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SUBMISSION

to the 13th Series Review of the Consumer Price Index

by the Department of Social Security

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1. Introduction

The Department of Social Security (DSS) is a major user of the Consumer Price Index (CPI) and considers that retention of the longstanding outlays approach has a widespread community acceptance and in the absence of special pensioner indexes most adequately reflects the prices faced by our customers. This submission discusses the likely impact on the Department and its customers of possible changes in the CPI, as discussed in the ABS Information Paper "Issues to be Considered During the 13th Series Australian Consumer Price Index Review" (ABS 6451.0). The issues are considered in the order they appear in that paper.

2. The Consumer Price Index and Social Security

DSS currently makes payments of $812 million a week to 5.1 million customers (annual expenditure is $42.2b or 7.8% of GDP). The Social Security Act under which DSS operates specifies that most payments will be indexed to the CPI. Most payments are indexed six-monthly; the important exceptions are Family Payment and youth payment rates, which are indexed annually. The CPI is also used to index the thresholds for many means tests.

The significance of DSS as a user of CPI indexation has increased since CPI indexation commenced in 1976. Recipients of DSS income support have increased from 13.2% of the population in 1976 to 21.3% in 1996. Aside from wage and salary earners, social security customers are the major group for whom the CPI is used to adjust income levels.

The purpose of the indexation provisions is to ensure that the purchasing power of DSS payments, and hence the living standards of those reliant on the payments, does not fall. The indexation process is potentially subject to some modification. The most important of these is that under legislation before Parliament the single rate of pension will not be allowed to fall below 25 per cent of Male Total Average Weekly Earnings (MTAWE). Pension rates, and hence higher than basic rate family payment, will be adjusted upwards where CPI indexation is insufficient to ensure this.

This '25 per cent benchmark' modifies the effect of the CPI in determining pension and family payment rates, as MTAWE can be expected to increase faster than the CPI over the long run. However, there are a number of significant reasons why the behaviour of the CPI remains very important in determining the real level of payments:

- Over shorter periods, real MTAWE may not increase. The CPI then acts to preserve the purchasing power of DSS payments until the long-run trend in wages is restored.

- The legislation does not provide for MTAWE-related increases to flow on to allowances. About 70% of social security customers (but only 65% of primary, ie non family related customers) are covered by MTAWE.

- While the current Government is strongly committed to maintenance of the 25 per cent benchmark, the proposed legislation has a 'sunset clause' after five years.

3. What the CPI should aim to measure

Payment rates and means test parameters are the product of carefully chosen trade-offs between adequacy of payments, maintenance of incentives and affordability of the social security system. The particular trade-offs chosen reflect the community's value judgements about these three competing objectives. Changes to the base of the CPI which could disrupt these trade-offs are undesirable. For this reason, DSS is strongly of the opinion that the principal purpose of the CPI must remain that of a relative purchasing power indicator, rather than as a broader inflation measure.

The CPI was originally developed to aid wage setting. It was thus constructed as a measure of change in purchasing power in wage earning households in the eight capital cities. While the CPI is now used for many other purposes it still remains very important in wage setting as all parties take account of it, both in formal wage setting institutions (for example, the IRC) and in individual employment contract negotiations. It is also used in many contracts for goods and services, typically as part of an 'escalation' clause.

It can be argued that the widespread use of the CPI can lead to feedback mechanisms which will tend to inflate future CPI's as wage and other contracts are set on the basis of this rise. From a macro-economic policy management perspective this would favour an <u>acquisitions</u> approach to the CPI, which would see most interest rate costs excluded as a cost of investment rather than consumption.

However, social security customers, have generally perceived the CPI to be a reasonable measure of changes in prices which affect the purchasing power of their pensions and benefits. Also, the Government has given very strong commitments to the maintenance of six monthly CPI indexation. Pensioner groups have at different times argued for special indexes to ensure that the CPI measured changes in the prices they face. Moving to a completely new conceptual framework for the CPI could be viewed with suspicion in the community if various prices were excluded that were considered to be important by social security customers, and if community perceptions are that these are likely to rise in the medium term.

DSS believes that the removal of interest-rate sensitive items from the basket, and in particular housing interest costs, would seriously compromise the CPI's use as the primary indicator of absolute prices for pension and indexation purposes. The widespread use of the CPI, including its use in indexation of welfare payments, is dependent on its widespread acceptance as a measure of the cost of living. Were it to be seen as measuring something else then there could be strong pressure to substitute some other measure of relative purchasing power -which could leave the feedback mechanism described above intact.

On this point, DSS already faces periodic lobbying by customer groups to use a specially adjusted CPI which, they argue, would more closely reflect their relative purchasing power. Broadening the base of the CPI (as suggested in later parts of this Submission) may address some of their concerns, but excluding major components such as housing interest rates and State and local government charges would increase pressure to move to a special 'pensioner' or 'low income' CPI.

Having changed indexes once, there would be renewed pressure from lobby groups to change to a differently based CPI at different points in the interest rate cycle.

Further, the development of price indexes for different sub-groups of the population would create problems in addressing the conflicting interests of various lobby groups. The basket of goods used for an optimal 'pensioner CPI' may look very different from the basket of goods for a 'low income working family' CPI. Adoption of a single special 'social security' CPI would therefore not necessarily provide a more equitable outcome across our customer groups than present arrangements, while the use of separate indexes in indexing payments for different sub-groups of our customers is administratively impractical.

Nevertheless, the retention of the CPI as a purchasing power indicator is no barrier to the creation of a separate index, either by the ABS or other parties, for macroeconomic purposes.

