

Inflation and Income

June 2009



This annual update by the Alliance Trust Research Centre to explore the relationship between income levels and inflation through 2008 has found that:

- In 2008, lower income households experienced the highest rate of inflation. On average, households on income levels of less than £7,800 faced an inflation rate of 4.9%, which was 36% higher than the headline rate of inflation.
- In 2008, lower income households faced an inflation rate which was almost 29% higher than the inflation rate experienced by the highest income households.
- In 2008, the biggest difference between the lowest and highest income groups occurred in the last month of the year when the inflation rate facing the lowest income group was almost 82% higher than that facing the highest income group.
- The lowest income households saw their inflation rate rise from 2.5% in January to 5.0% in December, an increase of 100% over the year. The rate facing the highest income households actually fell over the same period, from 2.8% to 2.7%.
- The findings highlight the problems of using a national average measure of inflation.

Our conclusion – it is the lower 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 2008. As in the initial study, data is sourced from the Family Spending Survey and monthly Consumer Price Index (CPI) 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 £7,800, 'lower middle' on an average income of £18,500, 'upper middle' on an average of £37,000 and the 'highest' on income of more than £68,000.

Alliance Trust income-related inflation rates

Our results highlight that households with different incomes face varying rates of inflation. In the first three months of the year, it was actually the upper middle income households which faced the highest rate of inflation and the lowest income households which had the lowest inflation rate. This trend however quickly changed given that food, gas and electricity and fuel price inflation was rising rapidly. All income groups experienced a sharp rise in their inflation rates however it was the lowest income households which suffered the largest increase. Their inflation rate peaked at 7.4% in September which was 42% higher than the headline rate and 43% higher than the rate being experienced by the highest income households. In

Contact

Shona Dobbie

Head of Research Centre

Alliance Trust PLC
8 West Marketgait, Dundee DD1 1QN

Tel +44 (0)1382 321000

Fax +44 (0)1382 321185

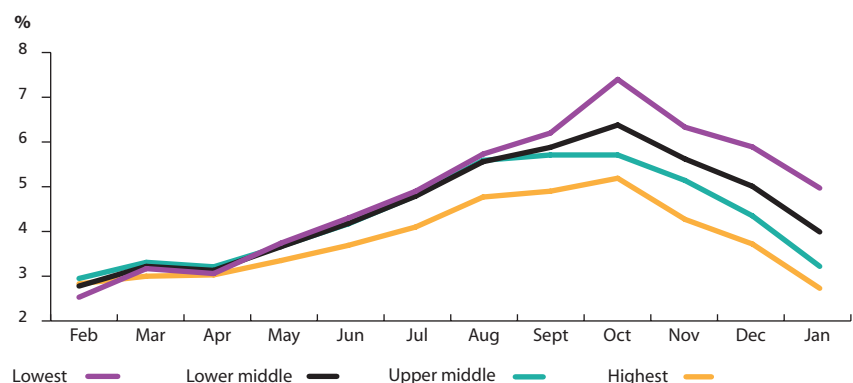
Email contact@alliancetrust.co.uk

Web www.alliancetrust.co.uk

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Alliance Trust income-related inflation rates



December 2008, the gap between the lowest and highest income households was the greatest. The lower income households faced an inflation rate which was 82% higher than the highest income households. The lowest income households suffered the most during 2008 due to the fact that they allocate a higher proportion of their spending on food and housing costs where prices rose sharply.

Explaining the results – spending patterns and income

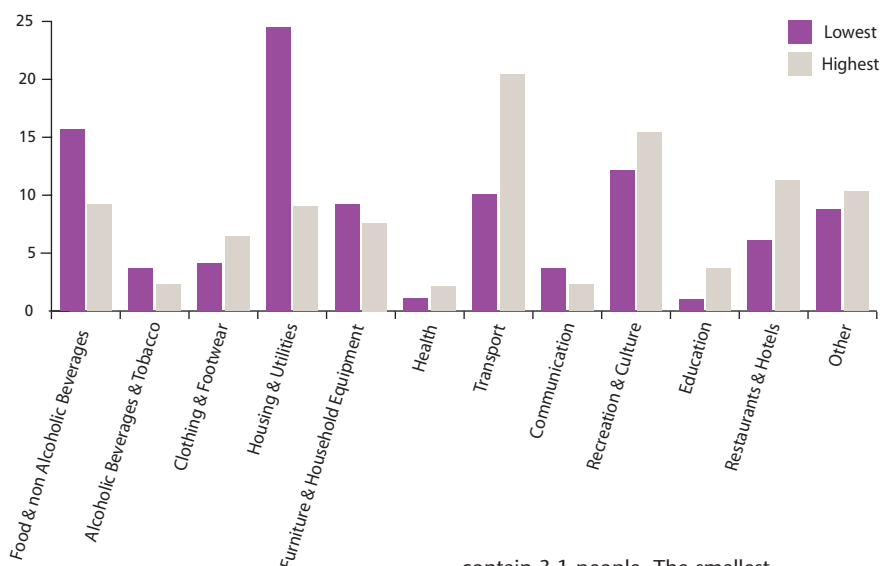
Our findings show that:

- 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 25% of spending is allocated to housing and utilities and a further 16% to food and beverages. Together, these categories of spending account for over 40% of all spending and 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 18% of the typical budget in this category of household. However, spending on recreation and culture is also relatively important, accounting for almost 15% of the total.
- Upper middle households allocate the biggest share of their spending to transport. On average, this category of spending accounts for more than 16% of the spending budget of these households, compared to just 10% in the case of the lowest income group of households. This group of households also allocate a relatively high share of spending to recreation and culture, at 16%.
- The highest income households allocate over 20% of their typical spending to transport, making this the largest category of their spending. This is twice the proportion of spending that the lowest income group allocates to transport. This category of spending has experienced elevated inflation as the oil price reached a record high in 2008, pushing up fuel costs. Recreation and culture is also a major area of

spending for the highest income group, accounting for over 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 just 9% of total expenditure, which is less than half the share allocated by the lowest income households. Spending on food and beverages accounts for just over 9% of the total compared with almost 16% in the case of the lowest income households.

- The highest income households also allocate over 6% of their spending to clothing and footwear compared with the lowest income households which allocate just 4% to this category. Clothing and footwear prices continued to fall throughout 2008.

Breakdown of Spending



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. 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 2008 and CPI reports for each month between January and December 2008.

Breakdown of Spending

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 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 3.1 people. The smallest households are those with the lowest incomes and on average these households contain just 1.2 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 2008, Consumer Price Indices (ONS), In-house analysis.