QUEENSLAND TREASURY

Wages Costs Assessment

Response to Commonwealth Grants Commission Staff Discussion Paper CGC 2015-03S

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Queensland Government

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Queensland's Position

Work program for Interstate Wages

- The timeframe for the Interstate Wages work program is too compressed to fully consider issues. The consultant's report on conceptual issues is not expected to be finalised until the end of November, and the release of Characteristics of Employees (CoE) data has been delayed until late October.
- Queensland is concerned there will be insufficient time for the CGC to properly consider the new data, and for states to do their own analysis, particularly if any unanticipated issues arise with the data. The Commission should consider delaying any changes until the 2017 Update, so conceptual, methodological and data issues can be fully analysed.

Conceptual case

- The current approach assumes that a single factor – states' relative private sector wages – is the driver of states' wage requirements. This assumption is simplistic and ignores the multitude of other factors whose influence on states' wage levels is at least as conceptually valid as the private sector wages assumption.
- Available evidence suggests that private sector wages is not an important factor in practice:
  - Without a strong observed relationship, the conceptual case for this assessment is not supported by evidence. Contrary to some states' views, the statistical relationship between relative private and public sector wages is of the utmost importance to the validity of the assessment methodology.
  - Queensland provided information during the 2015 Review on wages setting policy that showed the level of private sector wages is not a major consideration in wages policy. This means the assessment does not reflect 'what states do'.
- The factors influencing states' wages are likely to be very complex, and the need to compete for public sector employees in a national market is likely to affect wage levels, along with many other factors such as the fiscal environment in a state, the strength of parties involved in enterprise bargaining and differences in employee conditions.

Methodological issues

- Replacing Survey of Education and Training (SET) data with the CoE data is unlikely to be simply a matter of updating the data in the existing model, but will also require some methodological adjustments (for example, to the variables used in the model). Methodological changes in this key assessment should not be rushed.
- Queensland supports the proposal in the paper to include any employee characteristic in the model that could impact on wages if the impact is significant.

Data issues

- Queensland's previous submissions have shown that the choice of data used to determine relative wages can change the results substantially.
- If the CoE data produces a substantially different result to the SET data, this will cast serious doubt on the reliability and robustness of the assessment approach. The Commission will have no way of knowing which outcome is a better reflection of states' wage requirements, and a far larger discount will be required.

Proposed methodological change – capital cities

- Queensland does not support the proposed capital cities model. The proposal is based on the unsubstantiated assumption that a single state-wide wage is set based on wage requirements in the capital city. This assumption does not correspond to reality, and takes the wages assessment even further from 'what states do'.
- Capital cities are not the regions where it is most difficult for states to attract and retain staff at any given wage level. The need for states to provide higher wages to comparable regional and remote staff through loadings and allowances directly contradicts the logic underpinning the capital city proposal.
- In a highly dispersed state such as Queensland, the relative importance of capital city employees in setting wages across the state is greatly diminished. The need for periods of regional service in some occupations is likely to reduce the desirability of those occupations in dispersed states, even where regional loadings and allowances may be provided.

1.0 Introduction

The current wages assessment model assumes that states' relative private sector wage levels can be regarded as a proxy for states' relative public sector wage requirements. Effectively, it assumes that private sector wages are the sole driver of public sector wages, which is not reasonable or supported by evidence. While competition with the private sector may theoretically have some influence on the wages states must pay to attract comparable employees, it is only one of a range of factors, and its importance is questionable.

The influences driving differences in states' public sector wage levels are multifaceted and complex. They include the need to compete in a national market, the ability of state governments to set wages benchmarks in occupations dominated by government employment, the fiscal environment in which states are operating in any given year, differences in employee conditions, and policy choice.

In terms of the observed data, the goodness of fit of the private sector model has never been particularly strong, and has deteriorated in the most recent dataset as other factors, such as the need for fiscal restraint, have grown in importance. Also, information provided by Queensland's Public Service Commission demonstrates that, in practice, the need to compete with the private sector has not been a consideration in current or previous wages policies.

