Government of **Western Australia**
Department of **Treasury**

Commonwealth Grants Commission
2016 Update

Western Australia's Response to the

Wage Costs Assessment – Staff Discussion Paper CGC 2015-03S

September 2015

Contents

Key Points

- We believe the Commonwealth Grants Commission's (CGC's) objective to review the wages assessment by the end of 2015 is overly ambitious, especially given the late release of the key data.

- Wage cost pressures remain a significant issue for Western Australia and an assessment of wages disabilities (using private sector wage differentials) should continue.

- The proposed capital city assessment suffers from multiple conceptual issues and data is not available to quantify it.

  – As formulated by the CGC, it is fundamentally inconsistent with the horizontal fiscal equalisation (HFE) objective of ensuring capacity to provide the same standard of services in all jurisdictions, because (based on presently available modelling) it gives most but not all States capacity to pay above market wages in regional areas, and it reflects an approach to HFE not used elsewhere.

  – While it could be made consistent with HFE, it involves increasing the conceptual and data complexity of the assessment and we do not believe that this extra complexity can be justified in terms of the limited available data or the likely difference it would make compared to the current whole-of-State assessment.

  – The CGC's analysis of States' capital city/regional wage setting (and the implied relation to service costs) is very simplistic, taking no account of flexibility in service delivery models and use of employees.

- We are concerned that the Australian Bureau of Statistics (ABS) data the CGC intends to use does not cover very remote areas and will systematically understate Western Australia's employee costs in the regional areas it does cover. However, as we have not been given access to the ABS data at the time of this submission, we are unable to comment further.

- It is unclear to us what the CGC's current policy is on discounting, and hence whether a discount is appropriate for the wages assessment.

- It is imperative that the CGC, in the interests of transparency, fully document the issues raised by States, and provide meaningful responses ahead of the 2016 Update.

Timing Issues and the Ambition of the Review

We are concerned about the scope of the review of the wages assessment, given the limited time available to consider the complex issues involved.

CGC staff have indicated that their objective is to have agreement on the wages assessment by the end of 2015. We believe this is overly ambitious and we have the following concerns with this objective.

- The new Characteristics of Employees (CoE) data will not be available to States until late October and CGC modelling using the new data will not be available until sometime in November. This does not allow States much time to fully review the new data and modelling (which may require a consultant) and present a properly considered submission in December.
- In line with major methodology issues, the December submissions should be the basis for a proper debate on the issues, followed by a CGC draft proposal, followed by State views, followed by a revised CGC proposal and final State comments.
- In this submission, we have been unable to comment on the questionnaire used in the CoE survey, as it has not been made available for review. The ABS has advised that this will be provided alongside the release of the survey data in late October.
- The CGC has engaged a consultant to explore issues with the wages assessment, which will not consider the new data. The draft consultant's report will be provided to the States for review by the end of September.
  - States have only a narrow window of opportunity to review and comment on the consultant's draft report before it is finalised.
  - What if the consultant's report raises fundamental questions about the wages assessment?

We consider that it is not appropriate to make significant method changes as part of a quick annual update exercise. Given the materiality of the assessment and the depth of the issues involved, consideration of such changes should await the next review. At the very least, any major changes should be delayed until the 2017 Update.

Assessment of Wages Disability Should Continue

We are strongly supportive of the continuation of the assessment of wages disability. The assessment needs to fully capture the wage pressures faced by States such as Western Australia.

In-principle Reasons for Using Private Sector Wage Differentials as a Proxy for Public Sector Wage Pressures

