HOUSE OF LORDS

Select Committee on Economic Affairs

Uncorrected oral evidence: The use of RPI

Tuesday 12 June 2018

3.35 pm

Watch the meeting

Members present: Lord Forsyth of Drumlean (Chairman); Lord Burns; Lord Darling of Roulanish; Lord Kerr of Kinlochard; Lord Lamont of Lerwick; Lord Layard; Lord Tugendhat; Lord Turnbull.

Evidence Session No. 1 Heard in Public Questions 1–13

Witnesses

I: Chris Giles, Economics Editor, *Financial Times*; Paul Johnson CBE, Director, IFS.

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Examination of witnesses

Chris Giles and Paul Johnson.

Q1 **The Chairman:** Mr Giles and Mr Johnson, welcome to the Economic Affairs Committee. I am sorry that we kept you waiting; we were dealing with the aftermath of our report on higher education, which I hope you have not missed. We had one or two things to sort out.

Can you briefly explain for the benefit of the Committee and those watching our proceedings the differences between RPI and CPI and how they are calculated?

Paul Johnson: There are lots of similarities. Prices are collected in broadly the same way for the CPI and the RPI. The key difference is, first, that the RPI excludes particular groups of the population entirely; it does not take account of the spending patterns of pensioners dependent largely on the state pension or the spending patterns of the richest 4% by income.

CPI and RPI treat housing costs extremely differently for owner-occupiers. The RPI includes a measure of house prices and mortgage interest, whereas the CPI does not take account of owner-occupied housing costs at all. There are some relatively minor differences in coverage and in the way the indices treat insurance payments, for example.

The other, probably biggest, difference is in aggregation at the lowest level, where they do not have information on the quantities of different types of apple or different kinds of clothing to weight things. They average those differently. The RPI in quite a lot of cases uses an arithmetic average known as the Carli. Instead, the CPI uses a geometric average known as the Jevons. That difference in aggregation at the most elementary level has a large effect on the inflation as recorded by the two of them. There are a bunch of other differences, but I think those are the most important.

Chris Giles: I agree with that. It is important not to get too hung up on whether it is an arithmetic or a geometric average, because the RPI has two different forms of arithmetic average. It has the Dutot: if you take a whole bunch of prices, such as for oranges, and do a simple average to get the average price, a large part of the RPI does that. But the Carli index, which is the problematic part of the RPI when combined with the data underlying it, does not just try to find out the price of an orange in a month, it finds the average of the change in prices. That is the big difference. The CPI uses the geometric average to find the price of an orange in any one month, but the RPI, when it uses the Carli method, looks at the average of changes rather than the average of levels.

The Chairman: I suppose I should declare an interest, like everyone else in the country, in whether CPI or RPI has been used in calculating pensions and other matters. Do you agree with what the Governor of the Bank of England told us: that the differences in how the indices are calculated means that the RPI is around 0.7% higher than the CPI?

Chris Giles: Yes, Dr Carney got that entirely correct. It is also the figure that the ONS used in its latest analysis of the situation. It is smaller than the difference between the levels of the RPI and the CPI on average. That is because the other aspects of these two indices create the other differences between them, but the effect of the Carli index, or the averaging—the mathematical formula—comes to about 0.7%.

The Chairman: Do you think that the Government choose which index they are going to use according to whether they are paying or receiving money?

Chris Giles: Evidence suggests that they do. When they are paying money, they tend to uprate benefits in line with the CPI. Even the triple lock has the CPI as its inflation element. When they are collecting money, for example with student loans, it is the RPI. The one clear exception to this is index-linked gilts, which are bigger than everything else. It is a £400-billion market now. There has been no choice as to whether you change that. Where there has been a choice, the Government have chosen to take the route most favourable to them, or to taxpayers.

Q2 **Lord Lamont of Lerwick:** You have outlined very detailed, quite difficult differences between the two indices. One factor you mentioned was the treatment of housing costs, which is very different in the RPI and in the CPI. Rather than trying to say which is the better index, is there not an argument for just saying that they measure different things and both of them have a use?

Paul Johnson: Where it comes to the measurement of housing costs, there is some truth in that. If you are looking at how much someone of working age who has a mortgage needs to maintain their standard of living over time, you probably want some measure in there. But when you look at the fundamental formulae that we were talking about, it is extremely hard to make a case that there are different uses to which you could put the one and the other.

