

The impact in 2012-13 of the change to indexation policy

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1. Introduction¹

The inflation figures for September 2011 released this week by the Office for National Statistics (ONS) are important, because they affect how the tax and benefit system will look in 2012–13. Most parameters of the personal tax and benefit system – such as income tax thresholds and benefit amounts – and public sector pensions are typically increased each April in line with the rate of annual inflation measured in the previous September².

These indexation policies matter a lot. They affect changes in indexed parameters every year, so the effects of indexation policy accumulate over time, and their impacts on the levels of (for example) benefits can soon become very large.

In its first Budget last year, the coalition Government announced that it would be changing the measure of inflation used for the indexation of state benefit and tax credit parameters and public sector pensions. From April 2011, they would rise annually in line with the Consumer Prices Index (CPI), whereas they had previously risen in line with either the Retail Prices Index (RPI) or a derivative of the RPI known as the Rossi index (the same as the RPI except that it excludes council tax, mortgage interest and rent). Then, in the Budget of 2011, the Government announced that from April 2012 personal tax thresholds would also be increased in line with CPI inflation, rather than RPI inflation as previously³.

CPI inflation has tended to be lower than both RPI inflation and Rossi inflation (with Rossi inflation tending to be lower than RPI inflation). If this were to

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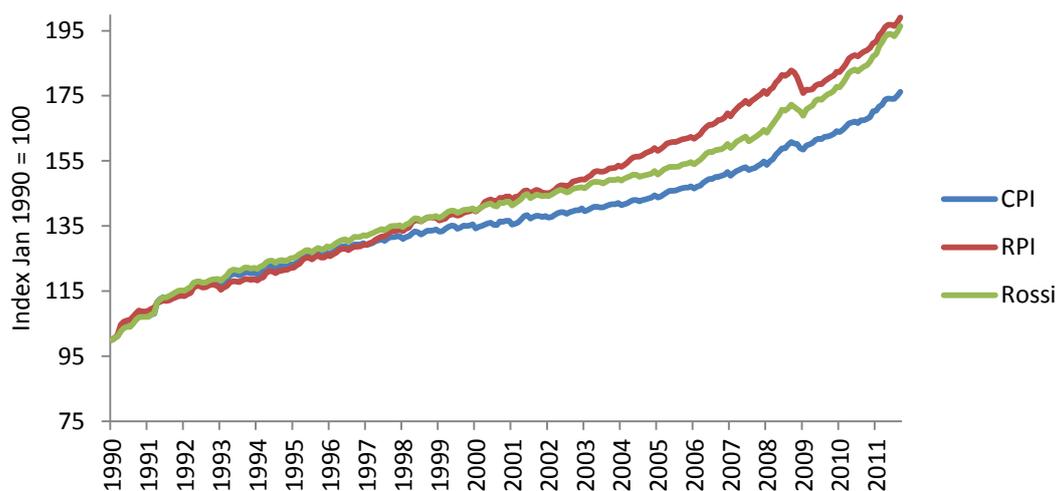
² A small number of parameters are typically frozen in cash terms, so in the absence of discretionary policy changes their real value tends to decline. Examples are Winter Fuel Payments; the family element of the Child Tax Credit; and the £150,000 per year threshold above which the 50% marginal rate of income tax applies.

³ Note that this change does not apply to the employer National Insurance threshold, the starting rate limit of savings income, income tax age related allowances, age-related income limits or the married couples allowance.

continue, benefits and personal tax thresholds would rise more slowly than they have in the past. Figure 1 shows how the RPI, CPI and the Rossi index have evolved since 1990. Over that period, the RPI has increased by an average of 3.3% per year; the Rossi has increased by an average of 3.2% per year; and the CPI by 2.7%. This implies that a benefit would be about 12% lower in 2012 had it been CPI-uprated rather than RPI-uprated since 1990.

Note that annual average rates of inflation mask variation over time: in some years (most recently 2009), RPI inflation has been lower than CPI inflation; and at other times, including very recently, RPI inflation has been considerably more than 0.6 percentage points greater than CPI inflation. But because the CPI tends to rise more slowly than both the RPI and Rossi, the switch to CPI indexation is expected to save the Government money in the long run, by reducing nominal increases in benefit payments and by increasing the revenue raised from ‘fiscal drag’ as personal tax thresholds are raised less quickly (and people thus become liable to pay higher marginal rates of tax over larger ranges of income than they would otherwise have done).

