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Rising cost of living: myth or reality?

by Andrew Haylen

1. Introduction

A significant concern for many households is the expense they incur to buy goods and services that are necessary to maintain a certain standard of living – that is, their ‘cost of living’.¹

Cost of living is an issue that dominates political and social debate, particularly with regard to housing expenses, petrol, electricity and grocery prices. It has often been claimed that the cost of living in Australia is out of control and that household incomes are falling behind that cost of living.²

The reality is that prices almost always rise, so it’s understandable this would cause concern in the community. For many groups such as the unemployed, students, pensioners, people with disabilities and low income working families, making ends meet is often a daily struggle.³

This paper doesn’t attempt to argue against this. Rather, it considers, at an aggregate level, just whether these cost of living pressures are getting worse relative to wages growth; and also whether the cost of living pressures are being felt more acutely by certain demographics in Australia.

If this isn’t actually the case, could it be that these cost of living pressures are driven by greater expectations or societal changes?⁴

This e-brief assesses, in general terms, key trends in various cost of living measurements (including the consumer price index), as well as wage indexes in Australia. By drawing on literature from the Reserve Bank and the National Centre for Social and Economic Modelling, this paper also provides an evaluation of standard of living changes in Australia.

2. Cost of living measurements

Although Australia’s official measure of price change for households is the Australian Bureau of Statistics’ (ABS) [consumer price index](#) (CPI), it is not specifically designed to measure the cost of living. This is largely because the CPI measures prices of a fixed basket of goods and services, with

unchanged short-term composition⁵ and quality. In reality, household consumption changes regularly to price and quality.

There are several other reasons why the CPI might not fully reflect household cost-of-living inflation. The Reserve Bank of Australia addresses these at length in the [March 2014 Quarter Bulletin](#). It is evident from this publication that three elements undermine the sole use of the CPI as a 'true' cost of living measurement:⁶

1. **Substitution bias** – This refers to the changing behaviour of consumers to price fluctuations; such that consumers will shift their consumption to lower inflation items to alleviate the impact of price increases. The CPI does not capture this behaviour because it is based on a fixed basket of goods, only updated every six years. Similarly, consumers generally shop around between outlets to obtain the best price. Both of these elements may result in an upward bias compared to 'true' cost-of-living inflation.
2. **Incomplete quality adjustment** – This refers to the improvement in the quality of goods and services over time. If prices increase in line with quality, then the cost of living is unchanged. Therefore, recorded prices need to be adjusted downward to account for the effect of quality improvements. The ABS performs quality adjustments for items which tend to have large and easily measurable quality improvements. However, for certain items, it is difficult to measure quality and therefore to adjust for improvements. Where quality is more difficult to assess, CPI inflation can potentially reflect an element of quality improvement, which is not a genuine rise in the cost of living.
3. **Treatment of housing** – The CPI also measures the cost of housing by evaluating the price of buying a newly built, free-standing house. Alternative approaches may be more reflective of living costs. In particular, those that measure the cost of servicing a mortgage might align more closely with actual household expenses.

According to the RBA (2014), the overall effect of the aforementioned factors is likely to be positive, meaning that CPI inflation would generally be expected to overstate cost-of living inflation (Table 1).

Table 1: Biases in CPI inflation as a proxy for cost-of-living inflation⁷

Source of bias	Estimated effect on CPI inflation relative to 'true' cost-of-living inflation
Substitution bias	0.25 to 0.5 per cent
Incomplete quality adjustment	0 to 0.5 per cent
Treatment of housing	– (+) when mortgage interest rates rising (falling)

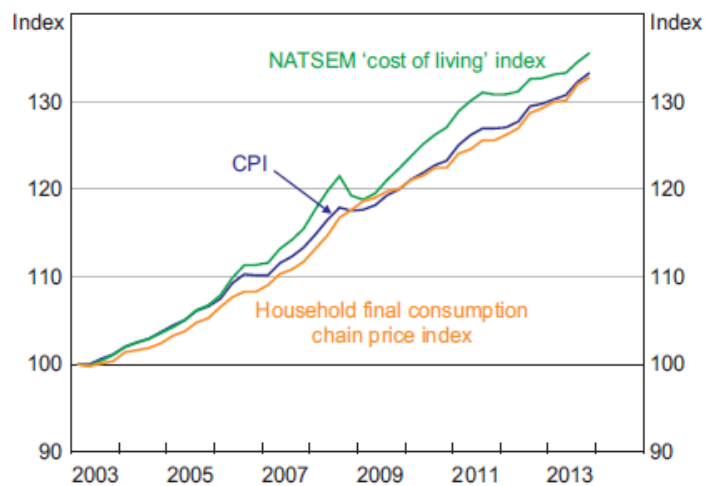
For practical and theoretical reasons, a true cost of living index is very difficult to measure and no such index is compiled within Australia or internationally.⁸ Other measures of inflation are available that assess cost of living movements. The most credible methods in Australia include the:

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- **household final consumption expenditure chain price index** – published by the ABS
- **analytical living cost indices** – published by the ABS
- **cost of living index** – published by the National Centre for Social and Economic Modelling (NATSEM)
- **cost of living index** – published by the Reserve Bank of Australia (RBA)

Generally speaking, they are closer in concept to a measure of cost of living inflation compared to the CPI.⁹ Despite their different approaches and some temporary deviations, these other measures have actually risen by similar amounts to the CPI over the past decade or so (Figure 1).