There are all sorts of ways of aggregating things and coming to a single price index, but it is an extraordinarily difficult thing to do. The evidence is pretty convincing that the RPI does it the wrong way essentially and gives you an inappropriate answer. It is not that it is doing something different; it is just not doing something in a way that gives you a statistically robust answer.

Q3 **Lord Tugendhat:** Are there other countries comparable to us that run two indices in parallel like this?

Chris Giles: Most countries have more than one index of inflation. The US certainly does. European countries do. I am not aware of any country that has such an issue with a very different outcome in the level of inflation used by the two indices because of the calculation, even though the prices in the shops for, say, clothing are the same in the RPI and the

CPI—there is no difference in collection, because the prices are the same. I am not aware of any other country that has this issue in its price series.

Lord Tugendhat: Does my memory serve me correctly? I seem to recall, but I may be wrong, that when the CPI was introduced the idea was that it would put us on a more similar footing with other European countries. The assumption was that the CPI would take over and the RPI would wither away. Is my memory correct?

Paul Johnson: I am not sure that it was quite that explicit. A decision was made back in 2002, which was associated in part with potential preparations for joining the euro, to give us a measure of inflation that was the same as the measure of inflation used across the eurozone. Changes made both by government and in the private sector to the use have been pretty gradual. There has not been a moment when government or anyone else has decided that the CPI should replace the RPI, although the UK Statistics Authority and the ONS have pushed pretty hard for that since 2010 after the errors in the RPI became apparent. Chris may correct me, but I am not aware of a statement by a Chancellor in the early 2000s to the effect that, "This will now replace the RPI for everything".

Q4 **Lord Turnbull:** My memory of 2002 is that it was a response, a sop, to the Prime Minister saying, "Are we nearly there?" Gordon Brown said, "We'll move a bit nearer by adopting the CPI". There used to be something called the Rossi index, which was named after Hugh Rossi and related to the inflation that pensioners suffer. Am I right in thinking that there is no longer a Rossi index or that it is not used in public policy?

Paul Johnson: From recollection, the Rossi excluded various aspects of housing costs in particular. I do not think it is produced any more; it is certainly not used significantly in public policy. If you look at the Budget of 2010 or 2011, when the Government moved from indexing benefits in line with the RPI to the CPI—they used to index state pensions with the RPI—one reason they gave was the way housing costs were taken account of in the RPI. They did not use the Rossi for state pensions; they used it for means-tested benefits, particularly, again, because of the way it treated housing costs.

Lord Turnbull: Do you think that using the same index for pensions for everyone, wealthy or otherwise, means that pensioners tend to suffer higher inflation than working people because they end up paying for more things that they would otherwise do themselves—they need more care, for example?

Paul Johnson: If you look over time, there are periods when pensioners have experienced higher inflation and periods when they have experienced lower inflation. Ignoring housing costs, if you are looking at the CPI they have experienced somewhat lower inflation in the most recent years than they experienced for quite a long period when they experienced somewhat higher inflation. It depends on what you are trying to do on average.

There is an argument to be made for having a pensioner-specific index, so that year by year pensioners are for example compensated for the costs that they specifically face. You could equally make the case that over the long term there is no particular reason to think that these indices will diverge and there would be a more straightforward and equitable sharing of the national cake using the same method.

I do not have strong view about which of those to use, but there is no particular reason for using RPI and CPI in different cases. There is no argument there.

Q5 **Lord Lamont of Lerwick:** Can I come back to the point I raised earlier about housing? I remember Nigel Lawson attempting to get the treatment of housing costs out of the RPI, which I think was rejected by the committee responsible for it; there was an RPI advisory committee at the time.

What do you think the merits are of the two different ways of measuring housing? As I understand it, the RPI attempts to collect to some extent actual housing and interest costs. I can see that you might take out the interest costs, but I would have thought that the actual house-price cost had some merit in it.

What is the difference between CPI and RPI on housing, and which is the more appropriate?

