III The CPI – uprating benefits and pensions

In its June 2010 Budget the Coalition Government announced that the Retail Prices Index (RPI) would no longer be used to determine the increase in benefits and state pensions. Instead the Consumer Prices Index (CPI) would be used to uprate benefits, and state pensions, including public service pensions. Subsequently, the Government announced that the CPI would be used to provide the statutory minimum revaluation and indexation for occupational pensions.

The move to the CPI results in an Exchequer saving of £1.2 billion in 2011/12 and this increases each year to £5.8 billion by 2014/15.

CPI, RPI and Rossi

The CPI is the main UK measure of inflation for macroeconomic policy and has been the basis for the Government's inflation target since December 2003. The CPI is also consistent with the EU standard Harmonised Index of Consumer Prices (HICP).

However, the RPI has continued to be used for the purpose of uprating many benefits, pensions and pay deals, while the Rossi index (the RPI excluding rent, mortgage interest payments, council tax and depreciation costs) has been used for means tested benefits.

The CPI and RPI are both consumer price indices and the calculation of each uses much of the same basic price data. There are, however, some major differences:

- The CPI **excludes** some goods and services included in the RPI. Some housing costs, including mortgage interest payments and council tax but not utility bills, are excluded from the CPI and account for much of the difference between the indices.

- The CPI **includes** some costs that are not in the RPI, such as charges for financial services and university accommodation fees.

- The CPI covers a **broader population** than the RPI, which excludes high-income households and low-income pensioners.

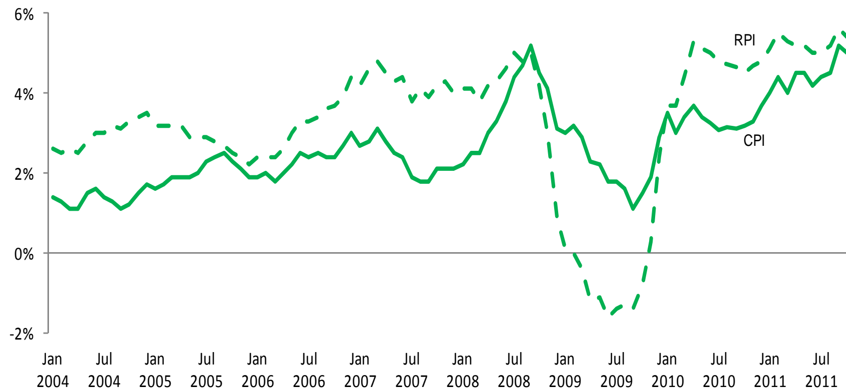
- There are differences in **the way the RPI and CPI are calculated**. The method used for the CPI (geometric means) will show smaller changes than that used for the RPI (arithmetic means), for a given set of data. The CPI formula allows for the fact that when the price of a particular good rises consumers are likely to react by buying and substituting with another product. If, for example, the cost of pasta rises, consumers might respond to this by substituting, say, rice for pasta. The RPI reflects increases in the cost of living on the assumption that consumers continue to buy the same quantities, in the short term at least, irrespective of price changes.

The Rossi Index is an RPI-style price index that excludes housing costs and for this reason it more closely tracks changes in the CPI than the all-items RPI. However, like the RPI the Rossi index is calculated using arithmetic means and it therefore will still show larger changes for a given set of data than the CPI.

CPI and RPI increases

The CPI inflation rate exceeded the more volatile RPI for 16 months during the 2009/10 economic crisis. However, in general, inflation as measured by the CPI tends to be lower than that measured by both the RPI and Rossi index:

Annual change in RPI and CPI (Jan 2004 to Oct 2011)

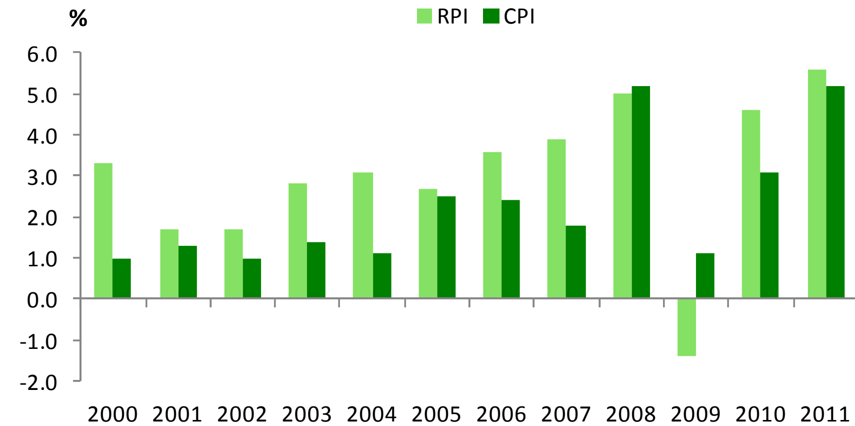


In terms of past experience of uprating, the RPI and CPI factors that could have been used in recent years are shown below:

