COMMONWEALTH GRANTS COMMISSION (CGC) 2016 UPDATE

WAGE COSTS ASSESSMENT

STAFF DISCUSSION PAPER CGC 2015-03S

NSW TREASURY COMMENTS

OCTOBER 2015

Summary

NSW Treasury considers there is considerable evidence of wage differentials between jurisdictions and a substantial conceptual case that these differentials can be attributable to factors beyond the control of States:

- wage differentials that exist in the private sector are not attributable to State government policies;
- though the strength of the relationship may vary in certain periods, over time State governments cannot divorce themselves from the realities of the wider labour market in which they operate.

Queensland's argument that 'New South Wales does not have any non-policy reason to pay high wages, and does so only because of the grants received as a result of this assessment' is wrong because NSW public sector wages do not influence the CGC's assessment in any way: the interstate wage assessment is totally independent of State public sector wage policy since it uses ABS data for private sector wages.

NSW Treasury notes the CGC argument that, for its assessment purposes, comparability should not be so encompassing as to mean that a 'comparable' employee, by definition, should have the same productivity in each State. The NSW Treasury argument that not all variables need to be standardised for simply extends this argument to other possible causes of interstate wage differentials. Just as some differences in productivity between States, due to factors beyond a State's control, may affect broader community wage levels, so some differences in occupational or industry structure, due to factors beyond a State's control, may exert upward pressure on community wage levels and therefore on public sector wages.

The CGC notes that discounting is inappropriate in dealing with the uncertainty of the impact of State policy choice in the wage costs assessment: since there is no reason to believe that policy and non-policy influences would work in the same direction for all States, discounting is unlikely to achieve a result closer to HFE. NSW Treasury considers the same argument can be applied to the use of discounting for possible unreliability of data: since there is no reason to believe that data issues will work in the same direction for all States, we do not know whether discounting achieves a result closer to HFE.

The CGC notes that ultimately the Commission will need to decide whether it considers that policy or non-policy reasons are more significant in influencing relative State wage levels and if it considered that policy reasons predominate, it should discontinue the assessment. NSW Treasury considers that such a decision should be made only in the context of a Review of methods rather than an Update, since it would entail much more than a re-examination of the wage costs data. The CGC paper has been provided in the context of the 2016 Update.

NSW Treasury notes the issue of whether the private sector wage level for the entire State or for some sub-set of the State best reflects the pressure on public sector wage levels was raised during the 2015 Review. New South Wales provided its views on this issue in its Second Submission to the

CGC 2015 Methodology Review, noting that if common State policy seems to be to set wages for the whole State based on capital city wage pressures, New South Wales considers private sector capital city wage differentials should be used as the proxy for public sector wage differentials between States. NSW Treasury views remain the same.

Introduction

This submission responds to the Commonwealth Grants Commission's request for State comments on CGC Staff Discussion Paper 2015-03S, Wage Costs Assessment. The Commission has indicated that it is particularly interested in:

- whether the Commission has accurately captured the essence of each State's arguments
- whether the CGC's assessment of State arguments adequately addresses them and
- any new arguments States wish to present.

After a brief summation of NSW Treasury's general views, this submission will follow the above structure.

General views

The wage costs assessment reflects non-policy interstate differences in public sector wage costs which impact on the cost of delivering State services.

The Commission notes its usual approach when considering whether differences between States should affect the GST distribution is to ask:

- 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 the differences in costs be developed from the available evidence, and if so what is the most appropriate way to make the assessment?

NSW Treasury considers there is considerable evidence of wage differentials between jurisdictions.

- ABS Survey of Education and Training and Average Weekly Earnings data show the existence of wage differentials between States in both the public and private sectors over two decades (Figures 2, 3 and 4 of the Staff Discussion Paper).
- Comparable public sector employees in the same occupation in different States are paid different wages (Tables 1, 2 and 3 of the Staff Discussion Paper).

