BEST PRACTICE

Inflationary Indices in Budgeting (2010) (BUDGET) (CCI) (new)

Background. Governments are under considerable pressure to relate their spending and taxation levels to cost inflation, yet each local government's experience with inflation can differ greatly from a national average. Local governments would benefit from having a well-constructed index of the changing costs of providing municipal services, but few governments have attempted to build and effectively use such a measure. This best practice reviews some of the options available for creating a municipal price index, and for dealing with some of the problems inherent in developing a cost index.

Once inflation measures have been selected, governments need to revisit these measures for accuracy, while maintaining transparency in their communications about which measures were used. Even if local governments can identify an index that is a good predictor of expenditures, they may not be able to use it due to legislative or other contractual requirements forcing use of the CPI.

There are many different inflation measures and indices. While this best practice covers some of the major indices, there may be sound and supportable means to develop specific indices based on weightings of expenditures by the local government. Because the factors underlying inflation can change rapidly an inflation rate that is reported today may not be the best figure to use to determine inflation for the upcoming budget year. Budget practitioners are encouraged to monitor both monthly inflation trends and available forecasts for the upcoming year and include an analysis of historical information when determining trends.

Recommendation. The Government Finance Officers Association (GFOA) encourages every government to consider using the inflation indices that work best as a predictor. This may mean the use of different indices depending on the expenditure category. The government should define the purpose for using an inflationary index and then select the appropriate index.

Inflation Indices. Although no measure is perfect, the most widely applied is the Consumer Price Index (CPI). Given its pervasive use in setting cost-of-living adjustments (COLAs), it can be the appropriate metric when calculating the rate of consumer inflation at the national level. The CPI measures the price changes for common household purchases. It focuses on expenditures for food, shelter, clothing and footwear, household operations and furnishings. Some other common price indices are listed below:

The Producer's Price Index (PPI) measures the price changes of commodities at different stages of processing.

The Gross Domestic Product (GDP) deflator, mostly used in national accounts, is designed to reflect current expenditure patterns in an economy, and therefore focuses on new domestically produced final goods and services.

The Construction Price Index (CPI), used by the U.S. Department of Commerce, reflects the changes in the cost of construction materials and skilled and unskilled labor. It is a composite derived from separate indices for construction of commercial facilities, residential housing, utilities, highways and general construction, as well as many other construction contract indices. Statistics Canada has developed a similar index for non-residential building construction.

The Education Price Index (EPI) for elementary and secondary school spending, also developed by Statistics Canada, compares current salary grids for teachers with a base year, and uses selected sub-indices from the CPI and the Industry Product Price Index as proxies for price increases for non-salary items purchased by school boards.

The Employment Cost Index (ECI) details the changes in the costs of labor for businesses in the United States. This index, readily available each quarter, is used to monitor inflation by measuring changes in labor costs for wages and salaries. Information is provided by the U.S. Bureau of Labor Statistics.

The Personal Consumption Expenditure (PCE) index measures how much it costs to buy a constantly evolving basket of consumer goods. It covers spending by rural and urban consumers; non-profit institutions that serve consumers; medical care and insurance funded by government and employers; and imputed financial services. The relative weights assigned to each of the detailed item prices in the CPI and in the PCE price index are based on different data sources. The relative weights used in the CPI are based primarily on household surveys, while the relative weights used in the PCE price index are based primarily on business surveys.

The Municipal Cost Index (MCI), published by the American City and County magazine since 1978, estimates the rate of inflation for purchases by American municipalities. The MCI is a composite index, a weighted average of more detailed price indices measuring consumer price cost fluctuations (using the CPI), industrial commodity wholesale prices (using the PPI), and construction contract costs (using the Construction Price Index).

Potential Flaws in Inflationary Indices. Governments need to be aware that regional differences exist in inflation measures, so the use of a “national measure” should be treated with caution. Regional factors may affect items such as salary inflation, for example, due to the local unemployment rate.

Healthcare benefits are usually the largest dollar component of the overall benefit category within governmental budgets. Inflation in this category has traditionally run much higher than the CPI rate.

Alternatives to Using Indices to Measure the Budgetary Impact of Inflation. While many indices track inflation, a government can use other methods to forecast or budget the impact of inflation:

- Economic consultants may be engaged to forecast inflation. Larger governments tend to hire economic consultants more often than smaller governments. Although the consultant may provide expert and unbiased opinion, there is still a cost associated with using a consultant which needs to be considered.
- Local universities or the state may provide inflation forecasts.
- Peer governments may be contacted to determine which inflation measures they have used successfully.
- Peer governments may wish to work together to create indices for their governments.
- Specific information on expenditure forecasts can be gathered from discussions with vendors.
- Existing contracts may contain a specific inflation clause or escalators.
- Governments may seek out relevant measures themselves, perhaps through industry-specific journals. There is a time factor involved with doing your own research.

References.

- Consumer Price Index: http://www.bls.gov/CPI
- Employment Cost Index: http://www.bls.gov/eci
- ENR Construction Index: http://enr.construction.com/economics/default.asp
- Gross Domestic Price Deflator: http://www.bea.gov
- Municipal Cost Index: http://americancityandcounty.com/mciarchive/marketbasket
- Personal Consumption Expenditure: http://www.bea.gov
- Statistics Canada: http://www.statcan.gc.ca/start-debut-eng.html

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