



Australian Government

Department of Finance and Deregulation

**SUBMISSION TO THE 16TH SERIES AUSTRALIAN
CONSUMER PRICE INDEX REVIEW**

March 2010

1. Overview

The Department of Finance and Deregulation ('Finance') welcomes the opportunity to provide a submission to the *16th Series Australian Consumer Price Index Review* conducted by the Australian Bureau of Statistics (ABS).

In its role as adviser to the Australian Government on matters relating to financial management and the Budget (in particular, sustainable expenditure growth), Finance has a strong interest in ensuring that the consumer price index (CPI) continues to provide an accurate and comprehensive measure of general price movements in the Australian economy.

The CPI is integral to indexation arrangements applied to government spending. Around half of all Government expenditure is impacted by movements in the CPI. The wider community generally understands and accepts the CPI as a measure of inflation. The general acceptance of the CPI as a measure of inflation is an important basis for its extensive use in indexation.

More generally, Finance's role in the preparation of budget advice requires an understanding of underlying economic trends and prospective developments. Inflation, measured by CPI movements, is an important variable in understanding economic trends and developments.

As a measure of general price movements, the CPI is a broadly accepted deflator for estimating government expenditure in real terms and the preferred deflator in the current economic climate. Estimates of real growth in government spending are used in the analysis of government budget trends and in the formulation of the Government's current fiscal strategy.

In the Reserve Bank of Australia's inflation-targeting regime, the CPI is central to the conduct of monetary policy. In turn, the achievement of good monetary policy outcomes is essential for sound fiscal policy outcomes and the sustainability of government finances.

While acknowledging the role of more specialised price indexes in gauging cost-of-living changes on specific groups within the community, Finance would be concerned about any changes to the current methodology of calculating the CPI which may diminish its capacity to provide a broad, conceptually sound, and widely accepted measure of inflation.

Specifically, Finance's view is that the CPI should continue to be a measure of general price inflation constructed on an *acquisitions* basis.

On other issues under review, Finance considers that:

- The benefits of introducing new ‘purpose-built’ price indexes, designed to measure cost-of-living changes for specific groups in the community, needs to be carefully weighed against the resource costs of preparing and maintaining these new data series and the possible implications for maintaining the quality of existing data. There should also be consideration of whether the existence of a range of price indexes is likely to create confusion in the community about the ‘correct’ measure of inflation.
- The current quarterly CPI series is sufficient for the purpose of indexation of government expenditure. However, monthly data may enable more timely judgments to be made on broad price trends and potentially contribute to better-informed policy decisions. Consideration should nevertheless be given to the cost of introducing and maintaining a monthly CPI series, in terms of both the financial cost and any consequences for data quality.
- Analytical variants of the CPI — such as the weighted median and trimmed mean measures of inflation calculated by the ABS using the methodology adopted by the Reserve Bank and (should it be introduced) seasonally adjusted CPI data — have the potential to provide additional information on price trends. The ‘original’ CPI data would nevertheless continue to be used for the purpose of indexation.

2. The CPI and the Budget

2.1 Indexation of Government Outlays

As a measure of general price inflation, the CPI is a key element of the Government’s indexation framework. Around half of all Australian Government expenses (or \$172 billion, as at the *2009-10 Mid-Year Economic and Fiscal Outlook*) are linked, to some extent, to the CPI.

The largest category of spending impacted by the CPI are personal benefit payments such as the age pension, disability support pension, family support payments and the Newstart Allowance. These payments are either linked to the CPI alone or in combination with an average earnings benchmark. For some benefits, such as the age pension, payments are also linked to movements in the Pensioner and Beneficiary Living Cost Index (PBLCI). In addition, the CPI impacts on civilian and military superannuation benefits.

Indexation arrangements for personal benefit payments and civilian and military superannuation pensions are contained in legislation. Conceptual or methodological changes to the CPI can therefore have significant impacts on expenditure and the sustainability of government finances. Some of these arrangements have been recently reviewed.

