

MEASURING INFLATION AS HOUSEHOLDS SEE IT: NEXT STEPS FOR THE HOUSEHOLD COSTS INDICES

January 2023

EXECUTIVE SUMMARY

Ex1. It is widely accepted that the purpose of a consumer price index should determine how it is compiled; a single index cannot meet all needs.

Ex2. The UK's Household Costs Indices (HCIs) are intended to measure inflation as experienced by households; in other words to see by how much a household's disposable income would need to rise to compensate for inflation. They complement indices such as the EU Harmonised Index of Consumer Prices (the UK version of which is known as the CPI), or CPIH, which were explicitly designed for macroeconomic purposes such as inflation targeting or for international comparisons.

Ex3. Since they are intended to measure the impact on the household budget, Indices such as the HCIs should be compiled on a payments basis, as far as practical. Acquisition data can be used when the date of acquisition is identical or close to that of payment. The user cost approach is not normally appropriate.

Ex4. Other key ways in which HCIs differ, or should differ, from "macroeconomic" indices are that they:

- a are weighted on a household (democratic) basis, as opposed to a "plutocratic" basis
- b include interest payments (including mortgage interest)
- c include student loan repayments (in the UK)
- d give full weight to insurance premiums
- e include all housing-related payments made by owner occupiers, including, we believe, at least some elements of capital payments
- f are on a "national" basis, excluding payments by foreign visitors and including, as far as possible, payments by residents when abroad. Macroeconomic indices are on a "domestic" basis, including expenditure by foreign visitors and excluding spending by residents when abroad.

Ex5. The UK Office for National Statistics has been developing HCIs since 2017, with an interruption during the pandemic. Indices are produced for a number of household groupings (by income decile, working age vs retired households, owner occupiers vs private renters vs social renters, households with and without children, households with and without a disabled person) as well as an overall index. The production of indices for different household groupings is an important characteristic of an HCI system.

Ex6. The indices published by ONS so far show monthly data back to 2005 in most cases. Until now they have been produced once a year at most but from 2023 they will be produced quarterly. We trust it will not be long before they are produced on a monthly basis alongside CPI and CPIH.

Ex7. The indices already cover most of the points in paragraph 4. Work remains to be done to produce them on a national basis (point 4f). However, current plans are to include the capital element of owner occupier housing in a secondary index once all the rest of the planned work has been completed. This decision was never debated and we urge that it is. We believe that mortgage capital payments, and also the initial deposit paid by first time buyers, need to be included in the main index.

Ex8. Mortgage interest is currently calculated using the RPI method. Prior to 2010, the series used the standard variable rate of interest; now the average effective rate is used. The use of the standard variable rate – now used in only a minority of mortgages – exaggerates the movement around 2008 when interest rates were cut sharply following the financial crisis. We urge that either the average effective rate is used throughout the series or, better, that the alternative method based on the lenders' model is used (see Appendix A).

Ex9. A key major development in the future will be enabling different household groups to reflect not just the differences in weights but also, where appropriate, differences in the types of products typically acquired. The experience of the surge in inflation in 2022, and concerns that “value” or “own-brand” products were rising in price faster than more up-market brands, has underlined the need to undertake more research in this area. ONS have started some experimental investigation. This will be a very major and long-term project but it is crucial and will deliver a step change in the quality of the indices.

Ex10. Other future developments we would recommend include a review of elementary aggregates used, more consideration of adjustments for quality change and consideration of the name of the series. We have problems with the use of the word “costs” since this can mean not just the item price per unit but the total cost paid in a transaction.

Ex11. The primary goal of HCIs is to measure inflation as experienced by households. This should make either the overall series, or a series for a household group, a suitable index to use when the uprating is aimed at tracking prices or enabling an income to keep pace with inflation. Currently either RPI or CPI are normally used for this purpose. RPI has well-known issues while CPI, and by extension CPIH, were not designed or intended for this purpose.

John Astin (astinja@gmail.com) and Jill Leyland (jill.leyland@gmail.com)