This suggests that the influence of private sector wage levels on the public sector is not strong relative to other factors, and an assessment based on private sector wage levels does not reflect average policy. On this basis, Queensland considers that the current Interstate Wages model does not reliably capture differences in states' wage requirements.

The Commission are pursuing an Interstate Wages work program that is to consider the conceptual case, methodology and data used in the assessment, with ABS Characteristics of Employees (CoE) data being considered as a replacement for the discontinued Survey of Education and Training (SET). This program needs to consider the relative importance of all factors affecting states' relative wage levels and develop a methodology that reflects these influences and average policy. If the private sector wages model is ultimately retained, a far larger discount must be applied to recognise that it is only one of a complex range of factors, many of which are not recognised in the assessment.

As part of the work program, the Commission are also considering a potential major methodological change – to assess states' wages using relative private sector wages in capital cities rather than the whole of state, on the basis that this would better reflect what states do. Queensland considers that the assumptions underlying this proposed change do not correspond in any way to what states do. In practice, state-side wages are not set by considering private sector wages in capital cities, or by only considering capital city needs. Of far greater concern to dispersed states are the areas where it is most difficult to attract and retain staff – the regional and remote areas rather than the capital city.

2.0 Timeframe for Interstate Wages work program

Queensland welcomes the work program the CGC is currently pursuing for the Interstate Wages assessment. The need to review the data used in the model due to the discontinuation of the Survey of Education and Training (SET) is a good opportunity to fundamentally re-examine the conceptual case and methodology as well as the data supporting the assessment.

The work program is complicated by the late release of the Characteristics of Employees (CoE) data that the CGC is considering as a replacement for the SET data currently used in the assessment. Currently, the ABS is expected to release the CoE data on 27 October 2015. This will interfere with the original timeframe, where the CoE modelling was due to be completed by the CGC and sent to states during October. Queensland is concerned there will be insufficient time for the new data to be given proper consideration, and for states to have the opportunity to do their own analysis, particularly if any unanticipated issues arise with the data.

It is important to note that using the CoE data is unlikely to be simply a matter of updating the data in the existing model, but will also require some methodological adjustments. For example, the Commission will need to consider what variables to include – some current variables may not be available in the CoE data, or may no longer be significant, while others may have significant impacts in the CoE data that were not significant in the SET data. The implications of these methodological adjustments will need to be carefully considered with input from states.

If issues do arise with use of the CoE data, these must be fully resolved or the data should not be used in the 2016 Update. If any issues cannot be fully resolved, the Commission should make no changes and continue to index the SET results for the 2016 Update. In the following year, work could be progressed on improving the data or identifying an alternative data source or methodology if necessary for the 2017 Update. The Commission should not decide to use the CoE data in the 2016 Update simply because there is no immediate alternative available. While the age of the SET data is a concern, it is preferable to address this issue in depth over the course of 2016 than to implement a methodology or dataset when there has not been time for a full, in-depth analysis.

Queensland is also concerned that there may not be time in the work program to fully address issues arising from the consultant's reports and the Australian Labour Market Research Workshop. The Workshop is due to be held in November, with the consultant to release a final paper after the discussion. This timeframe may not leave sufficient time for conceptual issues to be addressed. Again, the Commission should leave itself open to extending the work program into 2016 if it becomes apparent there are issues that warrant further investigation. The Interstate Wages assessment is too important a component of the Commission's methodology to rely on rushed conclusions.

3.0 Conceptual Case

There may be a case that there are differences in the wages states pay that are beyond their control, likely driven by factors such as differences in cost of living and attractiveness of location. However, there is little reason to believe the current Interstate Wages model reliably captures these pressures.

The current methodology assumes that a single factor – states' relative private sector wages – is the driver of states' wage requirements. This assumption is simplistic and ignores the multitude of other factors whose influence on states' wage levels is at least as conceptually valid as the private sector wages assumption. While states may compete with the private sector to some extent, state government wages will also be driven by factors such as national market pressures, states' ability to act as a dominant employer in some occupations, the fiscal positions of states, differences in employee conditions and policy choice.

