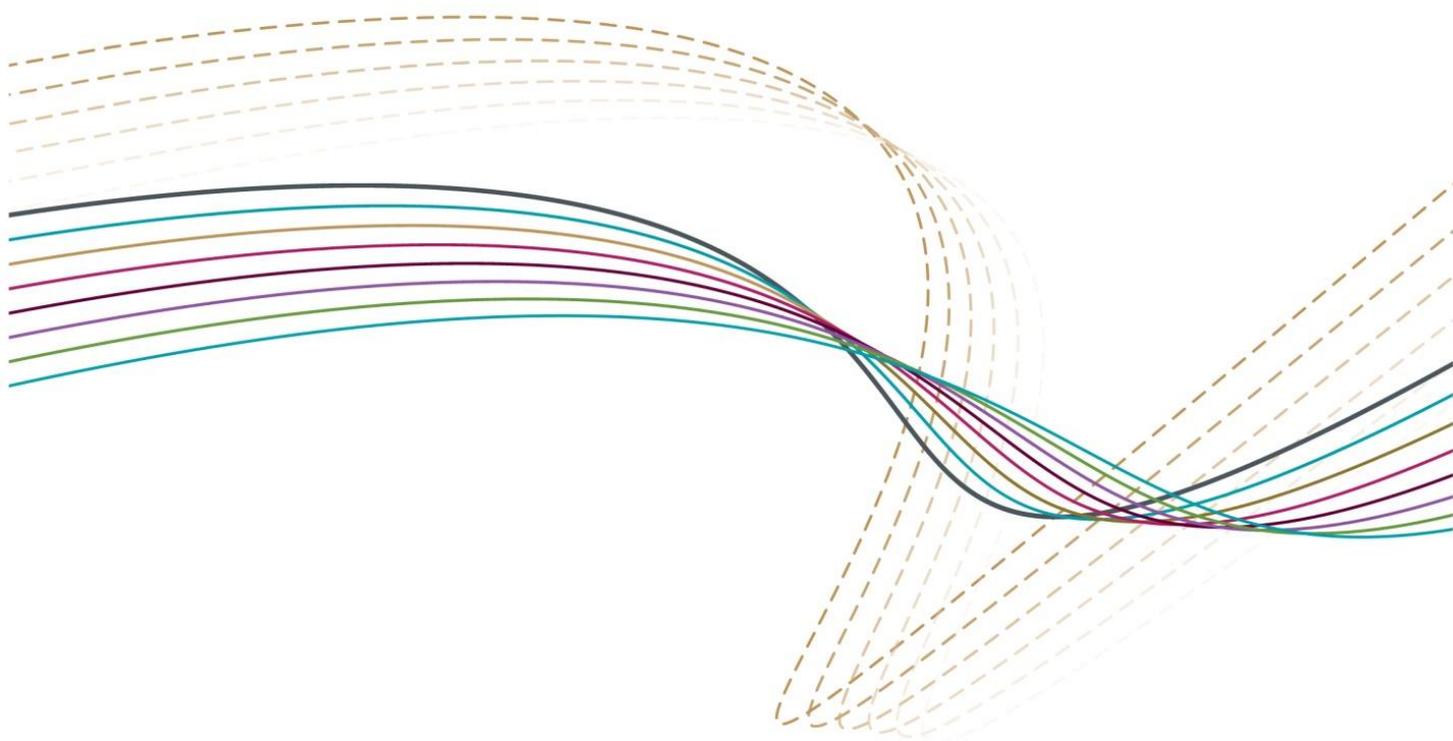


QUEENSLAND TREASURY

Wages Costs Assessment

Response to Commonwealth Grants Commission
Staff Discussion Paper CGC 2015-05S

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Queensland's Position

- **Queensland strongly supports the intention of Commission staff not to use the 'capital city model'.**
 - There is no evidence that using private sector wages in capital cities as the basis for the assessment would produce a better outcome, and it would have introduced a number of issues which are not present in the whole-of-state model.
- **Both potential data sources for the wages assessment are imperfect.**
 - The Characteristics of Employment (CoE) survey are missing critical education and qualifications information, and the Survey of Education and Training (SET) data are ageing. Queensland acknowledges the challenges this presents to Commission staff, further complicated by delays in access to the CoE data and the Flinders University research paper.
- **It has not been possible for states to provide meaningful feedback on the model in the time available.**
 - States are prevented from accessing the CoE data because of the ABS's strict organisational requirements. Meaningful consultation is a key part of the Commission's process, and especially critical given the CoE dataset is new and is missing variables.
- **Queensland continues to have serious concerns with the conceptual case for the wages model.**
 - The current model still assumes state wage costs are driven only by state relative private sector wages. Queensland and other states have previously argued there are many other factors, such as national market pressures, states' ability to be a dominant employer and state fiscal circumstances, which also impact state wage levels and are as conceptually valid as private sector wages.
 - As the 2009 SET data continues to be used as the basis for the assessment, the claim that private sector wages are an important factor in state wages policy is not supported by evidence of a strong observed statistical relationship.
 - New information in the Flinders University paper provides evidence to support the view that state governments are restricted in their wage setting policies because of national market pressures.
- **Queensland has concerns the model does not accurately reflect true residual state level differences.**
 - State level coefficients can only reflect true residual differences in wages once all significant employee level factors have been controlled for in the model. Without interrogating the CoE data other predictors cannot be identified, but factors such as education, qualifications and health status are significant wage predictors and are not included in the model.
- **These factors have markedly increased the uncertainty of the assessment, warranting an increased discount.**
 - Queensland has always held the discount should be increased in the wages assessment to recognise the weak conceptual case and worsening data issues. The proposed wages model has many new and unresolved conceptual, data and methodological issues, and the states have been unable to analyse and provide feedback on the model properly, owing to the tight timeframes and lack of access to data.
 - Ongoing issues with the model are now sufficiently severe for the Commission to have an increased level of concern about the certainty and accuracy of the assessment. The Commission should consider increasing the discount to 50%, at least until the issues with the CoE data are resolved and states can properly analyse the data.