Chris Giles: Both headline indices are deficient when it comes to housing. CPI is deficient because it takes no account whatever of owner-occupied housing, which is why the ONS has spent some time trying to introduce the new CPIH measure, which takes a rental equivalent; it tries to say how much it would cost you to rent an equivalent property to the one you own.

RPI is deficient, because it has two elements. One is basically the Halifax house price index. The other is the interest rate, although that has not been consistent over time. It used to be the standard mortgage rate, and now it is the average mortgage rate. So it has changed over time.

Neither is necessarily a theoretically pure or sound way of working out a sensible owner-occupied way of measuring owner-occupied housing costs, because it is half a user cost approach and half a payments approach, which is the interest element. So it falls between two stools.

A lot of research has gone on. In the end, the ONS chose a rental equivalence for the CPIH measure, because that is the internationally generally accepted best way of trying to find a proxy for owner-occupied housing.

Q6 **Lord Kerr of Kinlochard:** If a root problem with RPI is the upward bias in the Carli method, why do we not just do as the Canadians did in 1978 for the same reason: the upward bias in the Carli? Why do we not just get rid of RPI?

Chris Giles: We cannot get rid of RPI as the law currently stands. It is in primary legislation. Section 21 of the 2007 Act says, "The Board must under section 20 … compile and maintain the retail prices index, and … publish it every month". It is the only statistic that primary legislation says has to be produced. We do not do this for any other statistic, so in that sense it is the king of our statistics.

Lord Kerr of Kinlochard: That is a very strong argument if we are standing in the middle of Regent Street, but we are sitting in a Parliament that can change legislation if we make a serious effort and think about it. Should we do that? Should we get rid of it? Perhaps I should ask Paul Johnson. He has been struggling with this question and with the meaning of life and so on, and I think he has recanted of his previous view that you should not abolish it.

Paul Johnson: There are two issues. There is an issue for Parliament about whether it should be abolished, and there is a prior issue for the UKSA about whether the way it is constructed should be changed. Following the problems that became apparent after 2010, the then National Statistician stated that the RPI would continue to be published as was.

So first there was a consultation. Then there was a decision not to change the Carli but to stick with it. Then there was a decision, in order to provide certainty for people, that it should continue to be constructed as it currently is with the Carli and would be frozen; we are not entirely clear what "frozen" is.

There were very strong statements from previous and current National Statisticians and Chair of the UKSA that this is a very bad measure and people should not use it. It is being published according to the law and in a way that the ONS recognises is wrong. It has withdrawn national statistics status from it and it is very strongly encouraging people not to use it.

The problem in a sense is that no one is listening, or at least not everyone is listening—let us put it that way—partly because in some cases the Government decide not to, such as with student loans. In some cases, private sector organisation occupational pension funds and so on find that they cannot legally change it, because their rules are written in such a way that they have to stick with the RPI and the Government have decided not to introduce legislation to allow them to override that.

The most recent occupational pension Bill or White Paper—I cannot remember exactly what it is—will not give pension funds the ability to do that, so we are stuck in a world in which we have a statistic which the ONS recognises is significantly problematic, a Government who are not moving away from it in all cases and are not changing the law to allow others to, and some parts of the private sector that are stuck with it. That, in the case of pension funds, is creating a big redistribution from working-age people that is unintended.

The National Statistician stated relatively recently that they want to stick with this, that this is the policy. When I did my review three or four years ago, the hope and intention was that they would move away from using the RPI. Experience has suggested, as I said, that they have not or have not been able to, and we seem to be in a very suboptimal world where a lot of things remain linked to something that our own National Statistician is telling the world is a very bad thing to link things to.

The Chairman: If the Government accept the recommendations that we put out yesterday to abandon the present interest rate on student loans and tie it to the 10-year gilt yield, that will help with one part of the problem.

Lord Turnbull: This is the other option: the Government simply do not to use it. Then the private sector has to sort out the problem for itself. Then you immediately come to index-linked gilts. I have always thought that these are not just sold at a fixed price, they are sold at auction, and if you then say, "From now on, all index-linked gilts will be issued on the new basis", not a lot would change. The real interest rate would adjust and the price would adjust, so the long-term return would be what it would be with the other index.