The Interstate Wages work program should acknowledge the complex array of factors influencing states' wages and examine their relative importance. Queensland considers the available evidence suggests private sector wages is of lesser importance:

- Observed data does not support the conceptual case for private sector wages being an important factor. The goodness of fit of the private sector model has never been strong and has deteriorated in the most recently available data.
- The wages setting policies of states do not consider private sector wages or the impact they may have on the ability of government to compete in the labour market.

Importantly, the evidence of the observed relationship between relative private and public sector wages and the wages setting policies of states show that the private sector wages assumption does not reflect what states do in practice. Without evidence that the private sector wages model mirrors the way states set wages, the assessment does not satisfy the 'what states do' principle.

Issues relating to the conceptual case are due to be discussed in more detail at the Australian Labour Market Research Workshop to be held in November. In the interim, Queensland's comments on conceptual issues raised in the Discussion Paper and in the 2015 Review are below.

3.1 Importance of observed data and statistical relationship

The Discussion Paper notes that states have differing views on the importance of the observed relationship between comparable private and public sector wages. Queensland's view is that the statistical relationship is of the utmost importance. Without a strong observed relationship, the conceptual case for this assessment is not supported by evidence. A strong statistical relationship is required to satisfy the ‘what states do’ principle.

For this reason, Queensland does not accept the Western Australian argument that the statistical relationship is not relevant because it does not matter whether individual states choose to follow average policy. While it is not necessary for every individual state’s public sector wages to precisely mirror relative private sector wages, states must still be shown to follow the policy on average. This requirement is not satisfied in the current SET data.

In terms of the observed data, the goodness of fit (R^2) of the SET private sector model has never been particularly strong, and has deteriorated in the most recent dataset currently available, from 0.6049 in 2005 to 0.1494 in 2009, which is not a statistically significant relationship. This kind of relationship cannot be considered to support the theory that differences in private sector wages can be used as a proxy for differences in public sector wages.

The Discussion Paper offers a number of reasons for this low correlation – that relative community wage levels have little impact on public sector wages, that states have divergent policies at a point in time, or that there are sampling errors in the data. Queensland’s previous submissions have suggested the deterioration of the observed private/public relationship is evidence of a weakening in the actual relationship as other factors (such as the need for fiscal restraint) have grown in importance.

If the reason for the low correlation is that states had divergent policies at a point in time, than in order for the assessment approach to be valid, the divergence must correct itself in the new CoE data. Otherwise, the assessment will not reflect average policy. If the CoE data does not show a strong relationship between private and public wage levels, the assessment must be adjusted to recognise this, for example, by increasing the discount applied.

Queensland’s submissions to the 2015 Review also detailed the Queensland Government Statistician’s Office (QGSO) technical analysis of the SET data modelling. This suggested that the Commission Staff analysis overstates the measured goodness of fit because it ignores the significant measurement error associated with both the private sector and public sector relativities. The relativities are survey estimates where each carry a standard error and level of uncertainty, which are not factored in. If they were, the measured goodness of fit would be much smaller than those that have been presented in CGC discussion papers. The QGSO considered the SET data provided only weak support for the assumption that there is a positive correlation between private and public sector wages. This kind of analysis will also be pertinent to the analysis of the CoE data when it becomes available.

The QGSO analysis also discounted another potential explanation for the deterioration in the relationship between private sector wages – that it was the result of a lag in responsiveness of the public sector wage setting, primarily in Western Australia. It showed that when Western Australia is removed from the plot, the slope of the fitted line and the R^2 value remain much lower than for previous iterations of SET.

3.2 Wages setting policies of states

If states, in practice, considered private sector wages a major factor when deciding wages policy, this could constitute evidence that the private sector wages model reflects average policy and is an important factor in states’ relative wage requirements. However, Queensland is not aware of any evidence that supports this.

In the 2015 Review, Queensland’s Public Service Commission prepared a submission for the CGC detailing government wages policy and issues that are taken into consideration in setting public sector wages in Queensland. This submission made it clear that the state’s level of private sector wages is not a major consideration in wages policy, but rather:

- Queensland public sector wages policy is designed to support the fiscal strategy of the government;
- Neither current nor previous wage policies were set with any consideration of private sector wages, or the impact they may have on the ability of government to compete in the labour market.
- Differences in private sector wage levels are irrelevant to state governments because they do not compete in any tangible way for the labour required to deliver the vast majority of their services (ie doctors, nurses, teachers or police). State governments set the benchmark for the private sector in professions dominated by government employment.
- Government Owned Corporations are bound by a separate wages policy, and this indicates government is aware of where it is exposed to competition for labour with the private sector and where it is not.