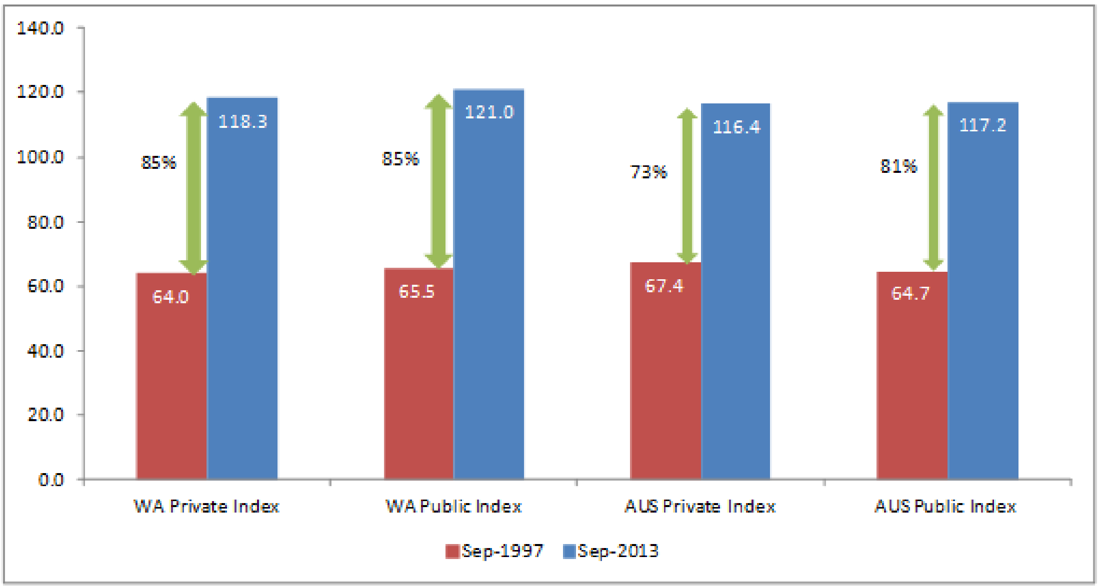
We believe that private sector wage differentials remain a suitable proxy for public sector wage pressures. We consider that the differentials in private sector wages are reflected in public sector wages through the influence of similar wage pressures and the requirement for public sector wages to remain competitive with the private sector. Competition for new entrants and movements of employees during buoyant economic conditions are sufficient to ensure a strong link.

While the 2009 Survey of Employment and Training (SET) data may appear to show a weakening in this relationship, we consider that this reflects confounding factors (see below) and we agree with the CGC staff that the relationship between public and private sector wages is likely to hold in the long term.

Movements in public sector wages often lag those in the private sector, reflecting the relative rigidity of public sector wages settings. Nevertheless, wages in Western Australia over the long term show comparable movements, as shown in Figure 1.[1]