Figure 1: Various cost of living indices, March quarter 2003 = 100¹⁰



Therefore, while the CPI is subject to certain biases when used to assess cost of living inflation, according to the RBA (2014):¹¹

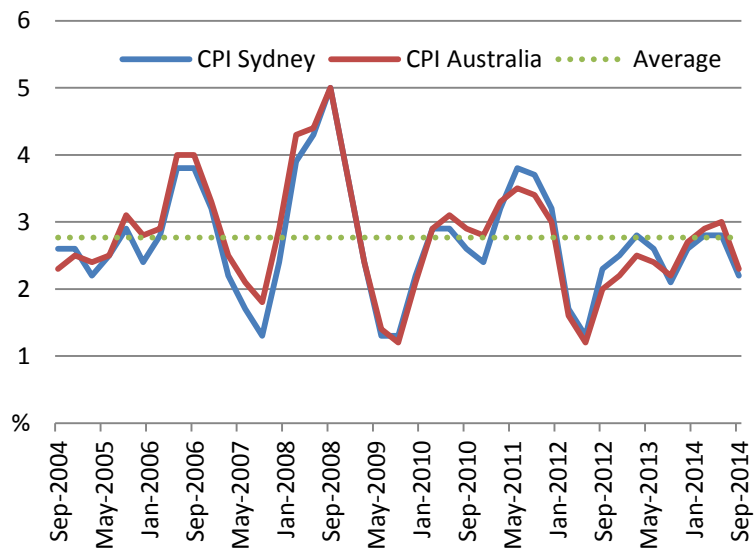
...these have either tended to even out over a long period of time or have been present in other measures to a similar degree.

3. Consumer price index

CPI inflation declined in the most recent quarter and is now below the 10-year Australian average. This followed several quarters where inflation had been rising in year-ended terms. The recent decline in headline inflation in large part reflected the repeal of the carbon price, which took effect retroactively from 1 July 2014.¹²

Looking at the longer term trend in the CPI (Figure 2), it is obvious that inflation is not out of control and, with the exception of the sharp fluctuation in 2008 and 2009, has stayed more or less within the RBA target band of 2 to 3 per cent.

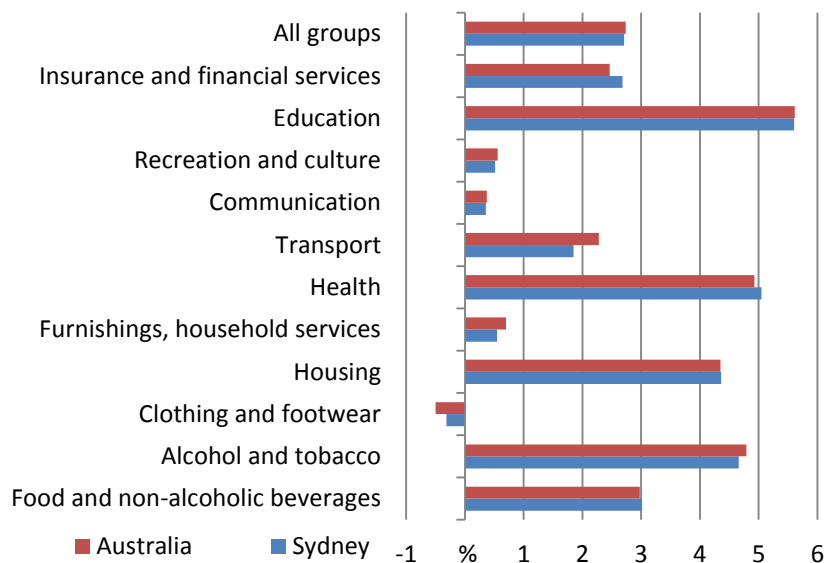
Figure 2: Annual change in the CPI, all groups, Sydney and Australia¹³



The CPI is a complex assortment of goods and services with each item having its own relative importance in the 'basket of goods'. While it is true that the price of some items, often the necessities of life, have increased significantly more than the CPI, there is also a range of other items that help to offset these price increases.

For example, over the past decade or so, education, health care and utilities prices have risen by more than the overall rate of CPI inflation (Figure 3). Other items have experienced inflation below overall CPI inflation; and for specific consumer durables, including clothing, footwear, and audio, visual & computing equipment, prices have even declined. Declines in these prices reflect significant improvements in productivity, sourcing from low-cost economies, the appreciation of the exchange rate and greater retail competition.

Figure 3: Relative price movements, by CPI expenditure group, 2004-2014¹⁴



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3.1. Inflation outlook

According to the RBA (2014), the CPI data for the September quarter was lower than generally expected, and market economists have revised down their forecasts in response.¹⁵

The RBA (2014) suggests that the spare capacity in labour markets is expected to see domestic inflationary pressures remain contained.¹⁶ Inflation is forecast to decline over the coming year to around 2¼ per cent before picking up, to be in the top half of the target range of 2 to 3 per cent over 2016. NAB also forecast inflation to decline in the 2014-15 financial year to 2.1 per cent, before rising to 2.8 per cent in 2015-16.¹⁷

Table 2: Reserve Bank of Australia inflation forecasts (%)¹⁸

	Jun-14	Dec-14	Jun-15	Dec-15	Jun-16	Dec-16
CPI Inflation	3	1.75	1.5-2.5	2.5-3.5	2.5-3.5	2.5-3.5
Underlying inflation	2.75	2.25	2.0-3.0	2.25-3.25	2.25-3.25	2.25-3.25

4. Cost of living indices

Inflation rates vary across individual households due to different spending patterns and because not all prices increase at the same rate. As a result, official aggregate measures will only approximate cost of living inflation for many households.

