

Australian Chamber of Commerce and Industry
Submission to the Australian Consumer Price Index Review
June 1997

The following is the submission to the 13th Series Australian Consumer Price Index Review presented on behalf of the Australian Chamber of Commerce and Industry (ACCI).

ACCI is the peak council of Australian employers, representing all State and Territory based associations and the majority of Australia's major national industry associations. Over 350,000 businesses across Australia are represented through the ACCI network.

ACCI, through its membership, represents businesses in all States and Territories, in all industry sectors and incorporating businesses of all sizes. ACCI is thus the most representative business organisation in Australia.

Recommendations

The Consumer Price Index should be the measure of price movements and not the measure of movements in the cost of living.

The approach to measuring price movements preferred by ACCI is the acquisitions approach. It is the inclusion of interest charges as well a variety of state taxes and charges which makes the current payments approach less satisfactory for measuring price movements. It is wrong in concept and incorrectly measures movements in the price level.

The third alternative measure put forward by the ABS is the cost of use approach. ACCI believes that such an approach is even more abstract and fraught with methodological difficulties than the payments approach. ACCI would not support any move to this approach.

If the payments approach is maintained, ACCI would therefore strongly support a return to the simple revaluation technique in valuing the quanta used in mortgage charges. Only in this way can the measure of inflation actually record movements in the quarter to which it refers.

ACCI strongly supports maintaining the CPI as a quarterly series and would oppose a move to a monthly series.

ACCI supports a shift to cover the entire population of the eight capital cities but sees no reason to extend this coverage into regional Australia because of the very, high cost.

Nothing useful would be achieved by having target indexes which provide price movements for any sub-component of the population. ACCI is strongly opposed to their introduction.

ACCI supports the creation of a new commodity classification in which all financial services are brought together.

ACCI supports the inclusion of *Home Computer Equipment and Software* and *Domestic and Homecare Services* in the CPI. On methodological grounds ACCI is less certain about the inclusion of *Other Financial Charges* which incorporate transaction account fees, charges and transaction taxes. ACCI does not believe that inclusion of *Tertiary, Education Fees* or *Gambling* are appropriate for inclusion in the CPI.

ACCI supports the work being done to develop spatial indexes. Similarly, ACCI believes that the series on *Prices of Imported Items* is valuable in concept and supports the continuation of work to improve the ABS's measurement capabilities in this area.

ACCI strongly supports measures to reduce bias in the CPI. In particular, more frequent re-weighting of the index may be an important means to reduce the level of

bias. The other recommendations listed by the ABS to reduce bias (page 53) are also endorsed by ACCI:

- . to continue to ensure its sample of outlets remains representative and new goods are introduced into the index where appropriate;
- . to investigate the feasibility of extending quality adjustments;
- . to adjust the elementary index formulae so that the most appropriate formula is being used.

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The Australian Chamber of Commerce and Industry has a high regard for the work of the Australian Bureau of Statistics. The ABS has a well-deserved international reputation. It provides an accurate and timely array of statistics covering all aspects of the Australian economy.

The Consumer Price Index has provided Australia with an accurate measure of price movements since its first introduction. ACCI has participated in the expansion and development of the CPI over the years, and has been privileged to be part of the consultation process as this expansion has taken place. It is recognised by ACCI and its member associations that the CPI provides an accurate and reliable measure of inflation in Australia.

It is expected that when this review is complete, there will be yet further development in the concepts and methodology underlying the CPI which will further refine the process of collection and which may improve its accuracy. ACCI, however, recognises that these further developments are unlikely to add more than at the margin to the underlying estimates of price movements.

Need for a Pure Price Measure

The basic question is whether the CPI is a measure of movements in prices or a measure of movements in the cost of living. This has been a central question in the past. ACCI has long been of the view that the CPI ought to be a measure of movements in prices rather than the cost of living.

Indeed, it has been a problem in the past that the most widely used measure of inflation is actually geared towards measuring movements in the cost of living. Increases in interest rates to slow inflation have been recorded as movements in prices. Thus, the very measures taken to slow the inflationary process have been recorded as an acceleration of inflation.

This is not to deny the need for a cost of living measure as well. But the basic issue is what form of measure will have the name "Consumer Price Index" attached to it. In the view of ACCI, the Consumer Price Index should be the measure of price movements and not the measure of movements in the cost of living.

Uses of the Consumer Price Index

ACCI is an extensive user of the CPI in monitoring inflationary trends in the economy, in deflating various economic series which are provided only in nominal terms and, in the Industrial Relations Commission where ACCI is the main employer party in the National Wage Case and other test cases.

