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# Information Paper

## Outcome of the 13th Series Australian Consumer Price Index Review

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**Information Paper**  
**Outcome of the 13th Series Australian Consumer Price Index**  
**Review**

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**AUSTRALIAN BUREAU OF STATISTICS**

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## LIST OF ABBREVIATIONS

ABS	Australian Bureau of Statistics
ACCI	Australian Chamber of Commerce and Industry
ACOSS	Australian Council of Social Service
ACTU	Australian Council of Trade Unions
AP&SF	Australian Pensioners' and Superannuants' Federation
CPI	Consumer Price Index
DSS	Department of Social Security
DWRSB	Department of Workplace Relations and Small Business
FISIM	Financial Intermediation Services Indirectly Measured
HECS	Higher Education Contribution Scheme
MTAWE	Male Total Average Weekly Earnings
OECD	Organisation for Economic Co-operation and Development
RBA	Reserve Bank of Australia

## PREFACE

In order to ensure the Consumer Price Index (CPI) continues to meet community needs, the Australian Bureau of Statistics (ABS) has regularly reviewed it since it was first compiled in 1960. These reviews update item weights and provide an opportunity to reassess the scope and coverage of the index and other methodological issues.

The issues to be considered in the review of the 13th series CPI were set out in *Information Paper: Issues to be Considered During the 13th Series Australian Consumer Price Index Review* (Cat. no. 6451.0) released on 9 May, 1997. Following release of the paper, there was extensive public consultation and a CPI Review Advisory Group, which represented a range of important users of the index, provided advice. I would like to thank all members of the public who put in submissions, and all the members of the Advisory Group who gave their time freely to help with this exercise. This paper represents a response to the information paper.

Decisions about changing any aspect of the CPI are generally extremely important and often most difficult to make. The decisions which have been taken represent an on-balance view of what sort of CPI is best suited to meet the varying requirements of the broader Australian community now and into the next century.

The 13th series CPI will be introduced in the September quarter 1998 and will be linked to the 12th series CPI at the June quarter 1998. A further information paper will be released about one month before the introduction of the 13th series CPI providing details of the new index, including the weighting pattern that will be adopted.

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## KEY DECISIONS

- The 13th series Consumer Price Index (CPI) will be specifically designed to provide a general measure of price inflation for the household sector as a whole. Accordingly, the ABS will adopt the acquisitions approach for the construction of the index and utilise a weighting pattern representative of all private households in the eight capital cities. The most noticeable changes from the current CPI will be the exclusion of mortgage interest and consumer credit charges from the index and the inclusion of net expenditure on new dwellings (excluding land).
- The population coverage of the CPI will be expanded from the current restriction to wage and salary earner households to cover all private households in the eight capital cities. This will result in the population coverage increasing from 29% to 64% of Australian private households.
- The CPI will continue to be compiled and published quarterly.
- A ninth major commodity group, Financial services, will be incorporated into the index, comprising specific fees and charges paid in respect of financial services together with the cost of financial intermediation services.
- Home computers and software, tertiary education fees and domestic services will be added to the index, but gambling will continue to be excluded.
- The Selected State and local government charges index and the index of imported items will be dropped. Both indexes will be replaced by more appropriate indexes to be developed in consultation with users. State and local government charges and imported items will continue to be included in the CPI.
- In light of the decision to change the design of the CPI to provide a better measure of price inflation for the household sector as a whole, the ABS will review the allocation of the CPI price sample across the capital cities with a view to optimising the national estimate. This work will be undertaken as resources permit and will involve further consultation with key stakeholders.
- The ABS will proceed to develop a measure of underlying inflation for the household sector in accordance with the proposals contained in *Information Paper: An Analytical Framework for Price Indexes in Australia* (Cat. no. 6421.0). The most significant characteristic of this measure is that it will net out the effects of changes in indirect taxes.
- The ABS will also develop analytical indexes specifically designed to measure changes in the cost of living of subgroups in the population. These indexes will be constructed on an outlays basis and will be published at approximately annual intervals.
- The ABS will introduce the facility to compile spatial comparisons of price levels in the eight capital cities as resources permit.
- The 13th series CPI will be introduced in the September quarter 1998 and will be linked to the 12th series CPI at the June quarter 1998.

## OUTCOME OF THE 13TH SERIES REVIEW

**1** The CPI is an important economic indicator and actions related to movements in it have direct and indirect effects on all Australians. The CPI is used for many purposes, including as an input to the wage and salary adjustment process, the indexation of pension and superannuation payments and government taxes and charges, the indexation of government bonds and business contracts and as a general measure of inflation for macro-economic policy purposes.

**2** The present 12th series CPI, which uses a 1989–90 weighting base, was first published in the September quarter 1992 CPI release.

**3** This information paper sets out the key decisions taken regarding the 13th series CPI, which will be introduced in the September quarter 1998 and linked to the 12th series CPI at the June quarter 1998 (see Timetable, paragraphs 75 to 83).

**4** The ABS has undertaken extensive public consultation about the 13th series CPI. This phase commenced on 9 May 1997 with the release of *Information Paper: Issues to be Considered During the 13th Series Australian Consumer Price Index Review* (Cat. no. 6451.0) which was sent to all subscribers of the CPI publication.

**5** Advertisements were placed in all major Australian newspapers drawing attention to the release of the information paper and inviting submissions on the issues to be considered. The ABS received 47 written submissions from organisations and individuals.

**6** Two seminars were held in each of the eight capital cities on the CPI review and a series of bilateral discussions were undertaken with some major CPI users. The CPI review was discussed at the July 1997 meeting of the Australian Statistics Advisory Council.

**7** The ABS also benefited from the deliberations of a 13th Series CPI Review Advisory Group, which met three times over the course of the review. The report of the CPI Review Advisory Group is Appendix 1 to this information paper. Membership of the Advisory Group, which represented a broad cross-section of CPI users, comprised:

Mr Chris Foster	Commonwealth Department of Social Security (DSS)
Dr Barry Gray	Commonwealth Department of the Treasury
Mr Scott Matheson	Commonwealth Department of Workplace Relations and Small Business (DWRSB, formerly Department of Industrial Relations)
Dr Malcolm Edey	Reserve Bank of Australia (RBA)
Mr Rob Brooker	Victorian Department of Treasury and Finance, representing State/Territory Treasury departments
Dr Steven Kates	Australian Chamber of Commerce and Industry (ACCI)
Mr Peter Davidson	Australian Council of Social Service (ACOSS)

Mr Tim Harcourt	Australian Council of Trade Unions (ACTU)
Mr Gerard Thomas	Australian Pensioners' and Superannuants' Federation (AP&SF)
Dr Chris Caton	Bankers' Trust Australia, representative business economist
Professor Max Neutze	Australian National University, and Chairman of the 12th Series CPI Review Technical Consultative Committee, representative academic.

**8** A list of the submissions received on the review is Appendix 2.

**9** The ABS is grateful to all organisations and individuals who participated in the public consultation processes.

## PRINCIPAL PURPOSE OF THE CONSUMER PRICE INDEX

### Background

**10** *Information Paper: Issues to be Considered During the 13th Series Australian Consumer Price Index Review* (Cat. no. 6451.0) noted that the various uses of the CPI could be conveniently categorised under three main headings:

- as input to the income adjustment process;
- for general indexation of public and private sector contracts; and
- as a measure of inflation for macro-economic policy management.

