State-wide wages.

The ACT does not support the proposal to use capital city private sector wages as the basis for assessment of interstate wage differentials.

The ACT considers that the evidence the CGC staff have used to support the conceptual case for this proposal is anecdotal, and does not provide reliable evidence of 'what States do'. The example provided by CGC staff relates to a Commonwealth agency and does not make any link to the policy of State Governments. An anecdotal presentation of the recruitment strategy of Centrelink does not constitute evidence of the factors which are considered as part of the wage setting strategies pursued by State governments for their own public sector functions.

Moreover, the statistical evidence provided by CGC staff does not offer strong support for the use of capital city rather than whole of State private sector wage levels as the benchmark for the assessment. The ACT has undertaken analysis on the correlation between the private and public sectors using the whole of State SET data compared to the capital cities only data from SET. This analysis shows that there is a stronger correlation between the rescaled factors in the whole of State regression than there is for the capital city regression. The results can be seen in Table 1 below. The private-public correlation for whole of State is 0.3968 compared to 0.1896 for the capital cities. This indicates that private whole of State wages are a better proxy for public whole of State wages than are private capital city wages. While it should be acknowledged that the sampling errors in the data create a degree of uncertainty in interpreting the results of this analysis, it clearly suggests that private sector whole of State wages are likely to be a better proxy for public whole of State wages than private sector capital wages.

Table 1: Public-Private Correlation Comparison between the Whole of State and Capital City Models Rescaled Factors

Whole of State	Private	Public	Capital City	Private	Public
	Rescaled Factor	Rescaled Factor		Rescaled Factor	Rescaled Factor
NSW	1.013914	1.064806	Syd	1.036987	1.071471
Vic	0.978992	0.950006	Mel	1.002643	0.963717
Qld	0.978483	0.987195	Bris	0.97608	1.009942
WA	1.056	0.962831	Per	1.040332	0.952603
SA	0.983309	0.955809	Adl	0.982514	0.96209
Tas	0.953761	0.995294	Hob	0.967925	0.993514
ACT	1.05311	1.057791			
NT	1.071884	1.016152			

Private-Public correlation:

0.396768

Private-Public correlation:

0.189561

Source: CGC regression estimate output.

The greater variability created by the change to the capital city model is highlighted by the the broader 95% confidence intervals for capital city versus whole of State for relative private sector wages as illustrated in figure A-5 of the Staff Discussion Paper. The ACT and the NT could be expected not to display a broadening of their confidence intervals due to there being no change in their respective samples. However all other jurisdictions appear to display at least some increase in the span of their confidence intervals, as displayed in the figure. In the case of Tasmania, the change is highly significant, with the model indicating 95% confidence that Tasmania’s location effect using the capital city approach is between around 1.03 and -0.88. Victoria also moves into uncertain territory, and while the confidence intervals for the ACT and NT haven’t broadened, their estimates have shifted so that it is now less clear whether the data indicates that these jurisdictions should be above or below average on this assessment.

Although the capital city-rest of state approach appears to be a better predictor of private sector wages than the whole of state approach i.e. there is a significant difference between capital city and regional private sector wages, that does not mean that it is a better proxy for public sector wages. As pointed out in the Staff Discussion Paper²⁸, the differences between capital city and rest of State are not as large in the public sector as in the private sector. **The ACT supports the view that States generally use whole of State agreements and therefore that public sector wages are more homogeneous between capital cities and the rest of the State than private sector wages.**

²⁸ CGC Discussion Paper CGC 2015-03S, *Wage Costs Assessment*, July 2015; Attachment A, para 9, p.28.

However, **we also contend that whole of State private sector wages are a better proxy than capital city private sector wages for State public sector wages.** No evidence has been provided that suggests State governments actually use private capital city wages as a benchmark in public sector wage setting. While accepting that States do, in general, use whole of State agreements when determining wages, this does not in itself establish the fact that States set these wages based on the wage levels in the capital city.

On the contrary the ACT considers that States will attempt to set wages in accordance with a fair market value, i.e. a wage that a comparable organisation would pay a comparable employee, regardless of where the employee is located within the State. Enterprise agreements are influenced by a number of factors including general economic conditions, cost of living, capacity to pay, measures to improve workplace productivity, the overall value of the benefits package and the enterprise's desire to be competitive in relevant labour markets²⁹. In setting wages, the fair market value is considered against wages both within the private sector of that jurisdiction and within the private and public sectors in other jurisdictions. There is no evidence to suggest that capital city rather than whole of State wage levels in the private sector are a more appropriate measure of the influences that State governments consider when setting wages.

Within this context, we have observed a weaker correlation between public and private sector wages when the SET is limited to capital city only. Further to this, limiting the sample to capital cities reduces the accuracy of the model (as shown by broadened confidence intervals for the private sector capital city measure). On this basis, there is no justification for the CGC to alter the current basis of the assessment which uses whole of State private sector wages as the proxy for public sector wages.

Federal Financial Relations

Treasury

CMTEDD

²⁹ O'Shea. T. *ACT Public Service Classification Review Element 2: Report Market Basis for salary levels for the ACT Public Service*, 2012, Black Circle Pty Ltd

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ATTACHMENTS

Attachment A: Cobb-Clark. D. and Junankar. P. N. *Input Costs and Fiscal Equalisation: Report to the ACT Government*, January 1996.

Attachment B: O'Shea. T. *ACT Public Service Classification Review Element 2: Report Market Basis for salary levels for the ACT Public Service*, 2012, Black Circle Pty Ltd