Executive Summary

It is an injustice to public sector retirees whose pensions are indexed to movements in the CPI:

1. that CPI indexation no longer maintains the purchasing power of their pensions as intended by Professor Pollard when he recommended CPI indexation in 1973; and
2. that the ABS makes almost no attempt to correct long held beliefs in the community that CPI indexation does maintain the real world purchasing power of a pension.

Prices that go into measuring the CPI are "pure" prices. That is they have been discounted for any perceived improvement in the quality of a product. Pure prices are not shelf prices. Shelf prices are what must be paid to purchase a product.

Discounting prices for changes in quality is in keeping with international best practice but it has wrecked the CPI as an index of what is needed to maintain the real world purchasing power of a pension or a benefit. This is because the CPI no longer even approximates the movement in the shelf prices of a basket of goods. As a result a pension indexed by CPI cannot maintain purchasing power as experienced by pensioners and as understood by most Australians.

It is a sad lapse by the ABS that it does not maintain any data about the extent of the adjustments it makes to shelf prices for changes in the quality of products. This frustrates any academic analysis of the issue.

Quality adjustments are thought to account for a reduction in the annual increase in the CPI of between 1% and 2%. An erosion of a pension by just 1% pa will after eighteen years depress that pension by 20% in the eighteenth year. If the erosion is 1.5% pa it will take only twelve years for the reduction in the pension to equal 20%.

The present arrangements for the indexation of public sector pensions go back to the March 1973 report, Enquiry into Superannuation Pension Updating, by Professor A. H. Pollard. Significant erosion of CPI indexation as a means of maintaining purchasing power must have come after that time. Any fair and conscientious reading of Pollard's report in its entirety shows that he had not the slightest inkling that the real world purchasing power of a pension indexed to CPI could be eroded as it is today by quality corrections.

Pollard devoted a whole chapter to discussing the desirable criteria for the adjustment of a pension. He wrote about the need for pension updating:

> *to enable officers of long service to maintain a reasonable standard of comfort after retirement;*
>
> *to give peace of mind; and*
>
> *to free the retiree from the ever present fear that a long retirement might bring severe financial problems in its latter years. (p. 15)*

His conclusion was:

> *The requirements of paragraph 2.1 are only satisfactorily met if an employee can be certain that adjustments will take place to what is considered to be an adequate pension on retirement, that those adjustments will take place frequently and that as a result of the*

adjustments he will continue to be able to buy the same range of goods and services despite increased costs. Costs increase almost continuously and maintenance of the purchasing power of a pension is therefore not achieved if pension adjustments are infrequent.

I therefore consider the appropriate criteria for pension adjustment in changing economic circumstances to be that

first,

there should be certainty of adjustment i.e. adjustments should take place automatically;

second,

the purchasing power of the pension should be maintained;

and third, (which follows from the second)

pensions should be adjusted frequently.

How could have Pollard written "to be able to buy the same range of goods and services despite increased costs" if he and his advisers had been aware of the impact of quality adjustments as implemented today?

The belief that CPI indexation compensates for increases in the cost of living and maintains purchasing power <u>in terms of shelf prices</u> has been prevalent throughout the community for many years. This goes back to when the world was a much simpler place. The Australian Government (which must include the ABS) has done little to disabuse the public or its servants of this increasingly flawed belief. It has allowed many tens of thousands of its servants to plan their retirement in the expectation that CPI indexation would maintain purchasing power of their pensions as expounded by Professor Pollard.

Possibly worse, the Government is able to exploit unjustly persistent public misconceptions about what CPI indexation delivers in its various statements opposing any improvement in the indexation of public sector pensions.

On 10 February 2005 the then Treasurer, Mr Costello made public the Government's response to the recommendations of a Senate Select Committee. In response to the Committee's recommendation that the indexation of public sector pensions be improved the Treasurer said:

This recommendation is not supported.

The Government at this time has no plans to change the indexation method for Australian Government civilian superannuation pensions. The Government believes that indexation using the Consumer Price Index (CPI) represents an equitable and satisfactory method over a period of years for increasing pensions, and protects the living standards of retired Australian Government employees.

In a recent article published by the Australian Bureau of Statistics (ABS) entitled Analytical living cost indexes for selected Australian household types: update to June 2004, the ABS measured and compared changes in the CPI against changes in prices of out-of-pocket living expenses experienced by different categories of households, including self-funded retiree households. The results have revealed that the CPI compares favourably with the cost of living index for self-funded retiree households over the six-year period to June 2004.

The Bureau's research indicates that for the period from June 1998 to June 2004 the CPI increased by 19.7 per cent. This compared favourably with the living cost index for self-funded retiree households, which increased by 18.6 per cent over the same period. Based on these results, the ABS article concluded that 'the CPI provides a reasonable estimate of changes in living costs for each of the selected household types over this period.'

The ABS findings reinforce the Government's belief that the CPI does provide a reasonable measure of the cost of living.

Mr Costello's response is misleading. The references to ABS living cost indexes provides no indication that those indexes are measured at constant value, that is after quality adjustments have stripped out a large part of what has happened to shelf prices. The most misleading part is at the end of the first paragraph. Mr Costello says that CPI indexation protects the living standards of retired Australian Government employees. In any practical sense and by Professor Pollard's criteria it does no such thing and panders to the popular misconception of what CPI indexation delivers.

The index which we know as the CPI no longer reflects consumer prices as understood by an ordinary person. It is a derivative of consumer prices but not more. There is lot of obsolete and misleading baggage that comes with the name "Consumer Price Index". It is high time that the index was renamed to reflect its primary purpose. The title needs to contain the word "inflation." It certainly should not contain the word "price". The most appropriate new name would seem to be "Retail Inflation Index"

The ABS should:

1. Maintain good records of the quality corrections that are being applied to shelf prices and facilitate public and academic study of those records.

2. Run an extensive public education programme about quality corrections and the impact they have on the ability of CPI indexation to maintain the purchasing power of a pension in terms of shelf prices.

3. Despite the obstacles change the name of the CPI to "Retail Inflation Index" to reflect the primary purpose of the index and to help put an end to out of date understandings/expectations of the CPI.