The primary use of the CPI has been to monitor movements in the price level. ACCI is concerned about inflation and the distortions that inflationary pressures create. As

an advocate for a low-inflation environment, it is important that a price index measuring what is taking place with prices is available.

A further major use of the CPI over the years has been as a deflator for various economic time series so that a nominal variable can be converted into a real variable. The CPI is, of course, intended as a measure of consumer prices, but other series, such as wage series and interest rates, can be converted into a real series in the absence of something better.

The CPI is also used to make international comparisons. The CPI is the basic price measure in most other countries, and certainly in all developed economies. The most common and appropriate means of comparison is the CPI.

Finally, but of very great significance, the CPI is used in the process of wage determination, generally by trade unions to measure changes in the real level of wages. This is a very important use of the CPI. However, this requires the CPI to be a measure of movements in the cost of living rather than of movements in the price level itself.

This is, in a very important sense, a specialist use of the CPI. With the end of wage indexation, there is far less justification for maintaining the CPI as a cost of living index, especially with no pure price index available.

Acquisitions Approach Preferred

The approach to measuring price movements preferred by ACCI is the acquisitions approach. This bases the CPI on the actual goods and services acquired by the target population and the proportions in which they are acquired. This is conceptually the clearest methodology. In terms of the basket of goods concept, quality adjustments aside, it requires no fabrication of a quantum with which to associate a price.

The payments approach, since it is based on household outlays, requires the creation of abstract quanta. This is particularly important in regard to mortgage interest payments and consumer debt for which there is no actual item sold against which a price can be recorded.

With house purchase, there is the additional problem that a home is both a consumption good and an investment good. Part of the attraction of home ownership is the forced saving element as well as the potential for capital gain. Thus the financing of home ownership captures major elements of householder investment decisions and should therefore be excluded from the CPI.

The current outlays or payments approach is a near equivalent to the acquisitions approach. However, the very fact that a "Treasury series" has had to be designed and is widely used is a strong indication of the inability of the current series to gain full acceptance.

It is the inclusion of interest charges as well a variety of state taxes and charges which makes the current payments approach less satisfactory for measuring price

movements. It is wrong in concept and incorrectly measures movements in the price level. It should therefore be abandoned in favour of the acquisitions approach.

The third alternative measure put forward by the ABS is the cost of use approach. ACCI believes that such an approach is even more abstract and fraught with methodological difficulties than the payments approach. ACCI would not support any move to this approach.

Mortgage Interest Charges and Consumer Debt

The use of mortgage interest payments as a proxy for the cost of home ownership creates problems which ACCI had noted before this approach was introduced. In particular the increased volatility was seen to be an important problem. Rising interest rates which might be used as a breaking mechanism on rising prices would be recorded as a price increase so that the very means being taken to deal with inflation might itself show up as an inflationary impulse in the CPI.

Volatility was also likely to occur if there were rapid increases in house prices which created large movements in the housing component which were not similar to other price movements taking place.

The methodology which was originally chosen for incorporating mortgage interest payments was the "simple revaluation" technique. This provided a fixed weight quantum whose value was increased quarterly with the movement in the price of houses. ACCI felt this was an inadequate methodology, but that it was superior to the other alternative recommended at the time which was the "debt profile" approach.

Although the simple revaluation technique was adopted at the 11th review, the debt profile approach was incorporated mid-way through the five-year period.

ACCI has had a long-standing opposition to the use of the debt profile approach to measurement of the cost of home ownership. One of the most important qualities in a price index is that it reflect actual movements in the quarter being recorded. The use of a moving average to record the quantum of housing means that the CPI might conceivably be moving upwards when prices were in fact static or indeed falling. It was considered to be a distortion in the recording mechanism.

Over the very long run both techniques amount to the same ultimate outcome. But during the recording period there are important differences which are not reflected in the actual movement taking place.

It is therefore the view of ACCI that the methodology least likely to cause problems, both conceptually and in practice, is to return to the rental equivalence approach.

The problems which have occurred since mortgage interest payments and consumer debt charges were introduced into the CPI have confirmed ACCI's original view that the CPI has become more volatile. Moreover, since the switch to the debt profile approach, there has been additional problems caused because of the delayed effects of movements in the cost of housing so that current movements in the CPI often tend to

reflect past movements in the price of housing so that movements in the CPI are no longer centred on the actual quarter.

ACCI recognises that to some extent this reflects something of the reality in the cost of a representative basket of goods. But at the same time, it is the view of ACCI that this causes serious distortions in the short-term movements in the index which cause the CPI to be less reliable as a measure of contemporary movements in the price level.