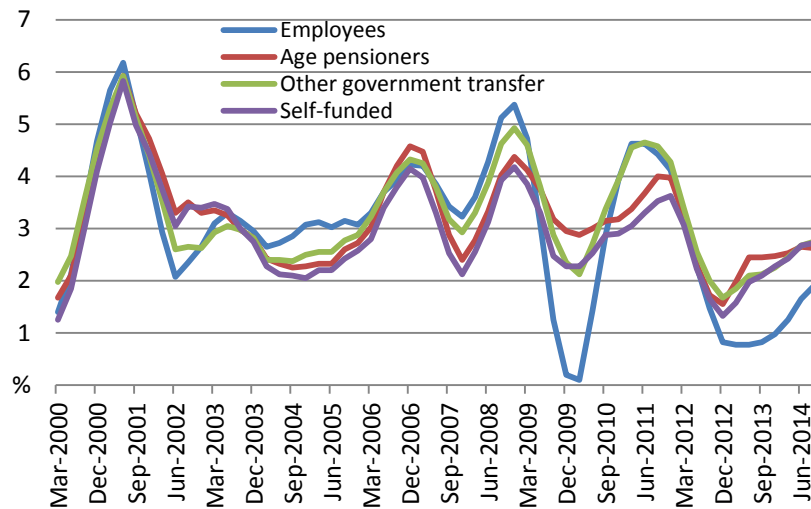
It is possible to gauge cost of living trends across various demographics. Of particular interest, is the cost of living index developed by NATSEM which recalculates the living cost indexes to suit the household expenditure patterns of a wide range of household types and also across the different Australian jurisdictions. The ABS and RBA cost of living statistics below are also adjusted to suit the various expenditure patterns of the respective demographics being estimated. Wages are not calculated in the indices presented below, as they only measure expenditure costs. Wages are incorporated in the standard of living indices presented in Section 6.

4.1 Australian Bureau of Statistics

The ABS [Selected Living Cost Index](#) estimates the distribution of inflation across households according to their main source of income. Inflation is measured for employees, age pensioners, recipients of other government transfers and self-funded retirees.

Differences in cost-of-living inflation, at least in the short-term, across households with different income sources are largely explained by changes in mortgage rates. This is particularly the case for employee household's cost of living inflation (Figure 4). In contrast, self-funded retirees, pensioners and other government transfer recipients are all less likely to have mortgages and be affected by interest rates, so their annual cost of living fluctuations are smoother. Over the longer term, cost of living inflation rates for these categories have generally followed similar trajectories.

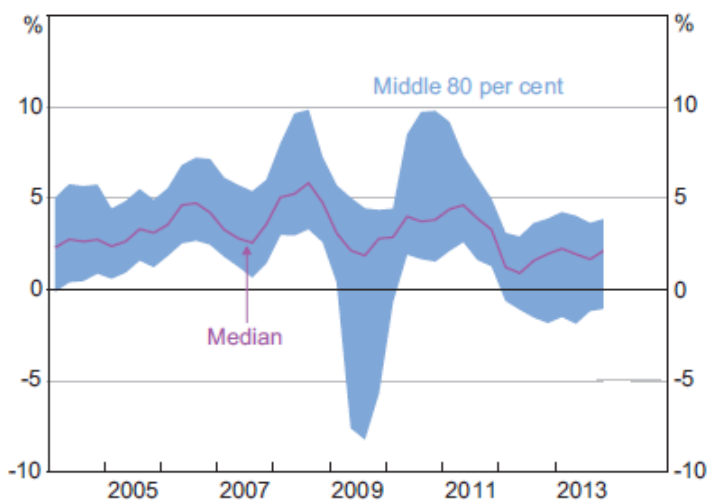
Figure 4: Quarterly cost of living inflation, by income source¹⁹



4.2 Reserve Bank of Australia

The RBA (2014) constructed a cost of living index from 2003 onward using data from the ABS Household Expenditure Survey.²⁰ The index shows that the distribution of cost of living inflation rates across households has been fairly narrow over the past decade (Figure 5).

Figure 5: Distribution of cost-of-living inflation²¹



In most years, less than 5 percentage points have separated the inflation rates of the middle 80 per cent of capital city households (ranked according to cost of living inflation rates). For all groups, the RBA cost of living inflation has not differed much from the CPI. The major driver of short-term differences (e.g. those exhibited in 2009) in inflation across households is the aforementioned interest rate movements.²²

Based on RBA (2014) analysis, over the past decade, low income households have experienced slightly higher rates of cost of living inflation than high income households:²³

The slightly higher rate of inflation for low income households over the past decade has weighed more on the growth in their real incomes than for high

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income households. However, this difference has not been large, with inflation for the lowest income quintile only around 4 percentage points more than the highest income quintile over the course of a decade.

Table 3: Cost of living inflation by household characteristics (%)²⁴

	Category share	Inflation since 2003
Disposable income		
Lowest quintile	20	39
2nd	20	36
3rd	20	35
4th	20	36
Highest quintile	20	35
Principal source of household income		
Wages and salaries	65	33
Age pension	10	36
Other transfer	10	38
Property income	5	32
Housing tenure		
Mortgagor	38	36
Owner	31	36
Renter	29	38
Family structure		
Family with dependent children	33	35
Family without dependents, head aged under 45	13	34
Family without dependents, head aged over 45	26	35
Lone person or non-family group household	28	39
Age of household reference person		
15-24	4	35
25-34	19	36
35-44	21	36
45-54	21	36
55-64	17	36
65+	19	37
Area of residence		
Adelaide	6	36
Brisbane	9	37
Hobart	1	33
Melbourne	18	37
Perth	8	37
Sydney	20	35
ACT or NT	2	37
Outside state capital cities and territories	36	36

It is clear from Table 3 that cost of living pressures haven't altered greatly between the different household types since 2003. The results in Table 3 show that there are no real standout groups that are facing cost of living pressures that have accelerated beyond that of other households either recently or over the longer term.

