

LEAP

Left Economics
Advisory Panel

Inflation Report 2009

Why Inflation is a class issue

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Commissioned by:



Contents

| | |
|------------------------------------------------|----|
| Executive Summary | 3 |
| Author's Foreword | 4 |
| 1. Methodology | 5 |
| 2. How Expenditure Differs | 6 |
| 3. Defining a new measure: Essential Inflation | 8 |
| 4. Findings | 9 |
| 5. Conclusions and Recommendations | 10 |

Executive Summary

- Inflation affects working class people in a variety of ways, as it directly or indirectly informs decisions on pay, benefits, pensions, student loan interest, council tax, etc
- Inflation is calculated by assessing changes in the price of a 'basket of consumer goods' weighted proportionately. The two most common measures are the Consumer Price Index (CPI) and the Retail Price Index (RPI). We propose a class-based third.
- Inflation affects people very differently in the UK, due to the high – and growing – levels of inequality
- These are certain expenditure items that it is hard, if not impossible, for people to 'do without' or even cut back on significantly or easily, even in times of recession
- The 'essentials' cost the poorest households over two-thirds of their expenditure, decreasing down to less than one-third for the richest.
- With the exception of food and drink, these 'essentials' are all areas where the Government either sets or regulates costs. There is therefore a responsibility for Government to ensure that inflation does not disproportionately affect the poorest households.
- In the year to February 2009, the ONS calculated the CPI measure of inflation to be 3.2%, and the RPI measure 0.0%. In the year to February 2009, **Essential Inflation** was -0.82%.
- However, if we look at the **Essential Inflation** rate broken down by decile, it was 1.92% for the poorest households and -3.21% for the richest.
- In terms of **Essential Inflation**, the past year has seen a rise in the cost of living for the poorest households, yet a fall in the cost of living for the richest households. The data clearly shows that inflation is a class issue.
- In current pay negotiations, where pay freezes are being proposed across organisations we should understand that a pay freeze is a real terms cut of nearly 2% in living standards for the poor, but a real terms increase for the richest.
- There is also an onus on Government to ensure the level of uprating for social security benefits, the basic state pension and the national minimum wage are all above the headline rates of CPI and RPI inflation

Author's Foreword

There has always been a debate about the true level of inflation. Like the ruling ideas of each age, the ruling definition of inflation has always been that which best suits those in power whether employers around a negotiating table or the Government setting benefit rises in Whitehall.

Inflation is calculated by assessing changes in the price of a 'basket of consumer goods' weighted proportionately. The two most common measures, the Consumer Price Index (CPI) and the Retail Price Index (RPI) use slightly different 'baskets' to tell us the rate of inflation.

Inflation affects working class people in a variety of ways, as it directly or indirectly informs decisions on pay, benefits, pensions, student loan interest, council tax, etc.

However, 'inflation' is not a neutral term in a society where there are wide disparities in income and therefore spending patterns. The reality is that inflation affects people very differently in the UK, due to the high – and growing – levels of inequality¹.

The Office for National Statistics' (ONS) Family Spending survey shows that the poorest 10% of households spend an average of £187.40 per week, compared with £1720.10 per week in the richest 10%. Therefore the richest spend in a week what it takes the poorest over two months to spend.

In this context, is a single inflation rate relevant? Different income groups will inevitably spend their incomes on different items, and individual items within the 'basket of goods' will contribute differently to the rate of inflation.

LEAP was commissioned by the Trade Union Co-ordinating Group (TUCG) to specifically look at how inflation affects different income groups.

In reporting our findings, we have defined a new inflation measure called **Essential Inflation** based on the essential goods that households cannot avoid purchasing, particularly relevant in a period of recession – and rising unemployment and short-time working – when households look to cut expenditure. We welcome a debate on the merits of this proposed new measure.

Please note: *This research report is exclusively based on data provided by the ONS Family Spending surveys and the ONS Consumer Price Indices reports. All subsequent calculations are those of the author.*

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¹ According to the Institute for Fiscal Studies (IFS) report in June 2008, "income inequality has risen for its second successive year and is now equal to its highest-ever level (at least since comparable records began in 1961)"

1. Methodology

Using data from the ONS Family Spending survey, available household expenditure data² was tabulated broken down by decile and then each expenditure item was calculated as a percentage of each decile's total expenditure.