1 See also our February 2014 submission to the 2015 Review.

Figure 1: Wage Price Index Comparison, Sept 1997 to Sept 2013

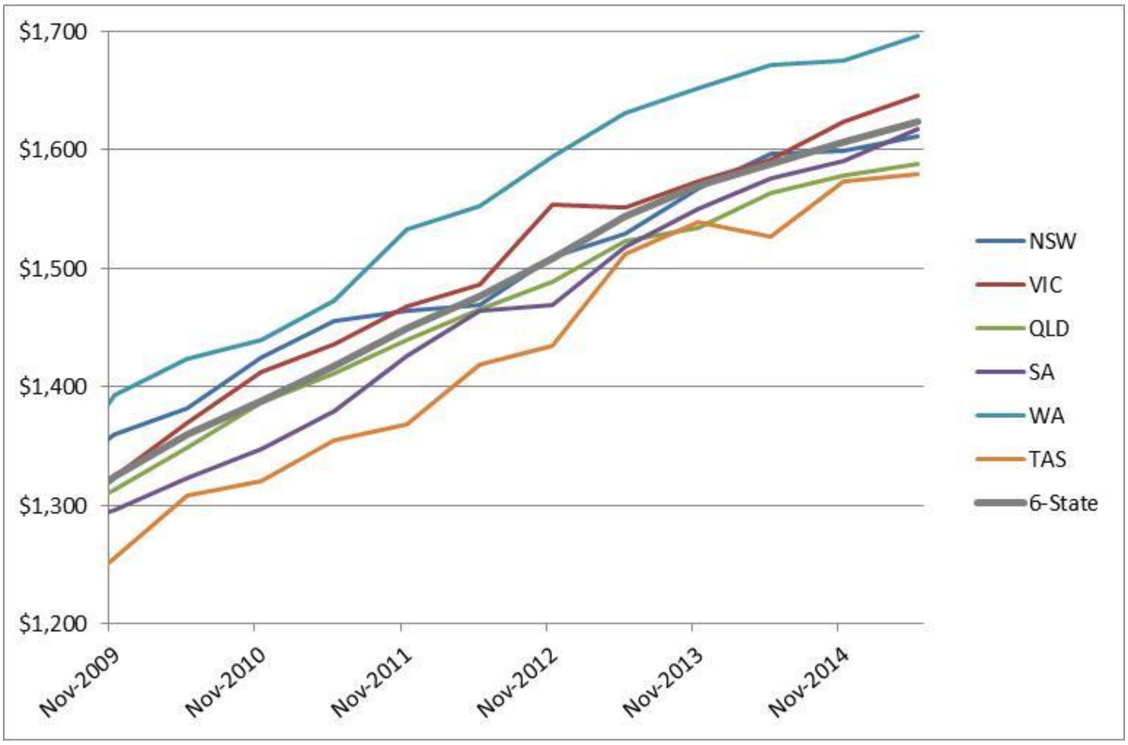


Source: ABS Wage Price Index, Australia September 2013.

States also have the policy option of holding down wages relative to the private sector, if they are prepared to accept a lower standard of employee (i.e. lower employee productivity), and a resultant lower standard of services.

Figure 2 below shows that public sector wages in Western Australia are the highest of all States and 4.9% above the six-State average across the period. However, Figure 1 suggests that, overall, States other than Western Australia may have actually grown their wages faster than the private sector. Consequently, the comparison of public sector wages across States in Figure 2 may significantly understate the underlying wage pressures in Western Australia (using a private sector benchmark).

Figure 2: Average Weekly Earnings, Full Time, Public Sector Total Earnings



Source: ABS Average Weekly Earnings, Australia, 2013.

Importantly, the States' wage policy choices are not relevant to fiscal equalisation, as the fiscal equalisation principle is predicated on capacity to provide an equal standard of services. On a standard policy basis, a lower/higher standard of services would result from restraining/elevating wages, but equality in that lower/higher standard of services would still need recognition of private sector wage differentials.

For these reasons, we support the continued use of interstate differences in private sector wages as an appropriate proxy for measuring interstate differences in public sector wages.

Empirical Support

In our February 2014 submission to the 2015 Review, we provided evidence that suggested that the SET whole-of-State analysis underestimated wage pressures in Western Australia.

On reviewing the latest data available from the Australian Taxation Office (ATO) and the ABS, it appears that the gap between wages in Western Australia and the rest of Australia has widened since the 2009 SET analysis.

ATO Data

Data from the ATO's Taxation Statistics for 2012-13 by industry show a much higher wage differential for Western Australia than the CGC's existing assessment (15% versus 7% before discounting). This is a considerable increase since 2010-11, when Western Australia's wages were 11% higher across all industries. Western Australia continues to have the highest wages for all but two industries (see Table 1).

Table 1: Industry Salary Comparison (Total of Private and Public), 2012-13 data year

Industry	WA compared to Australia	WA rank amongst six States
Agriculture, Forestry and Fishing	1.29	1
Mining	1.06	1
Manufacturing	1.18	1
Electricity, Gas, Water and Waste Services	1.41	1
Construction	1.22	1
Wholesale Trade	1.19	1
Retail Trade	1.06	1
Accommodation and Food Services	1.10	2
Transport, Postal and Warehousing	1.12	1
Information Media and Telecommunications	1.06	1
Financial and Insurance Services	1.10	1
Rental, Hiring and Real Estate Services	1.16	1
Professional, Scientific and Technical Services	1.14	1
Administrative and Support Services	1.25	1
Public Administration and Safety	1.19	1
Education and Training	1.08	1
Health Care and Social Assistance	1.12	1
Arts and Recreation Services	1.03	2
Other Services	1.19	1
Other	1.15	1
All Industries 2012-13	**1.15**	**1**

Source: Taxation Statistics 2012-13, Australian Taxation Office.

