Inflation: another index bites the dust?

The complicated task of tracking changes in the cost of living has taken another twist, as the new 'CPIH' measure of inflation recently lost its status as a national statistic due to concerns over the way it measures housing costs. The significance of this is that the CPIH was introduced in order to address the absence of housing costs in the Government's preferred measure of inflation, the CPI. The downgrading of the CPIH is specifically due to concerns that the index is not responsive enough to rental price changes and may be underestimating total inflation by around 0.2 percentage points.

The decision to downgrade the CPIH highlights two uncertainties around inflation. Firstly, it highlights the difficulty in assessing housing costs – a critical part of any estimate of the cost of living, particularly in the UK. Until recently at least, the CPI has not been widely used as a measure of the cost of living for pay-setting purposes, partly because it does not account for changes in the cost of owner-occupier housing. Now that the attempt to take account of housing costs in the CPIH has been called into question, the setback highlights the difficulty in accounting for this important element of consumer spending in the economy.

The other uncertainty highlighted by the recent decision is over which inflation measure is most useful. Of the four main inflation measures, two have now been downgraded from national statistic status. Of the two remaining measures, the CPI does not include owner-occupier housing, and the RPIJ is possibly the least well-known and least-used inflation measure of all. The confusion of new indices, downgraded indices and acronyms leaves lay people and experts alike at a loss as to which measure of inflation is 'best'.

This uncertainty, coupled with the fact that the Government continues to use RPI to uprate many official measures and indices, helps to explain why most pay-setters continue to use RPI as a main reference point for pay despite it no longer having national statistic status. The current month's data is particularly relevant, as the new 2.5% RPI figure is set to trigger train fare increases of 3.5% from January 2015.

Incentive pay fails to take off

A new discussion paper published by the Centre for Economic Performance asks the question: '*Are Firms Paying More For Performance?*' The answer they provide is that since the turn of the century, a slightly smaller number of employers have paid a significantly higher proportion of pay out as bonuses.

The report's authors set out to test the hypothesis that performance-related pay should be increasing in popularity. In this instance, they are referring to bonuses, share schemes, commission and other non-consolidated payments, rather than merit-related increases consolidated into basic pay as part of the annual pay settlement.* The authors cite apparent benefits to employers in terms of incentivising performance, as well as the increased availability of monitoring technology and falling levels of employee bargaining power as reasons for expecting the spread of incentive pay since 2000.

In fact, the picture they uncovered is one in which bonuses rose as a proportion of all pay from 2003 to 2007/08, but fell during the recession, and fluctuated thereafter. But more significantly, rather than performance payments spreading, the proportion of the UK workforce covered by incentive schemes fell gradually but steadily over the period. Instead, the report shows that, where bonuses were on offer, the amounts paid rose significantly in relation to base pay.

It should perhaps not surprise anyone who follows statistics on earnings and bonuses that these effects were predominantly driven by the finance sector. As the report states, 'firms in the finance sector are the most likely of those in any sector to pay bonuses, and those bonuses tend to be very large.'

The report analyses ONS data to show that incentive schemes are no more popular than they were 14 years ago. However, where bonuses are paid and particularly in the finance sector, incentive pay now accounts for a significantly larger share of employees' earnings. As the report puts it, 'much of the dramatic change in the bonus share seen in the economy at large can be attributed to movements in the gearing ratio of bonuses to base pay within the finance sector.'

The current state of flux means there is little consistent pattern in bonuses as a percentage of pay bills from one year to the next, with the picture further clouded by recent changes to bonus timings to take advantage of tax changes. But once the economy settles down, an important question will be whether and how approaches to bonuses might change in the recovery.

** IDS has recently been looking at base pay and progression in the private sector, including the extent to which this is linked to performance. Look out for the publication of our findings in the coming months.*