

**DEPARTMENT OF FAMILIES, HOUSING, COMMUNITY  
SERVICES AND INDIGENOUS AFFAIRS**

**SUBMISSION TO THE 16<sup>TH</sup> SERIES AUSTRALIAN  
CONSUMER PRICE REVIEW**

**APRIL 2010**

## **INTRODUCTION**

The Australian Consumer Price Index (CPI) is accepted by the Australian community as the primary measure of the change in the cost of living. The index is used extensively in the public and private sectors to determine and maintain the real value of payments under contracts, grants and legislation.

The Department of Families, Housing, Community Services and Indigenous Affairs (FaHCSIA) is the Australian Government's main source of advice on social policy and manages around one-fifth of the Commonwealth Budget. The CPI is used, in conjunction with other indicators of periodic changes in prices and real incomes, as a basis for indexing and benchmarking payments made under the *Social Security Act 1991*, the *New Tax System (Family Assistance) Act 1999* and a number of grant programs. Around \$72 billion per year of Commonwealth social security and family assistance spending is affected by growth in the CPI and the relativity of the CPI and other measures of changes in prices and real incomes.

As FaHCSIA payments represent a significant proportion of the incomes of low-income families and singles, it is important that the Australian community has confidence that these payments retain their integrity and are adequately indexed over time.

This submission represents FaHCSIA's preferred CPI system to support its role in social policy and program management.

### **FaHCSIA priorities for enhancement to the CPI and associated indexes**

In FaHCSIA's view the highest priorities for refinement of the CPI and associated indexes are as follows:

- Refining the methodology, sampling and reporting of the Pensioner and Beneficiary Living Cost Index (PBLCI) as a living cost index for pensioner and beneficiary households
- Development of a range of analytical living cost indexes (ALCIs), including a headline measure based on a consistent methodology to which other ALCI can be compared
- More frequent household expenditure surveys (HES), to support more frequent adjustment of index weights, reduce the bias in the CPI over time, and improve timeliness and frequency of information on household sector consumption
- Greater transparency with respect to the data and modelling used to compile the CPI and ALCI.

In this submission, FaHCSIA identifies a number of other enhancements to the estimation, scope and coverage of CPI and associated indexes as being desirable, but appreciates that some of these have a considerable cost and that priorities must be determined in a budgetary context.

## **PRINCIPAL PURPOSE OF THE CPI**

*Should measuring inflation faced by households (and the acquisitions conceptual basis) remain the principal purpose of the CPI, and what is the role of the CPI in the face of emerging community needs?*

FaHCSIA recommends that the CPI should be maintained with the purpose of measuring household inflation and a separate index (or indexes) be created with the single purpose of measuring changes in the cost of living. FaHCSIA considers that a single headline CPI cannot adequately measure both household inflation and changes in the cost of living due to the inherent conflict between these two concepts.

Currently the headline CPI is used as a proxy for the change in the cost of living for a whole range of government and community purposes. While historically the CPI's primary purpose was wage-setting, more recent changes to the methodology have been focused on developing a headline measure of household inflation for monetary policy purposes.

The current CPI methodology departs from the preferred approach for a cost-of-living index in a number of ways:

- The CPI measures price change for the household sector rather than the average household price change
- the component of owner-occupied housing costs that equates to the cost-of-use of accommodation is not included in the CPI
- measuring price inflation requires other factors like the basket of goods and services, and their quality and quantity to be held constant.

The Harmer Pension Review Report in 2009 found that “pension indexation for price change would be better undertaken through an index that more specifically reflected cost of living changes for pensioners and other income support recipient households.”<sup>1</sup> As a result of the review, the Government allocated \$18.5 million over four years from 2009-10 to the ABS to develop the PBLCI, for use in the cost-of-living indexation of payments covered by the Government's pension reform.

*How useful are supplementary indexes such as the population subgroup measures?*

FaHCSIA supports the ongoing production and further development of ALCIs, including the PBLCI. At the same time, FaHCSIA supports the extension of ALCIs to a number of population sub-groups.