NSW Treasury considers there is a substantial conceptual case that these differentials are attributable to factors beyond the control of States.

As the Commission notes, various strands of economic theory – equalising real wages but differing nominal wages to take account of differing costs or 'amenity' of living, differing macroeconomic conditions, labour force immobility – suggest plausible reasons for the existence of wage differentials between different regions in Australia unrelated to State government policies.

NSW Treasury agrees the conceptual case that such differentials are influenced by factors other than State government policy is strengthened by:

- Wage differentials that exist in the private sector are not attributable to State government policies. In all jurisdictions other than the Australian Capital Territory, private sector employment accounts for the majority of total employment, ranging from around 85 per cent in New South Wales, Queensland, Victoria and Western Australia, to around 80 per cent in South Australia and Tasmania and around 75 per cent in the Northern Territory. State government policy influence on private sector wage setting is limited.

- Though the strength of the relationship may vary in certain periods, over time State governments cannot divorce themselves from the realities of the wider labour market in which they operate. The ability of State governments to attract labour is undermined if the wages and conditions offered to public sector employees remain below general labour market and community standards for a significant period. Commission analysis of the SET data shows that high relative public sector wages have generally been observed in States with high relative private sector wages (Figure 1 of the Staff Discussion Paper).

State arguments

NSW Treasury has two comments on the CGC's treatment of State arguments. The first relates to the CGC's response to an argument put forward by Queensland. The second relates to a comment by the CGC relating to an argument put forward by NSW that not all variables need to be standardised since some differences in labour market structure may simply represent unavoidable wage differences between States.

Queensland comment on NSW policy

In commenting (paragraph 45) on Queensland's argument that 'New South Wales does not have any non-policy reason to pay high wages, and does so only because of the grants received as a result of this assessment', the CGC notes:

- any assessment for higher wages only provides untied funds to a State; it need not allocate that to higher wages

- it appears inconsistent with NSW recording higher wages prior to the assessment being in operation.

The CGC seems to have interpreted the Queensland argument as 'NSW pays higher wages because it is funded to pay higher wages through the GST distribution.' The alternative way to interpret the Queensland argument is that 'NSW pays higher than average wages so that the CGC will assess that NSW needs to pay higher wages.'

Viewed in this way, the main reason why Queensland's argument is wrong is apparent. NSW payment of public sector wages does not influence the CGC's assessment in any way. The interstate wage assessment is totally independent of State public sector wage policy since it uses ABS data for private sector wages.

Furthermore, given the discounting and time lags in the CGC process, NSW is not fully compensated and therefore continues to suffer a financial penalty.

NSW argument on need for standardisation

The CGC notes (paragraphs 60-61) that it considers it appropriate that same-industry interstate differences in productivity are captured (i.e. not excluded) in the indicator of private sector interstate wage differentials because it is a 'regional impact'. If some States have higher productivity and therefore higher wages in the same industry, this is a non-policy reason for differing wage levels and should be included in the measures.

The CGC (paragraph 62) accepts that, for its assessment purposes, comparability should not be so encompassing as to mean that a 'comparable' employee, by definition, should have the same productivity in each State. Productivity may vary between States for non-State policy related reasons, and that variation produces a region specific variation in wages that should be reflected in the indicator of interstate wage variation.

This has implications for the argument that New South Wales and Western Australia have made (paragraph 70) that 'not all variables need to be standardised for, arguing that differences in labour market structure may simply represent unavoidable wage differences between States, and hence unavoidable costs.'

The CGC notes (paragraph 71) that 'staff accept that differences in industry structure between regions are likely to impact the community wage level … to the extent that they do, this will be reflected across many industries and occupations and hence captured by our current approach.'

Earlier in the paper (paragraph 49) the CGC notes that 'to estimate the wage of the 'average' or 'comparable' worker, we must remove the influence of differences in worker characteristics. As an example: doctors receive higher wages than cleaners. If one State had many more doctors than cleaners, not considering this difference would lead us to estimate a higher average wage where more doctors are located. This higher wage would not be due to location, but due to the difference in occupation structure.'