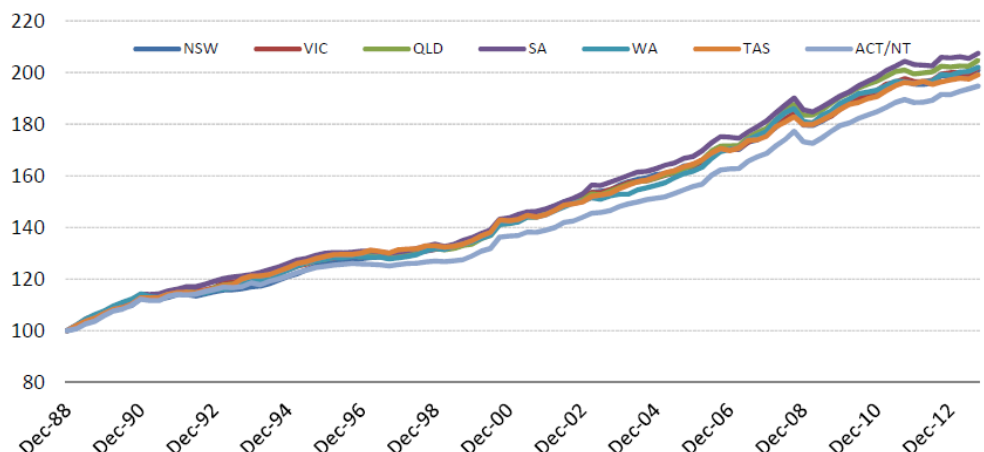
4.3 National Centre for Social and Economic Modelling

The NATSEM living cost indexes are designed to determine expenditure inflation for a wide range of household types for the period from 1988 to 2013. Indexes are also calculated on a State by State basis.²⁵

Over the longer term, cost of living inflation growth does not vary greatly between the States and Territories. Figure 6 shows the cost of living has grown fractionally quicker in South Australia and Queensland. South Australia's cost of living grew by around 2.3 per cent more than the national average over the 25 year period to December 2013.

The lowest increase in the cost of living is observed in the ACT/NT and Tasmania. The combined ACT/NT grew by around 3.9 per cent less than the national average over the same period.²⁶

Figure 6: Household cost of living index by State, December 1988=100²⁷



While the relative change in cost of living has not varied, the prices do vary in absolute terms between the Australian jurisdictions (Figure 7). Phillips (2013) estimates the price of a typical basket of goods and services in Australia, and then the same basket repriced specifically in each capital city of Australia. Sydney is the most expensive capital city with the typical basket of goods costing \$68,023 per annum. Adelaide has the lowest cost of living, \$4,476 cheaper compared to Sydney.

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Figure 7: Capital city cost of living comparison, NATSEM²⁸

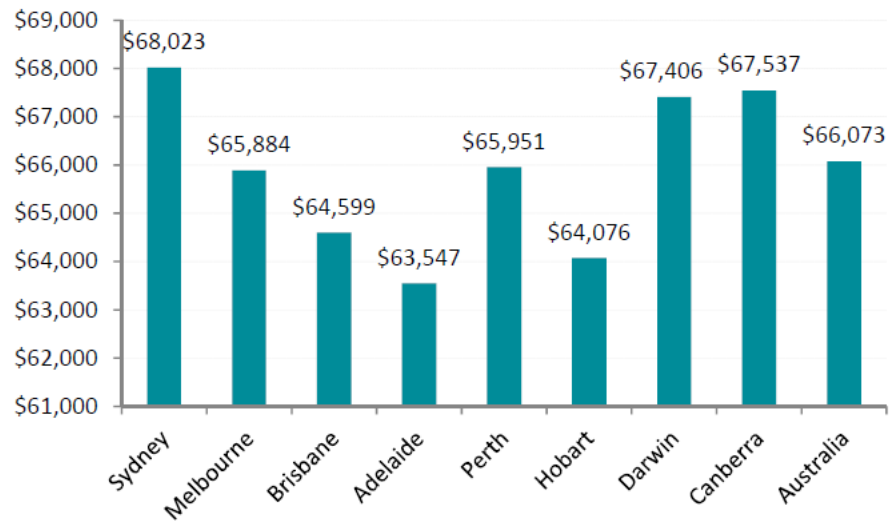
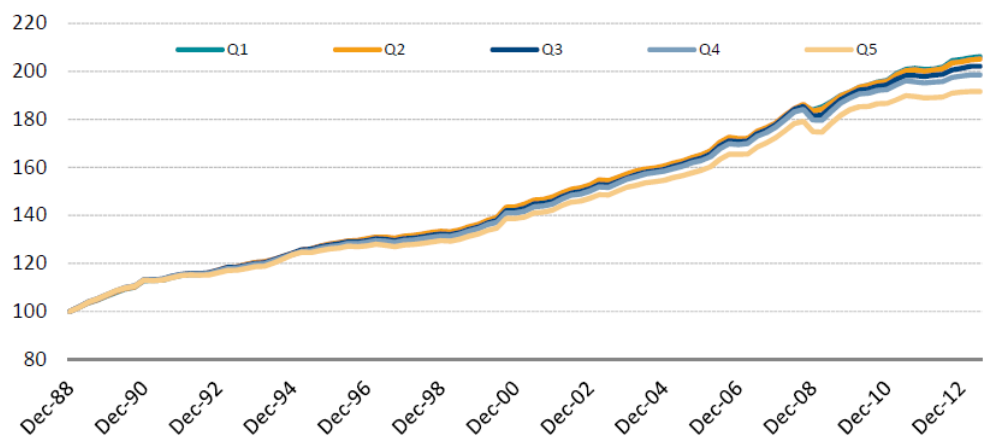


Figure 8 shows that changes in living costs do not diverge greatly based on income. There is a modest difference in the overall growth of the cost of living between income levels. Highest income households have experienced lower cost of living increases (6.9 per cent lower) since December 1988 compared to low income groups.

