Thoughts on HCIs following April 25th Seminar and Stakeholder Panel meeting

The seminar was very useful in bringing together people with an interest in the topic but who approached it from a number of different perspectives. It may not have resolved many outstanding questions but it did highlight the issues and the decisions that need to be made more clearly than previous discussions.

Following this there was a very constructive session on the topic at the Stakeholders' Panel. I support the general conclusions there. In particular I like the idea that there is a "maximalist" HCI which includes every item which is considered to be in scope along with the potential to construct versions without certain items for specific needs (eg to match a particular definition of income) – see below.

Use

Compilation decisions for any statistic clearly need to be made with potential uses in mind (albeit uses may change over time so there needs to be an iterative process). Two uses have so far been highlighted for HCIs:

- To understand inflationary pressures on households – including comparing with income measures
- As a potential uprating index. This was the original idea I had in mind initially particularly given the issues with the RPI and the fact that HICPs were not designed with this use in mind.

There are various definitions of disposable income. For example, I understand that that published by ONS alongside HCIs at the moment is not the same as that proposed by the Social Metrics Commission and likely to be adopted by DWP in analysis of poverty. Equally not all items proposed for inclusion may be appropriate for uprating due to circularity issues. Hence the attraction of the maximalist version alongside the potential to have versions excluding certain items (analogous to RPI and RPIX).

Martin Weale introduced another potential concept in his seminar presentation referring to welfare over the life cycle. This is an important concept but I would see this as better approached via an academic exercise rather than what should be a price index.

Basic points

HCIs are intended to be a price index. The basic concept is quite simple and straightforward even though some of the resulting decisions are not always easy and some of the "prices" (such as interest rates) are quasi-prices rather than actual prices. In my personal view the reason some people are struggling with the "concepts" is that they are over-complicating the basic idea.

In its latest release, ONS describes the HCIs as follows:

> *The Household Costs Indices (HCIs) are a set of experimental measures, currently in development, that aim to reflect UK households' experience of changing prices and costs. More specifically, they will aim to measure how much the nominal disposable income of*

different household groups would need to change, in response to changing prices and costs, to enable households to purchase the same quantities of goods and services at a fixed quality. Put simply, the broad approach of the HCIs is to measure changes in the cost of outgoings of households.

John Astin and I explained it rather differently but I have no problem with this and believe this should remain as the basic concept with the exception about the phrase at fixed quality for which see the point on this on page 4.

A crucial element, fully endorsed by the Stakeholder Panel, is to build public confidence in the index. Technicalities may be complex but the broad decisions should make sense to the man or woman in the street and they should be confident that the index will therefore broadly reflect the inflation experience of a "typical" household.

Where we are

So far the following differences exist with CPIH.

- Democratic weighting
- Credit card interest – the plan is to extend this to all forms of interest
- Insurance premiums included gross rather than net
- Payments approach to OOH
- Repayment of student loans rather than tuition fees (for students who do not pay up front)

The intention has always been that the index will notionally be on a "payments" basis so that it represents as closely as possible the impact on the household purse. This said, for practical reasons many items will be measured on an acquisitions basis so as to avoid double collection costs with a pure payments approach reserved for items where there is a substantial timing difference between payment and acquisition. Information on some of these is already collected by ONS and others can be added as time and resources allow.

Timing can matter when items such as durables are bought or partially bought using credit. Ideally the down payment and then repayments and interest should be recorded. However as the credit span is usually relatively short and to avoid undue difficulty or expense for the moment (at least) they should remain in the index on an acquisition basis but with interest payments on the purchase included as far as possible.

The question is what other changes from the CPI/CPIH approach should be included.

Owner occupied housing

I have always argued that the capital costs of housing should be included since shelter is a necessity and housing costs are a major expenditure for many household. Further although there is an investment element to it, that is only one of many motives for purchase and often the investment desire is simply to ensure that the house retains its value relative to other houses so that the owner is not disadvantaged when a move is necessary. It is an unusual investment which is often only realised toward the end of life or even at death, and it is not an investment that one can sell and walk away from as can be done with, for example, stocks and shares. The Social Metrics Commission consider mortgage payments as essential expenditure.

Alan Bentley from NZ argued at the seminar that mortgage payments are in a sense the "rent" paid to the bank for the portion of the house which is mortgaged. In the UK, when deciding whether to buy or rent it is not unusual for people to compare rent with mortgage costs.

Against this it is argued that this might cause issues for uprating as home owners are rewarded for a rise in the value of their house. ONS's original plan was to calculate two versions of the index, both with and without capital costs. This fits with the "maximalist/specific purpose" approach.

Ideally, in my view, the index should include the down payment for first time buyers plus the capital element of mortgage payments for all buyers (as well as the interest element). I would exclude down payments from second and subsequent buyers since these are often met from the sale of the first house so there would be double counting as well as any gain from the appreciation in value of the first house.

The NZ approach is, I understand, to multiply the change in the mortgage rate by the change in house prices and apply the result to the index for the previous period – the whole being done with one quarter's lag. While this is simple I cannot really see the justification for such an approach. I suspect that the best method is to model capital payments in the way mortgage interest is modelled. ONS presented results from this at the December Technical Panel meeting but they looked odd and I suspect the modelling was not correct.

Savings and pension funds

There was an argument made at the seminar that if a "cash flow" approach is adopted all savings and all taxes including income tax and NI should be included in the index.

I disagree that all savings, per se, should be included. This would change the index from a price index of what people buy to satisfy their "needs and wants" of the moment; also if you include all savings you effectively end up with a sort of net income index.

I can see arguments for including formal contributions to a pension scheme given that such payments now have something of a mandatory character. But they are not entirely mandatory as even under automatic enrolment the employee has the right to withdraw. There was a longish discussion on this at the stakeholder panel meeting as there are clearly pros and cons. Again this is an argument for a maximalist/specific purpose approach.

Taxes

Council tax is included in HCIs at the moment as it is in CPIH. It was pointed out at the Stakeholder panel that this is not consistent with some definitions of disposable income – on the other hand there are clear arguments for including it. Again the maximalist/special purposes approach works.

There is a good case for including Stamp Duty.

On the other hand income tax and national insurance are different animals as they are levied according to income and personal circumstances as well as often being deducted at source. I agree with the conclusions of the Stakeholder Panel that these should not be included. There might in the future be an argument for a "Tax and Price Index" analogous to the one based on RPI but this is a question for the future.

Other points
Second hand goods need to be considered in particular charity shops given their widespread use. Clearly this has resource implications for ONS. However a limited number of charities account for the majority of such shops so discussions with them to see if they have a sense of a typical price for selected items would be the first step.

The choice of elementary aggregate formula also needs to be reviewed. At the moment the same formulae as CPIH are used. Apart from the clothing issue, there are arguments for making greater use of Dutot, for example.

Quality change is another point. When the pre-quality change item is no longer available there is a strong case for not making any quality adjustment. This is another issue where there should be a conceptual difference between an HCI and CPI/CPIH.

Next steps
In my view the next steps are to continue working to improve student loan payments, increase the coverage of interest payments and develop a method for mortgage capital payments. Hopefully mortgage capital payments can be included by the next publication. At that point I would feel that HCIs are sufficiently complete for them to move to quarterly publication. Pension fund contributions would be the next bit step after that along with charity shops.

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