HMT/UKSA consultation on the Reform to Retail Prices Index (RPI) Methodology

GMB Union response

Introduction

This response is submitted on behalf of GMB Union. GMB represents over 600,000 workers across the private and public sectors. As a body that negotiates pay settlements on behalf of our members, GMB is a regular and experienced user of consumer price statistics.

GMB opposes the present proposals. This response makes general comments on the present consultation, and the substance and history of the joint HM Treasury and UKSA proposal to 'align' the RPI with the methodology of the CPIH.

Consultation background

While the decision to consult on the *timing* of the proposed changes – and not on the proposals themselves – is extremely disappointing, it is at least reflective of a process that has been remote, technocratic, and which has failed to uphold the principles of genuine consultation. It was notable that, at an open event on the future of the RPI hosted by the Royal Statistical Society on the 21 July 2020, the UKSA's representatives declined multiple opportunities to address the question of why the substance of the proposed changes was not subject to consultation.

Throughout this process, HMT and the UKSA have disregarded reasonable efforts to identify sensible, incremental reforms to the RPI. Engagement with the wider body of consumers of inflation statistics has been tokenistic, despite the gravity of the changes that are being proposed. Most notably, HMT and the UKSA have failed to seriously engage with the constructive proposals made by the House of Lords Economic Affairs Committee in 2019 that:

- The UKSA should cease to treat the RPI as a 'legacy measure' and restore the routine methodological improvements that were suspended after 2010

- The specific issue of clothing price collection in the RPI be addressed, with a range of potential solutions – which could include using the Jevons method for clothing price changes in the RPI, or revisiting data sources – considered

- The methods used to infer a general average of housing costs in the CPIH ('rental equivalence') were unconvincing and should be reviewed[1]

The RPI CPI User Group has argued that 'the ONS should … work toward the RPI regaining its status.'[2] We note that Paul Johnson, author of the 2015 review of consumer price statistics which was commissioned by the UKSA, has subsequently concluded that the process of methodological improvements to the RPI should be restored.[3]

The Board of the UKSA has a statutory duty under the Statistics and Registration Service Act 2007 ('the Act') to 'compile and maintain the retail prices index … [and] promote and safeguard … the quality of official statistics … [including] their impartiality, accuracy and relevance.' GMB shares the view that, by publishing a statistic that it describes as flawed without making methodological changes, the UKSA has not complied with these statutory duties.

We further note that, in the case of *British Telecommunications PLC versus BT Pension Scheme Trustees Ltd*, the High Court rejected the argument that the RPI had 'become inappropriate' for the purpose of uprating that scheme's benefits (a contention that was predicated on the arguments made against the RPI since 2010).[4] This judgement was upheld at appeal.

GMB values the immense contribution that the ONS makes towards aiding public understanding across a very wide range of policy areas including, most recently, the coronavirus crisis, which it has achieved in extremely challenging circumstances. We specifically welcome the ONS's stated intention that consumer price inflation statistical publications should be made more accessible to a wider range of users. The UKSA has a crucial role to play in maintaining and extending public confidence in the integrity and impartiality of official statistics, and their use.

We believe, with regret, that the consequence of the UKSA's singular focus on achieving the (effective) discontinuation of the RPI, and its disregard for the norms of public debate and consultation, has been to undermine confidence in its status as an impartial body. The fact that HMT (as a central department operating under Ministerial direction) and the UKSA are jointly running this consultation only adds to the suspicion that the changes are driven at least as much by politics as the technical arguments (on which there is no consensus).

As we argue below, the effects of the proposed changes will be particularly injurious as the UK seeks to recover from its sharpest fall in GDP in three hundred years, as millions of workers and pensioners' incomes will be reduced. GMB urges the HMT and UKSA at reconsider their approach, and instead consult on the restoration of methodological improvements to the RPI.

Effects of the proposed change

If the proposals are accepted in their current form then, after a brief transitional period, the RPI will cease to exist for all practical purposes. An index called the RPI will continue to be nominally published in a 'zombified' form that is nothing more than a clone of the CPIH. As we argue below, the deficiencies of CPIH as a measure of inflation as it is experienced by working households make this proposal particularly damaging.

The HMT and the UKSA's proposals, if adopted, will have a profound and negative effect on the incomes of millions of workers and pensioners. According to a recent Incomes Data Research Survey of employers found that roughly equal proportions of respondents considered CPI and RPI to be the 'most relevant' measure of inflation (and as IDR noted, employers have a natural incentive to prefer the lower CPI rate).[5] GMB's experience is that RPI is still the most commonly accepted basis for pay uprating purposes in the private sector.

RPI is also widely used for the purpose of uprating pension benefits: the Government Actuary's Department has said that RPI 'is the reference inflation for many pension schemes.'[6] The issue of the RPI's continued relevance to pension uprating has been extensively tested through the courts in the case of *British Telecommunications PLC versus BT Pension Scheme Trustees Ltd*. While attention has focused on pension funds' role as gilt holders, the minutes of the UKSA's Advisory Panel on Consumer Prices makes it clear that 'gains' for pension funds will come at the expense of pensioners' standard of living:

'Survey data suggests approximately 20% of pension schemes may lose money as a result of the potential change (i.e. schemes with mainly CPI pension increases). Conversely, there are early indications of support for the changes from some schemes that are expecting to gain from the proposed change (i.e. schemes with mainly RPI pension increases), albeit recognising that their members would receive lower pension increases.'[7]

While the UKSA and the Treasury have a particular legal duty to have regard to the impact of changes to the RPI on gilt holders, it is regrettable that the consultation document conveys a message (in Section 5) that *only* the considerations outlined in Section 21 of the Act are 'most likely to be relevant' to the Chancellor's decision. The effects of the proposed changes on wages and pension payments (and consequently on many people's standard of living) must also be relevant considerations, especially during a period when it is hoped that the UK will be recovering from the present recession, and one of the tasks of policy-makers will be to sustain consumers' purchasing power.