Chris Giles: That is certainly correct for gilts issued from now on. We need to remember that there are roughly £400 billion of index-linked gilts in issuance at the moment. At the time of the clothing change in 2010, there were £233 billion of index-linked gilts in issuance. That change alone increased RPI inflation by 0.3 or 0.4 percentage points a year, which means an additional taxpayers' cost that was entirely unintended of roughly £1 billion a year. That is about four times the annual cost of the Office for National Statistics, so that statistical change is costing British taxpayers four times the cost of the ONS every year. We could have a lot of quite good statistics for that money.

Lord Turnbull: A lot of people who own index-linked gilts now bought them knowing that the inflation factor in it was too generous, so they have taken the hit elsewhere. A big capital gain was made by the people who bought them at the start before this was all realised. I am not sure that there are too many of them left.

Chris Giles: Since most of them are pension funds, they generally hold them for a very long time, so we do not know exactly who held or did not hold them at the time. I looked at what happened on the day the ONS decided not to change the RPI—10 January 2013. The price of index-linked gilts went up so sharply at the time, obviously depending on their maturity, that it amounted to a one-off transfer to the holders of those index-linked gilts of £25 billion.

It was an extraordinary transfer, because the index-linked gilts had priced in the fact that the ONS was going to revise the RPI. I knew the decision in advance, because I sat on the Consumer Prices Advisory Committee. It was quite an odd thing as a journalist to know something that was extremely market sensitive and to be absolutely bound not to tell anyone quietly in our newsroom, knowing that it would have that effect. That is the scale.

Lord Turnbull: That is still no argument against changing it in the next Budget so that all future issuance is on the new basis. Would that still be better than where we are now?

Chris Giles: We could change all future issuance to CPI or a different index. It would not make a big difference in the cost. However, as there is now a potential ratchet in the difference between the CPI and RPI, all the ONS has said so far is that it will not countenance any change to the RPI that is detrimental to index-linked bond holders, but it will countenance changes that help them.

These issues of RPI index-linked gilts go out to 2068—there is another 50 years of them—so it is not a short-term issue. The gap can only get wider, so that is potentially quite a big fiscal risk. It is not a big fiscal risk compared with productivity, but it is a big risk for something that is entirely within government's gift to change and get right.

Paul Johnson: You preceded your questions, Lord Turnbull, with the statement that the private sector can sort this out for itself. It really cannot, because many private sector contracts, particularly occupational pensions, are written with RPI built in. The fact that RPI overstates inflation creates a very big, unintended redistribution from, for example, workers in occupational schemes to pensioners. They just cannot get out of that.

Lord Kerr of Kinlochard: Your change in position is from thinking that nothing should be done—it should not be abolished; you hoped that it would wither on the vine, but it should not be improved and the 2010 mistake should not be put right—to now thinking that the 2010 mistake should be put right and that we should go on publishing this index as well as CPIH but we should reform it.

Surely reforming it will also affect the interests of bondholders, just as abolishing it and moving to CPI instead would. I do not see the argument in principle for reforming it, given that we have introduced alongside it something that we think is a lot better.

Paul Johnson: There are two choices here: one is for the ONS and the other is for Parliament. For ONS, there are three places it can go. One is to stick with what we have and hope that some of these changes are made, but part of the problem in the private sector is that it finds that it legally cannot move away from the RPI in a way that frankly I had not quite appreciated at the time.

A second option is to correct it in the sense of undoing the changes to clothing inflation, for example, such that we get back to the RPI measuring the same thing it measured pre 2010. We know that there are problems with that and that it is far from perfect, but at least we would have something that was consistent over time.

The third option is to move from Carli entirely to Jevons, but we would then make bondholders as of pre-2010 worse off than they might reasonably have expected because we were reducing inflation as measured.

Those are the choices for the ONS. There is an entirely separate choice for Parliament, which is just to get rid of what Chris read out, which is the legal obligation to produce this thing. I am no lawyer, but some legislation would then be needed that oversaw a huge number of private sector contracts in which the RPI is specified. I assume that it would have to say, "Where it says RPI, we now mean CPI", and be subject to all sorts of judicial review. There would clearly be big legal implications of trying to do that. That is the set of options.

The option I went for three or four years ago was, "Given what the National Statistician has recently said and the certainty that he is trying to achieve, and given that he has said explicitly on a number of occasions, 'This is a bad statistic. Stop using it', let's hope that it withers and that the Government take notice of that and move as much as possible, including in future issuance of bonds, to CPI".

