

Inflation and Income

June 2008



This annual update by the Alliance Trust Research Centre to explore the relationship between income levels and inflation over the last year has found that:

- In the first half of 2007, lower income households experienced the highest rate of inflation. On average, households on income levels of less than £7500 experienced an inflation rate which was 30% higher than the headline rate.
- By the end of 2007, the highest income households were facing an inflation rate almost 30% higher than the headline rate and 13% higher than the lower income households.
- The lowest income households saw their inflation rate fall from 4.2% in January to 2.4% in December, a decline of 43% over the year. The rate facing the highest income households fell by only 4% over the same period, to 2.7%.
- In 2007, the biggest difference between the highest and lowest income groups occurred in the first two months of the year when the inflation rate facing the lowest income group was almost 50% higher than that facing the highest income group.
- The findings highlight the problems of using a national average measure of inflation.

Our conclusion – it is now the higher income groups which are facing the highest rate of inflation

The Alliance Trust Research Centre has updated research focusing on the relationship between income and inflation, focusing on trends which were present in 2007. As in the initial study, data is sourced from the Family Spending Survey and monthly Consumer Price Index reports to construct indices of inflation for each month. In our model we identify

four major income groups, representative of the lowest, lower middle, upper middle and highest income households. These are identified as 'lowest', on income of less than £7500, 'lower middle' on an average income of £18,000, 'upper middle' on an average of £36,000 and the 'highest' on income of more than £66,000.

Our results highlight that households with different incomes face varying rates of inflation. The lowest income households suffered the highest rate of

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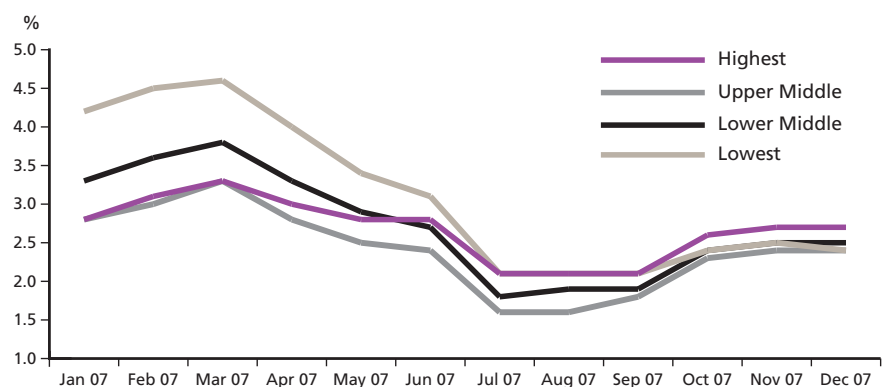
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Alliance Trust income-related inflation rates



inflation in the first half of the year. At the beginning of the year, these households faced an inflation rate of 4.2%. This was 50% higher than the inflation rate facing the highest income group. Over the year this gap narrowed and the trend reversed. At the end of 2007 the highest income households were facing the highest inflation rate. In December 2007, they suffered an inflation rate of 2.7%, which was 13% higher than the lowest income households. This is due to the fact that these households allocate the largest proportion of spending to transport costs which have risen recently due to the higher oil price.

Explaining the results – spending patterns and income

Our findings show that:

- In low income households, the highest proportion of spending is allocated to basic goods or necessities, namely housing and utilities, plus food and beverages. Typically, almost 23% of spending is allocated to housing and utilities and a further 18% to food and beverages. Together, these two categories of spending account for 41% of all spending. These categories of spending have experienced high price increases during the course of our study.
- Low income households have little disposable income left over to spend on discretionary goods, such as clothing, footwear and audio visual products, where prices have continued to fall.
- Lower middle income households also allocate the majority of their spending to housing and utilities which account for almost 16% of the typical budget in this category of household. However, spending on recreation and culture is also relatively important, accounting for 14% of the total.
- Upper middle households allocate the biggest share of their spending to recreation and culture. On average, this category of spending accounts for over 16% of the spending budget of these households, compared to just 12% in the case of the lowest income group of households. This group of households also allocate a relatively high share of spending to transport, at just under 16%.

- The highest income households allocate 20% of their typical spending to transport, making this the largest category of their spending. This is more than twice the proportion of spending that the lowest income group allocates to transport. This category of spending has experienced elevated inflation as the high oil price has pushed up fuel costs. Recreation and culture is also a major area of spending for the highest income group, accounting for just under 15% of total expenditure. Spending in restaurants and hotels accounts for a further 11%. Spending on basic goods such as housing and utilities accounts for less than 10% of total expenditure, which is less than half the share allocated by the lowest income households. Spending on food and beverages accounts for just 9% of the total compared with 18% in the case of the lowest income households.

- The highest income households also allocate 4% of their spending to education, almost four times more than the lowest income group allocates to this category. Education costs have risen sharply over the past year.

Alliance Trust Income-Related Inflation Rates

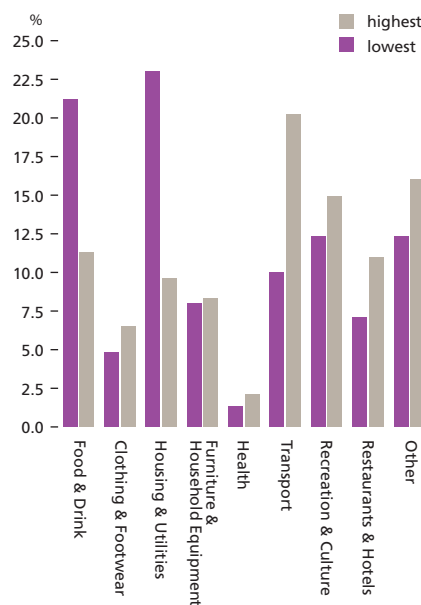
Inflation indices measure price changes for a 'shopping basket' covering a wide range of goods and services. Initially we looked at the breakdown of the CPI with a view to analysing how accurately the weights in this inflation index match actual expenditure patterns.

Methodology

Our analysis uses official data, provided by the Family Spending Survey and the Consumer Price Index (CPI). Both cover expenditure based on the international classification system, COICOP, which classifies individual consumption by purpose. We have used data from the Family Spending Survey 2007 and CPI reports for each month between January and December 2007.

The Family Spending Survey identifies detailed average expenditure, on a weekly basis, in terms of the age of the household reference person. In most cases, this is the person who either owns the household accommodation, or who is legally responsible for its rent. If there are joint householders then the reference person is the one with the highest

Breakdown of spending



income. If incomes are identical, then the eldest householder becomes the reference person.

Expenditure is reported on a household basis, rather than on an individual basis, and this has an impact on the total levels of spending recorded. In our study the largest households are those with the highest income. On average these households contain 3 people. The smallest households are those with the lowest incomes and on average these households contain just 1.4 people. Children's expenditure is included in the survey.

We have identified 12 major and 68 detailed categories of expenditure covering all the major commodities and services such as food, drink, clothing, household goods and services. Using data from the Family Spending Survey, we have identified average weekly spending on these items and we used this to calculate weighted indices of expenditure for our four representative income groups.

Sources: Family Spending Survey 2007, Consumer Price Indices (ONS), Inhouse analysis.