**11** The information paper also noted that there are three alternative conceptual approaches to constructing CPIs:

- the *acquisitions* approach, which defines the basket as consisting of all those consumer goods and services actually acquired by households during the base period;
- the cost of *use* approach, which defines the basket as consisting of all those consumer goods and services actually consumed (or used up) in the base period irrespective of when they were acquired or paid for; and
- the actual outlays (or *payments*) approach which defines the basket in terms of the actual amounts paid (or outlaid) by households during the base period to gain access to consumer goods and services (without regard to the source of such funds).

These approaches were described in Appendix 1 of that information paper. In practice, the conceptual distinctions are unimportant for most areas of household consumption because they either do not arise or are of no practical consequence. That Appendix explained the circumstances under which the distinctions are important. This is particularly the case with housing costs.

**12** There is no international standard approach which is recommended for adoption by countries. Therefore, countries have adopted different approaches which they believe best suit their principal uses.

User views

**13** During the course of this review, the ABS consulted with a broad cross-section of users.

**14** While individual users tended to focus on different aspects of the CPI, or address issues in different ways, the views expressed on the principal purpose of the CPI fell into one of two camps. Users argued either for the retention of the current cost of living focus or for a move to provide a better measure of changes in the general price level experienced by households. No user put forward the view that the CPI ought to be designed to directly measure underlying inflation (although there was widespread acceptance that such a measure should also be developed).

**15** Users arguing for the retention of the current approach offered one of three reasons. The majority of these users put forward the view that the principal use of the CPI remained as an input to the income adjustment process, either directly as in the case of social welfare beneficiaries or superannuants, or indirectly in the case of wage and salary earners. For these applications, it was argued that the objective is the maintenance of the purchasing power of the income flows or benefits and that the current approach to constructing the CPI was conceptually best for this purpose (although a number of users also correctly expressed concern about the extent to which the CPI adequately reflected the price experience of social welfare beneficiaries and households in receipt of superannuation). A minority argued for the retention of the status quo on the basis that change in itself will serve to increase uncertainty about the CPI among the many users of the CPI who may be less concerned with the conceptual correctness of the index. Others argued for the retention of the status quo on the basis that they might be financially disadvantaged. Included among this group of users are investment managers responsible for CPI-linked indexed bond portfolios.

**16** Users arguing that the principal purpose of the CPI should now be the measurement of price inflation for the household sector made one or more of the following points. First, the move away from a centralised wage determination system (under which employees tended to be compensated for previous changes in purchasing power), to a decentralised system which focuses more on the commercial circumstances of individual firms, has resulted in a decline in the importance of the CPI for income adjustment purposes. Further, to the extent that inflationary expectations are formed on the basis of historical experiences, a measure which excludes the volatile and often counter cyclical effects of interest rates would provide a better

indicator of the likely path of future price changes. Second, the importance of having a good measure of price inflation has increased since 1993 when the RBA introduced an inflation target. The benefits of controlling inflation are profound and flow to all Australian households including those on fixed incomes.

**17** It was also noted that recent legislative changes have altered arrangements for indexation of the majority of social welfare beneficiaries. As well as continuing the indexation of these payments to the CPI, further adjustments will be made, as necessary, to ensure that the maximum rate of the single adult social security pension (after indexation) will not fall below a rate equal to 25% of the annualised, original, all males, total average weekly earnings (MTAWE) figure, with flow-on effects for all other pensions and related family payments.

**18** These significant differences of view about the principal purpose of the CPI were mirrored in the deliberations of the CPI Review Advisory Group which spent most of its time on this matter. In the end, the Group was unable to reconcile these differences of view. These are elaborated in its report which is Appendix 1 to the present information paper.

#### Evaluation and decision

**19** Historically, the CPI was developed with the principal purpose of providing input to the highly centralised wage and salary determination process then existing in Australia. The CPI reference population was identified as being wage and salary earner households. Successive CPI reviews have served to ensure that refinements to the index have resulted in a measure increasingly more suited to its principal purpose.

**20** The 11th series CPI review, which was undertaken in 1986, recognised the broader range of uses for which the CPI was increasingly being used. The 12th series CPI review concluded that although the range of uses for the CPI had been growing steadily, its principal purpose remained, on balance, as an input to the income adjustment process (with its use as a general measure of inflation running second).

**21** Since the 12th series CPI review, the context in which the CPI is used has changed:

- Containing inflation, and the shaping of inflationary expectations of the Australian population, is attracting much more focus as an economic policy imperative.
- The RBA now administers monetary policy with the objective of keeping underlying or core inflation within the range of 2% to 3% over the business cycle.

- There has been a continuing trend towards decentralised, enterprise level wage and salary setting arrangements with the outcomes focussed on the commercial circumstances of individual businesses. From employees' perspectives these arrangements have focussed attention on more forward looking inflationary expectations rather than on past 'catch-up' approaches. (Centralised safety net arrangements continue to apply for those employees unable to take advantage of enterprise bargaining arrangements.)
- The absolute reliance of most social welfare beneficiaries on the CPI for indexation of their incomes has changed with the passing of the *Social Security and Veterans' Affairs Amendment (Male Total Average Weekly Earnings Benchmark) Bill 1997*, which provides for adjustments should the maximum rate of the CPI-adjusted single adult pension fall below 25% of MTAW.

**22** The extensive use of the CPI for general indexation of public and private sector contracts continues. The user consultation phase confirmed that other attributes of the CPI such as its prominence, its wide availability, its timeliness and the fact that it is never revised, continue to be most important for these uses of the index.

**23** After taking into account the practical implications of the alternative approaches to constructing a CPI on those most directly affected (see Appendix 3), the ABS has reached the conclusion that, on balance, the Australian community would now be better served by a CPI designed specifically to provide a general measure of price inflation for the household sector. Accordingly, the ABS will adopt the *acquisitions* approach for the construction of the 13th series Australian CPI. The most significant change that this will entail will be the exclusion of mortgage interest and consumer credit charges from the index.

**24** The exclusion of mortgage interest and consumer credit charges from the CPI will result in an index which will provide a better measure of changes in the cost of living of those households in receipt of social security benefits since only a small proportion of these households incur these expenditures. An acquisitions index is also assessed as providing a better indicator of the price experiences of other low income households. As such, it is judged to be a more appropriate measure for input to the process for adjusting the award safety net by the Australian Industrial Relations Commission. Through removal of the volatility arising from the inclusion of interest charges in the current CPI, the 13th series CPI should also provide a more reliable benchmark for assessing future price changes for parties negotiating enterprise agreements.

## PRINCIPAL PURPOSE OF THE CPI *continued*

**25** As the 13th series Australian CPI will still fall short of providing a reliable measure of 'core' inflation for the purpose of administering macro-economic policy, the ABS will proceed to develop a measure of underlying inflation for the household sector according to the methodology outlined in *Information Paper: An Analytical Framework for Price Indexes in Australia* (Cat. no. 5421.0). It is not possible to place a firm timescale on this development at this stage, however the ABS will commence more detailed consultations with key stakeholders as soon as practicable.

**26** Further, in recognition of the widespread interest in the extent to which rates of change in the cost of living vary across different groups in the community, the ABS will compile and publish analytical indexes specifically designed to measure changes in living costs for a range of population subgroups. These indexes, which will be constructed using the *outlays* approach, will be published at approximately annual intervals. The particular population groups for which these indexes will be compiled will be determined after further consultation. See also the section Population Coverage below for further discussion on this matter.

## FREQUENCY OF CONSUMER PRICE INDEX COMPILATION

### Background

**27** Of the Organisation for Economic Co-operation and Development (OECD) countries, only Australia and New Zealand compile and publish their CPIs on a quarterly basis; all other OECD (and some non-OECD) countries produce monthly CPIs.