The evidence provided by Queensland's Public Service Commission indicates that the private sector wages model does not reflect average state policy. The information provided on how states actually set wages in practise (ie, considering the government's fiscal strategy and not private sector wages) may provide insight about why the relationship between public and private sector wages are not well correlated in the most recent available data.

3.3 National Market

The paper notes arguments previously made by Queensland and other states that state government wages are more likely to be affected by national market pressures than by the differences in private sector wages within each state. Queensland considers that the factors influencing states' wages are likely to be very complex, and the need to compete for public sector employees in a national market is likely to affect wage levels, along with many other factors such as the fiscal environment in a state, the strength of parties involved in enterprise bargaining and differences in employee conditions.

States are more likely to face competition from other states, whose employees have comparable skill sets and professional training (nurses, teachers, police etc) than with the private sector, where employees either have different expertise or are affected by the states' market power in setting wages (in cases where states are the dominant employer).

The Discussion Paper argues that the national market argument is not valid because it presupposes that public sector wages will converge over time, and there is no evidence this is the case. It also suggests that even if consistent differences in states' observed wages is caused by policy choice, this undermines the national markets argument.

Queensland disagrees with this assessment. The national markets argument does not require states' actual wages to converge, because a lack of convergence could reflect policy choice (for example, in the different characteristics of employees states choose to attract). In discounting the national market theory based on an absence of convergence in actual wages, the Discussion Paper is holding the argument to a different standard than its own model – it has not been suggested that the private sector model only holds if all states precisely mirror private sector wages, only that they must on average.

It does not seem reasonable to argue that each state must compete against the private sector in that state, but at the same time faces no competition from other states for employees. This would seem to assume that employees would not or cannot move to find more desirable public or private sector employment in another state, which is clearly not the case.

The existence of a national market for public sector employees suggests a larger discount on the assessment is warranted. This would recognise that there are other factors exerting influence on public sector wage requirements that are not reflected in the private sector wages model and would likely moderate the differences between states.

4.0 Other Data Issues

Queensland's submission to the 2015 Review Draft Report highlighted that the choice of data used to determine relative wages can change the results substantially. This suggests that the current model is not robust, as there can be little confidence in its accuracy when a different choice of dataset changes the outcome (even though both datasets measure the same effects and are considered reliable). There is no way of knowing which result better reflects states' wage requirements.

For example, the Queensland Government Statistician's Office demonstrated in their submission to the October 2013 Proposed Assessments paper that 2011 Census income data adjusted by occupation structure gives significantly different wage relativities, with a reversed result for Queensland and the ACT. The strength of the relationship between public and private sector wages was also tested in this analysis and found to not be statistically significant in either the 2006 or 2011 Census datasets. The goodness of fit (R^2) values for the analysis were 0.0456 in 2006 and 0.1187 in 2011, lower even than the SET results in 2009.

This issue may increase in importance when the CoE data is used to replace the SET. If the new data produces a different outcome, this will cast serious doubt on the reliability and robustness of the assessment approach. The

Commission will have no way of knowing which outcome is a better reflection of states' wage requirements. In this instance, a far higher discount would be necessary to manage the uncertainty in the model's outcomes.

5.0 Simplification

Queensland supports the proposal in the Discussion Paper to not simplify the regression. The simplifications proposed during the 2015 Review were arbitrary and did not improve the quality of the model.

Queensland also supports the proposal to include any employee characteristic in the model that could impact on wages if the impact is significant, including additional variables (such as health status) that may be available. If any variables that were significant in the SET data are not available in the CoE data, this will be a cause of concern as it would suggest the disabilities produced by the CoE are less accurate. The Commission would need to consider whether the CoE data is appropriate and whether accuracy issues can be addressed through an increase to the discount.