This provides the means to calculate inflation broken down by decile, if the annual cost increase of each expenditure unit is known. Helpfully, the ONS also provides this data as part of its calculations for the CPI and RPI inflation measures³.

By cross referencing these two sets of data, it is possible to calculate the inflation rate for each decile. Furthermore, as spelt out in Sections 2 and 3, it is also possible to calculate the specific impact of the inflation rate for particular goods – or 'baskets of goods' – on each decile.

The example below shows how this works by looking at the data available, the calculations required, and then analysing the results:

Example 1: Tobacco

Data: ONS figures on tobacco expenditure shows the poorest half of households spend slightly less per week than the richest half (£4.16 compared with £4.96). However as a percentage of total expenditure this is 1.43% compared with 0.59%.

The inflation rate for tobacco was 4.4% in the year to February 2009, mostly due to Government increases in duty (so-called 'sin taxes').

Calculations: If the tobacco inflation rate (4.4%) is divided by 100, then multiplied by the percentage of expenditure spent on tobacco for each decile – one can calculate how much each decile's inflation rate is on each expenditure item. By adding together all the individual expenditure items, we calculate the total inflation rate for that decile (see Annex 1).

Analysis: Increases in tobacco duty hit the poorest (who actually spend less on tobacco in absolute terms) hardest, which seems neither pragmatic nor equitable.

By repeating these steps with the other items of expenditure an inflation rate for each decile is gradually built.

² The ONS data is 'equivalised' for household size: "Equivalisation reduces relatively the incomes of households with three or more persons (since their incomes are divided by values greater than 1) and increases the incomes of single person households (since their incomes are divided by values less than 1). For example, if a household consisting of a married couple and two children (aged twelve and sixteen) has an income of £30,000, their equivalised household size is $0.61 + 0.39 + 0.36 + 0.25 = 1.61$. This implies they need 61 per cent more income than a couple with no children to have the same standard of living. Their equivalised income would therefore be $£30,000/1.61 = £18,634$."

³ See: <http://www.statistics.gov.uk/pdfr/cpi0309.pdf>

2. How expenditure differs

In looking at the relative proportions spent on certain types of expenditure, there are some clear trends. For example, the typical decile 1 (poorest) household spends 9.66% of total expenditure on rent payments, which for decile 10 (richest) drops to 0.86%. However, mortgage costs are respectively 3.47% and 9.34%.

Although there is a relatively small proportional difference in total housing costs, inflation levels in the rental and mortgage sectors will clearly have class significance, as Table 1 below demonstrates:

Table 1

| Decile | % income spent on rent | % income spent on mortgage |
|---------------|-------------------------------|-----------------------------------|
| 1 | 9.66 | 3.47 |
| 2 | 7.61 | 2.76 |
| 3 | 6.30 | 3.99 |
| 4 | 5.57 | 5.65 |
| 5 | 5.24 | 6.05 |
| 6 | 4.62 | 7.82 |
| 7 | 2.88 | 8.62 |
| 8 | 1.98 | 9.09 |
| 9 | 1.40 | 10.04 |
| 10 | 0.86 | 9.34 |

Other 'basic' living costs – bills (council tax, water, electricity, gas, communications), food and drink, clothing, and transport – have also been calculated.

These items form an underlying expenditure that is uniform across households (e.g. some households don't smoke or drink, but all have to eat) since the goods are indispensable or mandatory – items that it is hard, if not impossible, for people to 'do without' or cut back on significantly or easily, even in times of recession.