**28** As set out in *Information Paper: Issues to be Considered During the 13th Series Australian Consumer Price Index Review* (Cat. no. 6451.0), the additional cost of compiling and publishing a monthly CPI would be considerable (at least \$1.87 million per year).

**29** The Australian CPI has always been compiled on a quarterly basis, although up to the early 1980s the index for the Food group was compiled and published on a monthly basis. While the issue of whether the CPI should be produced monthly has been raised from time to time, users have, on balance, agreed that a quarterly release is an appropriate strategy for Australia given the additional costs involved in compiling a reliable monthly measure.

**30** The frequency of compilation and publication of a statistic like the CPI represents a balance between the benefits and the costs. The benefits generally cited in favour of a monthly CPI are an increased ability to detect turning points and international comparability. The costs associated with a move to a monthly release would include the obvious additional resources required to collect and compile data more frequently and, possibly, a reduction in data quality. There is also the issue of the impact on financial markets. In a context where there is sometimes market instability surrounding CPI releases, there may be increased concerns with a monthly CPI, particularly if it is of lower quality than a quarterly CPI.

#### User views

**31** The issue of the frequency of CPI compilation attracted very little comment during the public consultation phase of the review. One financial market participant submitted that the CPI should be published monthly. While not arguing strongly for a monthly CPI in its submission, the RBA considers that a monthly CPI would have some information value. The majority view of the CPI Review Advisory Group is that there is not sufficient justification to incur the increased costs associated with a monthly CPI.

#### Evaluation and decision

**32** Given the lack of strong user justification for a monthly CPI, coupled with the considerable additional costs that would be incurred, it has been decided that the CPI will continue to be compiled and published quarterly.

## POPULATION COVERAGE

#### Background

**33** The current (12th series) CPI is constructed to reflect the expenditure patterns of wage and salary earner households in each of the eight capital cities. This restriction reflects the traditional use of the CPI as an input to wage determination processes. The Report of the Technical Consultative Committee for the 12th series review included the following recommendation (recommendation 6.3.6):

The committee found support for widening the scope of the CPI to cover a broader cross section of the population. The committee recommends that the ABS review the target population with a view to include additional household groups (subject to the cost implications of any such widening). This investigation could be undertaken prior to the next major review.

**34** In more specific terms, the coverage of the current CPI is as follows:

- The reference population is described as employee households, where these are defined as households deriving at least three-quarters of their income from wages and salaries, but excluding the top 10% of this group in terms of income.



- The regional scope is restricted to the eight capital cities, for which separate estimates of expenditure are derived for purchases by residents of those regions.
- Separate indexes are computed for the residents of each region.
- Expenditure relates to the total expenditures of population group households in each region and thus includes expenditure outside the region (including expenditure abroad).

The current CPI population group (capital city employee households) accounts for approximately 29% of Australian private households and 34% of total private household expenditure.

**35** The current restriction of the CPI reference population to employee households reflects the traditional use of the CPI as an input to wage determination processes. The restriction to the eight capital cities has been made on cost grounds.

**36** The restriction of the population group to employee households can be challenged on three fronts. First, the tight nexus between movements in the CPI and wage and salary adjustments no longer exists. Second, from an income adjustment perspective, the CPI is used directly to adjust the incomes of households that are not in scope of the CPI, specifically households in receipt of social security benefits or superannuation payments. Third, changes in the demographic profile of Australian households have resulted in a decline in the relative importance of employee households.

**37** *Information Paper: Issues to be Considered During the 13th Series Australian Consumer Price Index Review* (Cat. no. 6451.0) noted that the choice of region to be covered by the CPI is largely linked to the costs involved in price collection. A secondary, but important, consideration is the basis on which expenditure data is available — expenditure by residents of a region, or expenditure within a region. Expenditure estimates for deriving the weighting patterns used in constructing the CPI relate to the expenditures actually incurred by households resident in a region without regard to where the purchases were made. For households resident in large urban areas such as capital cities, it is reasonable to conclude that, with the exception of expenditure on holiday travel and accommodation, expenditure is incurred in the region of residency. Therefore, price measures can be constructed by reference to prices within the same region. For smaller population centres it is not reasonable to conclude that purchases are made locally, particularly for large expenditure items. This presents a significant practical problem in establishing reliable price samples. Both of these issues have played a role in determining the geographic coverage of the Australian CPI.

**38** During the consultation phase, user comments were invited on:

- extending the population coverage to all households in the eight capital cities;
- the benefits to be gained from extending the population coverage beyond the capital cities, recognising that the costs of doing so are likely to be significant;
- the regional indexes required; and
- any need for indexes for subgroups of the population.

#### User views

**39** Both in the submissions received and in the user seminars there was strong support for extending the reference population to include all households. The majority view of the CPI Review Advisory Group is also to extend the reference population to include all households. However, the ACTU, in arguing that the principal purpose of the CPI should be a measure of living costs for wage and salary adjustment, supports the present population coverage.

**40** On the issue of regional coverage there was some support for extending the CPI beyond the eight capital cities. While conceptually most users favoured a CPI with the widest possible geographical coverage, there was acceptance that the costs associated with a move to broaden the geographical coverage beyond the eight capital cities would be substantial. There was no support among CPI Review Advisory Group members for an expanded geographical coverage, as the benefits are not seen as being commensurate with the costs.

**41** There were mixed views on the need for indexes for subgroups of the population. Within the CPI Review Advisory Group there were strong differences of view on this matter. The DSS, the ACOSS and the AP&SF support the compilation, periodically, of subgroup indexes for analytical purposes. The ACTU supports the compilation of a wage and salary earner index if the reference population is broadened. The ACCI is strongly opposed to compilation of indexes for population subgroups, arguing that pressures would arise for 'movements in the relevant index [to] be of itself the justification for a movement in the payments of the targeted group'. ACCI is also concerned about the possibility that there would be 'picking and choosing' between whichever index was highest.

## POPULATION COVERAGE *continued*

### Evaluation and decision

**42** The challenges, as set out in paragraph 36 above, that can be made to a CPI restricted to wage and salary earner households are valid and can lead to serious credibility problems with the CPI. It has therefore been decided that the CPI reference population will be extended to all private households. The inclusion of social welfare beneficiary and superannuant households in the reference population better aligns the CPI for use in indexation of social security benefits and indexation of superannuation pensions respectively.

**43** Given the substantial costs that would be involved in extending the CPI beyond the eight capital cities, it has been decided to continue to restrict the CPI to the eight capital cities.

**44** The combined effect of the decisions set out in the previous two paragraphs will be to expand the population coverage of the CPI from 29% to about 64% of Australian private households.

**45** Notwithstanding the comments of ACCI quoted above, the ABS sees merit in compiling, for analytical purposes, indexes for subgroups of the population at approximately annual intervals. As noted in paragraph 26 above, these analytical indexes will be specifically designed to measure changes in living costs for a range of population subgroups and will be constructed using the outlays approach. ABS will consult further with interested users before final approaches are decided.

**46** In light of the decision to alter the design of the CPI to provide a better measure of price inflation for the household sector as a whole, the allocation of CPI price samples across the eight capital cities will be reviewed with the objective of optimising the national estimate. This work will be undertaken as resources permit and will involve further consultation with key stakeholders.

## COMMODITY CLASSIFICATION AND ITEM COVERAGE

**47** *Information Paper: Issues to be Considered During the 13th Series Australian Consumer Price Index Review* (Cat. no. 6451.0) identified a range of issues on which user views were sought in regard to the commodity classification and item coverage for the 13th series CPI.

