Introduction

The key to devising any credible price index lies in identifying the correct data source (eg. basket of goods) to be used and also a suitable method of using the data to calculate the index. The aim is to reflect accurately the spending habits of the general population and any movement in the general level of prices. At present, the government's preferred measure of inflation, the Consumer Price Index, was originally produced to enable a comparison to be made between the economies of different European countries, and as such would be described as a Macroeconomic Index. It is not however suitable as a way of measuring either household inflation or for uprating pensions and benefits.

RPI and CPI

The NPC, along with many other organisations, were strongly opposed to the removal by the Coalition government of the Retail Price Index (RPI) as the main index in 2010. Our policy remains one of supporting RPI as the best existing measure of price change across the economy, as it most accurately reflects the price increases felt by households. We therefore support the position of Mark Courtney in arguing for the retention of RPI in his paper *Consumer Price Indices in the UK*.

Nevertheless, we are also aware that the UK Statistics Authority has removed recognition of RPI as a "national statistic" and has up till now been using the Consumer Price Index (CPI) instead. However, CPI does not reflect the spending patterns of pensioners and the rising costs they face. In particular it does not include Owner Occupier Housing (OOH) costs.

An index such as CPI, which gives equal weight to the expenditure of the whole population, is also unlikely to reflect the expenditure levels and consumption patterns of the typical household. In fact, a recent pioneering paper by Flower and Wales (*Variations in the inflation experiences of UK households*) concluded that the CPI is broadly representative of the price experience of households around two-thirds of the way up the expenditure distribution. In RPI this was addressed by excluding the expenditure of the 4% of households with the highest income and also that of pensioner households, where at least three quarters of income was drawn from state pensions and benefits.

We disagree with the argument that most indices such as RPI overestimate inflation because people will substitute cheaper goods when prices rise. This assumption ignores instances where substitution is not possible, as well as the impact on the consumer's standard of living.

We consider it is unfair that many utility and transport charges continue to be linked to the RPI, whilst pensions and benefits have shifted to the CPI, meaning that the gap between costs faced by pensioners and pension increases will widen year on year.

The basket of goods and the method of calculation

A typical household would budget its expenditure by adding the total cost of the contents of a typical basket of goods, as put together under RPI. To work out the average cost of their purchases, they would divide the total cost by the number of items. This gives what is known as the Arithmetic Mean. Should they wish to work out their annual inflation rate they would sum the cost of the items in their basket at the start (A) and end (B) of the year, and divide the difference between these by the cost at the start of the year (B-A /A). Mathematically the ratio of the total costs at the start of the period and at the end is called the Dutot.

Measuring consumer price inflation for different household types

The NPC recognises that it would be inappropriate to use a single measure of price change across the whole economy. The purpose of an inflationary measure is to identify as accurately as possible the effect that price increases have on a particular segment of society, and different indices used for different purposes are calculated by different methods.

Given this, the current consultation has the opportunity to devise an index that is truly fit for the purpose of uplifting pensions and benefits to compensate for increases in prices and which could gain wide public acceptance and understanding. The development of a Household Inflation Index (HII) could therefore measure the change in prices as experienced by the typical UK household, on a monthly basis. Work on this has already been undertaken by the RPI/CPI User Group (Austin and Leyland) paper, but we are conscious that it has yet to adopt Dutot as the calculation method. This would be essential for any new index.

In addition, the ONS should seek to measure the experience of price changes by:

- Different income groups
- Household type eg. pensioners, those in receipt of benefits, single parents
- Geographical areas for an accurate reflection of the true impact of price rises in different parts of the country

Conclusion

In line with the NPC's longstanding policy, we therefore make the following recommendations:

- The Retail Price Index (RPI) is retained as the most suitable existing price index, capable of measuring the price inflation as experienced by the general population
- Neither the Consumer Price Index, nor CPI (H) are suitable at reflecting the spending patterns of pensioners and the rising costs they face
- A new Household Inflation Index (HII) should be developed, using Dutot as the method for calculating the index. If this is proven to be a more accurate measure of price inflation for UK households, along with securing a greater understanding and acceptance amongst the population, it should be considered as a replacement for RPI.
- The amount of inflation experienced by different household groups and in different geographical areas should also be measured.