

Developing an Index of Household Payments Response to ONS discussion paper of 15 August 2016

Introduction

1. On 15 August 2016 the ONS published a [discussion paper](#)¹ in response to proposals first set out in Astin, J. & Leyland, J. (2015) '[Towards a Household Inflation Index](#)'². The Royal Statistical Society (RSS) issued its [initial public response](#)³ on 22 August 2016.⁴
2. This more detailed response adds to our initial response, and has been prepared and agreed by the RSS' National Statistics Advisory Group. We have concentrated on basic principles and major issues of substance.
3. We also address three specific issues raised at the recent User Group meeting held at the RSS on 12 September. At the meeting, ONS said that the new index was not a measure of inflation and that only one main measure of inflation was needed. We disagree with both of these statements. We also think the proposed new title for the index is both misleading and incorrect, and suggest an alternative title.

Summary of RSS views

4. The RSS has consistently argued that the UK needs an index which reflects how price changes affect households. Our views on this matter are informed by our National Statistics Advisory Group, with particular reference to Astin and Leyland's paper, 'Towards a Household Inflation Index', which was commissioned by the RSS.
5. The RSS strongly supports the development of a monthly household payments price index to provide an alternative and complementary index to the CPI/CPIH. The proposed new index would have many features in common with the Retail Prices Index (RPI), but would correct some of the deficiencies in that index as well as updating its approach and coverage to reflect the realities of the 21st century. We believe that in the long term it would become the preferred price index for many purposes and a potential replacement for the RPI.

¹ ONS 'Methodology: Developing an index of household payments' (webpage), last revised 15 August 2016 <https://www.ons.gov.uk/economy/inflationandpriceindices/methodologies/developinganindexofhouseholdpayments>

² PDF available from <http://www.rss.org.uk/Images/PDF/publications/Astin-Leyland-HII-paper-Apr-2015.pdf>

³ RSS (2016) *Better measurement of inflation for households: Statement in response to ONS' proposed Index of Household Payments* (PDF), available from: <http://www.rss.org.uk/Images/PDF/influencing-change/2016/RSS-statement-better-measurement-inflation-households-Aug-2016.pdf>

⁴ This also follows our response to an earlier consultation: *Royal Statistical Society response to UK Statistics Authority Consultation on Measuring Consumer Prices: the options for change* (PDF), September 2015, available from: <http://www.rss.org.uk/Images/PDF/influencing-change/2015/rss-response-to-consumer-prices-index-consultation-Sept-2015.pdf>



6. To be useful to users, the new price index must be produced monthly. As such it would become an important tool in wage negotiations and indexation; and would correspond more closely to what the general public perceive of and experience as 'inflation'. The CPI/CPIH would continue to be of greater use for monetary and macro-economic policy and as an overall measure of inflation in the economy as a whole. Both should be published side by side in the monthly consumer price release.
7. As reflected in the ONS paper, the key differences of the new index from the macro-economic based CPI/CPIH would be:
 - Based on the regular payments made by households rather than just household consumption as defined in the national accounts. Thus allowing congruence with common public perceptions of regular and unavoidable household costs including interest payments and all owner occupier costs.
 - Weighted by household (so-called "democratic" weights) rather than by expenditure ("plutocratic" weights) so it better reflects the experience of the average household.
 - Gross expenditure based weights, rather than net of income. Thus for example full weight would be given to insurance premiums actually paid out by households, rather than reducing the weight to account for claims.
8. Comparisons with income measures and versions of the index by income or socio-economic groups would be a useful supplementary analysis to be produced annually, as envisaged by ONS.
9. We think the proposed title of the new index "Index of Household Payments" is both misleading and incorrect. This would be a price index, not an index of volumes, so the chosen title should reflect this; for example it could be called "Index of Household Prices".

Issues from the 12 September 2016 User Group meeting

10. We would describe 'Inflation' as the rate at which the general level of prices for goods and services is rising and, consequently, the purchasing power of currency is falling. However, the ONS CPI manual (section 1.4.1) says "*There is no single definition of the word inflation*" and we agree. The only practical definition of inflation is in fact the rates derived from the various indices used to measure price changes. Inflation has widespread impacts on different aspects of the economy, and on different household groups and no single operational method of measurement can meet all needs.
11. Different price indices are needed for different purposes. The CPI and the RPI were both published side by side for many years, until the downgrading of the status of the RPI.
12. The UK's CPI was designed specifically as an internationally comparable consumer prices index (HICP) to enable proper decisions to be made on the eligibility of EU member states to join the euro area. Although it shares most of its methods with other CPIs, it is designed as a macroeconomic index, and not as a compensation index.