**48** The issues are highly inter-related with those of principal purpose of the index.

Commodity classification

*Background*

**49** The commodity classification currently used for the CPI consists of eight broad groups of goods and services:

Food  
Clothing  
Housing  
Household equipment and operation  
Transportation  
Tobacco and alcohol  
Health and personal care  
Recreation and education

**50** These groups are further broken down into a total of 35 subgroups which are in turn broken down into a total of 107 expenditure classes.

**51** The commodity classification for the CPI is seen as serving a number of important purposes:

- it assists in describing the CPI item coverage, weighting patterns and methodology to a broad range of users;
- it provides a framework for defining item coverage and identifying whether new items are within scope of the CPI and, if so, where price observations 'belong'; and
- it facilitates the production of indexes for components of the CPI for analytical and other purposes.

**52** During the 12th series review of the CPI, the Technical Consultative Committee recommended that the ABS consider restructuring the commodity classification to create a ninth major group, 'Financial charges', which would include mortgage interest charges and consumer credit charges.

**53** Apart from the issue of the creation of a ninth major group, the ABS flagged some other possible changes to the commodity classification in the earlier information paper.

*User views*

**54** During the consultation phase, users were invited to comment on:

- the usefulness of creating a new ninth group for financial charges;
- whether mortgage interest charges for owner-occupied housing should be moved from Housing to a Financial charges group if so created; and
- any other comments on the CPI commodity classification.

**55** There was general support for the inclusion in the CPI of specific fees and charges paid in respect of financial services. However, the discussion in the earlier information paper about where mortgage interest and consumer credit charges should best fit in the CPI classification is academic given the decision, in line with the view now taken of the principal purpose of the index, to exclude these items entirely from the CPI.

**56** No users were opposed to the other possible classification changes discussed in the earlier information paper.

*Evaluation and decision*

**57** The exclusion of mortgage interest and consumer credit charges from the CPI simplifies, somewhat, the classification issues. A ninth group, 'Financial services' will be created to cover specific fees and charges paid in respect of financial services. Also the cost of financial intermediation services (see paragraph 62 below) will be included in this group.

**58** The user consultation phase did not reveal user concerns with proceeding with other 'fine-tuning' adjustments to the commodity classification. These will be pursued, with final decisions being taken in the context of the further developmental work required for the 13th series CPI. Final decisions on this matter will be detailed in a further information paper on the 13th series CPI to be published about one month before the introduction of the new index.

Item coverage

*Background*

**59** *Information Paper: Issues to be Considered During the 13th Series Australian Consumer Price Index Review* (Cat. no. 6451.0) noted that the current CPI covers approximately 95% of target group outlays on consumption. The results of the 1993–94 Household Expenditure Survey are being analysed to quantify the extent of under coverage and to identify those areas not currently covered with a view to assessing the feasibility of introducing them to the CPI. That information paper went on to discuss the merits of including home computer equipment and software, gambling, other financial charges, tertiary education fees, and domestic and homecare services in the index.

*User views*

**60** There was general support, including among the CPI Review Advisory Group, for the inclusion of home computer equipment and software, other financial charges, tertiary education fees, and domestic and homecare services in the index. One State Treasury department was opposed to the inclusion of the financial institutions duty and bank account debit levies in the financial charges component as these taxes are administered and do not reflect supply and demand conditions and inflationary pressures. There was no support for the inclusion of gambling in the index.

*Evaluation and decision*

**61** Home computer equipment and software, financial charges, tertiary education fees and domestic services will be included in the 13th series CPI. Gambling will continue to be excluded on practical grounds.

**62** Inclusion of financial services raises some complex issues in the context of the acquisitions basis of the index. As well as the fees and charges actually incurred, households also acquire financial services funded by financial institutions out of the interest rate margins on their financial intermediation activities. The mix can change over time. For example, financial institutions may increase fees and charges whilst reducing interest rate margins. To exclude the latter because of practical difficulties will bias the CPI. ABS will be investigating how such services can be most appropriately included in the index and will report on this matter in the further information paper to be released about one month before the introduction of the 13th series CPI.

**63** The acquisitions basis of the 13th series CPI will make irrelevant the interest payable by households on amounts borrowed under the Higher Education Contribution Scheme (HECS). Only the tertiary education fees themselves will be included in the index.

**64** The ABS will continue to include a contribution for owner-occupied housing in the CPI. The ABS has always been of the view that costs borne by owner-occupiers in respect of their principal dwelling represent a mix of investment and consumption expenditure — the difficulty being how to separate the two elements so as to only include the consumption element in the CPI. In the current CPI, the consumption element is represented by mortgage interest charges, local government rates and charges, house repair and maintenance expenses and house insurance costs. In the new series, the consumption element will be represented by the purchase of dwellings (excluding land), local government rates and charges, house repair and maintenance expenses and house insurance costs.

**65** As CPIs are constructed to reflect the experiences of a reference population in aggregate, the significance of house purchase under the acquisitions approach is determined only by those dwellings acquired from outside the reference population (i.e. transactions between reference population households are netted out, as positive expenditure by purchasing households is offset by negative expenditure on the part of the selling household). With the expansion of the CPI reference population to cover all private households in the eight capital cities, this effectively translates to the purchase of newly constructed dwellings and alterations and additions to existing dwellings (with the purchase of second-hand dwellings from the government and business sectors being insignificant).

**66** Accordingly, the net acquisition of new dwellings will be added to the 13th series CPI as a separate expenditure class within the housing group. Full details of the methodology to be used will be outlined in the information paper referred to in paragraph 62.

## OTHER ISSUES

**67** A range of issues regarding analytical series and spatial indexes were discussed in *Information Paper: Issues to be Considered During the 13th Series Australian Consumer Price Index Review* (Cat. no. 6451.0). This section summarises user views and decisions taken on these matters.

### Analytical series

#### *User views*

**68** There was general support for dropping the Selected State and local government charges index for reasons set out in the earlier information paper. There is interest, however, in the ABS developing an index (or suite of indexes) which would be relevant to assessing the impact of structural changes in government activities as well as relative State competitiveness. An example cited would be an index of utility (power, gas and water) prices. The CPI Review Advisory Group held similar views.

**69** The major user of the price index of imported items is the RBA, which recognises the shortcomings of the existing index. The RBA has proposed that indexes be compiled for 'tradeables' and 'non-tradeables', with the distinctions being made at the expenditure class level.

#### *Evaluation and decision*

**70** The ABS will further consult with users with a view to introducing analytical indexes along the lines discussed in paragraphs 68 and 69 above.

**71** Final decisions on the analytical series to be compiled will be detailed in the further information paper to be published about one month ahead of the introduction of the 13th series CPI.

### Spatial measures

**72** The CPI is a temporal price index, that is, it provides a measure of price change over time. The indexes constructed for each city measure how prices in each city have moved over time; they cannot be used to draw inferences about whether prices in one city are any higher or lower than prices in any other city.

**73** There was considerable user interest expressed in being able to make valid spatial comparisons of price levels across the capital cities. At the same time, users appreciated the practical and conceptual difficulties of such comparisons, especially in regard to the weighting patterns to be used. Given these complexities the CPI Review Advisory Group is of the view that such comparisons should be accorded a relatively low priority by the ABS.

**74** ABS accepts the views of the Advisory Group. ABS will introduce the facility to compile spatial comparisons of price levels in the eight capital cities as resources permit.

## TIMETABLE

**75** A timetable for the introduction of the 13th series CPI was included in *Information Paper: Issues to be Considered During the 13th Series Australian Consumer Price Index Review* (Cat. no. 6451.0).

**76** The public consultation phase has taken longer than was envisaged when that information paper was released in May 1997. In part, this was a result of the significant differences of view that emerged on the key issue of principal purpose of the CPI.

