

# Inflation and Income

April 2011



This annual update of the relationship between inflation and income by Alliance Trust Research Centre focuses on 2010. The results show that:

- In 2010, higher income households experienced the highest rate of inflation. On average, households on income levels of more than £70,000 faced an inflation rate of 4.5%, which was 36% higher than the headline rate of inflation.
- In 2010, higher income households faced an inflation rate which was 32% higher than the inflation rate experienced by the lowest income households and 13% higher than the inflation rate of the lower middle income households.
- Despite the highest income households facing the highest rate of inflation throughout 2010, their inflation rate actually fell from 5.1% in January 2010 to 4.4% in December, a fall of 14%.
- The lowest income households had the lowest rate of inflation in 2010. Their inflation rate averaged 3.4%. This is in sharp contrast to 2009 when they faced the highest average rate of inflation.

## Our conclusion – it was the higher income households which were hit hardest by inflation in 2010

The Alliance Trust Research Centre has updated research looking at the relationship between income and inflation, focusing on trends which were present in 2010. 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 £8,200, 'lower middle' on an average income of £18,900, 'upper

middle' on an average of £37,500 and the 'highest' on income of more than £70,000.

## Alliance Trust income-related inflation rates

Our results highlight that households with different incomes face varying rates of inflation. Throughout 2010 the highest income households consistently faced the highest rate of inflation. The average rate of inflation faced by these households was 4.5%, a figure 36% higher than the headline inflation rate. The highest income households started the year with an inflation rate of 5.1% which was almost 55% higher than the inflation rate being experienced by

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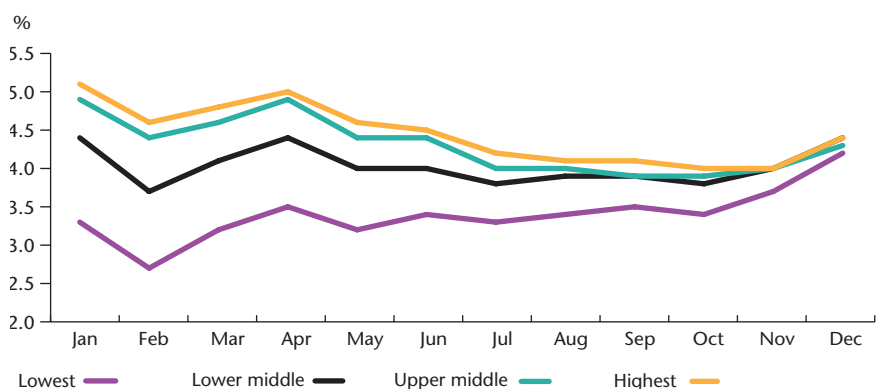
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## Alliance Trust income-related inflation rates (2010)



the lowest income households. At the end of 2010, however, the gap between the two had lessened significantly and the highest income households faced an inflation rate just 5% higher than the lowest income households.

### Explaining the results – spending patterns and income

#### Our findings show that:

- In high income households, the largest proportion of spending is allocated to recreation & culture and transport. Typically, more than 17% of spending is allocated to recreation and culture which includes spending on package holidays and sports admissions. A further 16% is allotted to transport, a category which experienced high inflation, particularly in the first half of 2010, due to high petrol price inflation.
- High income households allocate the smallest share of spending to food and non-alcoholic beverages, just over 10%. This makes them less vulnerable to higher food prices. Inflation in this category increased from 1.9% in January 2010 to 6.1% in December, hitting the other households harder as they allocate a larger proportion of spending to such goods.
- Upper middle income households allocate the majority of their spending to transport which accounts for over 16% of their budget. However, spending on recreation and culture is also relatively important, accounting for just under 16% of the total.
- Lower middle income households allocate the biggest share of their spending to housing and utilities. On average, this category accounts for over 20% of the spending budget of these households, compared to less than 10% in the case of the highest income households. This group of households also allocates a relatively high share of spending to food and non-alcoholic beverages, at 15%.
- The lowest income households allocate almost 26% of their typical spending to housing and utilities. This is more than twice the proportion that the highest income group allocates to this category. Food and non-alcoholic beverages are also a major area of spending for this group, accounting for almost 18% of total expenditure. This highlights how exposed the lowest income households

are to higher basic goods price inflation. Towards the end of 2010 food price inflation began rising, hitting the lowest income households the hardest.

- The lowest income households have little disposable income to spend on discretionary goods, such as clothing and footwear. They allocate just 4% of their spending to this category. In the past this helped to offset higher prices elsewhere to a certain degree. However in September 2010, clothing and footwear inflation turned positive for the first time since 1992, acting as another force pushing their inflation rate higher.

### 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 2010 and CPI reports for each month between January and December 2010.

### 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 1.3 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. 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 2010, Consumer Price Indices (ONS), In-house analysis.

### Breakdown of Spending