If the payments approach is maintained, ACCI would therefore strongly support a return to the simple revaluation technique in valuing the quanta used in mortgage charges. Only in this way can the measure of inflation actually record movements in the quarter to which it refers.

Frequency of Compilation of the CPI

It is noted that there is some consideration being given to publishing the CPI on a monthly basis as is the case in most other OECD economies. ACCI would be opposed to a change to a monthly release, both on cost and methodological grounds.

(i) Costs

Generally speaking, a move to a monthly CPI would involve a significant increase in costs. Full replication of the quarterly CPI on a monthly basis which would increase the collection needs by 150%. At the same time, since the number of price observations underlying each CPI release would fall from 100,000 to 80,000, each of the monthly estimates would be less accurate than the current quarterly series, although it is likely that the quarterly data, which would be the average of the three monthly estimates, would be more accurate than the present quarterly series.

The ABS estimate of an increase in the cost of compiling the CPI of \$4.1 million would represent an unacceptable increase in costs and would draw resources from other, more important, data collections. Even the partial increase in collections which is the minimum required would lead to an increase in costs of \$1.87 million. Such an increase in costs is totally unwarranted, especially since there are no advantages and other major disadvantages of moving to a monthly series.

(ii) Methodological Issues

The major reason for ACCI's opposition to the change to a monthly CPI is that it would lead to a fall in accuracy and an increase in the volatility of the series.

In saying this it should first be emphasised that there are no problems created for the Australian economy because the CPI is published only quarterly. There has been little pressure for a change since there is no apparent need for a change. Policy makers have been perfectly well informed on the general direction of inflation with the quarterly publication. There would be no improvement in our understanding if the CPI were published quarterly. Indeed, if anything, the quarterly publication of the CPI, because it would be more volatile, would reduce understanding of the direction of inflationary pressures rather than improve them.

The clearest comparison is with the shift from monthly to quarterly balance of payments statistics. The monthly release, because of the high level of interest it attracted, created a high degree of domestic economic instability. The ABS provided in its information paper an outline of the effect on interest rates of the monthly release of the balance of payments. The move to a quarterly series has almost entirely ended this form of economic instability.

The shift to a monthly CPI would reintroduce this form of instability. Each quarterly release would create similar interest that is now devoted to the quarterly series. However, since the monthly series, being smaller, would be less accurate, there would be greater volatility and more uncertainty about the actual direction of change. Quarterly aggregates may end up more accurate but the variation between months would be greater.

This increased uncertainty about the current trend would be translated into a higher interest rate regime and greater tentativeness about investment. This would be particularly the case given the attention the Reserve Bank gives to inflation as the basis for raising official rates.

Australia is very well served by the current quarterly series. ACCI is strongly opposed to any move from the present quarterly series.

Population Coverage

Ideally, the population coverage of the CPI should be the entire population. The spending pattern of each individual should be treated equally in the construction of the index and then in the calculation of the series. The concentration on wage earner households is an anachronism which is related to the time past when award wages were adjusted for movements in domestic prices. This is no longer the case.

It would also improve the value of the CPI if all regions were included in the index. If the entire population were included, then regional differences in price growth could be calculated. This would provide additional information on the state of the Australian economy and regional differences in economic conditions.

The main obstacle to an extension of population coverage is cost. While to extend the CPI beyond the wage earner population in the eight capital cities would create little increase in collection costs, to extend coverage into regional Australia would add significantly. It would require a major addition of resources into capturing the price of goods and services across large stretches of the Australian continent.

Our judgement, however, is that to do so would not increase the accuracy of the CPI. The CPI is an index and not a measure of the price level. It is a measure of price movements not the absolute level of prices. Within a single economy with a single currency the likelihood of significantly different rates of inflation in different regions is very low. The similarity of price movements between say Sydney and Darwin or Hobart would almost certainly be replicated in the regional centres of New South Wales, the Northern Territory and Tasmania.

ACCI would therefore support a shift to cover the entire population of the eight capital cities but sees no reason to extend this coverage into regional Australia because of the very high costs involved.

Targeted Series

There have been suggestions in the past that the ABS produce various sub-series which are targeted at particular groups. For example there has been some pressure for the introduction of a Pensioner Price Index which would have as its coverage the goods and services bought by those whose main income is the age pension.

ACCI is strongly opposed to the introduction of such series. The opposition extends beyond the potential for confusion involved although such confusion is likely to occur on a regular basis. Nor is this opposition fundamentally based on the considerable costs involved although that too must be an important consideration.