Figure 8: Household cost of living by disposable income level²⁹

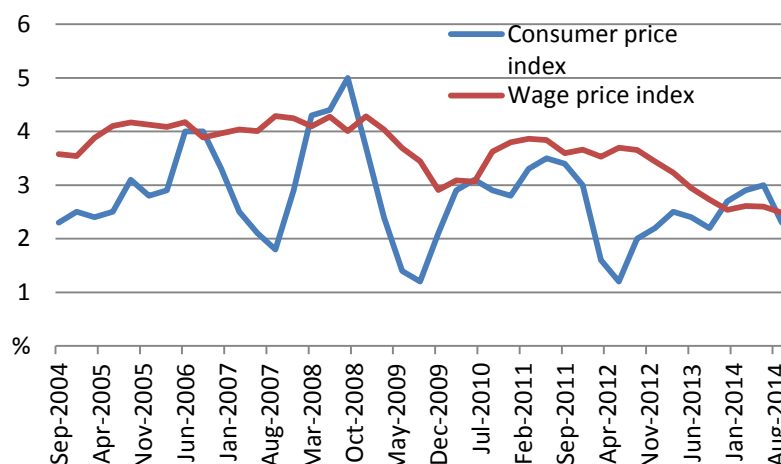


5. Wages

Income growth is equally as important as price rises in the context of the cost of living debate. This is ultimately what determines the *standard of living*³⁰ for households (Section 6). To illustrate, if all prices rise by 5 per cent but household income increases by 10 per cent, then clearly the household is better off than if incomes and prices were both unchanged.

Wage growth, as measured by the wage price index, remained low in the September quarter at 0.8 per cent and was down slightly for the year at 2.5 per cent. The slowdown in wage growth might have been felt more acutely in recent years as the consumer price index growth rate has converged to that of the wage index (Figure 9). However, over the longer term, wages growth has not been detrimental from a cost of living standpoint.

Figure 9: Wage price index growth, NSW and Australia³¹



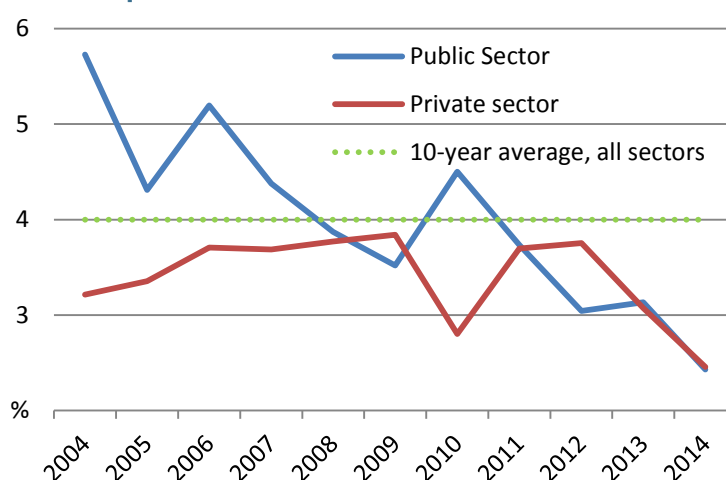
As evident in Table 4, wage growth has slowed across all of the States and Territories over the past year when compared to their respective longer term averages. New South Wales is 1.1 per cent below its 10-year average. Western Australia has the highest long term wage growth at 4.2 per cent.

Table 4: Wage price indices growth, by State, 10-year averages, year ended June quarter 2014³²

State	2014	10-year average	Gap
New South Wales	2.4%	3.5%	-1.1%
Victoria	2.7%	3.5%	-0.8%
Queensland	2.6%	3.8%	-1.1%
South Australia	3.3%	3.6%	-0.4%
Western Australia	2.8%	4.2%	-1.3%
Tasmania	2.3%	3.7%	-1.4%

The weakness in wage growth continues to be broad-based. Private sector wage growth has been weak, slowing to 2.4 per cent over the year (Figure 10).

Figure 10: Wage price index growth, NSW public and private sectors, year ended June quarter 2014³³



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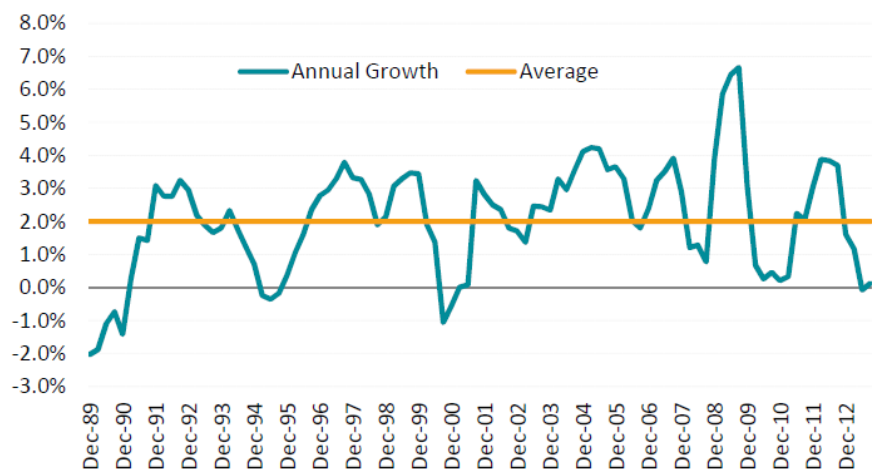
The broad-based decline in wage growth is consistent with other evidence of spare capacity in the labour market. In particular, measures of unemployment and underemployment are at elevated levels.³⁴

6. Standard of living

By comparing cost of living and income changes, Phillips (2013) derives the Australian household financial standard of living for a range of household types.