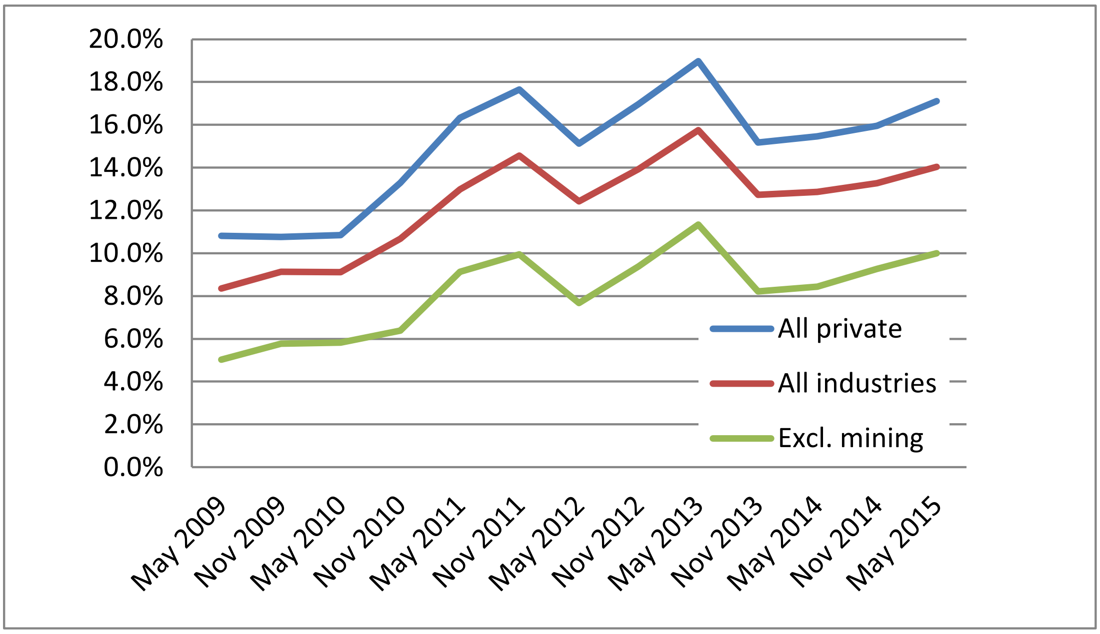
ABS Average Weekly Earnings Private Sector Wages Data

Figure 3 below shows that, since the 2009 SET survey, Western Australia's wage pressures have intensified relative to other States, and that this is not just a mining effect. In this regard, we note that, for full time ordinary time earnings, the difference between average weekly earnings in Western Australia and Australia over the time period May 2009 to May 2015 has increased by:

- 6.3 percentage points for the private sector;
- 5.7 percentage points for all industries (private and public); and
- 5.0 percentage points for all industries excluding mining (this increase would likely be somewhat larger if the public sector were excluded).

This analysis provides a reality check for the (as yet unknown) outcome of the CGC's analysis of the CoE data.

Figure 3: Average Weekly Earnings (Full Time Adult Ordinary Time), Percentage Difference between Western Australia and Australia



Source: ABS Average Weekly Earnings Australia. The exclusion of mining is a Western Australian Treasury estimate, using ABS data from Average Weekly Earnings Australia, Labour Force Australia, Australian National Accounts: State Accounts, Wage Price Index Australia (including unpublished data), and Employee Earnings and Hours Australia.

Issues with the Capital City Approach

General Concerns with the Proposal

As outlined in our previous submissions to the 2015 Review, we have strong concerns with the CGC's proposal to use a capital city benchmark, rather than a whole-of-State assessment.

