



ACOSS Submission | March 2010

**Australian
Council of
Social Service**

**ACOSS Submission to 16th Series
Australian Consumer Price Index Review**

March 2010

Executive summary

There are three key reasons why the CPI is important for ACOSS:

- a number of social security payments are indexed to the CPI, including the allowance payments;
- community sector organisations' funding agreements are often indexed to CPI; and,
- the CPI is the only existing official measure of changes in the cost of living, although it is not designed for this purpose.

In this submission, ACOSS advocates for the development of a national official cost of living index. We highlight the limitations of the Consumer Price Index (CPI) as it is currently measured as an indicator of changes in the cost of living, while acknowledging that the index plays an important role as a measure of general inflation and informs monetary policy.

We recommend that, should the CPI continue to be calculated on an acquisitions basis, a supplementary official cost of living index should be developed using an outlays approach. We also highlight the need for additional indexes to measure changes in the cost of living for the following specific population groups.

Recommendations:

- **If the CPI is to continue to be measured on an acquisitions basis, a supplementary official cost of living index should be developed using an outlays approach.**
- **Additional indexes to measure changes in the cost of living for specific population groups should also be developed and published.**
- **Increasing the frequency of the CPI release would be desirable, but due to the cost, complexity and risk to quality this is not a high priority for ACOSS.**
- **ACOSS supports a reassessment of the methodology used to measure price changes in the deposit & loan facilities expenditure class, and the weight of this item in the CPI.**
- **Increase the frequency of the Household Expenditure Survey (HES) to 2-yearly as a very high priority. The HES should be integrated with the income survey, perhaps as a sub-sample. The HES sample size should be increased.**
- **Any supplementary official cost of living index should be based shelf prices, rather than pure prices.**
- **ACOSS supports the development of spatial and regional price indexes to measure the cost of living in regional, rural and remote areas.**

Introduction

ACOSS is the national peak representative body for the community and welfare sector and the national voice for the needs of low income and disadvantaged Australians.

ACOSS is currently represented on the 16th series CPI Review Advisory Group.

The Consumer Price Index (CPI) is a key economic indicator, measuring inflation faced by Australian households for goods and services.

This major review of the CPI is focused around the following topics:

- Principal purpose of the CPI;
- Compilation frequency of the CPI;
- Evaluation of the deposit and loan facilities index;
- Maintaining the relevance of the CPI;
- Commodity classification;
- Analytical series; and
- Other issues.

This submission will address each of these issues.

Principal purpose of the CPI

ACOSS believes that there is a need for a national official cost of living index to meet a range of policy objectives, in particular: as a general measure of cost of living pressures experienced by Australian households and to provide an appropriate measure for the indexation of social security payments and community service sector funding contracts.

The CPI, as it is currently calculated, does not perform this function as it is measured on acquisitions rather than outlays approach.

Acquisitions and outlays approaches

Since the 13th series, the CPI has been designed to provide a general measure of price inflation using an *acquisitions* approach. As the Information Paper states, a major role of the CPI as it is currently designed is to 'provide a broad measure of inflation to inform macro-economic policy considerations'.

An *acquisitions* approach measures changes in the prices of goods or services *acquired* by a household in the relevant period. This excludes a number of costs which households may face in the period, for example, mortgage interest payments and interest paid on debt, where no 'acquisition' takes place during the period.

By comparison, an *outlays* approach is better adapted to measuring the cost of living or the 'purchasing power of money'. An outlays approach measures the costs incurred by households during the relevant period to gain access to goods or services. For this reason, a broader range of costs are included in the index, including changes in the rate of interest paid on mortgages and debt.

A true cost-of-living index would need to be concerned with the substitutions that consumers make in order to maintain their standard of living in the face of changing market conditions (for instance, buying chicken rather than beef when beef prices are high). By comparison, the CPI assumes the purchase of a fixed basket of goods and services and measures price changes in that basket alone.

