



## **SEMINAR**

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### **8. Treatment of owner-occupied housing in Australia – concepts and practices**

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# Treatment of owner-occupied housing in Australia – concepts and practices.

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## INTRODUCTION

The way in which owner-occupied housing is treated in a CPI is probably the single most debated topic by both domestic users of CPIs and price statisticians. Although the way in which it is treated should ideally be determined by the principal purpose of the CPI (or its measurement objective), in practice this may prove difficult. In addition to the difficulties that may be experienced in identifying a pre-eminent principal purpose for the CPI, national compilers have to take into account the proportion of the reference population that are owner-occupiers and the data requirements and compilation costs of the alternative treatments.

In 1997 the Australian Bureau of Statistics (ABS) undertook the most comprehensive review of the Australian CPI since 1960. The key outcome of that review was the adoption of a new measurement objective for the CPI. Prior to this review the CPI was designed specifically to measure the impact of ‘price’ changes on the purchasing power of after tax money incomes. Following the 1997 review the CPI was specifically designed to provide a general measure of price inflation for the household sector as a whole. Using the conventional parlance of price index compilers, this meant a move from an *payments* to an *acquisitions* approach for CPI compilation.

This paper provides a potted history of the Australian CPI from the early years of the twentieth century to the present day with a focus on the changes in the treatment of owner-occupied housing costs.

## OWNER-OCCUPIED HOUSING PRIOR TO THE 1997 REVIEW

From its inception up until the 1997 review, the most important use (or principal purpose) of the Australian CPI<sup>2</sup> was as an input to the highly centralised wage and salary determination process that existed in Australia for most of the twentieth century. For this purpose it was generally agreed that the

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<sup>2</sup> Although the CPI label was first used officially for the series introduced in 1960, for convenience the term is used in this paper to also refer to all of its predecessors commencing with the A Series Index first compiled in 1912 with index numbers extending back to 1901.

objective of the CPI should be to measure the impact of ‘price’ changes on the purchasing power of the after tax money incomes of wage and salary earner households.

The very first CPI had, by today’s standards, very limited item coverage. It included only food, groceries and house rents. Successive changes in these early CPI series saw a gradual expansion of the item coverage with the objective of achieving progressively better coverage of the actual expenditures of wage-earner households. However, the costs of home ownership were not included until the official introduction of the CPI in 1960. Prior to this, housing costs were represented entirely by rents actually paid by renting households.

The move to explicitly include in the CPI those costs peculiar to home ownership was motivated by the very rapid growth in home ownership in the post World War II years which saw house renting change from a major to a minor mode of house occupancy. The question that needed to be answered was what are those costs and how should they be measured in the CPI?

When the CPI was introduced in 1960, the items included to represent the expenditures of owner-occupiers were: Local government rates and charges; House purchase, including alterations; House repairs and maintenance; and House insurance. In explaining the choice of these items the ABS had this to say:

*“Extensive investigations indicated that no single housing component such as rent or house price was likely to prove adequate as a measure of price changes affecting the housing expenditure of wage-earner households in the period 1950-1960. . . . .*

*The method herein has been to adopt the practical device of using in the housing component those prices or charges that could be periodically ascertained for goods and services which have an important influence on housing expenditure of wage earner households. Cost of land is not considered to be relevant to the retail price index defined herein, and is excluded. **Interest charges present special difficulties of concept and measurement for which no generally acceptable solution has been found.** It is considered that the resultant items included form a sufficiently broad and representative housing component for a retail price index over the period covered. The elements of the situation may change and will be kept under review.” (from ABS 1987 emphasis added)*

In the years following the 1960 review, the incidence of home ownership continued to rise and the single most persistent criticism of the CPI was its exclusion of mortgage interest charges. These charges were viewed as accounting for a significant proportion of home owners’ costs and variations in mortgage interest rates were seen as having a significant effect on the purchasing power of incomes. However, the ABS continued to exclude interest

charges from the CPI on the practical grounds that the construction of an appropriate measure was beyond its reach.

In response to increasing demand from key users of the CPI the ABS established a research program to develop a price index for mortgage interest charges<sup>3</sup> in the first half of the 1980's. This work was completed in time for a review of the CPI undertaken in 1986.

The 1986 review re-affirmed that the principal purpose of the CPI was as an input to the wage determination process and that it should continue to measure the impact of price changes on the purchasing power of employee incomes to the best extent possible. A key outcome of that review was the decision to replace house purchase costs with mortgage interest charges<sup>4</sup> as the most significant component of owner-occupiers' costs.

This decision was seen as being consistent with the view that the primary motivation for house purchase is to obtain shelter, but it recognised the capital elements of such purchases. Capital payments can be viewed as those payments that result in no net change to a household's balance sheet. In the case of house purchase, these capital payments can comprise downpayments on dwellings and/or repayments of mortgage principal as the payments result in the reduction of an asset (cash) on the one hand offset either by the acquisition of another asset (equity in a dwelling) or a reduction in a liability (mortgage debt) – in either event such payments are eventually recoverable when the house is sold. Mortgage interest payments on the other hand represent an inescapable, non-recoverable cost of home ownership. While the ABS considered it inappropriate to include the capital components in the CPI, it considered the inclusion of mortgage interest charges to be entirely consistent with the principal purpose of the CPI.