- Depending on the data and method of implementation, if it is assumed that 'what States do' is to have inflexible wage setting and employment practices, this proposal could provide some States with above-average capacity to recruit workers. Regardless of whether this is, or is not, consistent with the CGC's past interpretation of HFE (an issue whose resolution requires subtle arguments to weave through fairly ambiguous terrain), it is difficult to justify in principle.

- The 2010 Review considered this approach, but rejected it. What has changed? In that Review, the CGC noted that:

  "If States are setting wages centrally, it is not clear whether they are setting:

  - a wage that reflects conditions in the State capital and are paying that wage in the rest of the State. This would suggest public sector wages would be higher than local private sector wage rate in the rest of the State; or

  - a wage based on the average conditions across the State (for example, using the average State private sector wage). This would suggest it would face greater difficulty filling vacancies in the capital city, but less difficulty in the rest of the State."[2]

- Disaggregating the labour market into capital city and regional areas is an arbitrary and unreasonable simplification. The large number of fly-in fly-out workers in Western Australia is evidence of the interactions between the metropolitan and regional labour markets. The regional labour market is also not homogenous, with different feedbacks operating between sub-regional labour markets and the metropolitan labour. The lack of any genuine differentiation between capital city and regional labour markets means that average conditions across a State are likely to be as influential on public sector wages as capital city private sector wages.

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[2] *Assessing Location Disabilities in the 2010 Review – Staff Discussion Paper CGC 2008/01-S*, page 19, paragraph 80.

- The CGC’s proposal involves greater conceptual and data complexity (as discussed below), but the current simpler method is already at the limits of (some would say beyond) what data can support. Should hundreds of millions of dollars be moved around on this basis?
- The discussion paper refers to the possibility of 'windfall gains'[3] from using a capital city standard. This does suggest some question about either the conceptual or data underpinnings of the proposed approach.
- From discussions held with CGC staff, it appears that, instead of the CGC being required to evidence its new method, States are required to prove that the new method is incorrect. We believe this is poor practice.

Consistency with HFE

In the 2015 Review, we argued that the CGC proposal was fundamentally inconsistent with the HFE objective of ensuring capacity to provide the same standard of services in all jurisdictions, as it focuses on input standards rather than service standards.

The HFE principle explicitly refers to service standards. As the CGC stated in its 2015 Review report that the HFE principle takes precedence over the supporting principles, and it has not provided any alternative definition of HFE, it follows that the statement of the HFE principle defines HFE.

The CGC proposal essentially allows States that have low regional wages (relative to capital city levels) to pay above market wages in the regions, while States with high regional wages are only provided funding to meet the market in the regions. As the distribution of the GST pool is a zero-sum game, the result is that States with high regional wages are essentially subsidising the provision of above market regional wages in other States.

If one State can pay above standard wages, and the other cannot, the State paying above market wages will:

- be able to attract higher quality staff;
- have lower staff turnover; and
- have lower vacancy rates.

[3] Page 22, “We acknowledge that this may provide windfall gains to some States”.

All of this will enable higher service standards. Higher quality staff will be able to do a better job, which improves service standards in itself, and potentially reduces resource requirements (e.g. fewer staff or lower level staff may be needed, or less support provided from the capital city).

This does not square with the HFE principle, which requires States to be enabled to have the same service standards.

The CGC proposal also appears contrary to its usual practice in implementing HFE. The CGC's assessments are based on the observed (empirical) consequences of State policies rather than States' declared policies. The CGC places clear limits on the extent to which it attempts to identify and capture the effects of State policies. It focuses on what is empirically clear.

For example:

- tax assessments are based on what States on average actually raise from their revenue bases in different value ranges. The CGC does not attempt to unravel the reasons why States have chosen their tax scales, or identify relationships between tax rates and the relative value of revenue bases; and

- key service assessments are based on what States on average actually spend on different sectors of their population, defined by factors such as age, socio-economic status, indigeneity and location. The CGC does not attempt to understand what States are trying to achieve through their spending, or identify relationships between the allocation of State spending among different spatial/socio-demographic groups and the relative importance of these groups.