The Government's commitment to include PBLCI in the indexation process provides extra protection and assurance that where pensioners' living costs

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<sup>1</sup> Harmer, J., *Pension Review Report*, Canberra, 2009, page 54

increase faster than those of the community, and faster than wage increases, pensions will increase in line with the increased living costs.

As income support payment rates are determined with regard to CPI and PBLCI, FaHCSIA supports further refinement to these indexes to ensure their usefulness as a proxy for changes in the cost of living, and their stability and integrity.

FaHCSIA also supports the extension of ALCIs to sub-groups in the Australian population. Groups of interest from a policy perspective may include: age cohorts (for example, seniors and youth), family type (with and without children, partnered and single), and housing tenure. A range of indexes covering these groups would support analysis of the changing circumstances and means of families and individuals; this in turn would facilitate better policy development and delivery. In this context, it is also important to have a headline ALCI covering all households, to support comparison of indexes for sub-groups.

From a broader perspective, an expanded set of ALCIs would be of significant benefit in supporting comparisons of real income growth across groups and over time, to better inform social policy analysis and debate.

## **COMPILATION FREQUENCY OF THE CPI**

*Does quarterly release of the CPI still meet user requirements, or would user needs be better served by a monthly CPI?*

FaHCSIA is not opposed to a monthly release of CPI. If there is only limited scope for changes to be made in the context of this review, other issues identified in our submission are of higher priority.

FaHCSIA considers that any move to a monthly CPI should only be made on the basis that the quality of the quarterly CPI series and the ALCIs is not eroded as a result of the increased frequency.

*Do user needs justify the additional costs of a monthly CPI?*

FaHCSIA considers that there are a number of other issues raised in our submission which would be a higher priority. These include, increasing the frequency of the HES, refining the PBLCI, and introducing a separate index with the single purpose of measuring the headline cost of living.

*Other issues around frequency of the CPI*

The timing of the release of the CPI and other indexes such as the PBLCI should be aligned.

The current lag between the release of the CPI and the PBLCI impacts on FaHCSIA's ability to utilise the PBLCI to inform budget projections in a timely

manner and puts pressure on timeframes for processing indexation increases for pensions, benefits and allowances.

## **EVALUATION OF THE DEPOSIT AND LOAN FACILITIES INDEX**

*Are financial services paid for indirectly by interest margins appropriate services for inclusion in the CPI?*

FaHCSIA is of the view that indirect charges included in interest margins on financial services might reasonably be included in the CPI to the extent that they are attributable to household rather than business consumption and can be estimated with a reasonable degree of accuracy. Greater transparency would assist users of the CPI to form a view on whether the current estimation methodology is appropriate. We note that ALCIs are produced on a different basis, incorporating change in the level of real interest paid on debt used to purchase products included in the CPI basket.

The recent volatility of the deposit and loans margin component of the CPI and its relatively large weighting in the index warrant further analysis. Research should be undertaken by the ABS to determine the reason for the volatility of the deposit and loan facilities index around the time of the global financial crisis, and the methodology used to estimate the index should be reviewed. The deposit and loan component should be retained while this review is undertaken, as removing and then possibly replacing it would impact on the weighting of other items in the basket of goods and services, and could potentially affect short-term growth in the CPI.

*Does the ABS methodology correctly measure the price change for this service?*

Greater transparency and detail around the methodology and data used by the ABS is required before most users could form a view on the current methodology.

## **MAINTAINING THE RELEVANCE OF THE CPI**

*Is the current frequency of CPI expenditure class weight updates (six yearly) adequate?*

FaHCSIA recommends an increase in frequency of the HES to every four years. A four-yearly HES cycle would maintain the current alignment of the HES and SIH. At the same time, it would be desirable to reduce the lag between the collection of HES data and revision of CPI weights and release of the HES.

FaHCSIA is concerned that the length of the current HES cycle is such that it is debatable whether the CPI towards the end of the HES cycle is representative of the actual impacts of price changes on households as

households are likely to change their consumption in response to sustained price rises for particular goods.

