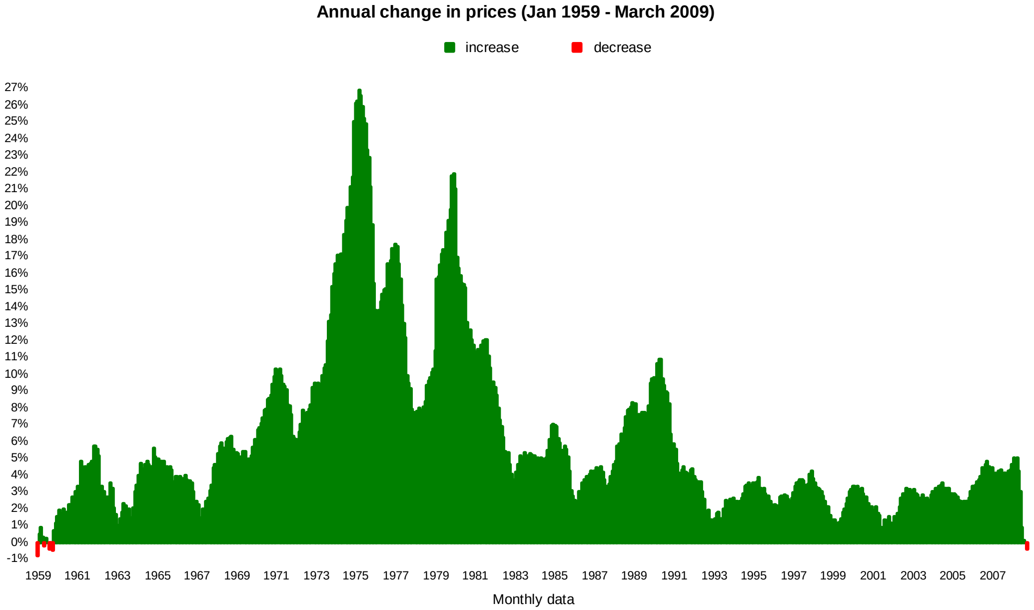
IV What happens when prices fall?

Inflation measured by the Retail Prices Index went negative in March 2009 for the fist time since 1960, largely as a result of falling mortgage interest costs and house prices.



It is likely that the annual change in the RPI will continue to be negative for much of the remainder of 2009. In the April 2009 Budget it is predicted that the 2009 September RPI will be a -3.0% change on a year earlier. By convention the September RPI is used to assess that appropriate factor for the uprating of state pensions and social security benefits in the following year. The RPI is also used for a variety of other purposes. This article looks at a range of policy areas and considers what the impact of negative inflation is likely to be.

State pensions, benefits and tax thresholds

In the 2004 Budget, the Government committed to increase the basic state pension by at least 2.5% a year, even if the change in the September RPI is less than this. This intention was confirmed in the 2008 Pre-budget Report and the 2009 Budget, so that the basic state pension would rise by 2.5% in April 2010. Other RPI-linked benefits would be kept constant in cash terms. In future years, when the change in the RPI is expected to be positive, state pensions and benefits would be uprated from their 2010-11 levels in the usual way, retaining any real terms gains.

The September RPI is also used to index income tax, tax credits and national insurance allowances, thresholds and limits. These will be treated in the same way as RPI-linked benefits, held constant in cash terms and subsequently uprated from that level in line with standard indexation in future years.

Public service pensions

The pensions paid to former public sector employees, teachers, NHS staff, civil servants etc are conventionally uprated in line with the annual change in the September RPI. There had been speculation that these pensions might be reduced if the annual RPI change was negative. Such a move would, however, require legislation and the Treasury has said there are no plans to change the law in this area.[i]

Non-state pensions and annuities

Annuities (which are often used to convert a pension lump sum into retirement income) can be bought on the basis of being linked to the RPI. The aim of this is to maintain the real value of income as the cost of living rises. What happens if the RPI falls will depend on the terms of the annuity contract and policy of the annuity provider. Some index linked annuities have a "floor" to protect planholders if inflation turns negative. Others do not, and in these cases it is possible that annuity incomes will fall if the RPI change is negative in the relevant month.

It is considered unlikely that pensions in payment from occupational schemes can be reduced (the law does not in any case permit reductions in pensions based on service from April 1997). Most company pensions are likely to be frozen in the event of prices falling. There has, however, been speculation that one year's deflation could be used to offset pension increases in a future year, when prices could be rising quickly.[ii]

Rail fares

Since January 2004 annual rises in regulated fares have been limited to RPI+1%. This is assessed annually against the change in the July RPI. Transport Minister Lord Adonis has announced that the formula will remain in place and that if RPI is significantly negative in July 2009 "it is the Government's intention to allow regulated fares to fall". Addressing the House of Commons Transport Committee, Lord Adonis confirmed that the Government's view was that this could mean a fall in prices, not merely a freeze in fares, if the RPI change were to be less than -1% in July 2009.[iii]

Student loans

Interest on income contingent student loans matches whichever is the lower of 1% above the highest of the high street bank's base rates base rates, or the March RPI. If the RPI is used the rate is applied later in the year from September. Interest rates on pre-1998 student loans have to track the RPI even if it turns negative. DIUS and HM Treasury are reviewing the position for loans after that date.

Business rates

Under existing legislation business rates are adjusted every April in line with the Retail Prices Index for the previous September. This meant a 5% increase in April 2009 followed by a likely decrease in the following year. The Government has announced that regulations would be brought in to allow businesses in England to spread payment of their 2009-10 increases in business rates bills over the three years to 2011-12. As a result, businesses will be able to pay a 2% annual increase in 2009-10 and the remaining 3% over the following two years.[iv]

Index Linked Gilts and Savings

National Savings Index linked savings certificates (once known as "granny bonds") have an interest rate that is related to the RPI. A negative inflation rate could therefore affect their value, however, the certificates will not fall below the value paid initially or, if higher, the preceding anniversary value.

Index linked gilts are adjusted for inflation measured by the retail prices index (RPI) over their lifetime. In the case of year on year price falls the value of such gilts would be eroded. However, one year's negative inflation would have a small impact over the whole term for particular gilt.

Rents

Potentially another area that could be affected by a decrease in the RPI is rents. There will, for example be some private sector tenancy agreements where the RPI is a factor. Here (and in other areas determined by a contract), the exact impact could depend on the precise terms of the contract. The RPI also forms part of the formula for determining rents in the social housing sector – the implications for 2010-11 of a September 2009 RPI link are currently being discussed.

Richard Cracknell xt 4632

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[i] Financial times 28 March 2009 *Public sector pension cut ruled out*
[ii] Professional Pensions 25 March 2009 *Watson Wyatt warns over impact of negative inflation on schemes*
[iii] Evidence to House of Commons Transport Committee 25.2.2009 (HC 233-ii)
[iv] http://www.hm-treasury.gov.uk/press_33_09.htm