That has not happened very much in the public or the private sector and much more slowly than one might have hoped. It may be that a second-best solution is now to move either to the pre-2010 situation or to using Jevons rather than Carli if Parliament is not going to abolish the whole lot.

Lord Burns: I am sorry for being late, Chairman. Are you saying, therefore, that simply leaving everything as it is now is the worst option?

Chris Giles: I think it is the worst option, because we potentially have an index that is deficient but is central to public life in this country until 2068. It is only going to continue, which I do not think is tenable in the long term.

Paul Johnson: I probably do not feel quite as strongly as Chris, but I broadly agree with that. We have a statistic that people either will not stop using or in many cases genuinely cannot stop using.

Lord Burns: In which case, is not the only sensible thing to have a programme or some set of proposals that will move away from it over a period?

Chris Giles: I agree.

Q7 **Lord Darling of Roulanish:** Before I return to RPI, I should declare my specific interests in the *Register of Members' Interests* as well as my general interest, in that everybody around this table is either in receipt of, or about to be in receipt of, a pension that will be affected by these indices.

Coming back to the question about RPI, both of you to varying degrees are saying that it is not a good index, that we should not be using it, and that if you were starting from here you would not invent it. Equally, I think both of you are saying that the problem is that, for the next 60-odd years, somebody somewhere is affected by these indices and would cry foul if we were to change them.

You also said that we can change the legislation. Obviously, since it was introduced in 2007, there was must have been a good reason at the time, but I cannot quite remember what it was. Would not any Chancellor or Government looking at a proposal for change, and assuming that the Government are the only ones who could do it, ask, "Who are the winners and losers were we to get rid of RPI?"? Can you outline that for us in general terms? Who would lose first?

Paul Johnson: If we were to get rid of RPI or change it such that it used the Jevons where it uses the Carli at the moment, which would be a similar thing to do, the losers would clearly be those who currently have incomes indexed to the RPI, who are largely those in receipt of private sector occupational pensions.

The big losers would be private sector occupational pensioners and the holders of index-linked gilts. As Chris set out, there are two groups there. One group would be real long-term losers, because they would have bought after January 2013 having been reassured that the RPI would continue as it currently works. They would therefore have paid more for their gilts on the understanding of how the RPI would be constructed. It would be a clear loss for that group if the RPI was then constructed differently or abolished and replaced by the CPI. They would be a group of people who would reasonably feel hard done by.

Lord Darling of Roulanish: That is some millions of people.

Paul Johnson: That is effectively through the holders of such funds, which are often occupational pension funds. There is an offsetting effect here, because if they lost on that side the funds might gain because they were paying less to pensioners. A significant number of people would lose as a result of that.

Those who held gilts, particularly bought before 2010, have had a windfall gain, as Chris set out. If we moved entirely to getting rid of the RPI or replacing it with the CPI, they would lose all that gain plus a bit. So they would be overall net losers but not by the same extent as those who have bought since, particularly since January 2013.

Chris Giles: Twenty-five million taxpayers would gain, of course.

Lord Darling of Roulanish: Yes, but since you are both political commentators as well as economic writers, it would not surprise you if any Chancellor looking at this marked it to be returned to his box and forgotten about.

Paul Johnson: Who is the decision-maker here? There is a decision-maker in Parliament, in the Treasury, on whether the RPI continues and what the legislation says. There is also decision-making within the UKSA and the Office for National Statistics about what formulae they use to produce those statistics. Clearly, the politics play into both, but they may play in differently to the statistical agency than to the Government.

Chris Giles: There is a fundamental point of principle here as well, which is that the ONS and the UK Statistics Authority have a duty to maintain, protect and safeguard the quality of official statistics. The RPI is not a national statistic, but it is still an official statistic, and that is their duty in law.

We would expect the process, the political economy of it, to go something like this: the ONS does its job and produces the most accurate RPI it thinks is good. It does not sit around saying, "This is a terrible statistic. No one should use it". Because of the law, it then has to go to the Bank of England to see whether there is a material detriment to some bondholders. Clearly the answer would be yes and the Bank of England would say so. Then it would go on to the Chancellor's desk and it would be a political decision as to what then happens.