FaHCSIA considers that the current frequency of the HES (and hence the update of the CPI expenditure class weights) is not adequate for policy analysis purposes. Currently, the six-yearly frequency means that policy modelling and analysis is often conducted using data which is out of date and may no longer be representative. As policy proposals are modelled well in advance of implementation and ten-year costings are becoming more commonplace, being able to base analysis on data that is as current as possible is important.

*Should the ABS consider the use of alternative expenditure weight sources between HES cycles?*

FaHCSIA's strongly preferred option is to increase the frequency of the HES. If this is not possible, alternative methods of updating expenditure weights between HES cycles should be considered.

*Are ABS strategies to keep the CPI contemporary effective? Should improving the measurement of services in the CPI remain a high priority for the ABS?*

The approach taken by the ABS to maintain the relevance of the CPI seems reasonable given the current structure of the index.

*Does the quality adjustment methodology meet user needs?*

FaHCSIA considers that the current quality adjustment process is not transparent and, as a result, it is difficult to form an opinion as to whether this meets user needs. There would be considerable benefit in making details of the process publicly available as well as the effect of the adjustments on the indexes. Notwithstanding this, FaHCSIA is concerned that the quality adjustment process is not suitable for cost-of-living indexes.

## **COMMODITY CLASSIFICATION**

*Are there any concerns about the commodity classifications used to construct the CPI?*

FaHCSIA has no concerns about the commodity classifications used to construct the CPI.

*Are there any purposes for which the industry-based IOPC and the purpose-based CPICC should concord (indirectly via the more detailed HEC)?*

FaHCSIA supports the publication of an official concordance from 5215.0.55.001 (IOPC) to CPI, which would be particularly useful for policy modelling purposes.

Household modelling and analysis, and estimation of the CPI-impact of policies that affect consumer prices, relies on an indirect concordance between IOPC and CPICC (via the HEC) to transmit estimated consumer price changes, by input-output category, through to household expenditure by CPI category. For example, modelling of CPI and household impacts of both the introduction of the GST and the proposed Carbon Pollution Reduction Scheme (CPRS) utilised this concordance.

FaHCSIA considers that publishing the concordance will provide greater transparency to policy analysis and improved community confidence in modelling that uses the concordance.

## **ANALYTICAL SERIES**

*Is the current suite of ABS analytical series useful?*

FaHCSIA strongly supports the continued development of the ALCI series including the PBLCI and, as mentioned above, would welcome an extension of this suite of indexes. The Department does not make extensive use of the other analytical series.

*Is the average retail prices data useful?*

The average retail price data series is useful for simple analysis of price trends and levels. FaHCSIA supports the retention of this series and suggests that the ABS consult with users of the series to determine whether it might usefully be extended.

*Is there any need for a seasonally-adjusted CPI in addition to an unadjusted headline CPI?*

FaHCSIA has no strong views on this issue.

## **OTHER ISSUES**

*Are spatial measures important and/or useful?*

FaHCSIA considers that spatial measures may be useful, depending on the methodology used.

Any spatial measure should be constructed using regionally-based weights as well as regional prices in order to be valid. Producing meaningful spatial measures is likely to require an expansion of the HES as well as the CPI survey and may involve significant cost. FaHCSIA accepts that extending the geographic coverage of the CPI and ALCIs has to be considered in the context of other priorities.

*Is there a need for regional indexes expanding the geographical coverage of the CPI beyond capital cities?*

FaHCSIA supports the expansion of the CPI and ALCIs to cover areas beyond the capital cities.

The current CPI population group represents about 64 per cent of Australian households. It is highly likely that the CPI as it stands is not representative of the price changes experienced in regional Australia. While FaHCSIA does not expect that an expansion of the coverage would extend to remote areas, expansion to regional areas is desirable.

The current CPI, based on the eight capital cities, is not representative of FaHCSIA's customer base, which includes a higher proportion of customers from regional areas.