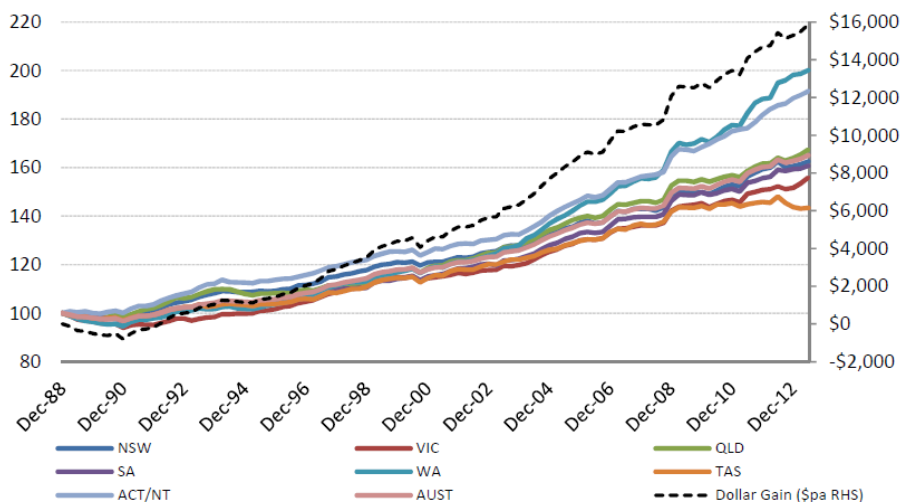
Figure 11 shows that growth in Australia's financial standard of living is positive in almost every one of the 25 years to 2013, at an average of around 2 per cent.

Figure 11: Household growth in Standard of living index³⁵



Overall, Australia's financial standard of living has increased by 63 per cent since 1988. After accounting for cost of living increases the average Australian household is ahead by around \$291 per week or \$15,000 per year (Figure 12).

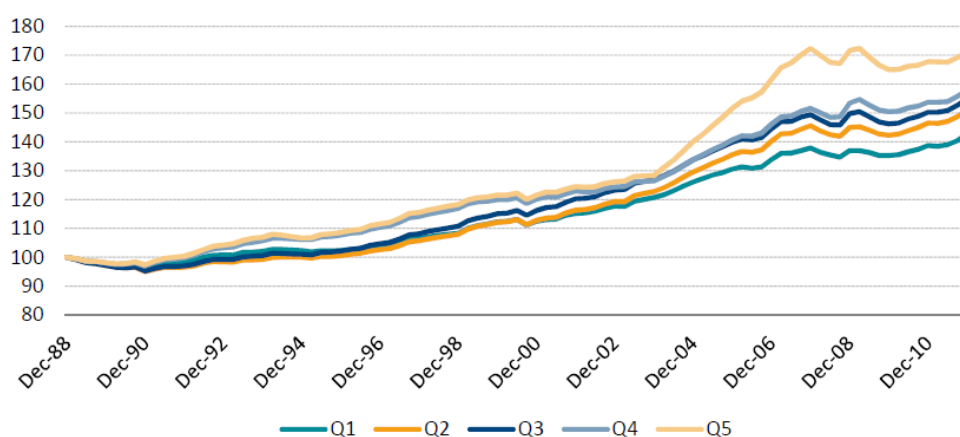
Figure 12: Standard of living Australia, Index – December 1988 = 100, NATSEM³⁶



Western Australian households doubled their financial standard of living over the past 25 years and have an extra \$24,044 per annum in income after accounting for their cost of living increases. The lowest growth occurred in Tasmania with an increase of around 49 per cent or \$10,246 per year. New South Wales households, on average, increased their standard of living by \$15,309 per year.

There were strong gains in household standards of living across all household levels; however, these gains were not equally spread across income levels.

Figure 13: Standard of living, income levels, NATSEM³⁷



The top 20 per cent of income households (Q5, or quintile 5) experienced the strongest gains of just over 70 per cent, while the gains of the bottom 20 per cent (Q1, or quintile 1) were around 42 per cent.

According to Phillips (2013), while Australia has become accustomed to a strongly growing economy and continuously higher living standards, maintaining such growth is not guaranteed. Phillips (2013) concluded:³⁸

While [more recent] results are a concern it is important to reflect on the fact that the recent conservative growth numbers are following on from an extraordinary run of growth, the like of which may not be seen for decades to come. Maintaining such a run was never a likely outcome and Australian households face the likelihood of more benign growth in our standard of living in the short to medium term.

7. International cost of living comparisons

International cost of living comparisons are more difficult to estimate than a comparison of Australian States. As NATSEM (2012) describes, this is because:³⁹

Large differences exist between the quality of products and the task of appropriately dealing with these differences and obtaining a broad selection of goods that truly represent the purchasing patterns in different countries is prohibitively expensive. Comparing a fixed basket of goods between countries also makes little sense as what is important in one country may be irrelevant in another.