The CGC's capital city proposal reflects a specific interpretation of State policies which is no more than an assumption. Let's assume there actually is 'overpayment' of regional staff relative to the capital city[4] after allowing for econometric issues (see below) and the scope for flexibility in service provision structure and work expectations. Is this to be interpreted as an unwanted consequence of an inflexible wage policy or a desired outcome (which could be to preference regional areas)?

[4] 'Overpayment' here means that regional public wages/regional market wages are greater than capital city public wages/capital city market wages.

As discussed below, the ongoing existence of State-wide wages and general lack of capital city top-ups suggests that States can work with this policy to achieve their broader aims. Under a regional preference policy, where regional wage pressures are higher than the capital city (as in Western Australia) regional areas would be preferenced by topping up the base wage.

Accordingly, consistent with the CGC's general practice, if it can be reliably determined that States on average pay above-market wages in regional or remote areas, then all States should be given the capacity to pay this average above-market wage in regional areas.

In practice, this sort of refinement seems unwarranted, given the quality of available data, and it is unclear that it would significantly change the assessments compared to the current whole-of-State approach.

What States Do

In the Discussion Paper, the CGC responded by saying that "The Western Australian solution, of assuming that States can recruit average staff everywhere, is in conflict with our 'what States do' principle."

Our response is as follows.

- As noted above, the CGC has indicated in its 2015 Review report that the HFE principle takes primacy over supporting principles like 'what States do'.
- In any case, 'what States do' needs to be specified in relation to some context. Taken literally, there is no end to what might be considered relevant to what States do, so that every State faces unique circumstances. In the present context, we think 'what States do' refers to the average standard of services provided by States in areas that the CGC has classed as comparable (e.g. major cities or remote areas), at the average level of efficiency.
  - This is consistent with the HFE principle, and consistent with the focus of States on service standards. We will provide supplementary information outlining the pursuit of service standards for key agencies in Western Australia.

- The CGC's model of 'what States do' in paying staff is really only a fraction of the total picture of 'what States do' with staff in the pursuit of service outcomes. Structures of service provision and work expectations are flexible. Whether an occupation in a regional area is, or is not, being 'overpaid' relative to the market depends not just on the remuneration, but on the role expectations for that occupation in that regional area, as distinct from the capital city.

- Moreover, consistency with 'what States do' should mean that, if some States are paying above-market rates in regional areas, then other States (such as Western Australia) should have that capacity too.

- Using a strict 'what States do' approach to achieve HFE is a complex road. Obtaining the necessary data is not a short-term exercise. The empirical evidence needs to be examined to identify: how regional employees are used differently to capital city employees; how quality expectations differ; and how differences in employee use and quality expectations may vary depending on the relative 'real' remuneration of the employees ('real' remuneration is remuneration relative to the local market wage for the relevant set of skills and experience).

Our view is that, compared to a strict 'what States do' approach, the current approach of determining a State-wide average market wage is much simpler, probably produces a similar outcome to an appropriately specified capital city approach, and produces a more reliable outcome (given the data complexities of the alternative approach).

Factors that Determine State Wage Setting

The CGC has suggested that States set a State-wide base wage reflecting capital city wage pressures.

State wage-setting is a complicated process that considers many factors across public and private and metropolitan and regional labour markets. As noted above, these interactions make it difficult to make a simplifying (and arbitrary) assumption that regional wages reflect capital city wage pressures. Further evidence is needed from the CGC in support of this hypothesis.

Nevertheless, as a couple of Western Australian agencies have indicated, it is not unreasonable in Western Australia to assume that the base wage reflects capital city pressures. In Western Australia's regional areas, it is considered that the market 'wage' for the required skills is generally above the capital city level, and often far above the capital city level. We will be providing supplementary information on remuneration in regional and remote areas for public sector employees in key Western Australian agencies.

Some other States may face more complex situations, if the regional market wage is generally below the capital city market wage. It is far from clear to us what the net outcomes in these other States might be, or how they might be demonstrated. In setting a State-wide base wage, these States would need to consider:

- whether, as a matter of policy, they want public regional wages to exceed the local market (as a boost to these regions), or public capital city wages to be below the local market (to hold general wages and prices in check); and
- how any remaining gap between the capital city and regional areas could be bridged through different work expectations or location specific top-ups.