Lord Darling of Roulanish: The officials you referred to, in the UK Statistics Authority and the ONS, are saying in different ways, "Keep it".

Chris Giles: No, they are saying, "We can't get rid of it. Don't use it".

Lord Darling of Roulanish: But that is the same as keeping it, is it not? If you are not getting rid of it, you are keeping it.

Chris Giles: They are saying, "Let's keep it". They might well say, and they were thinking of saying this before deciding against in 2013, "We need to keep it, because the law says we have to produce it, but let's keep an accurate index that actually tries to be an accurate measure of general retail price inflation rather than something we know is wrong".

Lord Darling of Roulanish: They are not doing that because of the error that was discovered and which seems to have been baked into things.

Chris Giles: It does not have to be baked in.

Lord Darling of Roulanish: It is at the moment.

Chris Giles: It is at the moment, yes.

Lord Darling of Roulanish: Just to be clear, your preferred way of sorting this out would be to get those who have a legal responsibility to make recommendations and to police these things to say, "Look, all of us are agreed that this is not the right index. Therefore, the Government should consider changing the law so that at some stage it is taken out of the system".

Chris Giles: I think it is rather difficult to get a law change. My preferred solution would be for the ONS and the UK Statistics Authority to do their job under the law, which is to protect and safeguard the quality of official statistics and so produce an as accurate as possible RPI. As there would be a detriment to bondholders, it could then be turned over to the politicians to say whether that went through. So it is not officials taking distributional decisions but politicians, as it should be.

Q8 **Lord Darling of Roulanish:** We have been talking about RPI for the last 40 minutes. If we are agreed that it is defective, what about CPI? Before we go any further, should we be looking at the other measure of inflation as well?

Chris Giles: As I said earlier, CPI is defective as it applies to owner-occupied housing. The ONS has found a solution to that which it now promotes as its headline index. No one is using it, so no one treats it as a headline index yet. That would be a good index. It could be what you term the new RPI if you wanted to. The ONS could define the RPI as its CPI measure. That is entirely within its gift.

Lord Tugendhat: Sorry, which question are we on now?

The Chairman: Whichever one you want to ask.

Q9 **Lord Kerr of Kinlochard:** Can we go back a second? I knew nothing about the gilts angle to this, but my locus classicus is a remarkable article by Mr Giles, who said that 96% of index-linked gilts would not be affected in any way, because the prospectuses had been written in a way that meant that no action would have to be taken if we got rid of RPI.

As for the 4%, the value of their gilts is well above the redemption level. The Chancellor would be obliged to write to them and say that he was going to make this change and that if they wanted to they should sell out-; they could get a redemption value straightaway. Nobody would do anything was the point that you made in the article. That seems to be right.

Why do we see the gilts market as a serious obstacle to this? I agree, of course, that you could not do it overnight. You would have to signal well ahead and there would have to be a timetable. But if we do not start some time, we are going to be stuck with this problem for a very long way.

I have a supplementary question. If you reform the RPI and make it more accurate in your view, the gilts market has been a false market for a period. Do you have to think about retrospection? No. Once you start reforming, you are in quite difficult territory. I prefer the simple, totalitarian approach of the Giles article.

Chris Giles: I am very pleased that you think that, my Lord. There are three issues of index-linked gilts where clauses stipulate that it has to go to the Bank of England and then to the Chancellor. They are the issues that mature in 2020, 2024 and 2030. All the more recently issued gilts have nothing. There is just a caveat emptor clause. In all those issues, you could get rid of the RPI. The prospectuses say that they would be linked to an index that the Chancellor considers "continues the function of being an officially recognised index measuring changes in the level of UK retail prices". That is the clause in the prospectus, so there is no particular problem with the index-linked gilts market.

There has been a natural experiment, which was the consultation on changing the RPI in 2012. The expectation in the markets was that there would be a change. The index-linked gilts market worked perfectly well. No one in the market liked it—there is no question that they all hated it—but there was never an issuance that was not perfectly well subscribed, and if you remember we were issuing a hell of a lot of gilts in 2012. There is no sign that if the index-linked gilt market was changed over a period of time, particularly if, as the Governor of the Bank of England suggested, some notice was given, it would cause a problem for Britain's ability to finance the Government.