Table 2 below shows the proportion of expenditure by decile that is spent on these items – often termed 'essentials' or 'basics':

Table 2

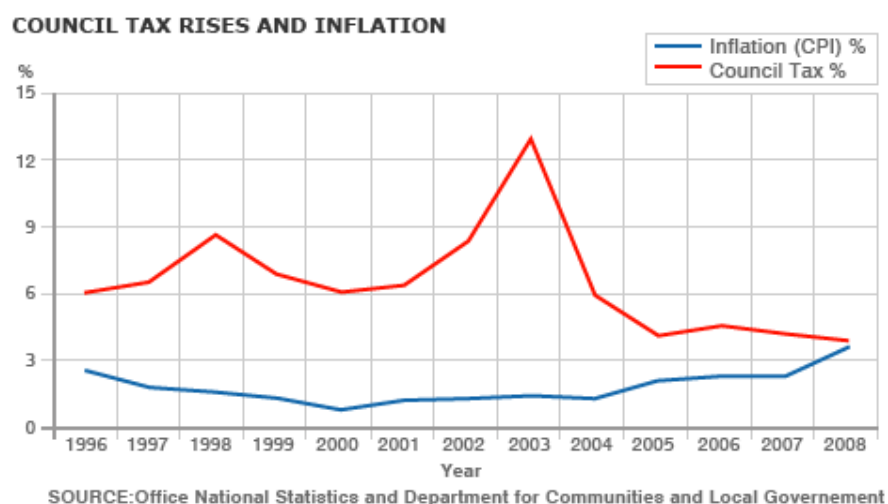
| Decile | 'Essentials' spend (% of total) |
|--------|------------------------------------|
| 1 | 67.18 |
| 2 | 64.81 |
| 3 | 54.94 |
| 4 | 50.98 |
| 5 | 46.73 |
| 6 | 45.05 |
| 7 | 41.86 |
| 8 | 36.65 |
| 9 | 34.34 |
| 10 | 29.10 |

The 'essentials' cost the poorest households over two-thirds of their expenditure, decreasing down to less than one-third for the richest.

Within this there are some glaring examples of how different expenditures affect those on different incomes. Council Tax is confirmed as a regressive tax when, despite its banding system, as a proportion of expenditure it costs the poorest half 4.1% compared with 2.5% for the richest half.

Graph 1 below shows that Council Tax has consistently risen at a higher rate than the Government's preferred Consumer Price Index (CPI) inflation measure in each of the past 12 years:

Graph 1



Even more starkly water bills cost the poorest households proportionately six times as much as the richest. It is a similar situation for gas and electric bills too. These have also seen above inflation increases in recent years, disproportionately hitting the poorest households and indicating that the real level of inflation felt by the poorest households might be higher than reported. It is therefore a progressive measure that Ofwat has rejected calls from the water companies for bills to rise above inflation, and instead the regulator has proposed that average bills fall by 4% from April 2010⁴.

Food and drink (excluding alcohol) is another example. According to the ONS, food and drink inflation was 11.3% in the last year – which is significant when the poorest decile spends over 18% of its income on food and drink, compared with less than 3.5% for the richest decile.

3. Defining a new measure: Essential Inflation

Section 2 highlighted how levels of inequality mean that the relative costs of different goods are very different for different income groups. If individual goods change value at different rates (e.g. the price of electricity goes up 10%, but the cost of transport goes down 5%) then inflation rates should consider how each household consumes these goods.

For the purposes of this new measure, the basic living costs (essentials) are defined as: housing, bills (council tax, water, electricity, gas, communications), food and drink, clothing, and transport.

Before proceeding it is worth questioning whether this definition of ‘essentials’ is relevant, and to consider why this particular ‘basket of goods’ has been chosen and termed ‘essential’?

There are several factors that helped to include and exclude items from the ‘basket of goods’ used in the ONS calculations for CPI and RPI inflation. The main items excluded were any leisure goods and services – since these are barely purchased or used at all by the poorest – and tobacco and alcohol costs were also excluded, since these are not generally considered ‘essential items’ (though see Example 1 for the effect of tobacco duty). Education and health costs are also excluded since these are predominantly payments for private provision by a small minority of the richest.

The items included are predominantly items which it is either legally or biologically necessary to purchase: shelter (housing and related costs, e.g. council tax, home insurance), heating (electricity and gas), clothing, transport, communications, food and drink, and water.