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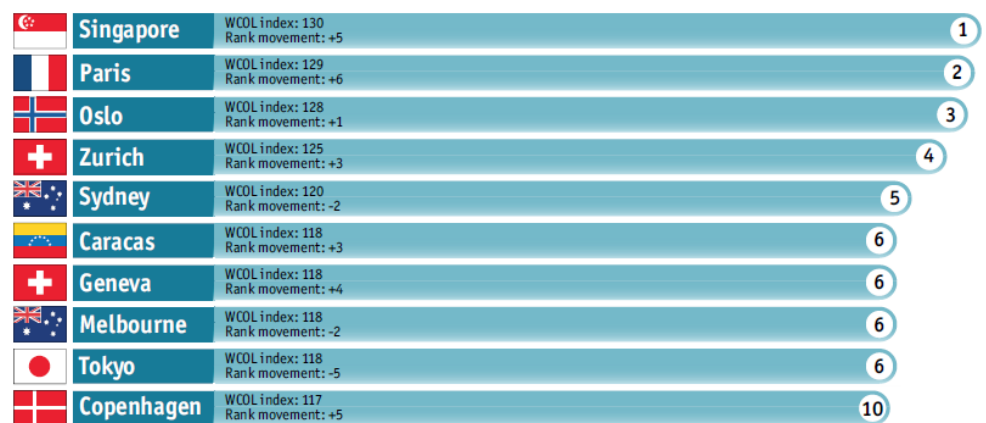
In spite of these difficulties, there are indexes which attempt to compare international costs of living, including [The Economist Intelligence Unit](#) index that prices a representative basket of goods in terms of a single currency.

This index is designed for those in the international job market to compare relative costs of living. As such, the most important driver of change in this index is the exchange rate of individual countries. For Australia, this means that as the currency appreciated, the cost of living position in the index also increased.⁴⁰

This rise in exchange rate and relative prices in Australia does not necessarily represent an increase in the cost of living for Australians. In fact, the appreciation of the exchange rate has seen Australian incomes, paid in Australian dollars, rise relative to those of many other developed economies.

With these concerns in mind, Figure 14 shows that Sydney and Melbourne are two of the most expensive cities in the world for the international worker.

Figure 14: The ten most expensive cities in the world, based on The Economist Intelligence Unit Index⁴¹



In any comparison of price levels it is also important to consider relative incomes, with GDP per capita statistics the best proxy for this. According to the World Bank GDP per capita statistics, Australia ranks 14th; outranking other wealthy countries such as Sweden, Canada, Germany, and the United Kingdom.⁴² GDP per capita measures are generally considered to correlate well with a country's standard of living. However, as NATSEM (2012) notes:

The drawback of GDP measures are that they take a narrow economic perspective and do not necessarily take into account other important measures of standard of living such as education levels, quality of life, life expectancy and inequality.

The Human Development Index developed by The United Nations helps to overcome these problems by including such measures. With this index Australia performs particularly well ranking second out of the 188 countries measured.⁴³ Therefore, while Australia's prices are higher than most other nations, incomes and general standard of living are relatively high.

8. Perceptions about the cost of living

As has been illustrated, cost-of-living inflation in Australia has been moderate and usually outpaced by wage growth. In addition, differences in inflation across different household types have not been large. Nonetheless, the cost of living is a source of significant concern for households. The obvious question then is: how is it that cost of living pressures remain so front of mind?

The RBA (2014) provides a detailed response to this question in the [March 2014 Quarter Bulletin](#) and highlights community perceptions of inflation as a key factor that contributes to these concerns:⁴⁴

Households may perceive inflation to be higher than measured inflation, either due to biases in their perceptions or because they interpret the cost of living differently from the standard statistical measures.

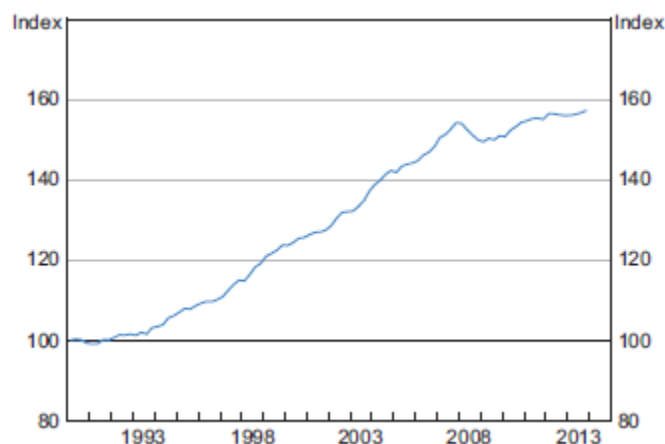
The RBA (2014) noted research in Australia and internationally that found individuals had tended to place greater weight on: prices that have risen, rather than fallen; larger price changes, particularly those that change periodically rather than smoothly; and prices for items that are purchased frequently.⁴⁵ These factors can ultimately create upward biases in the cost of living perceptions of the average consumer.

In the media, much less publicity is attributed to the falling prices of cars and other imported technology than is paid to petrol, electricity and grocery price rises. Imbalanced reporting about price changes can also alter the public view about the ‘true’ cost of living.

Additionally, it is difficult for individuals to adjust for quality changes when observing inflation. For example, progressive releases of new iPhone models in recent years have been priced similarly, despite the clear improvements in quality and value from the product. Therefore when quality is considered, real prices of phones have actually declined.

As illustrated in Section 6, living standards have improved when compared to even 20 years ago. Real consumption per person has also risen substantially, further indicating an increase in living standards (Figure 14).

Figure 14: Real household consumption per capita⁴⁶



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Yet, over time individuals do not compare the cost of achieving the same standard of living, rather that of a 'reasonable' standard of living. As NATSEM (2012) explains:⁴⁷

Perhaps it is all this spending that makes us stress about the cost of living? Keeping up with our reference group (often named 'the Joneses') may be a source of stress to some. Friends purchasing that new plasma screen television, a five bedroom house with a home theatre room or a shiny new SUV can all lead to feelings of envy. For others it may be that the world today demands more from us in terms of educational requirements, more high technology equipment or leaner spare time means outsourcing child care and chores.

