Public Consultation:
A consultation on the Reform to Retail Prices Index (RPI) Methodology

To: HM Treasury, RPI Consultation Team

By: The Intergenerational Foundation

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The Intergenerational Foundation (www.if.org.uk) is an independent think tank researching fairness between generations. IF believes policy should be fair to all – the old, the young and those to come.

Introduction

The Intergenerational Foundation (IF) is supportive of the Authority's proposal to align the methodology used to calculate the Retail Price Index (RPI) with the lead national measure of inflation, the Consumer Prices Index including owner occupiers' housing costs (CPIH). We are aware that the timing of this change will only be decided based on its impacts on the index-linked gilt market and bondholders, as specified under the Statistics and Registration Service Act 2007. Nevertheless, we are pleased that the government is welcoming consultation responses on wider impacts beyond the index-linked gilt market.

IF believes that the wider applications of the RPI measure may disproportionately impact younger people. We are concerned about two uses of the RPI in particular: student loans and rent reviews. Our consultation response will answer the following questions in relation to these two policy areas:

5. What other impacts might the proposed changes to address the shortcomings of the RPI have in areas or contracts where the RPI is used?

6. Are there any other issues relevant to the proposal the Authority is minded to make of which the Authority or the Chancellor ought to be aware?

1. **Younger workers are paying thousands of pounds in additional student loan repayments due to the shortcomings of the RPI**

Given that the use of the RPI as a measure of inflation is internationally discouraged, its application in setting the interest rate on student loans has been repeatedly criticised for leaving younger people with an unnecessarily large amount of debt. Due to its flawed methodology, the RPI measure systematically overstates inflation, and has been running on average one percentage point higher than the CPIH inflation rate since 2010.[1] This means that outstanding student debt will grow on average one percentage point higher than national inflation.

The Authority's proposed changes to the RPI measure is expected to correct this issue, however, it is difficult to quantify the amount of money that graduates would save because there is little current evidence on how using the RPI as opposed to the CPIH measure impacts lifetime repayments.

One way in which we can derive a close estimate of the impact of aligning the RPI with the CPIH is to look at the effect of lining the measure up with the CPI. Although not the same, these two measures move closely in line with each other because their methodologies are very similar; since 2010, there has only been an average difference of 0.16 percentage points in their growth.[2] IF can estimate the impact of switching from the RPI to CPI as a measure of inflation using the results from a study carried out by the Institute for Fiscal Studies (IFS)[3], which investigates how setting the interest rate in different ways affects an individual's outstanding debt and level of repayment.

Under the current system, interest rates on student loans are set to RPI+3% whilst students are still in study and RPI plus 0–3% depending on income after graduation. The IFS paper estimates the impact of changing how the current system is set, layer by layer. In one scenario the researchers estimate the impact of removing the 3% additional interest attached to the RPI (i.e. diverting to RPI+0%), whilst in another they estimate what would happen if we also replaced the RPI with the CPI (i.e. CPI+0%). As the only variation between the first and second scenario is the type of inflation rate measure used, the difference between their estimated effects can represent the impact of switching from the RPI to CPI as a measure of inflation.

Table 1. Estimated effect of diverting from the current interest rate attached to student loans

Earnings group	Estimated lifetime graduate repayments under different interest rate scenarios (real non-discounted)		
	RPI + 0%	CPI + 0%	Difference
Lowest-earning 20%	£3,400	£3,400	£0
Middle-earning 20%	£32,200	£30,800	-£1,400
Highest-earning 20%	£60,000	£50,500	-£9,500

Source: IF re-analysis of IFS (2017) results.

The results of this simple re-analysis are presented in Table 1. They suggest that shifting from the RPI to CPI can save younger people from paying thousands of pounds in repayments. However, the level of money saved is unequally spread across the income distribution: the highest-earning 20% are expected to experience the largest reduction in their repayments across their lifetime – of a magnitude of £9,500 – whereas the middle-earning 20% of workers see a reduction in their repayments of £1,400 (in 2017 prices). For the lowest-earning 20%, on the other hand, there is no estimated impact. This group repays £3,400 of their outstanding debt on average regardless of which inflation rate was adopted, which is likely a symptom of the larger

[1] ONS (2018) *Shortcomings of the Retail Prices Index as a measure of inflation* Newport: ONS

[2] ONS (2020) *Consumer price inflation, UK: January 2020* Newport: ONS

[3] Belfield, C., Britton, J., and Hodge, L. (2017) *Options for reducing the interest rate on student loans and introducing maintenance grants* London: IFS

issue of young workers being stuck in low-paid employment. We can expect a similar pattern to follow when the proposed alignment of the RPI to the CPIH measure is implemented.