Paul Johnson: I would not speak with that much confidence about that, given the history that we have had. We have had a clear assurance from the National Statistician that it will not be changed. We have a Government who are seen, I think correctly, to be rather cynical about where they choose to use the CPI and where they choose to use the RPI. There is at least some danger that, given that history and context, making a change to CPI could have some negative consequences. There would be clearly be significant losers among gilt holders and it would be seen as a significant political decision because it would end up coming to the Chancellor. I am not saying that that is a knock-down argument, but one has to take it pretty seriously.

Q10 **Lord Tugendhat:** You have explained why the world has to continue as it is, but how much could the Government save in reduced debt interest payments if they switched index-linked gilts into CPI? It is rather a hypothetical question in light of your earlier answers.

Chris Giles: It is a £400 billion-sized market. The difference between CPI and RPI is about one percentage point a year; 1% of £400 billion is £4 billion a year. It is quite a lot of money.

Lord Turnbull: If you only did it for a new issue, would that help?

Chris Giles: That would not save anything, because you would expect that to be compensated. It is purely a question of distribution. It is a zero-sum game: you have winners and you have losers. Everyone has to recognise this. You are not conjuring money from nowhere. It is a question of whether the current system with a defective RPI is redistributing in a way that is inappropriate and whether it would be better if we did it in the way that was initially expected of bonds, which was to be a measure hedged against the increase in general retail prices.

Lord Tugendhat: I asked earlier whether any other countries have two indices similar to us. You answered that. I also asked why we had introduced CPI. When the euro was introduced, did any members of the eurozone change from an existing index that had been in use for a long time to a new index?

Chris Giles: Quite a few European and other countries have over time moved from an index with a Carli in it to Jevons or Dutot indices. In no other country was the problem as bad as it is here. That is because the Carli index is not just an idiotic index; it is combined with the data. It is a bit like a knife. If you have a very sharp knife, in the right hands it is a very useful tool, but in the wrong hands it is a very dangerous weapon.

Unfortunately, we in this country have been using the Carli index with data, which exacerbates the known biases in that index. It is because we have this combination of the two together that we have this massive spread. We know from going to shops that certain clothes—the obvious example that is used quite a lot is a woman's strappy top—have not gone up in price at all in the last decade or so, but the way the RPI calculates this shows that the price has gone up fivefold. That is entirely incorrect. The price bounces up and down, which exacerbates the bias in this index.

The other ways of measuring inflation also have their problems. You have to be very careful with the Jevons index and the CPI not to have a price of zero for anything, because it blows up the calculation. The key issue is to marry the data that you have with the correct index. What we are doing in this country at the moment with the RPI is marrying wholly inappropriate data with the Carli part of the index. That is why you get this very large bias.

Q11 **Lord Tugendhat:** When you look at other European countries, is there one—or two or however many—that you feel has an index that most accurately captures the movement in prices as those prices affect the population of the country?

Chris Giles: I personally do not have a specific country that I think is better. Many other countries have less ambition in the way they collect prices in shops. That means that the data is much more stable, which is sometimes a good thing and sometimes a bad thing. We have been quite ambitious in the way we collect clothing prices. The 2010 clothing change was an ambitious change that had entirely good intentions behind it—to try to widen our sampling of clothing prices—but it had the very unfortunate effect of making a bias that we already had in the index much worse.

The Chairman: Thank you very much. Mr Johnson, you have been clear. Perhaps I am being a bit slow. I am not absolutely clear what you would like us to do now about this matter.

Paul Johnson: At the least, I would like you to recommend to the Government that they stop using RPI wherever they currently use it.

The Chairman: That is the easy answer.

Paul Johnson: It is the easy answer, but it is important. It is also true where regulators use it. I do not know to what extent you can make recommendations to the ONS, but I certainly think you should consider asking it to correct the RPI rather than stick with its current policy of leaving it as it is.

As I have expressed, my mind has changed over the past several years because it has become apparent that it is simply not possible for a lot of users of the RPI to move away from it. The result is a substantial, expensive and unintended redistribution.

Lord Layard: The other alternative mentioned was having the specific authority replace the RPI with the CPIH so that you stop having more than one index—you say that the RPI is the CPIH—and put that into law in the way we are putting European law into British law. That is what the RPI is.