13. In contrast, the RPI was designed as a compensation index, with the specific goal of enabling the uprating (or negotiation) of wages and salaries in line with rising prices. It has features which clearly differentiate it from the CPI.
14. With the RPI's methodological framework now effectively frozen, a gap remains in the UK's inflation measures which the new IHP could fill. The emphasis with this new index is on price changes or inflation as experienced by households. Thus, the new price index would be consistent with the primary aim of a consumer price index as given in the international CPI Manual.
15. A good example of the difference between the proposed IHP and the CPIH is the treatment of housing costs. The IHP would measure the actual outgoings of households (mortgage interest and part of the capital costs of housing) while the CPIH uses imputed rents as a proxy for housing costs, so as to be in line with national accounts concepts. We wish to see mortgage interest reflected in the new index, because it is a very important part of many households' outgoings. It is perceived of as expenditure by households paying it, even if it is not so classified in national accounts.
16. CPI, CPIH, RPI and the new index and are all different measures of price changes and hence "inflation". But they differ according to purpose and users need to be aware of the different rationale for each. There is nothing new in this multi-index approach. The UK has two main unemployment indices and several indices of wages, salaries and income. Each index has a useful purpose, despite the differences between them.
17. Finally, we need to address the title of the new index. The new index would measure changes in prices experienced by households. The current proposed title suggests that this is a volume index not a price index and has already led to misunderstanding at the recent user group meeting. Misleading and incorrect aspects of the ONS' proposed title need to be addressed. We suggest instead "Index of Household Prices", which conveniently has the same initials – IHP - as the ONS proposal.

Response to ONS Questionnaire

Q1 Do you believe that there is a need for this type of index? If so, why?

The CPI was designed for macro-economic purposes and more specifically to facilitate comparisons across the EU (as the Eurostat HICP). The widely used RPI, which had been developed originally for wage negotiations and inflation indexation, no longer has National Statistics status and has a number of known deficiencies. The CPI also has known deficiencies for some uses. A new household based price index is needed which better reflects the experiences of the average household.



Q2 What is your need for this index and why do you believe it would be suitable for your need?

One of the key charitable purposes of the RSS is to help ensure that statistics can be used effectively in the public interest⁵. As indicated above we see the IHP as having many potential uses as an ultimate replacement for RPI. In addition, we think this development would put the ONS in the lead internationally in the field of Consumer Price indices.

Q3 How frequently would the index need to be published to meet this need?

Monthly - see our summary above. This could usefully be supplemented by annual data for subgroups of the household population and comparisons with income based indices.

Q4 What is your preferred treatment for weighting (for example, household expenditure weighted or economy-wide expenditure weighted)?

We strongly prefer the 'democratic' weights (household weighted) as this emphasises the differences from the CPI/CPIH and would more closely meet the needs of users for an index close to what the public perceive and experience as inflation.

We note the discussion in the consultation paper about means of approximating the weights to this basis. We agree with the ONS conclusion that total implied household expenditure from both sets of weights should be consistent.

Q5 What is your preferred population (for example, all UK or private UK) coverage?

We would be content for it to be private UK households similar to the RPI. However ONS should use the expenditure of all private households when calculating weights, without the exclusions (highest earners and pensioners) used in the RPI.

Q6 What is your preferred expenditure (for example, national or domestic) coverage?

National is our preferred target. In particular expenditure in the UK by non-residents should be excluded from the weights. We note some of the difficulties set out in the paper on measurement of UK household expenditure abroad, and would be content for an approximation to this to be used so long as overseas holidays are included (as in the RPI).

Q7 What is your preferred approach to timing?

In principle it should be payments, but in practice only specified items would need to differ from the CPI acquisition basis (as in the ONS paper).

We disagree with the ONS view expressed on page 10 that release practices for the CPI might be compromised by using some prices in a monthly IHP ahead of their appearance in the CPI. There

⁵ See RSS' *Strategic plan 2014-18* (PDF) http://www.rss.org.uk/Images/PDF/about/strategy-summary_flr.pdf

is no way that a few individual prices could be seen as pre-release of CPI components. Holding back the IHP for a month or more for this reason would in fact be a more serious breach of the code of practice.

Q8 What is your preferred treatment for the following items?

Interest payments

The most important thing is for mortgage interest to be included as part of owner occupied housing costs.

More research is needed on whether it is feasible to cover consumer debt (including credit cards). The effective rates from banks collected by the Bank of England would not be an adequate source on their own, as they exclude high interest consumer lending by other financial institutions. The stock of average household debt would lead to an expenditure based weight, so there is a need to use the debt of the average household to achieve a democratic weight.

