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A Short History

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Preface

The story of the Retail Prices Index (RPI) is a dramatic one. The RPI was first produced in interim form in June 1947, and in its full form from January 1956. Over the next 40 years it was gradually improved through the development of its methodology together with an expansion of the basket of goods and services. Its use also grew to encompass the adjustment of wages, pensions, benefits and government bonds in response to overall changes in prices. It remained the sole measure of inflation in consumer prices until 1996 when the need for a common measure of inflation across the member states of the European Union led to the introduction of a new measure—the Harmonised Index of Consumer Prices. In the UK this new measure was first published in 1997 and became known as the Consumer Prices Index (CPI) and aspects of its methodology differed from the RPI, resulting in a different estimate for inflation when the two indices were calculated using the same data, the CPI usually being smaller. The main cause of the difference, the use of different formulas, became known as the "formula effect" and became one of the most debated technical topics in official statistics.

In 2010, two changes started a chain of events that would result in the RPI losing its National Statistics status. Firstly, a perceived problem in clothing inflation led to a change in collection instructions intended to improve the capture of clothing prices; this unexpectedly led to a widening of the gap between RPI inflation and CPI inflation from 0.54 percentage points to 0.86—a considerable change. Secondly, the government decided to switch the indexation of state pensions and some benefits from the RPI to the CPI, using the justification that the CPI was a more appropriate measure to use. With CPI inflation being lower than RPI inflation, many people would lose in the future as benefits and pensions would increase at a slower rate due to indexation with the CPI rather than the RPI. The combination of these two events raised the profile of the two indices and their different estimates of consumer price inflation to wide public notice.

In August 2010, the Royal Statistical Society wrote to the UK Statistics Authority expressing concern about the differences between the measures; they urged an investigation into the issue and, in particular, the use of different formulas. In response, the Office for National Statistics (ONS) began a two year programme of research, with independent advice provided by external experts to supplement the work of the ONS. By 2012, the ONS concluded that it was the methodology of the RPI that was at fault, particularly a specific formula (the average of price relatives) that was causing an upwards bias. The UK Statistics Authority presented options for changing the way the RPI was produced and launched a public consultation. It included the option to leave the RPI unchanged.

Changing an indexation measure is not a simple matter. The long history of use of the RPI meant that it was embedded in a wide variety of financial arrangements. These included forming the basis for wage negotiations, the adjustment of benefits, pensions, contracts and some government bonds. In some cases, such as private pensions and index-linked government bonds, these were long-term commitments where the expectation of beneficiaries was for long-term stability in the means of indexation.

The public consultation resulted in a large number of respondents stating that they wished the RPI to remain unchanged. Some respondents with economic and statistical expertise disagreed with the technical assessment of the ONS that the RPI was at fault. In responding to the views captured by the consultation, the National Statistician (Jill Matheson) acknowledged demand for stability in the measure while accepting the ONS view that the RPI was a poor measure of inflation; she announced that the RPI would continue unchanged to meet legacy uses. In addition, she strongly encouraged a move away from the use of the RPI to the CPI.

What was the government's response to this advice? The government had already started to change its preferred indexation measure from the RPI to the CPI in 2010 and after 2012 it continued, proceeding in a cautious manner so as to protect revenue for the Exchequer. A few new uses of the RPI by government were introduced, but in response to criticism, the Chancellor of the Exchequer promised that this would stop. For private pensions, the use of the RPI has remained in place despite legal challenges by some companies trying to switch the indexing measure from the RPI to the CPI to limit pension liabilities and make the schemes more sustainable. For government bonds, a material change away from the RPI, or a material change to the methodology of the RPI, would trigger the option for bond-holders to ask for redemption of bonds at potentially considerable expense to the Exchequer. This was a powerful disincentive to make changes.

The government looked at the potential to change the indexing of private pensions, overriding pension agreements. It has also considered issuing CPI indexed bonds to sit alongside existing RPI indexed bonds. However, in both cases there were difficulties and it decided against change. This had the effect of maintaining the use of an officially discredited index with seemingly no end in sight. This situation attracted criticism from many stakeholders, including the Governor of the Bank of England. In response, the House of Lords Economic Affairs Committee carried out an inquiry, delivering a highly critical report at the start of 2019. This prompted the UK Statistics Authority to write to the Chancellor of the Exchequer proposing modifications to the RPI. The Chancellor has accepted that the RPI in its current form must change, but has delayed consent until 2030 at the latest and 2025 at the earliest.

This book tells the story of the RPI, from the early developments that preceded its inception, to its foundations after the Second World War, its subsequent development and the sequence of events that led to it losing its National Statistics status. Chapter 1 introduces the concept of the level of prices, how it is measured and the uses of such a measure. Chapter 2 gives a brief description of the early developments that established the foundations of inflation measurement in the Nineteenth Century, through the creation of the first official measure at the start of the First World War; the chapter ends with a description of the creation of an interim index of retail prices just after the Second World War. Chapter 3 describes the introduction of the Retail Prices Index and the development of the index in its early years. The further development of the RPI is covered in Chap. 4; this includes the addition of measures of owner occupiers' housing costs to the index, improvements to local price collection and the publication of sub-indices. Chapter 5 describes the impact of the introduction of the CPI, the response to the influential Boskin Report from the US and the differences between the RPI and CPI. It also considers inflation measures and their uses from a political viewpoint. The dramatic events from 2009 to 2013 are the subject of Chap. 6—this covers the events that led to the RPI losing its National Statistics status in 2013. Lastly, Chap. 7 considers the events of the years 2014 onwards with the Johnson Review, government consultations on private pension indexing and index-linked bonds. It ends with the 2018–2019 House of Lords inquiry and the official response.

In order to deliver a short description of the history, the extent of the exploration of the historical background is necessarily limited. A much fuller account can be found in our previous book (O'Neill et al. 2017). The description of how a measure of inflation is produced is kept very brief and we have not included any of the mathematical details behind the calculations of the two measures; Appendix A gives the basic details of the formulas. An introductory guide to how inflation measures are produced is available from the ONS (2017); our previous book on Index Numbers (Ralph et al. 2015) also provides both background information and mathematical details. We also provide a timeline of events in Appendix B.

In writing this book, we have consulted a range of sources. Firstly, all three authors have worked for the Office for National Statistics and have personal experience to draw on. Secondly, many helpful papers are available on-line from the ONS and the National Archives including the RPI Advisory Committee papers. To gain a more detailed view of past events, we have consulted many paper files in the National Archives. Thirdly, we have benefited from the personal experience of colleagues who worked on price statistics going back to the 1970s. In combining such a large volume of information into a relatively short book we have had to summarise many complex and interesting topics. Extensive references are provided for those readers who would like to follow up on specific topics.

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Finally, we'd like to note that the views expressed in this book are those of the authors and not necessarily those of the organisations for which they work.

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