1.0 Introduction

The current Wage Cost assessment model assumes that states' relative private sector wage levels can be regarded as a proxy for states' relative public sector wage requirements. Queensland and other states have long argued the wages assessment has severe conceptual and data limitations. For instance, the assessment assumes private sector wages are the sole driver of public sector wages, which is not reasonable or supported by evidence. The relationship between public and private sector wages had also deteriorated in recent years, with Queensland demonstrating during the 2015 Review it was no longer statistically significant.

During the 2015 Review, the Commission committed to a broad review of the wages assessment once new data became available.

Since the 2004 Review, the ABS Survey of Education and Training (SET) has been used as the basis for the wages assessment. The last SET survey was run in 2009. In August 2014, the ABS replaced the SET survey with the annual Characteristics of Employment (CoE) survey, and the first available data and preliminary results were provided to states in November 2015.

The 2014 CoE survey contained information about employee education and qualifications. However, owing to a processing failure by the ABS, the data is not available in the 2014 survey. Because of the missing CoE information and the age of 2009 SET survey, Commission staff intend to recommend a combination approach for the 2016 Update –

- Indexed 2009 SET survey data in 2012-13 and 2013-14
- 2014 CoE survey in 2014-15

Commission staff regard this approach as an appropriate balance between estimating wages using important factors (such as education), and using up to date data. For the 2017 Update and beyond, Commission staff intend to recommend phasing in the annual CoE survey data as it becomes available.

In the 2015 Review, Commission staff proposed changing the wages assessment to use the differences in private sector wages in capital cities, rather than whole-of-state wages. Commission staff now consider there is insufficient evidence to support a change to an assessment based on capital city wages, as they were unable to find evidence that public sector employees received the same wage across the state, and could not determine if private sector wage levels in capital cities produced a better measure than whole-of-state wages. Queensland strongly supports the Commission staff's change in position – the capital city model was based on unsubstantiated assumptions about state wage setting policies and was not 'what states do'.

Commission staff do not intend to make any changes to the existing 12.5% discount. Despite the serious issues with the model, staff do not consider the level of uncertainty has changed enough to warrant an increased discount.

2.0 Timeframe for Interstate Wages work program

In the early stages of the wages assessment work program, Queensland and other states raised concerns about the Commission's proposed timeframe. Owing to the timing of the release of the CoE data, the timeframe was considered too compressed, and there was concern that if issues arose during the work program there would not be sufficient time for Commission staff and states to properly consider and resolve the issues. Queensland continues to hold this view.