- The Government's *Pension Review*, chaired by Dr Jeff Harmer, released its report in February 2009. It found that while the CPI moved broadly in line with the age pensioner Analytical Living Cost Index over time, short term variations did arise. As a result of this Review, the Government decided to introduce PBLCI as a supplementary indexation factor.
- The *Review of Pension Indexation Arrangements in the Australian Government Civilian and Military Superannuation Schemes*, conducted by Mr Trevor Matthews, was provided to the Government in August 2009. It recommended that Australian Government civilian and military superannuation pensions continue to be indexed by the CPI, which was considered to be the most suitable index to protect pensions against inflationary price increases available.

The CPI also impacts on other outlays through the indexation arrangements applied to forward estimates of departmental and program costs to reflect changes in wage and non-wage costs. Within the indexation framework, the CPI is the main price measure used to reflect changes in non-wage costs.

While providing incentives for efficient service delivery, the framework is designed to provide supplementary funding to Australian Government agencies (though, in many cases, not full compensation) in response to movements in prices and wages. Indexation also ensures that expenses are valued in terms of the prices of the year in which they are incurred.

2.2 The use of the CPI as a deflator

Measurement of real spending growth is used in the analysis of trends in real government spending and in the formulation of the Government's current fiscal strategy.

In the current economic climate, the CPI provides a more accurate depiction of real government expenditure growth than the non-farm GDP deflator, which was used before the 2008-09 Budget¹. Large improvements in Australia's terms of trade due to the boom in mineral commodity prices have caused the non-farm GDP deflator to increase much more rapidly than the CPI, and the non-farm GDP deflator became a less accurate broad measure of movements in the costs that are relevant to government spending. Therefore, using the non-farm GDP deflator distorts trends in real spending growth.

¹ See Australian Government (2009, p. 10.6). For comparison purposes, a series deflated by the non-farm GDP deflator was also included in the 2008-09 and 2009-10 budget documents (Budget Paper No.1).

3 Issues under consideration in the current Review

3.1 CPI methodology

The ABS has invited comment on the whether the principal purpose of the CPI should continue to be the measurement of general inflation (on an ‘acquisitions’ conceptual basis) and the role of alternative price indexes as measures of cost-of-living changes for specific groups within the community.

Finance regards the CPI, as currently measured on an ‘acquisitions’ basis, to the best measure of general inflation currently available and this is reflected in its use in the indexation framework for government expenditure. Finance’s view is that the CPI should continue to be constructed on an ‘acquisitions’ basis.

The ABS (2010, p. 6) notes that for most areas of household expenditure the difference between the ‘acquisitions’ approach and the alternative ‘outlays’ approach is small. However, in two areas – owner-occupied housing costs and financial services and the use of credit – the distinction is more important.

In a previous CPI review, the ABS (1997) found that exclusion of mortgage interest payments (consistent with the ‘acquisitions’ approach) was conceptually appropriate for an inflation measure. It also noted that the exclusion of mortgage interest payments was appropriate where monetary policy was used to target the inflation rate. This is because of the ‘feedback loop’ created when interest rates are raised to counter inflation and, in turn, these higher interest rates feed directly into higher inflation.

Finance supports these conclusions. It also notes that, as the CPI is used for indexation purposes, there is the potential for an additional ‘feedback loop’ because, for example, higher measured inflation results in higher indexed spending which may have further inflationary effects. However, these effects may be comparatively small.

The arguments that favour the exclusion of mortgage interest payments also suggest that an ‘acquisitions’ approach should be followed in relation to consumer credit. That is, consumer credit interest payments should be excluded in the same manner as mortgage interest payments.

On this basis, and given the need for the CPI to continue to be a conceptually sound measure of general price inflation, Finance would not support moves to an ‘outlays’ based measurement of the CPI.