The ongoing existence of a State-wide wage and general lack of capital city top-ups may reflect that States can generally work with this policy to achieve their broader aims. However, as the example of teachers' location-dependant pay in Perth shows, it is possible to provide a higher wage in the capital city.

Capital City Proposal - Econometrics

If the CGC wishes to pursue a capital city approach, a number of econometric issues need to be considered, including:

- how to draw an appropriate boundary between capital city areas and regional areas;
- how to treat Hobart and Darwin, which the CGC now recognises as regional areas;

- how to ensure that results are not influenced by differences in the nature of private employment between capital cities and regional areas that are not picked up in the CGC's explanatory variables:
  - For example, how comparable between capital cities and regional areas are the various occupation categories for managers and professionals? Public employee skillsets are relatively similar between capital cities and regional areas; and
- how to ensure that regional results are not distorted by undersampling of regional areas, which can very heterogeneous.

Some of these issues are also relevant to the current whole-of-State econometric model, although at the whole-of-State level they may be expected to wash out to some extent. These issues are much more critical in the capital city model because of the greater degree of disaggregation and the CGC's proposed asymmetric treatment of regional wages (i.e. the treatment depends on whether regional wages are above or below capital city levels).

Other Issues

Data Issues

We have concerns with the ABS CoE data that the CGC intends using.

- We understand that the ABS survey does not cover very remote areas. These are the highest cost areas for Western Australia (as our supplementary information will show) and an allowance for them is needed. The CGC's regional cost assessment only recognises these costs on a standard basis, and hence does not recognise different market wage pressures in the very remote areas of different States.
- As noted above, regional areas are very heterogeneous and it is not clear whether they are adequately sampled.
- It is not clear whether the ABS survey covers all forms of employee remuneration, including accommodation subsidies, extra leave, travel entitlements, etc. As noted above, the ABS has not allowed States to access the survey prior to the data release in late October.

Model Specification and Statistics

We request that the CGC provide:

- a full specification of the model used, including the assumptions that underlie it;
- coefficient estimations and error analysis;
- model test statistics; and
- a correlation matrix for the variables.

Treatment of Uncertainty

The CGC's wages assessment currently has a 12.5% discount.

However, it is unclear to us why the CGC discounts this assessment and what rules the CGC currently uses to determine whether or not to apply a discount.

The 2015 Review Report appears inconsistent – it states that discounting addresses uncertainty (Volume 2, page 467, paragraph 47), but also argues that it should not be applied where it would introduce bias (Volume 2, page 15, paragraph 72; also page 17, paragraph 81).

In the light of this, it is unclear why the discount is applied to the wages assessment or what it is trying to achieve. If the discount is not clearly justified under the existing rules, it should be removed.

CGC staff have advised that there is internal CGC documentation about the use of discounting, but this documentation has not been made available to States. Given the lack of clarity in this area, we consider that circulating this paper to the States would help assist States in understanding the CGC's policy on this issue.

As we have noted before, discounting needs to be looked at globally rather than taking a narrow view. This would help to mitigate the inherent level of subjectivity in the application of discounts and choice of discount rates.

Documenting the Issues

We consider it imperative that the CGC, in the interests of transparency, fully document issues raised by States, and provide meaningful responses to those issues ahead of the 2016 Update.

Unfortunately, in the Discussion Paper there is no mention of Western Australia's concern that the SET survey did not pick up most employee accommodation subsidies in remote areas.

As another example, the CGC's response to our claim that a capital city wage standard is contrary to HFE is to say that our position is contrary to the 'what States do' supporting principle. However, this level of detail does not provide sufficient information for readers to form a view on the appropriateness of the proposal. The documentation should note the issues about the relative primacy of HFE and the supporting principles, and how the 'what States do' principle should be understood in the context of the HFE definition, the quality of staff and how States use their staff.