NSW Treasury is suggesting that just as some differences in productivity between States may affect broader community wage levels and be due to factors beyond a States' control, so some differences in occupational or industry structure may exert upward pressure on community wage levels and be due to factors beyond a State's control.

Industry structure can be influenced by non-State policy factors, e.g. natural resource endowment, climate and national government policies. Industry structure also could, to some extent, simply be a 'regional impact' that should be reflected in (i.e. not removed from) the indicator of regional wage variation.

NSW Treasury is reassured if differences in industry structure between regions likely to impact the community wage level are captured by the CGC's current approach. We may be misunderstanding the CGC's current approach. However, if that approach removes the influence of differences in worker characteristics, it is not clear to us how those influences are still reflected in the measured wage level.

Further NSW Treasury comments

The remainder of the submission provides NSW Treasury comments on further issues raised in the Commission's Staff Discussion Paper. These issues relate to discounting; changes to assessments in an Update; and using capital city rather than whole of State wages in the interstate wages assessment.

Discounting

The CGC notes (paragraph 73) that there 'is no reason to believe that policy and non-policy influences would work in the same direction for all States. Therefore, discounting is unlikely to achieve a result closer to HFE.'

This comment is made in the context of some States arguing that State policy can affect private sector wages, and presumably that the assessment should be discounted for that reason.

However, it raises the issue of whether discounting should ever be used, since we never know whether discounting, used for any reason, takes us closer to or further away from HFE.

The wage costs assessment is discounted by 12.5% to reflect a low level of uncertainty around whether the SET data are sufficiently reliable, whether the econometric model controls for all relevant factors that could influence wages and whether private sector wages are a good proxy for the pressures on public sector wages.

We have no reason to believe that the uncertainties used to justify the discount would work in the same direction for all States. The possible unreliability of the SET data, the possible non-inclusion of all relevant factors that influence wage levels in the econometric model's calculation of comparative wage levels, the possibility that private sector wages are an inadequate proxy for public sector wage pressures, would affect different States in different directions.

Changes to assessments in an Update

The CGC notes (also in paragraph 73) that the 'Commission will need to decide whether it considers the policy or non-policy reasons to be more significant. Staff would recommend that, if the Commission concluded that differences in private sector wages are primarily driven by non-policy differences it should retain the assessment. If it considered that policy reasons predominate, it should discontinue the assessment.'

The CGC paper has been provided in the context of the 2016 Update. NSW Treasury considers that a decision along the lines foreshadowed above should be made only in the context of a Review of methods rather than an Update.

The Commission noted in the 2015 Review that:

> The Commission has update guidelines, agreed with States, which give us the flexibility to make changes in methods, following consultation, in relation to major changes in federal financial relations and major budget developments and to apply new or better data. This ensures the relativities remain as contemporaneous as possible but are not changed unnecessarily. Re-examination of the wage costs data would be permitted by these guidelines.

NSW Treasury notes the Commission's view that re-examination of the wage costs data would be permitted by the update guidelines. We consider that the Commission changing its view on whether differences in private sector wages are primarily driven by non-policy or State policy differences would entail much more than a re-examination of the wage costs data.

In addition, if the Commission concludes that State policy predominates in explaining differences in private sector wages (and by implication public sector wages), it would need to look closely at many other assessments currently made by the Commission to decide whether State differences are primarily driven by policy or non-policy factors and whether an assessment should be continued. State policies are likely to play some role in many of the differences between States that are currently assessed that are based on internalised data.

Wage relativity floor

In paragraph 80, the CGC notes that: 'In past reviews … the Commission has considered there may be a floor to wage relativities, below which relative public sector wages cannot reasonably fall….State views on the merits of this argument would also be appreciated.'

