THE ROYAL STATISTICAL SOCIETY

Incorporated by Royal Charter: 1887

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Sir Michael Scholar
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Statistics House
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25th August 2010

Dear Michael

One of the items in my letter to you of January 2009 concerned the Retail and Consumer Price Indices (RPI and CPI). We noted that both indices have drawbacks and asked that the monitoring report that you then planned to look into the communication of inflation indices should also cover their compilation. Since then, as your subsequent letter of June 2010 confirmed, the Consumer Prices Advisory Committee (CPAC) has been established.

The decision by the Chancellor to link a number of benefits and pensions, currently linked to the RPI, to the CPI from next April highlights all the issues with the indices. I am writing to you about our concerns separately from the other points raised in our general correspondence, partly as we believe these to be of particular importance given the legal, policy and business uses made of inflation indices, and partly as we understand that the next meeting of the CPAC is on September 6 and that on that day it will consider its future work programme. You will also shortly be considering the results of the formal UK Statistics Authority review of these indices under your regular assessment programme. I am writing at some length as the issues are complex.

Jill Leyland and Andrew Garratt recently had a very helpful meeting with Dennis Roberts and Pam Davies of the ONS regarding our concerns. We are aware therefore that some of the developments we would like to see are already in hand or planned – but not all. In the light of the Chancellor's decision, we would argue for a more comprehensive, and possibly more urgent, approach.

We also understand that the ONS hopes to undertake some user consultations. The possibility of the RSS holding a meeting on the indices' methodology has also been raised. Before going further I want to say that we welcome both of these initiatives and will willingly offer RSS help and cooperation to make these as comprehensive and successful as possible.

Our concerns fall into three categories:

1. The way in which the Consumer Price Index has over the years gained increasing prominence in ONS material and is now the headline index even though it is not necessarily the best index for all purposes.

As we all know, the CPI was originally the Harmonised Index for Consumer Prices (HICP) constructed in order to compare price movements between EU countries; its methodology and coverage are on agreed EU definitions. Lack of agreement over the treatment of owner occupier housing costs, of particular importance for the UK, means that these are still excluded; it is debatable whether its exclusion of items such as council tax, vehicle excise duty, trade union subscriptions and television licenses, and its inclusion of spending in the UK by foreign residents, are appropriate for all purposes. Its methodology, specifically the comprehensive use of the geometric mean at the lowest level of aggregation, has many supporters. It is approved by some other international bodies as well as the EU. However, some would argue that it is not the best approach for products where consumers are typically slow to substitute newly cheaper outlets, brands or varieties for existing more expensive ones.

In 2003, following the decision by the then Chancellor to use the HICP as the policy indicator for the Bank of England's Monetary Policy Committee, the then National Statistician decided to rename it the CPI. Recently the ONS has changed its press notice so that only the CPI appears as the headline index.

We do not feel that CPI should have sole star billing in this way. While the policy use of the CPI clearly makes it a key index, other indices are key for other uses. Giving prominence to CPI ahead of other indices means that users are implicitly being encouraged to use it for purposes, such as wage negotiations, for which it is not ideal. Naturally, this is exacerbated by the resulting impact on media commentary, and the lack of clear guidance on the appropriate use for the range of inflation measures available.

The UK appears to be unusual in giving this prominence to the CPI/HICP, and in renaming the HICP the CPI. Other comparable EU countries – for example France, Germany, Italy, Spain, the Netherlands – all publish a national index as their headline figure with the HICP published as an additional index. This mirrors UK pre-2003 practice with RPI and RPIX.

We understand that the CPAC has been examining how owner occupier housing costs could be included in the CPI/HICP and that its work is close to a conclusion. As a first step, we urge you to consider giving "CPI plus owner occupier costs" equal billing with the current CPI whether or not other EU countries follow suit. As soon as possible thereafter we feel that all potential uses of inflation indices should be reviewed and consideration given to establishing the most appropriate coverage and methodology for all purposes.

2. Methodological differences, the "formula effect" and the RPI

The RPI is widely used in commercial contracts and in uprating certain private sector pension schemes. The rates of inflation shown by the CPI and RPI can at times differ widely, causing some confusion. It is easy enough to explain when this occurs as a result of coverage differences. But the RPI inflation rate has also been consistently higher than the CPI rate due to the "formula effect" whereby the RPI uses an arithmetic mean at the lowest level of aggregation while the CPI uses a geometric mean. Over the last five years, according to the ONS press notice, the difference in the annual inflation rate due to the formula effect has never been less than 0.43 percentage points and has been as high (recently) as 0.86 percentage points.

Over time this alone will make a substantial difference to the measured price level. For example, the formula effect would lead to a pensioner whose pension is specifically linked to the RPI being noticeably better off after a few years than one whose pension is linked to the CPI.

We consider it highly unsatisfactory that a difference in statistical treatment should generate such a substantial difference in the two indices; we are not aware of any other country where the difference is as great.. We understand that the difference is partly due to the UK's wider use than most countries of the "average of relatives" version of the arithmetic mean rather than the "ratio of averages". This could be exacerbated by the use of January (when sales in retail shops are common) as the intra-year base month, and by "price bounce" effects. Opinions among those we have talked to differ as to whether or not it is also influenced by the UK giving greater latitude to price collectors as to the type of product they collect for certain goods (since the extent of the difference between the average of relatives and the geometric mean increases with the heterogeneity of the relatives).

Some would argue that the RPI overstates inflation as a result of this. We appreciate that the 2007 Act puts constraints on the extent to which the ONS can alter the methodology since any fundamental change considered to be detrimental to the holders of index linked bonds issued before July 2002 could, under certain circumstances, trigger early redemptions. Nevertheless this should not preclude an investigation of the problem so that at the very least it is fully understood; the methodology used should be the best possible (bearing also in mind that if the RPI is considered to overstate inflation then holders of index-linked bonds linked to it are being overcompensated for inflation at taxpayers' expense). Equally the coverage and scope of the RPI needs to be reviewed in the light of user needs.

3. The need for CPAC work to be more open.

Very little has been published about CPAC's work. Given the importance of the indices we consider that there would be a benefit in CPAC being more open and public than has so far been the case. Publication of its work programme would give interested parties a better understanding of what issues it is addressing and the timetable on which it is doing so. This should be complemented by publication of summary minutes allowing interested parties to understand those decisions that had been taken , and those areas where further discussion was felt necessary. In turn, there would be benefit to CPAC in being seen as being both as transparent as possible, and inclusive of external input, without prejudicing frankness of discussion.

In summary therefore we urge you and your colleagues to ensure that in the coming months the methodology and coverage of the indices are fully examined in the light of all user needs, that the ONS press notice is changed so that the CPI returns to being one of a number of headline figures published, and that the work of the CPAC is made more public. We welcome the fact that the ONS already plans some initiatives on these lines. We feel that the Chancellor's decision makes matters more urgent and increases the need for a more comprehensive review. The political and legal factors involved make this all the more necessary. The RSS and the Statistics User Forum are willing to assist as necessary.

I am copying this letter to Jil Matheson, Stephen Penneck, Richard Alldritt, Dennis Roberts and Pam Davies and also to Bernard Jenkin MP as Chair of the Public Administration Select Committee. In line with our normal practices it will also be placed on our website (and I assume also on yours).

Kind regards

D. J. Hand.

David Hand
President.