RPI and CPI September increase 2000 to 2011
% change over 12 months

Sept	RPI	CPI	Higher
2000	3.3	1.0	RPI
2001	1.7	1.3	RPI
2002	1.7	1.0	RPI
2003	2.8	1.4	RPI
2004	3.1	1.1	RPI
2005	2.7	2.5	RPI
2006	3.6	2.4	RPI
2007	3.9	1.8	RPI
2008	5.0	5.2	CPI
2009	-1.4	1.1	CPI
2010	4.6	3.1	RPI
2011	5.6	5.2	RPI

Annual change in RPI and CPI to September (2000 to 2011)



Changes in the RPI and CPI follow largely similar patterns. However since 2000 in all but two years (2008 and particularly 2009, when mortgage interest rate falls pushed the RPI down) would the RPI have produced a higher uprating than the CPI.

Future factors

The factors in 2011 which could form the basis for the uprating in 2012 are based on measure of inflation in the year to September 2011. The CPI increase was **5.2%,** over the same period the RPI increased by 5.6%.

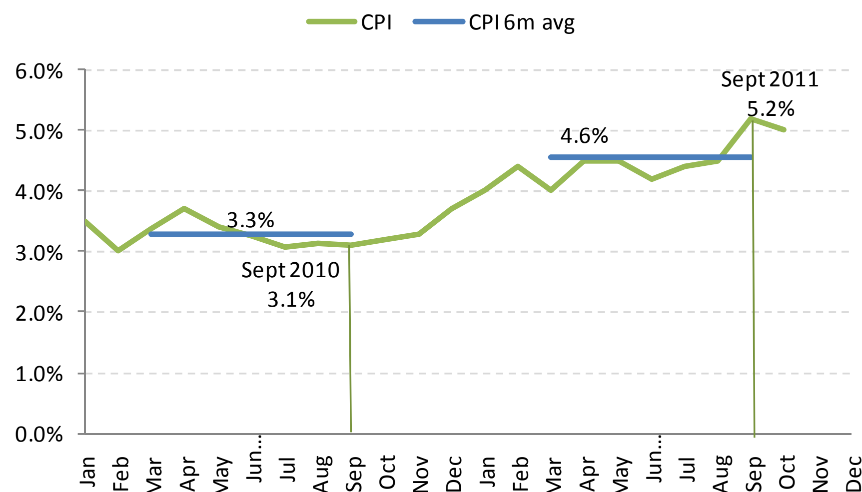
It has been suggested that the Government may use an alternative inflation measure; possibly the average CPI increase in the 6 months to September 2011, which would give an increase of 4.6%. Another alternative would be the increase in average earnings which increased by **2.9%** in the 3 months ended in July 2011.

In September 2011 the CPI increase was 5.2% on a year earlier. This is 0.6% points higher than the average annual increase for the 6 months to

September 2011. In 2010, the September CPI increase was 3.1%; 0.2% points lower than the average CPI increase of 3.3% for 6 months to September 2010.

Annual CPI increases and 6 month average increase to September

(Jan 2010 to Oct 2011)



Occupational pensions

Index-linked public service pensions also changed from being increased in line with the RPI to the CPI, from April 2011. The formal link for public service pensions is with the increase in the additional state pension. The minimum indexation requirements for revaluation and indexation of occupational pensions is also in line with the CPI. In many cases, however, pension scheme rules provide specifically for indexation to be in line with the RPI and these are not over-ridden by the change to the CPI as a minimum requirement.

Long term effects

While in a single year the change to the CPI makes only a small difference in the amount of additional benefit or pension that is paid to an individual, the effects cumulate over time. This is particularly important in the case of pensions, which can be paid for many years and, in the case of occupational schemes may also contain elements of revalorisation over years of working life too.

While the increase in the RPI has typically exceeded that in the CPI by around 0.7% points in the past, because of changes in the way that the prices of footwear and clothing are measured early in 2011, the gap between the CPI and RPI may be up to 1% point in the future.

If the RPI exceeds the CPI by 1% point a year, after ten years the value of a payment uprated by the CPI would be around 91% of what it would have been under RPI uprating; after 20 years, it would 83% and after 30 years 75%.

Further information

ONS' *Consumer Price Indices Technical Manual* provides a detailed explanation of how the RPI and CPI are compiled.[1]

IFS' *The distributional effect of tax and benefit reforms to be introduced between June 2010 and April 2014*[2] includes a discussion of the RPI/CPI differences and the appropriateness of the move to the CPI for uprating.

[1] Hhttp://www.statistics.gov.uk/statbase/product.asp?vlnk=2328H

[2] Hhttp://www.ifs.org.uk/publications/5246H (Oct 2010)

Richard Cracknell Nov 2011