The role of different inflation indices

'True' inflation is a latent factor: it cannot be directly observed. Different indices have diverging histories and intended purposes, and GMB believes that there is value in maintaining a variety of indices to meet the varying needs of users of consumer price estimates.

The CPI (formerly referred to by its 'proper title' of the Harmonised Index of Consumer Prices) was not intended to function as a measure of inflation as it is experienced by most working people. The CPI was designed to standardise the measurement of macroeconomic price changes across the European Union – it does not include housing costs for no better reason than that a pan-European approach to measuring prices in this area could not be agreed.

The CPI measures a number of items that are not relevant to pay bargaining, such as stockbrokers' fees.[8] By contrast, the RPI (which began life as a 'cost of living' index) excludes items such as foreign students' tuition fees, and the top 4 per cent of households' costs. It is the only inflation index that directly measures owner-occupier housing costs.

In theory, the CPIH should remedy one of the deficiencies of the CPI through its inclusion of housing costs. However, the CPIH only estimates owner-occupier costs based on an inference from rental data. This is akin to using the price of apples to estimate the cost of oranges. The House of Lords Economic Affairs Committee has said that it was 'not convinced by the use of rental equivalence in CPIH to impute owner-occupier housing costs.' In addition, the CPIH uses a plutocratic weighting for housing costs, which is skewed towards the expenditure of the wealthiest households which tend to experience inflation at lower rates; the ONS has said that if the alternative democratic weighting was used, then the headline CPIH 12-month rate would be higher.[9]

As the Royal Statistical Society has said:

'CPIH and ... CPI are both macroeconomic indices. They are helpful to the Treasury and Bank of England in seeing how the nation's economy is doing, but <u>they are an</u>

unsatisfactory measure of inflation as it affects British households.[10] [Emphasis added]

The ONS itself has further said that 'the [CPI] is not a cost of living index. That is, it is not a measure of the change in the minimum cost for achieving the same 'standard of living.''[11] CPI and CPIH clearly have significant drawbacks as a reference index in pay setting purposes.

The development of the Household Cost Indices (HCIs) is an interesting and valuable endeavour, and there is rightly interest in a range of potential applications for the indices. The experimental HCIs have already provided value by demonstrating that lower-earning households experience higher rates of inflation. However, the development of the HCIs has been slow, and they are not currently suitable for practical use. Their potential for use in pay setting is currently purely theoretical, and we do not know of any cases of the HCIs being referenced for pay setting purposes. In addition, there is continued requirement for generalised measures of inflation as it is experienced by working households (for example, in national pay negotiations covering large employers) which the development of the HCIs would not address.

Much of the criticism of the RPI has focussed on its use of the Carli method of calculating average changes in prices. It is worth noting that the axiomatic, technical tests that the RPI is held to have 'failed' – of which, 'price bouncing' is the most famous (in relative terms) – have not been shown to have any meaningful effect on the 'formula effect' gap between RPI and CPI (and its derivatives).

While the consultation document assumes, without justification, that the existence of the formula effect must derive from flaws in the RPI, there are good reasons for thinking that that use of the geometric mean in the Jevons approach (which will always calculate change to be equal to or less than the Carli method) may underestimate inflation, as argued in Donald Hirsch's 2015 review of the differences between the two indices,[12] and more recently in the judgement in the *BT versus BT Pension Scheme Trustees* case. Seen from this vantage point, the pre-clothing change formula effect gap of around 0.5 per centage points can be argued to have represented a healthy estimate of the range within which the 'true' rate of inflation was likely to fall.

For related reasons, most European countries have maintained the publication of national consumer price indices alongside the Harmonised Index of Consumer Prices (CPI). Maintaining the RPI, and updating its methodology, would represent a positive alternative to the current, flawed proposals.

Conclusion

It is highly disappointing that the Treasury and the UKSA have chosen to consult only on the timing of their proposed changes, not on the substance of the changes themselves.

The proposed changes to the RPI's calculation would have a profound and negative impact on the incomes of millions working people and pensioners. The reduction in incomes arising from this change could stall the long-term economic recovery by dampening aggregate demand.

The arguments that the UKSA and the Treasury have relied on do not represent a consensus view, and there are strong arguments in favour of retaining the RPI as a measure of working households' costs for reference in pay setting (for which purpose the CPI and the CPIH are unsatisfactory measures).

As a positive alternative approach, GMB would support the restoration of incremental updates to the RPI's methodology which have been suspended since 2010. Such an approach would command widespread support, would likely reduce the formula gap back to its pre-2011 norms, and would maintain a sensible mix of inflation rates which are well suited to the needs of particular users of consumer price inflation statistics.

References

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