Following this line of argument, it is likely that the notion of what is a reasonable standard of living has also increased, as households have become accustomed to consuming more goods and services and those of a higher quality. As a result, perceived increases in the cost of living may partly reflect the cost of attaining a higher standard of living for many households.

9. Conclusion

So is the concept of a rising real cost of living in Australia a myth or reality? The short answer: it is a myth; although the issue is complex and comes with a number of caveats. In particular, that is not to say that there aren't segments within Australian society struggling with acute and chronic cost of living pressures. Rather, at an aggregated level, cost of living pressures do not appear to be great as might initially be perceived.

In short, longer term price and living cost inflation in Australia appears to be contained. Indexes developed for different household categories show that almost without exception, regardless of the type or socio-economic position of households, living cost increases have been contained and have not diverged significantly based on demographic characteristics.⁴⁸

The end result of this is an improved standard of living for Australian households. Overall, Australia's financial standard of living has increased by 63 per cent between 1988 and 2013. New South Wales, on average, increased its standard of living by \$15,309 per annum.

Of course, prices of certain items, including essentials such as health and education, have risen at a relatively fast pace in recent years. However, other items have compensated with much lower or negative price inflation, such as audio visual and computing equipment, motor vehicles and clothing and footwear.

On a global comparison of a representative basket of goods and services, Australian cities rank among the most expensive, largely the result of a relatively strong Australian dollar in recent years. Nevertheless, Australia remains one of the richest nations and enjoys a standard of living higher than most of the world.

- ¹ Jacobs, D, Perera, D, and Williams, T., [Inflation and the cost of living](#), 2014, RBA Bulletin, March Quarter 2014, p.33
- ² AMP, NATSEM, [Prices these days: The cost of living in Australia](#), May 2012, Income and Wealth Report, Issue 31, p.2
- ³ For more discussion around the cost of living pressures facing people experiencing poverty and disadvantage, see: NCOSS, [Cost of living: Who's really hurting?](#), March 2014
- ⁴ AMP, NATSEM, [Prices these days: The cost of living in Australia](#), May 2012, Income and Wealth Report, Issue 31, p.3
- ⁵ That is, the composition of the basket of goods and services in the consumer price index only changes every six years.
- ⁶ Jacobs, D, Perera, D, and Williams, T., [Inflation and the cost of living](#), 2014, RBA Bulletin, March Quarter 2014, p.34
- ⁷ Ibid, p.36
- ⁸ AMP, NATSEM, [Prices these days: The cost of living in Australia](#), May 2012, Income and Wealth Report, Issue 31, p.4
- ⁹ ABS, [Consumer Price Index: Concepts, Sources and Methods](#), 2011, 6461.0.
- ¹⁰ Jacobs, D, Perera, D, and Williams, T., [Inflation and the cost of living](#), 2014, RBA Bulletin, March Quarter 2014, Graph 2, p.36
- ¹¹ Ibid, p.35
- ¹² RBA, [Statement on Monetary Policy](#), November 2014, Chapter 5: Price and wages developments, p.49
- ¹³ ABS, [Consumer Price Index, Australia](#), September 2014, Cat. No. 6401.0
- ¹⁴ ABS, [Consumer Price Index, Australia](#), September 2014, Cat. No. 6401.0
- ¹⁵ RBA, [Statement on Monetary Policy](#), November 2014, Chapter 5: Price and wages developments, p.54
- ¹⁶ Reserve Bank of Australia, [Statement on Monetary Policy](#), August 2014, p.72
- ¹⁷ NAB, [Global and Australian Forecasts](#), October 2014, NAB Group Economics
- ¹⁸ RBA, [Statement on Monetary Policy](#), November 2014, Chapter 6: Economic Outlook, p.61
- ¹⁹ ABS, [Selected Living Cost Indexes, Australia](#), September 2014, Cat. No. 6467.0
- ²⁰ For details around the methodology see Appendix B: Jacobs, D, Perera, D, and Williams, T., [Inflation and the cost of living](#), 2014, RBA Bulletin, March Quarter 2014
- ²¹ Jacobs, D, Perera, D, and Williams, T., [Inflation and the cost of living](#), 2014, RBA Bulletin, March Quarter 2014, Graph 3, p.37
- ²² Ibid, p.38-40
- ²³ Ibid, p.38
- ²⁴ Ibid, Table 2, p.39
- ²⁵ A detailed description of the methodology used to construct the indexes in this report is provided in the report: Phillips, B., NATSEM Household Budget Report, June 2013
- ²⁶ Phillips, B., [NATSEM Household Budget Report: Cost of Living and Standard of Living Indexes for Australia](#), September quarter 2013, p.9-10
- ²⁷ Ibid, Figure 2a, p.9
- ²⁸ Ibid, Figure 9, p.18
- ²⁹ Ibid, Figure 2b, p.10
- ³⁰ Defined as the level of wealth, comfort, material goods and necessities available to a certain socioeconomic class in a certain geographic area.
- ³¹ ABS, [Wage Price Index, Australia](#), September 2014, Cat. No. 6345.0
- ³² ABS, [Wage Price Index, Australia](#), September 2014, Cat. No. 6345.0
- ³³ ABS, [Wage Price Index, Australia](#), September 2014, Cat. No. 6345.0
- ³⁴ RBA, [Statement on Monetary Policy](#), November 2014, Chapter 5: Price and wages developments, p.52
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