Supplementary price indexes

In response to the change from the ‘outlays’ approach to the ‘acquisitions’ approach, the ABS introduced the Analytical Living Cost Indexes. These provide conceptually sounder measures of cost-of-living changes for specific groups in the community, thereby addressing some community concerns that the CPI was not adequately reflecting their circumstances (ABS 2010, p. 7).

Finance notes that it is not surprising that the CPI does not completely reflect the circumstances of all specific groups. As a broad measure of inflation, the CPI is necessarily an ‘average’ measure. Therefore, it will not at all times completely reflect the experience of some groups within the community with regard to movements in the cost of living.

While acknowledging the importance of information provided by cost-of-living indexes, Finance is concerned that the existence of a range of price indexes, unless carefully managed, could increase confusion around inflation measures. This point has been noted by the ABS:

The ABS recognises that a single measure of consumer prices does not meet all user requirements. However, the ABS would be concerned about publishing measures that could be viewed as competing with the headline CPI measure. The ABS has a responsibility to ensure that the broad user community is not confused by the presence of alternative CPI measures. The increased demand on the ABS to develop complementary indexes raises questions around the relevance of the headline CPI. The challenge for the ABS is to strike a balance between maintaining the integrity and independence of the CPI, and providing robust analytical price measures to meet community needs. (2010, p. 8)

Even if the supplementary series move broadly in line with the CPI over time, differences in specific months or quarters may add to confusion about price movements.

Finance would also be concerned if resources diverted to the production of supplementary indexes resulted in a reduction in the quality of CPI data.

However, Finance also acknowledges the recommendation of the Matthew’s Report that, should a measure which better reflects the experience of superannuants become available in the future, the Government should consider its use in indexing Australian Government civilian and military superannuation pensions.

3.2 Frequency of compilation

Another issue under review is the frequency of the compilation of the CPI. For indexation purposes, a quarterly CPI is sufficient. For example, payments such as the age pension and civilian and military superannuation pensions are indexed twice yearly, while other payments such as family support payments are indexed annually.

A more frequent CPI may enable earlier identification of inflation trends. However, it should also be acknowledged that monthly data can be more volatile and can make the early establishment of trends, within an acceptable bound of confidence, problematic.

Finance also notes that the current CPI is produced on a timely basis (with data available no later than the last Wednesday of the month after the end of the reference quarter).

Finance notes that the ABS (2010, p. 9) has indicated that a significant increase in resources will be required to produce a monthly series of comparable quality to the current quarterly series.

Consideration would therefore need to be given to the cost of introducing and maintaining a monthly CPI series and to any implications for the overall quality of CPI data associated with moving to a monthly series.

3.3 Analytical variants of the CPI

The ABS has sought feedback on the usefulness of variants to CPI data – specifically, Reserve Bank measures of underlying inflation and (if introduced) seasonally-adjusted data.

As a broadly accepted measure of price inflation, the CPI in original terms (that is, not adjusted for seasonal influences) is the most appropriate price index for use in the indexation of government expenditure and as a deflator for deriving annual estimates of expenditure in real terms.

The Reserve Bank measures are now well understood and widely used in the analysis of underlying inflation trends, and Finance considers them useful. Similarly, seasonal adjustment of original data is well understood by analysts and a seasonally adjusted CPI series would provide additional information in monitoring underlying inflation trends. However, for the purpose of indexation, the ‘original’ CPI will continue to be the preferred option because the data are not subject to revision.

4 References

ABS (Australian Bureau of Statistics) 1997, *Outcome of the 13th Series Australian Consumer Price Index Review*, Information Paper, November, Cat. no. 6453.0, Canberra.

_____ 2010, *Issues to be considered during the 16th Series Australian Consumer Price Index Review*, Information Paper, December, Cat. no. 6468.0, Canberra.

Australian Government 2009, *Budget Strategy and Outlook*, Budget Paper No. 1, May, Canberra.