The paper suggests a separate COICOP class for interest payments. This seems sensible, but mortgage interest payments should remain under owner occupied housing costs.

We do not agree that including the cost of credit would have “perverse effects” (footnote 2 to section 3) for those households not in debt – it would simply have no effect. We strongly oppose inclusion of interest income (or any income) in the new index because it does not form any part of household outgoings.

Student loans⁶

Both the fees and the loan repayments should be included. Some individuals incur the former and others the latter – there is no double counting. In most cases different households are involved, but some with a graduate and a student in them could be paying both. We do not see loan repayments as a tax, but even if it were so classified in national accounts, we would still wish to see it in this payments based index.

Insurance premiums

The weight and payments must be gross for a payments based index. Income (from claims) should be seen as part of wider income measures.

Life insurance premiums

The Astin and Leyland paper makes a distinction between “life insurance” (payable on death only) and “life assurance” (payable after a fixed term or on death whichever is earlier). They only want the first of these included. Term life insurance (where someone makes payments for a fixed period, say to the age of 60, and gets no benefit if he or she lives beyond 60) should be regarded as similar to motor insurance. It is very different from Life Assurance where the insured (or his/her estate) is guaranteed a payment, and where the premiums are a type of saving or investment.

The ONS paper fails to make this distinction.

⁶ If the population coverage is private households, then we presume that students in communal/institutional establishments would be excluded.



Taxation

We agree with the ONS paper that regular payments classed as a tax, but seen by the public as expenditure (such as Council tax and Stamp Duty), should be included.

Owner occupier housing costs excluding capital costs

The issue is that we need to include how much households are paying each month towards buying their house. Many house purchases and most for younger people are funded mainly by a mortgage but there are exceptions, for example where someone is trading down and selling a house the own outright to buy a retirement flat.

These costs should be included based on a payments basis including major repairs and modifications. This would differ from the RPI which includes housing depreciation as a proxy for major repair costs.

Capital housing costs

We agree in principle with Astin and Leyland that these should be included gross for first time buyers and net (where positive) for other buyers. Net housing purchase expenditure would need to be calculated (or proxied) at the level of the individual household rather than at the level of the UK economy as a whole. This might be the one exception to the general principle of gross weights.

We appreciate however that including capital housing costs is a radical departure from traditional consumer price index practice, and we would be willing to accept that it might be left to a later stage of development.

Q9 Are there any other areas you believe we need to consider with regards to this index?

In the construction of any price index, important decisions have to be made about the formula used for aggregating price quotations, especially at the elementary level. This was a question which ONS did not address and which the Astin and Leyland paper deliberately set aside for a second stage of development, until more progress has been made on the formula issue.

ONS have said that the use of the Carli aggregation formulae is no longer in line with best practice. However, the APCP-Technical, set up by the ONS, makes a more nuanced judgement on this point, as expressed in the minutes of its January 2016 meeting:

“Panel members agreed that the relative merits of the mathematical properties of elementary aggregate formulae were finely balanced when considered from a theoretical standpoint. However, the performance of each formula in practice is an important consideration for use.”

There will be different opinions about the importance to be assigned to different practical considerations, but the way should be left open for an assessment of which aggregation formula should be used for which items by which index, depending on its purpose.

As the RSS have said many times in the past, the ONS need to reduce the difference between use of the Carli and Jevons for aggregation of price quotations, particularly for clothing, by methodological improvements. The very large difference undermines the credibility of both the



CPI/CPIH and the RPI, and would have the same effect on the proposed new index. Progress in this area, could, for example, allow greater use of the simpler arithmetic average (Dutot), as in the RPIJ, and would make it easier to use the same formulae in all consumer price indices, which, other things being equal, would be desirable.

Q10 Do you have any additional comments?

The ONS paper makes much of the value of linking the new household payments price index with income indices. While not the prime purpose of the new index, we agree this would be a useful supplementary analysis. Such welfare measures are an area where the merit of the new index relative to the CPI stands out most clearly. It could, for example, be used to replace the RPI in the previous personal inflation calculator. It would also lend itself more easily than the CPI to the construction of consistent sub-indices for different household types; and, as the ONS says, it could usefully be set against an index of earnings or income that was constructed in a comparable manner.

We dispute the first sentence in section 2 of the ONS paper. The current CPI was never designed to measure “inflation as perceived and experienced by households”. It is the same as the Eurostat HICP which was designed to measure personal sector consumption inflation in the economy as a whole and for maximum comparability between EU member states. Eurostat never intended the HICP to be the preferred index for domestic use and nearly all EU countries still produce their own indices, better suited to their own needs than the HICP.

Response submitted by RSS’s Policy and Research Manager, 22 September 2016