Figure 1. The RPI, CPI and Rossi indices, 1990-2010



2. The distributional impact in 2012–13 of the change to indexation rules

In the first two years of the new indexation regime, the relevant rates of inflation were 4.6% and 5.6% for the RPI, 4.8% and 6.8% for the Rossi index, and 3.1% and 5.2% for the CPI. As a result, benefits that were formerly indexed to the RPI and the Rossi will be about 1.8% and 3.1% lower respectively in 2012–13 as a result of the switch to CPI indexation, in the absence of other policy changes in relation to those benefits. For example, the rate of Jobseeker’s Allowance for a single person in 2012–13 will be £71.00 per week; were it still indexed to the Rossi, as previously, it would be £73.25 per week. As explained above, the size of this effect will compound indefinitely over time. Note that the size of the differential between Rossi inflation and CPI inflation during the first two years

since the indexation switch has been particularly large by recent historical standards (see previous section); the differential between RPI inflation and CPI inflation was large in September 2010 at 1.5 percentage points, but closer to its recent historical average in September 2011 at 0.4 percentage points.

The Treasury estimated that the switch to CPI indexation for benefits, tax credits and public sector pensions would save about £1.1 billion in 2011–12 and £2.2 billion in 2012–13. The switch to CPI indexation for personal tax thresholds from 2012–13 will affect only National Insurance thresholds in the first year, because other policies had already been pre-announced relating to income tax thresholds in 2012–13 (the personal income tax allowance is being raised by £630; the higher rate income tax threshold is being frozen; and the additional income tax rate threshold is by default frozen in any case). This switch is thus only expected to raise £0.1 billion in 2012–13. The revenue raised by the switch to CPI indexation will grow over time, as year-on-year increases in benefits, public sector pensions and tax thresholds will in general be lower than they would have been under the previous indexation rules⁴.

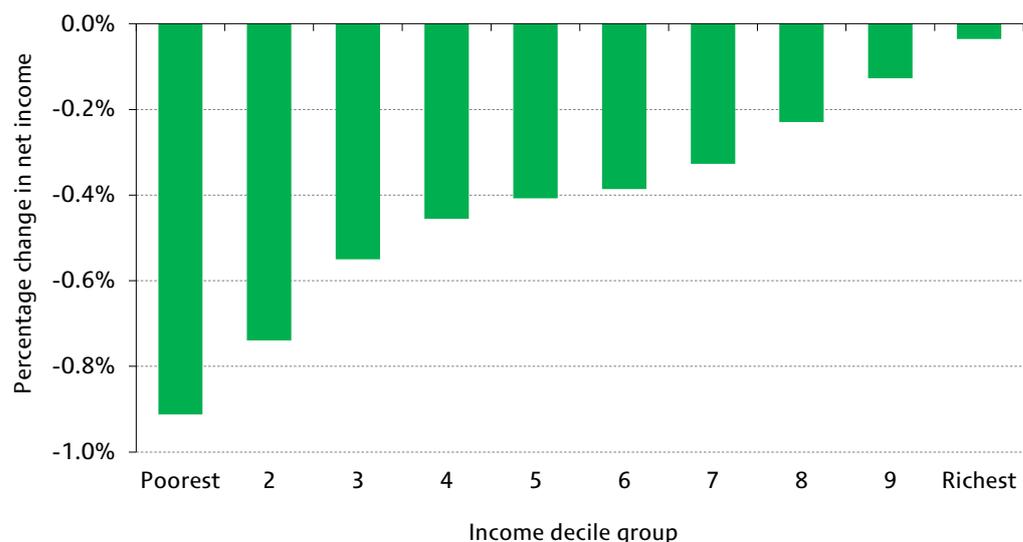
We now have the inflation figures that will be used for indexation in April 2012. Figure 2 shows the distributional impact up to 2012–13 of the changes to the indexation rules. Unsurprisingly, since much of the revenue raised by the indexation switch comes from savings in benefits and tax credits which are disproportionately received by those on low incomes, the effect of the indexation switch hits those on lower incomes harder as a proportion of income. This pattern is reinforced over this particular period by the fact that the slower uprating of personal tax thresholds – which will tend to hit those further up the income distribution by increasing ‘fiscal drag’ – will not affect income tax thresholds until after 2012–13, and it will begin to affect National Insurance thresholds only in 2012–13 (rather than 2011–12, as for benefits, tax credits and public sector pensions). In addition, as mentioned earlier, the difference between RPI inflation and CPI inflation has recently been quite large by recent historical standards, and this acts to increase the impact of the indexation change. On the other hand, the effect of the indexation switch for benefits in these first two years is made smaller by the fact that various benefits are – as a result of other policy announcements – being frozen or cut anyway, and are therefore unaffected by the default indexation rules over this period⁵.