Chris Giles: That is an entirely plausible answer. If the Government wanted to put that into law, that would be an entirely reasonable way of going forward.

Lord Lamont of Lerwick: Although the methodology would still be faulty in the RPI.

Chris Giles: Sorry, I might have misunderstood your point, Lord Layard. I thought you were saying that you would change the methodology of the RPI so that it was not the current methodology of the CPIH.

Lord Layard: But would what become the CPIH would be the RPI, because you only have one index. I must say that it seems very peculiar to me to fiddle with the RPI and partially remedy some of its defects but still have two indices. What can you not call your preferred index the RPI?

Paul Johnson: It depends on what you are trying to achieve and how much redistribution you are willing to accept. As I said, a minimal change might be to change the way in which clothing and maybe one or two other things are collected for the RPI or measured in such a way that you have the RPI being no more wrong than it was pre-2010.

That way, you end up in a world with a significant amount of consistency and you are not undoing a set of expectations over a very long period. You could get rid of the Carli in the RPI altogether or you could go the whole hog towards CPIH, but then you are changing all sorts of things about the way that housing costs in particular are measured.

These are not easy questions, because the further you go along that continuum, the more retrospection—and the more winners and losers—you create relative to current expectations. As suggested, that is a big political decision, which would have big consequences for redistribution. That is why it is a tough decision to make, without question. If you move along further, and if you move straight from RPI to CPIH, the change, retrospection and redistribution will be big.

Q12 **Lord Lamont of Lerwick:** Mr Giles described earlier the difference in the treatment of housing between RPI and CPI. What is the difference with CPIH? I ought to have declared an interest. Like everybody else, I have a

House of Commons pension.

Paul Johnson: For owner-occupied housing, CPIH uses a measure of rental equivalence to measure the cost of owner-occupied housing. In other words, it tries to get a sense of how much you would have to pay to rent your home. That is intended to get the opportunity cost of living in your home as opposed to renting it out. That is difficult, because it does not reflect what people understand to be cost of remaining in their home. Certainly at an economy-wide level, it gives a sense of inflation.

Lord Lamont of Lerwick: How is that different from the CPI?

Paul Johnson: The CPI simply has no measure of owner-occupied housing at all.

Q13 **Lord Kerr of Kinlochard:** I am sorry. Following on from the Chairman, I want to pin down exactly what you think we should do, Mr Johnson. Are you saying that the least bad course is probably to take the RPI back to the state it was in in 2010? In other words, it would still be unsatisfactory but without its more recent defects any longer. In which case, would you not simply be flying in the face of what you think should happen, which is that it withers on the vine? Surely the more you revalidate it, the less likely it is to wither on the vine? Why do we not just rename CPI as RPI and all go home?

Paul Johnson: I am afraid that I am going to offer a sort of "on the one hand, on the other" answer.

The Chairman: The politicians are meant to be on this side.

Paul Johnson: Economists are two-handed as well. There are trade-offs, such as the ones I described. If you were to move overnight from redefining CPIH as RPI, in 50 years' time we would be in a better place because we would have a measure that we can all agree is a much better measure of inflation, that is robust and that measures what we are trying to achieve. But tomorrow you would have a lot of extremely unhappy people who have just lost an enormous amount of money in the long run and will, not completely unreasonably, think that you have broken a contract.

That is just a trade-off. I do not have a very strong view on where you should sit on that trade-off, but I think we are probably in the wrong place on that trade-off at the moment. You cannot move away from what is happening for so long. I feel more strongly about the impact it is having on private sector occupational pensions, which simply cannot move away from this RPI measure.

The Chairman: I suspect that you are probably in a better position to know what might happen in 50 years' time than many members of the Committee.

Lord Turnbull: How can you make this transition? Option A is to say that we will recalculate it all and produce the level of the RPI as it would have been had we never made this change, or we say that the RPI is what it is in June this year and from now on it will move in line with the new methodology. I assume you are doing that.

Chris Giles: You cannot do the formula, because the RPI cannot be revised. It is never revised backwards.

The Chairman: On that note, I think that is going to be an interesting investigation by the Committee. Thank you for your very helpful evidence.