**77** The decision to move to an acquisitions based CPI will increase the research and development effort required in the lead up to the introduction of the new index. Further, the ABS sees some merit in commencing the new index at the start of a financial year.

**78** For the above reasons it has been decided that the 13th series CPI will be introduced in respect of the September quarter 1998 and will be linked to the 12th series at the June quarter 1998. An indicative timetable of activities leading up to the introduction of the new index follows.

*Mid November 1997*

**79** Release and widely distribute this information paper summarising the outcome of the public consultation phase of the 13th series CPI review and setting out the major decisions taken on the conceptual basis of the new index.

*November 1997 to June 1998*

**80** Develop new price collections (e.g. for domestic services) and finalise index structure.

*August 1998*

**81** Estimate new expenditure patterns and weights.

*September 1998*

**82** Publish information paper with details of the index structure and weights.

*October 1998*

**83** Release of the September quarter CPI with the 13th series.



## APPENDIX 1

# REPORT BY THE CONSUMER PRICE INDEX REVIEW ADVISORY GROUP ON ITS DELIBERATIONS ON THE 13TH SERIES REVIEW OF THE CONSUMER PRICE INDEX

### INTRODUCTION

**1** The ABS *Information Paper: Issues to be Considered During the 13th Series Australian Consumer Price Index Review* (Cat. no. 6451.0), hereafter referred to as the scoping paper, identified major issues for consideration in the 13th Series review of the Consumer Price Index (CPI). It was provided to all subscribers to the CPI and placed on the ABS Internet site.

Advertisements in major newspapers invited submissions to the review and two public seminars were held in each capital city. The ABS received 47 submissions from the public.

**2** An Advisory Group, comprising representatives of major users (see Annex 1 for the composition of the Group), was formed to assist the ABS in its deliberations. The Group met on three occasions (16 May, 30 June and 7 October 1997). In addition to the meetings of the Group, the ABS held bilateral meetings with each member of the Advisory Group.

**3** This report draws together the views of the Advisory Group on the issues raised in the scoping paper.

### PRINCIPAL PURPOSE OF THE CPI

#### Scoping paper

**4** The scoping paper identified the principal purpose for which the CPI is required as being critical to any decisions about the method of compilation and the items included in the index. Uses of the CPI were classified under three general headings: as input to the income adjustment process; for the indexation of contracts; and as a measure of inflation for macro-economic policy management. It was noted that the first category had declined in significance in terms of wage and salary setting and there was an increasing requirement for a measure of inflation.

**5** Three conceptual bases for a consumer price index were listed in the scoping paper. The outlays (or payments) approach defines the item coverage (basket) in terms of the actual amounts paid by households to gain access to consumer goods and services. This approach is most appropriate to the principal purpose of income adjustment for which the CPI was originally constructed. Other conceptual approaches are acquisitions, under which the basket is defined to include all those goods and services actually acquired by households in the base period, and cost of use approach under which the basket includes all those goods and services actually consumed (or used up) in the base period. Under the three conceptual approaches the main differences arise in respect of the treatment of durable goods, particularly housing, goods and services provided at non-market prices, and items of expenditure which cannot be directly resolved into a quantity and price component.

## APPENDIX 1 *continued*

### Summary of Advisory Group discussion

**6** Given the critical nature of principal purpose to the conceptual basis of the CPI, the Advisory Group spent most of its time on this matter. The Group comprises representatives of users which have quite different interests in the CPI and it is clear that no consensus on principal purpose can be reached. It is felt that in these circumstances it is appropriate to summarise the view of each member, noting that full articulation of the arguments is contained in members' submissions.

#### *Department of Social Security (DSS)*

**7** DSS makes payments of \$42 billion per year in benefits to five million people and most of these payments are indexed to the CPI. Legislation is before Parliament that does not allow the single pension to fall below 25% of Male Total Average Weekly Earnings (MTAWE) and this safety net provision flows on to all pensions and family payments (about 70% of DSS beneficiaries). The CPI continues to be used to adjust pensions every six months. The MTAWE provision only comes into play in the event that the CPI adjusted pension falls below 25% of MTAWE. The remaining 30% of beneficiaries continue to have payments indexed by the CPI alone.

**8** DSS regards the purpose of indexation as maintaining the purchasing power of payments and wants this to remain as the principal purpose of the CPI. DSS sees difficulties in moving away from the current practice. It would be impractical to have different indexes for various welfare groups. There are about 200 references to the CPI in DSS legislation. In addition, clients would view a move away from current indexation arrangements with suspicion. In particular, DSS believes that it would be a bad time to change the conceptual basis of the CPI if we are near the bottom of the interest rate cycle.

#### *Commonwealth Treasury*

**9** The Treasury submission shows that the three conceptual bases of the CPI produce similar results in the longer term. Treasury argues that developments since the last review suggest the CPI should move to be a measure of inflation.

**10** The previous CPI review recognised that income adjustment was still the major role for the CPI, although the wages system was going through a transition at the time. Wage negotiations are now more forward looking and have a longer term focus so that inflationary expectations are more important: hence the need for the CPI to measure inflation. In regard to social security payments, Treasury notes that the inclusion of mortgage interest payments means the CPI is not representative of the expenditure of welfare recipients and that MTAWE would be the dominant determinant of future pension adjustments. The increased policy focus on maintaining a low inflation environment requires a suitable, accurate and high profile measure of inflation. The inclusion of interest rates in particular makes the CPI inadequate, hence the use of the Treasury underlying inflation measure.

## APPENDIX 1 *continued*

**11** Treasury advises that the Treasurer would need to reach an opinion as to whether any change in the CPI methodology was materially detrimental to investors in indexed bonds (in accordance with the Treasury indexed bond prospectus). Treasury also advises that, while financial market participants accept the regular review of the CPI, there have been concerns expressed that a change to an acquisitions basis could produce, at particular points in time, CPI outcomes lower than would otherwise have been the case and thus reduce the returns from Treasury indexed bonds.

### *Australian Council of Trade Unions (ACTU)*

**12** ACTU submission notes that the CPI is of vital importance in wage adjustment. It is critical in arbitral proceedings before the Australian Industrial Relations Commission when award wage rates generally are to be varied in 'Safety Net' or national wage contexts. It is also important in enterprise bargaining, and is often explicitly mentioned in formal enterprise agreements (the Department of Workplace Relations and Small Business (DWRSB) notes that about 4.5% of enterprise agreements include reference to the CPI, while the ACTU has estimated the figure at around 9%). The ACTU argues that recent labour market changes are not reason enough to change the conceptual basis of the CPI. There are other measures of inflation available to policy makers and the cost of changing the CPI would not be worth it. While the ACTU acknowledges inflation measurement is important, income adjustment should be the main purpose of the CPI.

### *Department of Workplace Relations and Small Business*

**13** DWRSB considers that the CPI continues to play an important role in the wage adjustment process, even though the system is not as mechanistic as in the past. This, coupled with its concern that community acceptance must not be jeopardised, leads DWRSB to the view that the current outlays approach to constructing the CPI should be maintained. DWRSB is concerned that if mortgage interest charges are excluded, home buyers will not be adequately represented in the index. If it were decided to go with an acquisitions approach and reduce the weight for housing, DWRSB is concerned about public perceptions and in any event would still want an outlays index for wage and salary earners. DWRSB is not convinced that putting house prices into an acquisitions measure would accurately reflect living costs.