The Information Paper notes that these alternative approaches are likely to result in short-term rather than long-term differences in outcomes. However, given the role of the CPI in indexing a range of social security payments, it is important that the index is responsive to changes in the cost of living over the short and longer term.

The ABS notes that a third approach, the *cost-of-use* approach, is best adapted to measuring changes in living standards as this index relates to goods and services consumed in the relevant period, irrespective of when they were acquired or paid. However, the *cost-of-use* approach is the least preferred option for the ABS and is not considered in detail in the Information Paper. Given that this approach is not open for serious consideration as an alternative index, the focus of this submission is on the acquisitions and outlays approaches.

Other indexes

The 13th series review identified widespread interest in the 'extent to which the impact of price change varies across different groups in the community'. As a result, the ABS now compiles and publishes a number of living cost indexes for selected types of Australian households, published separately to the CPI on a quarterly basis.

Existing subgroup indexes include:

- employee households;
- other government transfer recipient households;
- age pensioner households; and
- self-funded retiree households.

These measures are based on an *outlays* approach and, as the Information Paper notes, are therefore 'the conceptually preferred measures for assessing the effect of changes in prices on the out-of-pocket living expenses of subgroups of the Australian population'. However, as they are based on a fixed basket of goods and services, they do not reflect changing consumer preferences and the substitutions which consumers make in response to changes in relative prices.

The new Pensioner and Beneficiary Living Cost Index (PBLCI)

The relevance of the CPI for income support recipients has declined somewhat due to the introduction of the Pensioner and Beneficiary Living Cost Index (PBLCI).

The PLCLI is intended to more accurately reflect the changes in the cost of living for pensioner and beneficiary households. The PBLCI is calculated on an outlays basis.

The PBLCI was introduced as a means on increasing pensions. The first PBLCI showed an increase of only 0.1%, but this is due to inclusion of housing and insurance payments, both of which have decreased. The index is less stable than the CPI as it gives more weight to variable food prices.

The maximum rates of a **specific** and **limited** range of pensions are now indexed by the greater of the movement in the CPI and the PBLCI. Those payments which will indexed to the PBLCI include the age pension, the Disability Support Pension (for persons over 21, or under with children), the Wife Pension, Carer Payment, Bereavement allowance and the Widow B pension. This means that a range of pensions and allowances will continue to be indexed only to CPI, including the Newstart Allowance, Parenting Payment (Single), Youth Allowance and a number of other allowances (Sickness, Mobility, Carer, widow, etc). Due to a change in the last Budget, Family Tax Benefit is now also indexed to CPI instead of to wages. At the time, ACOSS expressed our concerns about the impact of this measure on child poverty over time.¹

ACOSS is concerned about the inequities and complexities of separate indexation arrangements for different payments. We discuss these issues in more detail in our forthcoming paper on reform of working age payments which recommends changes to payment indexation to address the anomalies and inequities between payments. These are broader policy issues for Government consideration, and therefore outside the scope of this review, but they form part of the context in which the review is taking place.

The need for an official cost of living index

ACOSS submits that there is a need for an official cost of living index to meet a range of policy purposes:

1. To inform the general public about changes in the cost of living;
2. As an equitable basis for the indexation of social security payments; and
3. As a more realistic and adequate basis for the indexation of community sector funding contracts.

There are several ways to achieve this. One option would be to redefine the principal purpose of the CPI and therefore change the basis of measurement from an acquisitions to an outlays approach (as before the 13th series review). While ACOSS would support this policy change, we recognise that there are other ways to achieve the same policy outcome while maintaining the CPI as it is currently measured for broader macroeconomic policy purposes.

A second option would be to develop a supplementary official cost of living index. ACOSS notes the concerns expressed by the ABS about multiple indexes and the risk of community confusion by the presence of alternative CPI measures. However, we suggest that with appropriate explanatory information this confusion could be managed.

A range of additional population-specific indexes, in addition to the PBLCI, would also be useful, including a low wage earners index and a low-income families index.

¹ For more information, see ACOSS Factsheet, 'Changes to family payments will increase child poverty', June 2009, available at <http://acoss.org.au/images/uploads/6121.pdf>.

