A consumer price index designed specifically to measure inflation as experienced by private households

Commentators generally use the word “inflation” as if there was only one way to measure it. But indices of inflation serve a wide range of different purposes: estimating trends in real income and purchasing power, a basis for uprating pensions, benefits, wages, regulated prices, contracts, tax brackets, economic assessments, interest rate targeting; international comparisons of inflation, consumer expenditure deflation in the national accounts, and so forth. It is widely accepted that no single consumer price index can serve all these different purposes effectively.

There are several official measures currently available in the UK. The most common one is the CPI (see below). There is also the RPI – still in wide use even though officially not recommended due to technical aspects in its construction. Then there is the CPIH, favoured by ONS but little used.

Now there is a newcomer: the Household Costs Index (HCI) published by ONS. This short article aims to show why the HCI should be used for measuring inflation as experienced by ordinary households, in preference to the other measures.

The HCIs are currently being developed specifically to measure inflation as close as possible to that actually experienced by households and will be published quarterly from 2023. In addition to an overall index, they are produced for different household groups. For instance, they are calculated for pensioners, for people of working age, for households with and without a disabled person, for home owners and for renters. They are also calculated for different income groups from low to high.

When fully developed the HCIs, in addition to providing the closest estimates of inflation as actually experienced by households or groups of households, will also be a natural choice for uprating indices where the aim of uprating is to mirror household inflation experience.

Neither the RPI, CPI nor CPIH are suitable for these important uses.

At present, the most widely used inflation index in the UK is the CPI – Consumer Price Index. This is the British name for the index used throughout the EU, known as the Harmonised Index of Consumer Prices (HICP). It was designed in the 1990s so as to have a price index for the Eurozone countries and others which would be constructed using the same principles and methods in each country. Its main use is for the European Central Bank in its task of setting the interest rate for the eurozone. It is also used by the Bank of England for a similar purpose.

On its first publication in 1997, it was clearly stated that the HICP was <u>not</u> designed as a measure of household inflation, and thus not for such purposes as uprating wages or pensions. That would require a different type of index. It is worth noting that almost all EU countries use their own national index for uprating pay and pensions.

What are the main differences between the HCI and the CPI?

These can be summarised as follows:

1. The HCI includes interest paid on loans. Specifically, mortgage interest, student loan interest, credit card interest, interest on loans such as for the purchase of cars or other household durables. The CPI excludes <u>all</u> forms of interest payments.
2. The HCI includes Council Tax. The CPI does not.

3 The HCI covers insurance premiums for cars, travel, health etc. in full. The CPI covers these payments only to a limited extent.

4 The HCI is calculated in a way that covers all households in equal measure. The CPI gives a much higher weight to households which spend more than the average.

CPIH, unlike CPI, does include an estimate of owner occupier costs. However, this is based on a method called “rental equivalence” which effectively estimates the rents that owner occupiers would notionally pay for the properties they own. While there are some arguments for this approach in economic theory, in practice rental markets are very different to house purchase or mortgage markets and trends are often dissimilar. Otherwise, with the exception of the fact that it includes Council tax, CPIH has the same disadvantages as CPI, although we note that ONS has recently published occasional versions where households are equally weighted.

RPI is closer to the concept of a “household” index than CPI and CPIH, although not as close as the HCIs (for example it covers mortgage interest payments but not other forms of interest). But technical problems in its construction mean that it no longer has National Statistic status and after 2030 it will be calculated in the same way as CPIH, thus losing all claims to be a household index.

Since 2017, ONS has published the HCI results only on an annual basis. The frequency will be increased from 2023. So it is currently not easy to estimate the differences between the (annual) HCI and the (monthly) CPI in terms of the index values themselves. The Royal Statistical Society (RSS) believes there is now a strong case for ONS producing and publishing every month two main price indices: the CPI (or CPIH) and the HCI (along with the RPI).

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