### **THE 1997 REVIEW AND OWNER-OCCUPIED HOUSING**

By the time of 1997 review of the CPI, the operation of the Australian economy had changed in a couple of key respects. There had been a significant move away from centralised wage determination processes to decentralised, enterprise level arrangements and the Reserve Bank of Australia had formally adopted an inflation target for the administration of monetary policy<sup>5</sup>. After considering the views of all users of the CPI, the ABS concluded 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 as a whole.

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<sup>3</sup> The research program was also tasked with developing a price index for consumer credit charges.

<sup>4</sup> The conceptually similar item, "consumer credit charges" was also added.

<sup>5</sup> See Woolford 2005 for more detail.

The question this raised was, how would a measure of price inflation for the household sector differ from a measure of the impact of price change on net money incomes of employee households?

The issue of how best to measure inflation is very complex<sup>6</sup>. Despite universal usage of the term 'inflation', there is no generally agreed definition that is sufficiently precise to develop an unequivocal measure. Nevertheless, there is some convergence of views as to the conceptual properties that would be possessed by an index designed for the analysis of price inflation for the household sector. Key amongst these is the view that inflation is a phenomenon peculiar to the operation of markets. Therefore a measure of inflation would encompass only market transactions.

As might be expected, the most problematic area was identified as the treatment of owner-occupied housing. While none of the parties to the review disputed the effect that interest rates have on the purchasing power of household incomes, they also agreed that interest rates were not market 'prices' in the same sense as (say) the prices of oranges. Rather than being thought of as representing the price of some specific good or service, interest rates are best viewed as representing the relative 'price' of consuming today rather than in the future. Those users who argued that the CPI ought to be a measure of price inflation were of the unanimous view that this measure would not include interest charges. There was less certainty when it came to identifying precisely how to measure price inflation for owner-occupiers.

The ABS rejected both the *user cost* and *rental equivalence* measures on conceptual grounds as neither appeared to be consistent with the price inflation measurement objective as neither could be said to reflect actual market transactions. In constructing the CPI it was not considered necessary, or sometimes even desirable, to strictly adhere to the conventions used in compiling the national accounts. This is particularly the case for owner-occupied housing where, by convention, the national accounts separate the ownership of dwellings from the household sector – creating notional transactions between households as landlords and tenants. While this provides an effective mechanism for distinguishing the value of the flow of services actually consumed by households, the distinction is arguably less relevant for a measure of price inflation.

The ABS decided that a CPI constructed using the *acquisitions* approach best met the requirement for a measure of price inflation. Accordingly, price inflation for owner-occupied housing would be represented by the purchase of dwellings (excluding land), local government rates and charges, house repair

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<sup>6</sup> See ABS 1997 (a) and Woolford 1999.

and maintenance expenses and charges for house insurance services<sup>7</sup>. As the CPI was constructed to represent the household sector as a whole, the significance of house purchase was determined only by those dwellings acquired from outside the household sector (i.e. transactions between households were netted out). In practice this translates to the purchase of newly constructed dwellings and alterations and additions to existing dwellings.

The outcome of the 1997 review may appear somewhat paradoxical in that the way in which owner-occupied housing is now measured in the CPI has reverted to that in use prior to the 1986 review. However, it is more correct to view the practice prior to 1986 as illustrating the measurement limitations then being experienced rather than take the view that the ABS has now changed its mind about what constitutes the best approach for measuring the impact of price change on the purchasing power of household incomes. The ABS continues to construct analytical living cost indexes (at approximately yearly intervals) for selected household types using the *payments* approach (i.e. including mortgage interest charges).

### **SOME CONCLUDING COMMENTS**

While it has often been observed that the three general approaches to constructing a CPI (the *use*, *outlays* (or *payments*), and *acquisitions* approach) tend to deliver similar outcomes over the longer term, they can diverge significantly in the short term. With analysts more often than not focussing on the short-term outcomes it is important that whatever variant of the CPI is compiled, its measurement objectives, methods, and strengths and weaknesses are well documented.

The fact that approaches differ across countries for all the right sort of reasons, makes international comparisons that much more difficult. Countries should therefore be encouraged to follow the advice provided in the *Resolution concerning consumer price indices adopted by the Seventeenth International Conference of Labour Statisticians, 2003* and compile and disseminate an index that excludes housing and financial services (paragraph 80 of the Resolution).

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<sup>7</sup> With the weight for insurance services changing from a gross premiums basis to a net premiums basis to reflect the value of the insurance service acquired by households rather than the gross outlays made to gain access to insurance services.

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