In the 2010 Review, the CGC applied a 25 per cent discount to Tasmania's modelled wage outcome. It considered data from the 1997, 2001 and 2005 Surveys of Education and Training (SET) 'indicates there are constraints on the variation of public sector wages, and that there are likely to be bounds within which public sector wages lie.'[1] The Commission suggested relative public sector wages in Tasmania could not fall as low as the SET data suggested Tasmania's relative private sector wages had fallen.

1 CGC, 2010 Review, Volume 2, p. 505.

In the 2011 Update, after the release of the 2009 SET, the CGC removed this adjustment. The 2009 SET showed relative public sector wages paid in Victoria and South Australia were comparable with Tasmania's relative private sector wages, suggesting the assumption that there were bounds on the variation of public sector wages from the average was not sustainable.[2]

In the 2015 Review, NSW Treasury agreed with the staff recommendation to continue to not adjust Tasmania's modelled results. We noted also that the CGC applies a general 12.5 per cent discount to the interstate wages assessment to acknowledge uncertainties in the wages assessment and therefore saw no need for a further discount for Tasmania.

NSW Treasury has no reason to change that view at this time.

Capital city versus whole of State wages

The CGC notes (paragraph 84) that if private sector wages vary within a State, but public sector wages do not, because State governments generally negotiate and set wages on a State-wide basis, it is worth considering whether the private sector wage level for the entire State or for some sub-set of the State best reflects the pressure on public sector wage levels.

This issue was raised during the 2015 Review. NSW Treasury notes New South Wales provided its views on this issue in its Second Submission to the CGC 2015 Methodology Review (January 2014, pp. 155-157). NSW Treasury views remain the same. For ease of reference, those views are summarised here:

> Given common State policy seems to be to set wages for the whole State based on capital city wage pressures, New South Wales considers private sector capital city wage differentials should be used as the proxy for public sector wage differentials between States.
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> In New South Wales, wage negotiations for Sydney-based employees exert a strong influence on public sector wages across the State. New South Wales public sector wage agreements generally have uniform State-wide base rates of pay for the same employees in the same occupations across the State, however there are often allowances or other conditions which are provided to employees in regional areas. The base pay rates are influenced by wages needed to attract and retain labour to public employment in Sydney, with its relatively high living costs, particularly for housing.
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> CGC staff note that SET data suggests that States use whole of State agreements considerably more than the private sector. The SET data shows that public sector wages are more homogenous between capital cities and the remainder of the State than are private sector wages.
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> New South Wales agrees that, provided data of sufficient quality is available, using private sector wage differentials in wages paid in capital cities as the proxy for public sector wage differentials between States makes sense since capital city wage pressures are reflected across States.

2 CGC, 2011 Update, p. 40.

The CGC notes (paragraph 92): 'Staff are currently inclined toward using the Greater Capital City Statistical Areas as defined by the ABS, which are agglomerations of SA4 regions. SA4s are designed to encompass local labour markets. We welcome State views on the correct labour market area to use if such an assessment were to be performed.'

The ABS notes that labour markets were a key consideration in the design of SA4s, with the aim being to reflect the high degree of connectivity between labour supply and demand. Labour markets in Australia are characterised by a large number of very small regional labour markets, a smaller number of medium sized labour markets around regional centres, and very large labour markets representing the major metropolitan centres.

The ABS notes that the Greater Capital City Statistical Areas (GCCSAs) are designed to represent areas whose people '… regularly socialise, shop or work within the city, but live in the small towns and rural areas surrounding the city.'[3] NSW Treasury notes the Greater Sydney area comprises the Sydney metropolitan area, Central Coast, Outer West and Blue Mountains, and Outer South West, but does not include Newcastle and Lake Macquarie and Illawarra. If this definition of 'labour market' is used in this assessment, NSW Treasury considers the same definition should be used for capital city areas in the transport assessment, given the linkages between areas noted by the ABS.

3 ABS, Australian Statistical Geography Standard (ASGS): Volume 1 – Main Structure and Greater capital City Statistical Areas, Australia, July 2011, p. 31.