2. Lower student loan debt and rent inflation leads to better long-term social and economic outcomes

The government should also be aware of the substantial evidence on the long-term social and economic benefits of lower student loan debts. In 2018, the Centre for Global Higher Education conducted an extensive review of the existing literature on the impacts of student debt on holders' long-term social and economic trajectories. The RPI, in its current form, can indirectly influence numerous factors of a young person's life through increasing their level of student debt, including their career choices, time taken to save up for the deposit for their first home, the value of their home, pension savings and mental health.[4]

This is concerning from not only a societal point of view, but also the fiscal standpoint. The review found that student debt significantly discouraged young people from pursuing entrepreneurial activities, which could eventually take a toll on the economy. Similarly, the link between debt and mental health should also be taken seriously from a fiscal perspective; mental health issues have been found to lead to lower rates of employment, higher levels of benefit receipt and use of healthcare resources[5] – all of which have consequences on public finances through reduced tax revenues and increased spending on public resources.

3. More data needed on the impact and scope of index-linked rent reviews

Addressing the shortcomings of the RPI will likely also work in favour of younger tenants in the private rental market. In recent years, there have been reports of a growth in the popularity of index-linked rent reviews, which link rent prices to the RPI rather than to market rent. It is likely this is more often the case for long-term tenancy contracts, the terms of which can tie tenants into such annual rent increases over multiple years. In many cases, tenants consequently pay a substantial amount more overall in rent than they would have done if the property had been leased at the market price. Landlords have continuously chosen to stick with this index despite the introduction of the more robust alternative measure of inflation, the RPIJ, in 2013.

Young people are disproportionately impacted by this practice precisely because they account for almost half of all renters and spend a larger proportion of their lives renting than previous generations did at the same age. In 2017, the head of approximately 46.5% of households renting privately was aged 34 and under.[6] Over the past two decades, the average age of a first-time buyer has also increased from 25 to 33.

As a result, this takes a large toll on young people's livelihoods. Last year, the Intergenerational Foundation investigated the consumption patterns of different age groups and how they have changed over time. Our results showed that households where the representative is under 35 spent on average 29.6% of their weekly spending on housing and utility bills in 2016-17. That is, around 20% more of their weekly

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[4] de Gayardon, A., Callender, C., Deane, K. C., and DesJardins, S. (2018) *Graduate indebtedness: its perceived effects on behaviour and life choices – a literature review* London: Centre for Global Higher Education

[5] McCrone, P., Dhanasiri, S., Patel, A., Knapp, M., and Lawton-Smith, S. (2008) *Paying the price. The cost of mental health care in England to 2026* London: King's Fund

[6] ONS (2018) *UK private rented sector: 2018* Newport: ONS

expenditure than older generations would have had at the same age 15 years ago.[7] This finding is likely to be driven not only by the rise in house prices and the higher tax burden, but also the increasing reality that young people are finding themselves in low-paid jobs which offer little security.

It is possible that reforming the RPI measure will benefit tenants, who may face lower increases in their rent as a result. However, there is little available data on the use of index-linked reviews to be able to predict the true impact. For instance, it is not clear whether the changes to the RPI inflation rate will incentivise landlords to switch to other forms of rent reviews which could be equally or perhaps more disadvantageous to tenants, such as fixed rent reviews. IF therefore recommends that the government takes more measures to gather information on the type of rent reviews that are being applied in the private sector using relevant national household surveys.

4. The COVID-19 crisis has worsened the economic burden for young people

Finally, it is important to put these issues into the context of the current pandemic crisis. It is said that the UK is heading into the worst recession that it has experienced in decades. However, when the CPIH decreases, as it usually does during a recession, the RPI does not necessarily decrease with it. For instance, student loan repayments in 2020 to 2021 will be attached to a higher inflation rate than they were in the previous year, despite the CPIH rate suggesting that inflation actually fell by 0.3 percentage points between March 2019 and March 2020.

This timing of these discrepancies is most costly for young people, who are the most likely to experience disruption to their income streams and career progression as a result of the pandemic.[8] In April, IF found that young households (where the household representative is aged between 16–34) would also be the least likely age group to be able to sustain previous levels of expenditure upon facing a 25% drop in income for 3 months.[9] IF hopes that the Chancellor will take the worsening economic circumstances for young people into account.

If you would like to learn more about the work of the Intergenerational Foundation please contact:

Liz Emerson
Co-Founder
Email: liz@if.org.uk
Mobile: 07971 228823

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[7] Kingman, D. (2019) *All Consuming Pressures: the cost of living crisis facing younger generations* London: IF

[8] Dias, M. C., Joyce, R. and Keiller, A.N (2020) COVID-19 and the career prospects of young people London: IFS

[9] Kingman, D. (2020) Are young adults more financially vulnerable during the lockdown? London: IF