Recommendations:

- **If the CPI is to continue to be measured on an acquisitions basis, a supplementary official cost of living index should be developed using an outlays approach.**
- **Additional indexes to measure changes in the cost of living for specific population groups should also be developed and published.**

Compilation frequency of the CPI

The CPI is currently measured on a quarterly basis. As the Information Paper notes, Australia and New Zealand are the only two Organisation for Economic Cooperation and Development (OECD) countries that do not publish monthly statistics.

Although increasing the frequency of the CPI release would be desirable, given the cost, complexity and risk to quality of more frequent compilations, this is not a high priority for ACOSS.

Like the CPI, the Pensioner and Beneficiary Living Cost Index (PBLCI) is measured quarterly, with payments to be indexed on 20 March and 20 September. These indexes should continue to be compiled with the same frequency to avoid creating further inequities in the indexation of different payments.

Recommendation:

- **Increasing the frequency of the CPI release would be desirable, but due to the cost, complexity and risk to quality this is not a high priority for ACOSS.**

Evaluation of the deposit and loan facilities sub-index

The deposit and loan facilities sub-index was developed to measure financial services charges as part of the shift from the outlays to acquisitions approach.

The deposit and loan facilities sub-index includes *indirect charges* (interest rate margins) and direct fees and charges. Australia is the only country to include indirect charges. The deposit and loans sub-index has shown recent volatility due to the global economic downturn.

The Information Paper seeks comment on:

- Whether financial services paid for indirectly via interest margins are appropriate services for inclusion in the CPI; and
- Whether the ABS methodology correctly measures the price change for this service.

Recommendation:

- **ACOSS supports a reassessment of the methodology used to measure price changes in the deposit & loan facilities expenditure class, and the weight of this item in the CPI.**

Maintaining the relevance of the CPI

Frequency of CPI weight updates

The frequency of the CPI re-weighting is dependent on the Household Expenditure Survey (HES) which is now run on a six yearly cycle, but used to be conducted every two years. The HES captures consumer spending patterns across a range of goods and services.

The small sample size means that the HES is poorly adapted to picking up regional variations or a significant portion of the unemployed population.

Increasing the frequency and the sample size of the HES should be a very high priority. It is a very important measure for researchers and policy makers on poverty and living standards.

There is a clear disparity between the level of resources directed to conducting the HES and to calculating other economic indicators (GDP, employment figures, the CPI). This is despite increasing public interest and concern about living standards, reflected in the development of Treasury's wellbeing framework and the Government's Social Inclusion agenda.

Recommendation:

- **Increase the frequency of the Household Expenditure Survey (HES) to 2-yearly as a very high priority. The HES should be integrated with the income survey, perhaps as a sub-sample. The HES sample size should be increased.**

Quality adjustment

The CPI is priced to 'constant quality' to measure pure price change over time. This means that the contribution of quality change to price movements is estimated and then removed.

As the Information Paper notes, an argument against quality adjustment or 'pure pricing' is that it does not represent the shelf price of goods and services. Pure pricing has been criticised for causing a downward bias which can result in consumers seeing their consumer power being eroded. For example, this method would under-estimate the replacement costs of whitegoods which change with technological advances. Although replacement costs may be high (particularly for low income households), the CPI is unlikely to capture the real costs to consumers due to the increase in quality through technological advances.

Self pricing better reflects the actual price paid for goods by consumers. Consideration should be given to a national official cost of living index being based on a shelf pricing model.

Recommendation:

- **Consideration should be given to a national official cost of living index being based on a shelf pricing model.**

Other issues

Spatial and regional indexes:

ACOSS argues that there is a real need to measure, in some way, the cost pressures faced by Australians in regional, rural and remote areas, particularly in light of higher fuel prices, transport costs and food costs.

We would therefore support the development of spatial and regional indexes to better capture price pressures in non-urban areas.

Recommendation

- **ACOSS supports the development of spatial and regional price indexes to measure the cost of living in regional, rural and remote areas.**