### *Australian Council of Social Service (ACOSS)*

**14** ACOSS considers that the CPI should reflect changes in household living costs in a timely manner and should be valid and credible. ACOSS leans towards an outlays approach as it is more credible in the eyes of the average household. ACOSS is not sure if the acquisition approach would achieve the Reserve Bank of Australia (RBA) objective of reducing inflationary expectations in boom times if the measure did not correspond to the commonsense perceptions of households with mortgage interest costs. ACOSS accepts that there are problems in including housing interest rates because of their volatility but supports publication of the current index and one excluding mortgage interest charges.

## APPENDIX 1 *continued*

**15** ACOSS is reluctant to have separate indexes for pensioners or other income support recipients. Recipients are a diverse group. ACOSS would like to explore the suitability of a measure excluding housing interest rates for income support households, but if this is different to the CPI it would not be credible to use it to index income support payments. ACOSS believes that more research should be conducted in order to better understand changes in the cost of living among different recipient groups.

### *Reserve Bank of Australia*

**16** The RBA argues that the CPI should be a measure of inflation, and therefore supports an acquisitions approach. Interest rates are conceptually different from other prices because they represent the relative price of current versus future spending, rather than being a component of the current price level. Inclusion of the level of interest rates is therefore conceptually inappropriate in an index that is used as a general measure of inflation.

**17** The decision as to whether home purchase should be included in an acquisitions index of consumer prices depends on whether home purchase is considered to be consumption or investment. If it is counted as investment, it would be excluded from the index. If it is consumption, then it should be measured by the cost of net additions to the housing stock, excluding the land component.

**18** The RBA also noted that the inclusion of interest rates in the CPI was inappropriate for indexation purposes in the case of pensioners who were net recipients of interest income. Inclusion of interest rates in the CPI for indexation purposes would amplify rather than reduce swings in their real income.

### *Dr Caton*

**19** Dr Caton supports the RBA views. He notes, however, that if a change to the acquisition approach were to be introduced, the timing could be unfortunate if interest rates were viewed as being at or close to the lower end of the cycle, with possibly unfavourable implications for both income-support recipients and the indexed bond market.

**20** Dr Caton commented that the indexed bond market initially was unconcerned about possible changes to the CPI, but the degree of concern grew over time as the Review received more media attention. This increased concern was also reflected in subsequent submissions to the ABS.

## APPENDIX 1 *continued*

### *State Treasuries*

**21** The New South Wales and Queensland Treasuries and the Queensland Government Statistician expressed the view that the CPI should measure inflation. The Queensland Treasury felt that the current headline CPI met the objective of measuring inflation, and that a second measure similar to the Commonwealth Treasury underlying inflation rate is needed as a tool for setting monetary policy. With Commonwealth payments to the States indexed to the headline rate and interest rates at a low, some States have expressed concern about the timing of any possible exclusion of mortgage interest charges. The inclusion of owner-occupier housing costs is relevant to these indexation arrangements because they were intended to ensure that each State and Territory has the capacity to provide a particular standard of service.

### *Australian Chamber of Commerce and Industry (ACCI)*

**22** ACCI argues that the primary purpose of the CPI is as a measure of inflation but also recognises that there are a wide variety of purposes for which the CPI is used. However, as the primary purpose of the CPI is to measure trends in inflation, ACCI supports the use of the acquisitions approach. But whichever approach is chosen, ACCI strongly believes that there should be only a single measure of inflation produced by the ABS.

**23** ACCI is concerned that the introduction of the debt profile model in 1989 converted the CPI from a contemporaneous measure. ACCI prefers the simple revaluation approach which was the methodology originally used by the ABS. If the payments approach is retained, there is a need to look at the treatment of interest rates.

### *Professor Neutze*

**24** Professor Neutze notes that the CPI is used for two distinct purposes and there is a need for two separate indexes. It is more appropriate to keep the CPI as a cost of living index as it was originally structured this way and it is easier to change the understanding of financial markets than it is of households. Professor Neutze is surprised that those who want the CPI to measure inflation have not highlighted its narrow base, e.g. exclusion of capital and producer goods.

**25** Professor Neutze notes that home purchase includes both an investment and a consumption element. The only way to adequately separate out the consumption element is to use the rental equivalence approach, although this presents practical problems in Australia given the relatively thin rental market. He does not see the RBA approach as credible as it would give too low a weight for housing in the CPI.

## APPENDIX 1 *continued*

**26** Professor Neutze accepts that inflationary expectations have become more important. At the same time a wider range of welfare payments is now indexed.

### *Australian Pensioners' and Superannuants' Federation (AP&SF)*

**27** AP&SF regards the main purpose of indexation as maintaining the purchasing power of pensions and other allowances and the adjustment of superannuation payments. This should remain the principal purpose of the CPI. AP&SF acknowledges that while inflation measurement is an important component, income adjustment should be the main purpose of the CPI.

**28** AP&SF is aware of the significant debate occurring amongst older people about the relevance of the CPI to their circumstances, though for a number of reasons, is not willing to support the application of a special index for older people. A major factor is that there are significant variations within the retiree population and one 'pensioner' or 'retiree' index would not represent all older people's consumption patterns. Some older people will still do better or worse than the average from time to time. However, on balance, the current CPI-based approach to price movements is better than any alternative proposed so far. AP&SF, however, is concerned about a growing lack of confidence in the CPI amongst its constituency and supports actions by the ABS to restore this confidence.

### Advisory Group view

**29** The Advisory Group notes the many uses that are currently made of the CPI and they are expected to continue into the future. Irreconcilable differences of view exist among the Advisory Group about what should be the principal purpose of the headline CPI.

## FREQUENCY

### Scoping paper

**30** The scoping paper noted several arguments for producing the CPI on a monthly basis. On international comparability grounds, all OECD countries except New Zealand and Australia compile a monthly CPI, while the International Monetary Fund's Special Data Dissemination Standard specifies that CPIs should be compiled monthly, while also allowing countries some flexibility in meeting the standards. A monthly CPI may also help in earlier detection of turning points.

**31** However, the cost of producing a monthly CPI is considerable and unless compelling arguments emerged during the consultation phase, the ABS predisposition was that the CPI should continue to be compiled and published on a quarterly frequency.

## APPENDIX 1 *continued*

### Summary of Advisory Group discussion

**32** Only the submissions of the RBA and one financial market participant support the move to a monthly CPI. The RBA recognises that a monthly CPI could be a ‘noisy series’, but argues that moving averages could be used to reduce this problem and still produce more timely information about changing trends in inflation. The RBA also proposes that, to reduce the cost of moving to a monthly CPI, the ABS could consider limiting coverage for the additional months to Sydney and Melbourne.

### Advisory Group view

**33** Overall, the majority of the Group is of the opinion that there is not sufficient justification to incur the costs associated with changing the frequency of compilation and publication of the CPI from quarterly to monthly.

## POPULATION AND GEOGRAPHIC COVERAGE

### Scoping paper

**34** The present population coverage of the CPI is households with at least 75% of their income deriving from wages and salaries, but excluding the top 10% in terms of income, in the eight capital cities. The restricted population coverage reflects the historical use of the CPI in the wage and salary determination process and efforts to contain the cost of compilation.

**35** The ABS proposed extending the population coverage to include all households given the wider use now made of the CPI. User views were specifically sought on the regional coverage required, the possibility of optimising the price collection for production of a national index and the need for indexes for subgroups of the population.

### Summary of Advisory Group discussion

**36** There is strong majority support for extending the population coverage to include all households. However the ACTU, in arguing that the principal purpose of the CPI should be a measure of living costs for wage and salary adjustment, supports the present population coverage.