The work program was delayed because of the issues of the 2014 CoE survey missing education and qualification information, and the delayed release of the Flinders University research paper. While these issues were beyond the control of the Commission, they cut down an already tight schedule.

In the first Staff Discussion Paper in July, Commission staff outlined their intention for the Interstate Wages work program.

Over the course of this year, we expect to have access to a new data source, and to be informed on the conceptual underpinnings of the assessment by a range of independent experts and by further consultation with States. The recommendations we put to the Commission will evolve through this process.
(Staff Discussion Paper 2015-05-S pp. 3)

Given the revised timeframe, there has not been adequate time for the Commission staff or states to consider the new data or Flinders University research, nor will there be sufficient time for Commission staff to consider state views ahead of providing staff advice to the Commission.

The revised timeframe has meant states are unable to do meaningful analysis and interrogation of the CoE data and model. Shortly after receiving the Commission staff's latest paper, Queensland was advised by the ABS that ABS organisational requirements would prevent states accessing the CoE data in the timeframe provided. Meaningful consultation is a key part of the Commission's process, and especially critical in this instance given the issues with the missing CoE variables.

The late delivery of the Flinders University research has meant the Commission staff did not have time to contemplate the findings in the latest wages paper. The Flinders University research was a key part of the wages assessment work program and it appears to have been abandoned because of time constraints.

Because of the issues that have arisen, the Commission staff only have one week to consider state submissions before making a recommendation to the Commission in early January 2016. This is compared to the original timeframe where the Commission staff had all of December to consider state submissions – a timeframe Queensland already considered ambitious. Queensland is concerned that given the new timeframe and issues that have arisen, it is unlikely Commission staff can meaningfully consider and incorporate state views to the Commission.

3.0 Capital cities

Queensland strongly supports the intention of Commission staff not to use private sector wages in capital cities as the basis for the assessment. Since the 2015 Review, Commission staff have held the view that capital city wages would provide a better proxy for the community wage, and the recent change in position demonstrates the lack of sufficient evidence or compelling conceptual case to justify a change in methodology.

Specifically, staff were unable to find evidence that public sector employees received the same wage across the state, and could not determine if private sector wage levels in capital cities produced a better measure than state wide wage levels.

In previous responses to the Commission, Queensland presented evidence that while states may set state wide wage levels, they are not based on capital city requirements. In the 2015 Review, Queensland's Public Service Commission prepared a submission detailing government wages policy and issues that are considered when setting public sector wages. According to the QPSC, the primary consideration for wage setting is the government's fiscal strategy. Private sector wages in capital cities are not a consideration.

Furthermore, in many jurisdictions, including Queensland, capital cities are *not* the regions where it is most difficult 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 provided evidence the conceptual basis for the capital city model was uncorroborated.

The capital city wages model was unnecessary and based on unsubstantiated assumptions. While Queensland does not support the whole-of-state model (for reasons outlined below), it is preferred to the capital cities approach.

4.0 Conceptual Case

Queensland has long held concerns about the conceptual case underpinning the wages assessment. While there may be a case that there are differences in the wages states pay that are beyond their control (such as cost of living), there is little reason to believe the current model reliably captures these pressures.

The current model still assumes state wage costs are driven only by state relative private sector wages. Queensland's consistent view, mentioned in previous CGC wages submissions, is that the model ignores the many other factors that also impact state wage levels that are as conceptually valid as private sector wages, such as national market pressures, states' ability to be a dominant employer in some sectors, the fiscal position of states, differences in employee conditions and policy choice. As the conceptual case underpinning the model has not

changed, Queensland considers all the same arguments still apply to the proposed wages assessment. However, some new comments regarding the proposed approach, CoE data and Flinders University research are below.

Observed statistical relationship

Queensland's view is the statistical relationship between private and public sector wages is critical to support the conceptual case of the wages assessment. Without a strong observed statistical relationship, the assessment does not satisfy the 'what states do' principle.

The statistical relationship between private and public sector wages in the 2009 SET data is very weak, as measured by the goodness-of-fit ($R^2=0.17$). While the relationship has improved in the CoE data ($R^2=0.58$), until the new data is fully phased in, the assessment will be based largely on a very poor model for measuring public and private sector wage relativities. Indexing the 2009 SET data using the Labour Price Index will have no material impact on this model and the 2012-13 and 2013-14 assessment years will retain this high level of unexplained variance.

