**Inflation Variability across Australian Households: Implications for Inequality and Indexation policy**

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**Key findings**

We examine the differential experience of inflation by households across the income distribution. We find that:

- the lowest income households have experienced the most inflation and those at the top have experienced the least inflation; and
- these differences are driven by inflation in the prices of tobacco and alcohol.
- lower income households consume a greater proportion of their budget in tobacco and alcohol.
- if we examine inflation in all other goods, excluding alcohol and tobacco, there is no difference in inflation across the income distribution.

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**What we knew**

- Consumer price index (CPI) is used to index a variety of government payments.
- If the inflation experience of low-income households is different to the average, indexation of government payments which primarily go to low-income households may be over- or under-compensating those households for price changes.
- Standard approaches to looking at the change of inequality in real incomes over time may be flawed if households in different parts of the income distribution face different rates of inflation.
- Previous research from Canada, the U.S. and Europe is mixed. In the US, there is some evidence that lower income households have faced lower inflation rates, potentially making them better off than would be implied by indexing incomes by CPI.

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**What we do**

- We construct inflation measures for household income groups that can be directly compared to the official measure of inflation, CPI.
- We use the same data sources, price index methods, products and product classifications, and measurement of price change as the Australian Bureau of Statistics (ABS) CPI.
- We use data from the ABS CPI and the ABS Household Expenditure Survey (HES) for the period 2011-2018.
- We produce aggregate measures of inflation for each household income quintile by combining expenditure patterns estimated from the HES with price changes from the CPI.
- We use *chain linking* to combine the expenditure patterns across different years of the HES.
What we know now

- The lowest income (bottom 20 per cent) households experienced more inflation (14.8 per cent) between 2011 and 2018 than the highest income (top 20 per cent) households (13.3 per cent).
- If we remove expenditure on alcohol and tobacco, the lowest income households experience less inflation (11.3 per cent) than the highest income households (11.9 per cent).

What this means for policy

- Government policy is the main factor behind rising prices for tobacco and alcohol. These policies result in lower income households experiencing higher inflation than households at higher incomes.
- Indexing payments to CPI for the lowest income households will under-compensate them for their actual inflation experiences. However, if we think of CPI indexation as compensation for non-tobacco/alcohol expenditure, then indexation by CPI is roughly correct.
- Should lower income households be compensated for their relatively larger preference for alcohol and tobacco? This is not necessarily inconsistent with using prices to affect behaviour.
- Or, should society take the view that some preferences are better than others and not compensate lower income households for having the ‘wrong’ preferences?
- This raises a couple of interesting policy questions:
  1. To what degree does society want to achieve public health benefits by suppressing incomes as opposed to altering relative prices in a way that does not affect overall well-being?
  2. To what degree should indexation reflect societal preferences for some types of consumption as opposed to others?
Reasonable people can differ on the answers to these questions, but it is important to recognise that different policy proposals implicitly take different positions on these issues.

Caveats

- While we allow for the fact that low and high income households spend different amounts on different expenditure categories, we use a common CPI basket for all household types.
- If low and high income households consume different goods, then their inflation experiences may be different. Our study will not capture this.

Where to now?

- Further research using detailed scanner data linked to demographic information, for example, will allow a deeper understanding of the inflation experience of different types of households.

More information

- Links to the
  - full working paper
  - the published version
- We would welcome the opportunity to present our research to your team and to discuss potential joint research projects on related or similar topics.
- Contact us at robert.breunig@anu.edu.au or marcel.van.kints@abs.gov.au