**37** There are strong differences of view within the Advisory Group on the issue of indexes for subgroups of the population. DSS, ACOSS and the AP&SF support the compilation, periodically, of subgroup indexes for analytical purposes. If the reference population is broadened beyond wage and salary earner households then the ACTU would support the compilation of a wage and salary earner index. On the other hand, the ACCI is strongly opposed, for reasons set out in its submission, to compilation of indexes for subgroups of the population.

**38** There is no support among Advisory Group members for indexes at regional levels other than the capital cities, essentially on the grounds that the benefits of so doing are not seen as being commensurate with the costs.

## APPENDIX 1 *continued*

**39** Currently the CPI is constructed to produce indexes of a uniform standard for each capital city. The RBA argues that for its purposes there are only 'minimal advantages in having eight regional CPIs which usually move closely with the national CPI' and would support changes which would optimise the accuracy of the national index. State Treasuries are strongly opposed to any loss of detail in the capital city indexes.

Advisory Group views

**40** Overall, the Group is of the view that:

- the target population for the CPI be expanded to all households;
- that the regional coverage remain with the eight capital cities;
- noting the strongly held contrary views of the ACCI, the ABS produce, periodically, experimental indexes for selected population subgroups possibly on an annual basis only; and
- the ABS investigate the advantages and disadvantages of optimising the index at the national level, noting the State Treasury views that the existing detail of the capital city indexes be maintained, and discuss further with key stakeholders when more information is available.

### COMMODITY CLASSIFICATION AND ITEM COVERAGE

Scoping paper

**41** In the scoping paper it was proposed that a ninth group 'Financial Charges' be introduced into the CPI which would draw together all financial charges incurred by households, including interest on student loans associated with the Higher Education Contribution Scheme (HECS). Arguments were advanced for, and user views sought on, including mortgage interest charges in this group.

**42** Minor changes to the commodity classification were proposed, including amalgamating expenditure classes that had low significance, renaming some expenditure classes and separately recognising some items.

**43** In regard to item coverage, it was proposed that some items now be included in the CPI, including home computer equipment and software, tertiary education fees, other financial charges and domestic and homecare services. The inclusion of gambling was not seen as a high priority.



## APPENDIX 1 *continued*

### Summary of Advisory Group discussion

**44** There is general support for the inclusion of financial charges applying to households in the CPI, although less clear support for the creation of a ninth group. In its submission, the New South Wales Treasury opposed the inclusion of bank fees and charges because, inter alia, they include taxes on bank accounts which are independent of inflationary pressures. The Queensland Treasury and Queensland Government Statistician opposed the creation of a ninth group, preferring financial services to be separately identified within the existing eight groups. The Group recognises that the decision on the overall conceptual basis of the CPI will significantly influence what should be done here. Some members suggest financial charges could be included in existing groups. Another view opposes the transfer of mortgage interest charges from the Housing group to the new ninth group if created, arguing that mortgage interest charges are an essential element of housing costs and that inclusion with the Housing group is needed for housing analysis. ACCI expresses concern about the use of the debt profile method for compiling mortgage interest charges.

**45** The RBA, in its support for an acquisitions-based CPI, proposes use of the financial intermediation services indirectly measured (FISIM) methodology for including financial services associated with borrowing and lending. This would allow consistent inclusion of both intermediation margins and financial service charges in the CPI. The RBA argues that this method is best suited to capturing the changing mix of financial intermediation costs between these two components.

**46** All members support expanding the commodity coverage as proposed while none raise any concerns about possible restructuring/renaming of certain expenditure classes.

### Advisory Group views

**47** The Group is of the view that:

- decisions on the issue of a ninth group must be taken in the context of the conceptual basis of the 13th Series CPI, as should the appropriate treatment of mortgage interest costs; and
- that household computers and software, tertiary education fees, financial charges and domestic and homecare services be included in the CPI, but that gambling should continue to be excluded for reasons set out in the scoping paper.

## OTHER ISSUES

### Scoping paper

**48** The ABS proposed dropping the Selected State and local government charges index and sought user views on the continued appropriateness of the indexes for imported and domestically produced items.

## APPENDIX 1 *continued*

**49** The ABS also sought user views on the likely demand for spatial price indexes.

### Summary of Advisory Group discussion

**50** The Queensland Treasury opposed the termination of the Selected State and local government charges index, reflecting the corporatisation (rather than privatisation) of government services in that State. The New South Wales, Victorian and South Australian Treasuries are not opposed to dropping the series. There is some interest from several State Treasuries in an index of utility (e.g. power and gas) prices in order to make interstate comparisons.

**51** Acknowledging the shortcomings in the series, members are not opposed to dropping the imported and domestically produced indexes. The RBA proposes that indexes be compiled for tradeables and non-tradeables with the distinctions made at the expenditure class level.

**52** Some interest has been expressed in spatial indexes. However, these appear to have low priority and reservations have been expressed about their usefulness and interpretation.

### Advisory Group views

**53** The Group is of the view that:

- the index of Selected State and local government charges be discontinued and replaced by an index of utility prices to be determined in consultation with State Treasuries;
- the approach to estimating prices of imported and domestically produced items be modified along the lines proposed by the RBA; and
- compilation of spatial indexes be accorded a relatively lower priority by ABS.

### CONCLUDING COMMENTS

**54** The Advisory Group recognises the complexity of the issues surrounding the compilation of the CPI and the reality that there is no single best way in which to construct it. At the end of the day a judgement must be made based on sometimes competing, but equally valid, uses to which the CPI is put. These judgements are best made by the Australian Statistician.

**55** The Advisory Group commends the thorough public consultation processes adopted by the ABS in this 13th Series review. Members have also appreciated the opportunity to participate in the Advisory Group.

October 1997

## ANNEX 1

### MEMBERSHIP OF THE 13th SERIES CPI REVIEW ADVISORY GROUP

Mr Chris Foster	Commonwealth Department of Social Security (DSS)
Dr Barry Gray	Commonwealth Department of the Treasury
Mr Scott Matheson	Commonwealth Department of Workplace Relations and Small Business (DWRSB) (formerly Department of Industrial Relations)
Dr Malcolm Edey	Reserve Bank of Australia (RBA)
Mr Rob Brooker	Victorian Department of Treasury and Finance, representing State/Territory Treasury departments
Dr Steven Kates	Australian Chamber of Commerce and Industry (ACCI)
Mr Peter Davidson	Australian Council of Social Service (ACOSS)
Mr Tim Harcourt	Australian Council of Trade Unions (ACTU)
Mr Gerard Thomas	Australian Pensioners' and Superannuants' Federation (AP&SF)
Dr Chris Caton	Bankers' Trust Australia, representative business economist
Professor Max Neutze	Australian National University, and Chairman of the 12th Series CPI Review Technical Consultative Committee, representative academic

## APPENDIX 2

### LIST OF SUBMISSIONS MADE ON THE 13TH SERIES REVIEW OF THE CONSUMER PRICE INDEX

Submissions to the 13th Series Review were received from the following organisations/individuals:

AMP Investments Australia Limited  
Anti-Cancer Council of Victoria  
Armstrongs Solicitors  
Association of Independent Retirees, Inc.  
Australian Chamber of Commerce and Industry  
Australian Council of Public Sector Retiree Organisations  
Australian Council of Social Service  
Australian Council of Trade Unions  
Australian Financial Markets Association  
Australian Industrial Relations Commission  
Australian Investment Managers' Association  
Australian Pensioners' and Superannuants' Federation  
Bridgewater Associates, Inc.  
Burswood International Resort Casino  
Canberra ASH (Action on Smoking or Health) Incorporated  
Coles Myer Ltd.  
Commonwealth Department of Employment, Education, Training  
and Youth Affairs  
Commonwealth Department of Health and Family Services  
Commonwealth Department of Social Security  
Commonwealth Department of the Treasury  
Commonwealth Financial Services  
Cook, Mr L.G.  
County Investment Management Limited  
Deutsche Morgan Grenfell Australia Limited  
Duckworth, Mr J.  
Gordon, Mr D.  
Government Statistician for Queensland  
Griffiths, Mr W.H.  
John A Nolan & Associates Pty. Ltd.  
Lend Lease Investment Management Division  
Lewis, Mr P.S.  
Macquarie Investment Management Limited  
National Can Industries Ltd.  
National Seniors Association  
New South Wales Treasury  
Northern Territory Department of Housing and Local Government  
Queensland Treasury  
Real Estate Institute of Australia Ltd.  
Reserve Bank of Australia  
Ryan, Mr T.M.  
SBC Brinson Ltd  
SBC Warburg Australia Limited  
South Australian Health Commission

**APPENDIX 2** *continued*

State Rail Authority of New South Wales  
Superannuated Commonwealth Officers' Association (Federal Council)  
Incorporated  
Williamson, Wing Commander L. C. RAAF (retired)  
Woolnough, Mr R.

**1** The uses of the CPI are many and varied. It is used:

- to assess changes in the purchasing power of household incomes;
- to construct measures of real income;
- to directly adjust some incomes (such as government pensions and benefits and superannuation income);
- to adjust fees and charges in a multitude of private and public sector contracts (with references to the CPI appearing in more than 100 pieces of Commonwealth and State legislation alone); and
- in the modified form of the Treasury underlying inflation measure, for macro-economic policy purposes.

So called 'underlying' or 'core' inflation, as embodied in the Treasury measure of underlying inflation, removes from the CPI basket those goods and services for which prices are significantly affected by exogenous factors, to arrive at a measure which reflects price movements which are predominantly influenced by market forces. No user has argued that the 'headline' CPI should be developed with this construct in mind.

**2** Analysis of the various uses leads to the formulation of two broad views of what the CPI ought to measure:

- changes in living costs actually experienced by households; or
- changes in the general price level.

It is fair to say that all users see the CPI as providing a measure of 'inflation' in some sense. These two alternative views of precisely what the CPI ought to measure serve to highlight the differences of opinion about what is 'inflation'.

**3** Households tend to think about inflation in terms of changes in their living costs. That is, an individual household's perception of inflation is determined by the extent to which the outlays it is required to make on goods and services change over time. From this perspective, the outlays they incur in respect of meeting interest payments are as valid as those incurred in meeting grocery bills, in so far as changes in either one affects the purchasing power of their money incomes. Accordingly, households generally regard the terms 'inflation' and 'change in the cost of living' as interchangeable. The current Australian CPI is designed to provide the best possible measure of this view of inflation for wage and salary earners, although not necessarily for other types of households.

**4** Economists, on the other hand, have a different view of inflation. From an economist's perspective, inflation relates to the contemporary rate of change in the prices of goods and services. While there are some areas of consumer expenditure for which this view differs from the household cost of living view, in the main these are of little practical consequence. The exception is in the area of interest rates. Economists do not regard interest rates to be 'prices' in the same sense as (say) the prices of oranges. While interest rates (and changes in interest rates) are important in their own right, they are more correctly viewed as representing the price of money or the relative price of consuming today rather than in the future. Therefore, economists regard it as inappropriate to include interest rates in any measure purporting to record the contemporary rate of inflation as they say nothing about the current rate of change in prices of goods and services.

**5** In general, sophisticated users of price indexes appreciate the theoretical distinctions between changes in the cost of living and price inflation. They recognise that the conceptually desirable properties of price indexes best suited to measuring each of these phenomena are such that it is not possible to design a single index capable of perfectly satisfying both of them. As each construct provides important information about the behaviour of prices in the economy, they both represent legitimate demands on the national statistical system. However, the CPI occupies a unique position on the statistical landscape and there can only be one CPI. Therefore, the key issue is 'which of these views should underpin the design of the CPI?'

**6** If the indexation of incomes and benefits payable to households is intended to preserve the purchasing power of such incomes and benefits, then the index should be constructed to best measure the household view of inflation. While the current outlays approach to constructing the CPI achieves this, it does so only in respect of the CPI population group (i.e. wage and salary earner households) in aggregate. The index may not adequately reflect the changes in the living costs of many households that are now dependent on the CPI for income adjustment. Those households in receipt of social security benefits and superannuation payments for example, have expenditure patterns that differ significantly from those of employee households or households in aggregate.

**7** The extent to which differences in expenditure patterns influence the behaviour of price indexes depends on the variation in individual price movements. If prices of all items move at exactly the same rate then differences in expenditure patterns (relative weights) are irrelevant. The more divergent price movements become, the greater the role of expenditure patterns in correctly measuring the aggregate impact of price change.

## APPENDIX 3 *continued*

**8** As interest rates do not represent the current price of a good or service, interest rates cannot be expected to move in line with prices of goods and services. Movements in interest rates are often both large and against the trend of current price change. Therefore, differences in the relative importance of interest charges across population groups are likely to result in differences in measures of the change in living costs. For example, in the June quarter 1997, Mortgage interest and consumer credit charges fell by 7.1% while prices of all other items rose by 0.2% on average (resulting in the CPI, including interest charges, falling by 0.2%).

**9** Retired persons and households whose principal source of income consists of social welfare payments, incur relatively less expenditure on interest charges than households on average. This can be largely explained by differences in housing tenure, with these households being more likely to either own their principal residence outright or to rent (rather than being in the process of purchasing). The following table presents data from the 1993–94 Household Expenditure Survey which illustrates differences between employee households and households of retired persons or those in receipt of social security benefits.

<i>Household type(a)</i>	<i>Percentage of households in the process of purchasing principal dwelling</i>	<i>Average weekly expenditure on mortgage interest charges</i>	<i>Average weekly income(b)</i>	<i>Expenditure on mortgage interest charges as a percentage of income</i>
	<i>%</i>	<i>\$</i>	<i>\$</i>	<i>%</i>
Age pensioner	5.2	0.67	246.63	0.27
Other social security	11.5	7.71	297.46	2.59
Superannuant	6.5	1.24	430.78	0.29
Employee	42.8	41.53	796.57	5.21

(a) By principal source of income.

(b) After tax.

**10** Although the problem posed by differences in expenditure patterns could be resolved by producing separate CPIs for each of the various population subgroups, this solution is not compatible with the requirement of having only one CPI. Therefore, given a choice between a CPI which excludes interest charges entirely and a CPI which incorporates interest charges with a weight representative of the community as a whole, it is clear that the former provides a better measure of the changes in the cost of living experienced by those households who are particularly dependent on the CPI for income adjustment.

**11** Thus, despite the apparent conceptual contradiction, a measure constructed to best measure general price inflation for the household sector as a whole would provide a better measure of the changes in the cost of living of those households who are most dependent on the CPI for income adjustment. The construction of such an index would require adoption of the acquisitions rather than the outlays approach.



### **APPENDIX 3** *continued*

**12** In addition to providing a better measure of changes in the cost of living of those households in receipt of social security benefits, an acquisitions index covering all households is also assessed as providing a better indicator of the price experiences of other low income households. As such, it would also be a more appropriate measure for input to the process for adjusting the award safety net by the Australian Industrial Relations Commission.

**13** Through removal of the volatility arising from the inclusion of interest charges, an acquisitions index should also provide a more reliable benchmark for assessing future price changes for parties negotiating enterprise agreements.





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