6.0 Capital cities

During the 2015 Review, the Commission proposed changing Interstate Wages to base the assessment on differences in private sector wages in capital cities rather than the whole of state. The proposal was put on hold until the new CoE data became available (rather than develop a new methodology using data from 2009), to be revisited in the 2016 Update. The conceptual case for the proposed capital city model is underpinned by two assumptions:

i) Rather than set wages for each individual region, states pay comparable employees a single wage set in a state-wide agreement; and
ii) The single state-wide wage is set based on the region with the highest private sector wages (in most cases, the capital city). Otherwise, states would not be able to attract staff in all regions.

While states may generally use state-wide agreements to set wages (leaving aside regional loadings and allowances), it is an unsubstantiated assumption that this is based on wage requirements in the capital city. This assumption is based on an artificial model of how wages would theoretically be set and does not correspond to reality.

The main practical consideration ignored by the capital city model is that capital cities are not the regions where it is most difficult to attract and retain staff at any given wage level. Queensland (and other states) provide regional loadings and allowances to attract staff to less attractive (non-capital city) areas. The need for states to provide higher wages to regional staff, even when private sector wages are lower in regional areas than the capital city, directly contradicts the logic of the capital city model. If the assumption that states must pay the highest wages in capital cities is incorrect, there is no logic underpinning the selection of the capital city as the basis for a state-wide wage. In a highly dispersed state such as Queensland, the relative importance of capital city employees in setting wages across the state is greatly diminished.

In practice, the state wide wage is not set by considering private sector wages in capital cities, or by only considering capital city needs. Evidence of this has been provided in the information provided by the Queensland Public Service Commission during the 2015 Review, which confirmed that the ease or difficulty of filling roles in Brisbane does not determine the level at which state-wide wages policy is set[1]. As it appears that one of the main reasons the Commission is interested in moving to a capital city wage model is a belief that it better reflects 'what states do', the model should not be adopted, as it is clear this is not correct. If the Commission do not believe the current whole-of-state model reflects 'what states do' either, then fundamental investigation is required into how state wages policies are struck and the implications for the interstate wages assessment.

[1] Queensland Public Service Commission response to Interstate Wages Assessment, 2015 Review

A case study provided by Queensland in the 2015 Review discussed teacher wage setting. This demonstrated the disconnect between capital city private sector market forces and the wage setting for teacher positions, and suggested that the state government has a significant level of monopsonistic power over teacher wages:

- The state government employs around two thirds of the teachers employed in Queensland (accounting for around 20% of the states' workforce);
- There is no evidence of a shortage of supply in teachers;
- Over 50% of Queensland schools are located outside of metropolitan areas; and
- Enterprise bargaining negotiations typically focus on employment conditions and other policy issues rather than labour market forces.

Under these conditions, the private labour market (particularly in the capital city alone) has little meaningful influence on teacher pay.

As well as regional loadings, another aspect of policy designed to encourage teachers to work in remote locations is a system whereby teachers can earn points towards more desirable city positions through regional placements. An implication of this policy is that regional loadings payments do not fully compensate teachers for the condition of living in a less desirable location (if they did, a points system would not be required to ensure regional positions are filled).

In a highly dispersed state where the need to fill a large number of regional and remote positions means that a period of regional service is likely to be required, this is likely to reduce the desirability of the profession in that state compared to other states. Employees will require compensation for location conditions (including for attachment and migration costs) over the course of their career, or dispersed states would not be able to attract employees of the same standard as other states. However, if regional loadings do not provide full compensation in the short term, this implies that the overall state-wide wage must be higher to compensate teachers over the longer term course of their careers.

In this way, the level of capital city wages is likely to be influenced by the wage required to attract staff to regional and remote locations. This is further supported by the fact that city locations remain easier to fill than regional and remote locations, even where regional loadings are provided.

These kinds of employment conditions are not mirrored in the private sector, and particularly will not be reflected in private sector capital city wages. While there may be comparable employees for some occupations in capital city and regional areas in the private sector, these employees would need to be fully compensated for their location, or they would move to a higher wage area. This option is often not available to employees where the state government is the dominant employer.

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