Queensland's submissions to the 2015 Review 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 carries 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 presented in CGC discussion papers. The QGSO considered the SET data provided extremely weak support for the assumption that there is a positive correlation between private and public sector wages.

The 2014 CoE data demonstrate a comparatively stronger goodness-of-fit ($R^2 = 0.58$), however without the opportunity to submit the data for scrutiny, it is not possible to know if similar (or different) issues exist with the CoE data.

Queensland considers the assessment discount should be adjusted to recognise the weak relationship between private and public sector wages with the SET 2009 data, and uncertainty about the robustness of the CoE data.

National market

Queensland (and other states) has long held that public sector wage requirements are more likely influenced by national market pressures than by the differences in private sector wages in each state. 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).

It has never seemed reasonable to argue that each state must compete against the private sector in that state, but at the same time face no competition from other states for employees. The Flinders University paper found evidence that states compete for workers in two labour markets simultaneously, the national market and the local market (pp. 25-26). The paper identifies the public sector premium – the degree to which the public sector pays higher wages than the private sector without receiving equal higher quality employees – is below average in states with above average private sector wages and above average in states with below average pay. According to the researchers, this "*provides some evidence that the states are competing in a national market for their public sector workers and cannot diverge too much from the national norms as they all need very similar and specific types and quality of workers*" (pp. 12).

Commission staff have not been able to take full account of the Flinders University paper findings owing to the tight timeframes they faced. However the evidence of the existence of a national market for public sector employees suggests a larger discount on the assessment is warranted.

5.0 Methodological issues

Owing to the shortened timeframe and a lack of access to the data source, Queensland has been unable to interrogate the data properly or fully explore the Commission's proposed methodology. This has severely restricted Queensland's capacity to provide meaningful feedback on the proposed methodology.

Queensland has previously highlighted the importance of the model including all significant employee characteristics. State level coefficients can only reflect true residual state-level differences in weekly wages once all significant person level determinants have been included in the model.

The wages model attempts to account for all possible employee characteristics however, it can only include variables collected in the CoE survey. Aside from the aforementioned missing education and qualification data, health status variables have found to be significant predictors for wages in both the 2009 SET data and the results presented by the Flinders University paper. Without interrogating the 2014 COE data, other predictors cannot be investigated but there is reason to believe that other employee level factors are significant wage predictors but are currently not included in the modelling.

Given the probability that there are significant employee level factors – including but not limited to the education and qualifications factors – missing from the CoE model, Queensland has substantial concerns about the accuracy of the model. The loss of access to the data has meant that the states' have been unable to explore the extent to which these variables affect state wage differentials. Given the uncertainty, Queensland believes an increase to the discount is warranted.

6.0 Data issues

The revised timeframe and ABS access requirements for the CoE survey data have meant states have only been able to provide limited analysis of the data for the proposed changes to the wages assessment. Queensland has been unable to provide comments on the quality of the dataset, such as whether CoE provides a more robust estimation of states' wage requirements. Given the issues with both datasets, Queensland has concerns about the reliability of the assessment approach.

Meaningful consultation is a key part of the Commission's process, and especially critical given the issues with the missing CoE data. It is important for the Commission's processes to be transparent and for states to be able to participate fully in the work program otherwise they will not understand or have confidence in the assessments. Given the issues around the missing variables and lack of access to the data, a far higher discount is necessary to manage the uncertainty in the model's outcomes.

Queensland has already outlined concerns that the SET 2009 data is an extremely poor measure of wage relativities (relative private sector wages paid for comparable employees in each state) between public and private sector employees, a problem which will be relevant as long as the SET 2009 data is used in the wages model.

The proposed wages model also raises the issue of the missing CoE variables. Commission staff intend using data from the 2014 CoE survey to derive the 2014-15 wage relativities. However, owing to a data processing error, education and qualification data were lost. Commission staff suggest that without these variables, models perform very similar to former models which do include these variables; the goodness-of-fit (R^2) does not change much at all. However, it should be highlighted that models with or without the state-level variable showed almost no change in the R^2 statistic when using the 2009 SET data, as shown in QGSO's analysis as part of the 2015 Review. By this account, removing the state-level variable from a model which contains all the possible person-level variables (especially since not all the state-level variables are statistically significant) would suggest there is no actual difference in the state-level wage relativities.