With the exception of clothing and food and drink, these are all areas where the Government either sets or regulates costs. There is therefore a responsibility for Government to regulate inflation for these goods and ensure rises do not disproportionately affect the poorest households.

⁴ See: <http://news.bbc.co.uk/1/hi/business/8164243.stm>

4. Findings

In the year to February 2009, the ONS calculated the CPI measure of inflation to be 3.2%, and the RPI measure 0.0%.

Based on this data, in the year to February 2009, **Essential Inflation** was -0.82%. Given that **Essential inflation** only accounts for a proportion of total expenditure, I have given an adjusted version of **Essential Inflation** (see column 3 of Table 3 below), which worked out as -0.16%.

Broken down by decile, the **Essential Inflation** rate for each group is set out in Table 3 below:

Table 3

| Decile | Essential Inflation rate (%) | Adjusted for total expenditure |
|----------------|------------------------------|--------------------------------|
| 1 | 1.92 | 1.29 |
| 2 | 2.38 | 1.54 |
| 3 | 0.98 | 0.54 |
| 4 | -0.10 | -0.05 |
| 5 | -0.64 | -0.30 |
| 6 | -1.64 | -0.74 |
| 7 | -2.14 | -0.89 |
| 8 | -2.58 | -0.95 |
| 9 | -3.17 | -1.09 |
| 10 | -3.21 | -0.93 |
| Average | -0.82 | -0.16 |

But why should the **Essential Inflation** rate be so different for different expenditure groups, if these are the 'essentials' which everyone uses? The answer is twofold: firstly, as shown in Table 2, the proportion of total expenditure that these 'essentials' represents varies greatly; and secondly the individual items within the **Essential Inflation** category are not used equally, since poorer households generally rent, whereas relatively richer households are more likely to have mortgages instead – and, as Table 4 (below) sets out, the inflation rates vary between the rental and mortgage categories.

Table 4

Individual inflation rates for 'Essential Inflation' items⁵

| Rent | Mortgage | Council Tax | Home Insurance | Water | Food & Drink |
|----------|-----------|----------------|----------------|-------|--------------|
| 2.90 | -39.90 | 3.60 | -9.00 | 6.50 | 11.30 |
| Clothing | Transport | Communications | Electricity | Gas | |
| -6.40 | -1.40 | -0.70 | 18.00 | 33.80 | |

Therefore, in terms of **Essential Inflation** the past year has seen a rise in the cost of living for the poorest households, yet a fall in the cost of living for the richest households. The data in Table 3 (above) clearly shows that inflation is a class issue.

Likewise in a year where much of the economic discussion has been about low inflation, and even deflation, we can see that there are inflationary pressures in a number of sectors, including gas, electricity, food and drink and water.

It is clear that the rate of inflation is not an objective single headline figure, but a subjective complex of forces which affect people very differently.

5. Conclusions and Recommendations

In current pay negotiations, where pay freezes are being proposed across organisations (e.g. British Airways⁶) it is important to understand that a pay freeze is a real terms cut of nearly 2% in living standards for the poor, but a real terms increase for the richest. Unions are therefore correct to argue that low paid workers should not be treated the same in pay negotiations as senior management grades (even ignoring arguments about reducing existing pay differentials).

It also means that unions representing the lowest paid workers should be calling for pay increases of at least 2% just to maintain living standards.

Government must ensure that in areas it regulates that – many of which are covered in the **Essential Inflation** measure – rises are kept down so as not to disproportionately affect the poorest.

The Government must also ask the Low Pay Commission to reconsider its recommendations that the National Minimum Wage (NMW) rates rise by only 1.1% in October 2009 – less than the rate of inflation for the second consecutive year. This would represent a decline in relative living standards for low paid workers, if there pay is increased only in line with the NMW uprating. Likewise upratings to social security benefits and the basic state pension this year must also be more generous.

⁵ The figures above are taken from ONS data from 'Consumer price indices, February 2009'

⁶ See: <http://news.bbc.co.uk/1/hi/business/8127705.stm> 'British Airways seeks pay freeze' 30/06/09