The reason for this opposition is the assumption that would inevitably be made that a movement in the relevant index should be of itself the justification for a movement in payments to the targeted group. Although such an assumption would be unjustifiable, there would be strong potential for political pressures to grow to index payments to this series.

To use the Pensioner Price Index (PPI) as an example, an increase in the PPI larger than the movement in the CPI would lead to pressures on those who adjust pensions to raise pensions by whatever amount the PPI showed. Because the series is specially targeted on pensioner incomes, there would appear a *prima facie* case for raising pensions.

There is also the possibility that there would be picking and choosing between which index was highest. When the PPI is higher than the CPI it would be chosen and when the reverse occurred, then it would be preferred. The potential for disputes with others on an index which was growing systematically more slowly than other indexes would be legion.

Nothing useful is achieved by having target indexes of this kind and ACCI would be strongly opposed to their introduction.

Commodity Classification and Item Coverage

(i) Financial Services

The main issue is whether there are advantages in introducing into the CPI a *Financial Services* commodity classification. As the information paper notes, the introduction of this classification is dependent on whether it is decided to retain mortgage interest charges and consumer debt interest in the CPI.

Although it is ACCI's view that these do not belong in a properly constructed price index, it will be assumed during this discussion that the current approach and

structure is maintained and therefore that mortgage payments and consumer debt remain in the CPI.

Under these circumstances, it would be preferable to create a new commodity classification in which all financial services were brought together. The value would be more than simply grouping this suspect category. It would also eliminate the confusion which must now exist when looking at the various components which currently incorporate these items. It would thus permit the actual movement in the price level of the other commodity classifications to be shown directly.

(ii) Item Coverage

The ABS has raised a number of possible items for inclusion in the 13th series of the CPI.

It would appear imperative to include home computer equipment and software in the CPI. This is a major item of household expenditure and it is becoming more important. Moreover, the necessary data for calculation do not appear difficult to estimate nor would it be difficult to update each quarter.

Domestic and Homecare services appear to be an important inclusion in the revised CPI. These are part and parcel of modern life and appear relatively easy to find estimates of both price and quanta. ACCI would support their inclusion.

The inclusion of Other Financial Charges which incorporate transaction account fees, charges and transaction taxes appear to be an appropriate inclusion in the CPI. Much will depend on whether the ABS can properly estimate both the size and impact. If the methodological difficulties can be overcome, these components should be included.

Inclusion of Tertiary Education Fees, however, appears inconsistent with the aim of the CPI. Tertiary education is not, or ought not, to be considered a consumption item. It is part of the formation of human capital. ACCI does not believe that inclusion of Tertiary Education Fees is appropriate for the CPI.

Gambling should also not be included for the reasons outlined by the ABS. The conceptual issues in defining an item to be priced and then putting the price on the item are large while the gain in accuracy is small.

Analytical Series

Spatial measures would be of great interest and benefit in the CPI. Being able to make comparisons of the absolute level of the cost of living between capital cities would assist economic analysis in a number of ways. The ABS is encouraged to continue this work.

As the information paper notes, there has been less focus on the Selected State and Local Government Charges series over recent years. ACCI which had used it extensively in the past has found it less useful in recent periods.

However, it is a useful figure and the very fact that it is highlighted in the way it has been may itself brought pressure to bear on State and local governments. ACCI sees no reason to drop this series since its continued inclusion creates no pressure on costs.

The series on Prices of Imported Items is valuable in concept. Even though it may add to costs, if the figure can be refined so that the current methodological problems can be overcome, it would be preferable to keep it and improve it rather than leave it as it is, or what would be worse, delete it altogether.

Bias in the CPI

Because a fixed basket of goods does not permit substitution between products when there are shifts in relative prices, there is an inherent upwards bias in the measure of prices calculated by the CPI relative to the cost of living. It is also difficult in concept to measure improvements in quality which, if not properly captured, can also add an upwards bias to the measurement of prices.

Given the use of the CPI to adjust various government payments, it is important that the CPI does not overestimate the actual movement in prices. The ABS is particularly encouraged to examine the possibility of more frequent re-weighting of the CPI to ensure that bias is kept to the minimum.

Given the possibility of the potential for large overpayment in government benefits and therefore in government outlays if there are biases in the CPI, it would appear that providing the ABS with additional funds for more frequent re-weighting of the CPI is an appropriate use of public money.

The other recommendations listed by the ABS are also endorsed by ACCI:

- . to continue to ensure its sample of outlets remains representative and new goods are introduced into the index where appropriate;
- . to investigate the feasibility of extending quality adjustments;
- . to adjust the elementary index formulae so that the most appropriate formula is being used.