⁴ In isolation, raising the Upper Earnings Limit for National Insurance more slowly will actually cost the Government money, because the marginal rate of National Insurance falls (currently from 12% to 2%) once this limit is passed. Hence, the policy change means that employees pay the higher marginal rate of National Insurance over a smaller range of income than they would otherwise have done. But this is easily offset by the revenue-raising impacts of increasing other personal tax thresholds, and benefits and tax credits, more slowly.

⁵ Note that, in the Treasury’s estimate of the revenue raised by the indexation switch (given in the 2010 Budget), it assumed that the indexation switch was the first benefit reform introduced, and then costed other policy changes given the indexation switch. This order in which reforms are assessed does matter. For example, its estimate of the revenue raised in 2011–12 from the switch to CPI-indexation includes the ‘effect’ of

The Figure shows that the magnitude of the impact of this change has so far been small – the bottom income decile group, who are the most affected group as a percentage of income, lose less than one per cent of their net income on average. However, the effects will accumulate over time as the CPI grows less quickly than the indices that were previously used for indexation (see above). Note that Figure 2 does not include the impact of the switch to CPI-indexation for public sector pensions, since they cannot be separately identified from other pensions in the data underlying this analysis.

Figure 2. The Distributional Impact in 2012–13 of Changes to Default Indexation Rules since April 2011



Notes: Income decile groups are derived by dividing all households into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth. The impact of the switch to CPI-indexation for public sector pensions cannot be modelled.
Sources: Authors' calculations using Family Resources Survey 2008–09 and TAXBEN.

Over this particular period, it is worth noting that those further up the income distribution, who rely predominantly on earnings for their income, have also seen their primary income source grow less quickly than RPI (or Rossi) inflation. The Office for Budget Responsibility (2011) expects annual growth in average earnings to be 2.0% and 2.2% in 2011 and 2012 respectively, compared with 5.1% and 3.6% for the RPI and 4.2% and 2.5% for the CPI. Hence, default rises in benefits have continued to at least match rises in average earnings since the indexation switch (although there have also been various other discretionary cuts to benefits and tax credits over this period). However, this is a peculiarity of the present period: in the longer term, we would expect earnings to grow more

updating Child Benefit more slowly, even though in a separate reform (which was costed after the indexation switch) it chose to freeze Child Benefit in cash terms. In this particular context, where we are specifically interested in the change to indexation, it makes sense to take the rest of the policy environment as given and *then* assess the indexation switch. In other words, in the distributional analysis here we treat the indexation switch as though it were the last policy introduced.

quickly than prices once again. The difference between the rates that benefits and earnings increase will then tend to widen the gap between the incomes of benefit recipients and the rest, as has happened historically, and this will be exacerbated by the change to the indexation rules for benefits.

The impact of the changes on pensioners deserves a little more elaboration. From 2011–12, a so-called ‘triple lock’ was introduced for the indexation of the Basic State Pension: it will always rise by the higher of inflation, average earnings growth, or 2.5%. A change to the measure of inflation used is therefore only relevant for the uprating of the Basic State Pension if either CPI or RPI inflation is higher than both average earnings growth and 2.5%. Historically earnings have tended to grow more quickly than both the RPI and the CPI. Hence the ‘triple lock’ should mean that, in the long run, the impact of the indexation switch on the Basic State Pension is relatively small⁶. However, the current period is unusual in that inflation is higher than both average earnings growth and 2.5%. Therefore, the Basic State Pension will be lower in 2012–13 than it would have been if the measure of inflation used were still based on the RPI rather than the CPI. (This was not the case in 2011–12, as the Basic State Pension was protected from the change in the measure of inflation used for one year.) In the long run pensioners should still gain significantly from the introduction of the triple lock: they just will not gain by *as much* as they would have done if the measure of inflation used had not changed.

Given the importance of indexation policy in determining the future shape of the tax and benefit system, it would be helpful for the Government to set out its thinking on such policy systematically. Why should the Basic State Pension rise at a different rate to working-age benefits? Why should it rise at a different rate to public sector pensions? Why should the employer’s National Insurance threshold rise at a different rate to the employee’s National Insurance threshold? It is important to realise that these questions are separate from the issue of how generous the tax and benefit system should be to particular groups. Justifications for indexation rules should relate to the way in which the generosity of the tax and benefit system to particular groups should *change over time*. For example, if one thought that the Basic State Pension should be higher, this is an argument for raising the level of the Basic State Pension. It is not, in itself, a good argument for increasing it at a *faster rate* year-on-year.

⁶ By contrast, the switch to CPI-indexation for public sector pensions will affect the increase in the value of those pensions whenever CPI inflation and RPI inflation are different.