4. Frequency of the CPI

There are proposals to release the CPI monthly rather than quarterly. The primary reason for doing this would be to satisfy IMF standards for national statistics - failure to adhere to these standards may complicate access to some international capital markets. There are two basic ways a monthly series could be done:

- a full replication of the existing survey each month; or

- using imputation from a partial sample to estimate monthly data.

The first is expensive but accurate, the second cheaper but approximate.

In DSS' view, there is little to gain from a monthly release and some possibility of loss. A monthly release could conceivably lead to pressures for more frequent indexation. More frequent indexation would lead to an increase in payment outlays - not only would there be less delay between price increases and rate increases, a monthly series could be expected to be more volatile than a quarterly series. In periods of low inflation, volatility in the CPI could 'ratchet up' the real level of payments because payment rates are not reduced when the CPI falls.

If a monthly series is to be produced, the full replication approach would be preferred as it is likely to yield less volatility than the proposed imputation approach.

5. Extensions of the CPI to cover the whole population and regional Australia

The CPI covers prices only in the eight capital cities in Australia. The reference population on which it is based is the first nine income deciles of employee households. Both of these limitations are a direct result of the CPI being originally constructed as a cost of living indicator for centralised wage setting. Most DSS customers, self-funded retirees and the self-employed are excluded. All of these groups have become increasingly large fractions of the population since the CPI was instituted - DSS income support recipients were 17.9% of the Australian population in the 11th Series review in 1986, were 19.9% in the 12th Series review in 1992 and are now 21.3%. All of these groups are likely to have somewhat different consumption patterns to those of the employed.

The CPI population and DSS customers

The MTAWE benchmark ensures that pensioners' and low-income families' incomes stay constant relative to those of the community over the long run (disregarding changes in the distribution of work). In the short run, CPI indexation policy is intended to ensure that the purchasing power of our customers' payments do not fall. However, if movements in the prices faced by our customers differ significantly from those faced by wage earners in capital cities (the base for the CPI) this intent will not be fully achieved.

Including DSS' customers in the reference population, though, would reduce any disparity between their actual purchasing power and their purchasing power as measured by the CPI, although the size of this effect depends on the weighting algorithm used. If a consumption based weighting is used, the impact will be less than the actual increase in the reference population would suggest as low-income people consume less.

In practice there may be only modest differences in outcomes between indexation according to such a measure and present indexation policy because the rounding and AWE benchmark provisions reduce the effects on rates of minor differences. As noted earlier, DSS does not consider that these differences justify the use of a special price index for social security customers. However, there may be some benefit in further reducing them by including our customers in the more broadly based CPI.

A regional CPI

The exclusion of regional Australia from the CPI has probably had only a modest effect on aggregate CPI movements, simply because the great bulk of the Australian employee population is in the cities. It does hamper any studies of long-term trends in relative living standards between the city and country. The absence of regional areas from the major prices survey in Australia may influence perceptions of the relevance of the CPI to regional areas, regardless of any practical effects.

However, these are arguments for the inclusion of regional Australia in the reference population, rather than for creation of a separately-published regional CPI series. The relatively small sample that would be used means such a series is likely to be quite volatile - there is a possibility of rogue figures leading to pressure for unwarranted government action. In any case, a 'regional CPI' may tell us little about changes in any one of the very disparate regions that would be included. For these reasons, the ABS should closely examine the likely reliability and usefulness of any separate regional CPI series before proceeding with separate compilation and publication of it.

6. Commodity classification

Currently, items within the CPI consumption basket are broadly grouped according to the source of their production. While DSS supports the proposed reorganisation of groupings according to the items' use rather than their provenance, we have some concerns about the treatment of housing costs under this proposal.

Financial Charges

This new grouping will, among other things, put mortgage interest costs in a different grouping from other housing costs. This makes it more difficult to construct an overall index of housing costs, but recognises that it is become increasingly difficult to separate mortgage interest costs from other consumer interest costs - people are increasingly bundling their other debts into a single loan secured by their home equity.

DSS believes that mortgage interest charges would most usefully be retained in the Housing Group classification as the major purpose of the home loan is still for housing rather than consumer credit. While we recognise that 'housing loans' are used for more than just housing, to say therefore that all of the cost changes in them should be treated as a 'financial service' does not reflect the reality of the experience of the Australian population. Such treatment would run directly counter to the concept of attempting to classify commodities by use; these loans are still taken out primarily for housing purposes and hence the use classification should reflect this.

The problems which the removal would generate can be seen if we consider what an index would look like. It would have under the item of 'use' only a rental component and some rates, insurance, etc. This cannot be considered as a representative index of the housing consumption experience of households. Given the relatively small proportion of the population who rent it may also introduce significant bias into the apparent measure of housing costs.

A better approach may be to maintain mortgage costs within the housing component and develop a consumer financial component which would incorporate account charges, consumer credit etc. This would require the ABS to research and analyse the degree to which mortgage loans are being used for other purposes, but it would avoid the need for two inconsistent measures of housing cost - the "Housing" group in the CPI and the proposed specially constructed index of housing costs.

Extension of the CPI to include new items

DSS welcomes the separate inclusion of bank fees, tertiary education fees, home computers and gambling in the CPI, all of which have some policy interest. Given the special difficulties of measuring all of these components, though, we ask that the ABS take particular pains to document the methods by which they are measured.

7. State and local government charges

DSS acknowledges the technical problems in measuring State government charges on a consistent basis. DSS, a number of other Departments and some academic researchers are concerned with the distributional effects and effects on inter-governmental relations of these changes. For example, current proposals for comprehensive tax reform must be cognisant of the changes in tax at the State level. The continuation of this series is therefore of value to those interested in these questions, despite its current unreliability. It would be better if the ABS examined methods of dealing with these problems rather than simply dropping the series.