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PRIME MINISTER

COMMUNITY CHARGE AND THE RPI

Paul has left you a valedictory note on economic policy. I think he has analysed the origins of current problems very clearly and I agree also with his views on the future.

I would particularly like to endorse what he says about trying at this stage to change the basis of the RPI. I do not believe you can succeed in trying to change people's perception of inflation by this initiative and I believe you will attract a great deal of discredit if you try.

First, some technical points. There are two separate issues on the community charge and the RPI.

(i) should the community charge have been treated as a direct tax and hence outside the index? I believe strongly that it should. Indeed in compiling the national income accounts that is precisely what is done. This has caused some problems, for example, in calculating the public spending/national income ratios as the switch to treatment has reduced the denominator and hence increased the ratio. It is odd, to say no more, that we are suffering the disbenefit of this while suffering the penalty of the opposite treatment in the RPI - heads we lose, tails we lose. But this decision was consciously taken by the Government because it did not want to risk problems with IG's. At the time we expected the charge to be £175 and inflation to be under 5 per cent. Had we known what we know now, our priorities would have been different.

(ii) should the rebate and reliefs be netted off? I believe that the CSO and Treasury are right on this. Their criteria are that when a subsidy is paid selectively and financed by a third party, ie central government, it should be treated as an income support not a price reduction. The community charge reliefs fit these criteria. Also the RPI is an index of prices not a cost of living index. The gross community charge is the price, since it represents what the authority gets by one means or another from the chargepayers. NO To enter the net price, or the cost to the chargepayer, is to measure the effect on the cost of living. One effect of doing that would be to weaken the case for excluding mortgage interest. Our objection to its inclusion is that it is not a price but we cannot deny it is an element in the cost of living. Another feature of your proposal is that you adopt the net approach for community charge but not, say, for rents.

On technical grounds, therefore, there is a case for taking the community charge right out but not for a different treatment of the reliefs.

However, my main worry is the presentational case. Now that the 8.1 per cent for March has been published, commentators will be revising their estimates for April to close to 10 per cent. If you subsequently change the basis, you will not succeed in preventing, in people's minds, the occurrance of 10 per cent inflation. The overwhelming impression will be that inflation has really got to 10 per cent but the Government has changed the rules to overturn the verdict. The Government will look as if it cannot come to terms with what has happened and is wishing the problem away. The fact that it is being done instantly, with no consultation, will make it difficult to convince people that the change is based on a sound case rather being born out of expediency.

Hitherto, there have been statistical arguments about the RPI, but, unlike the unemployment figures, it has not encountered political controversy. This would now occur. Legal battles from IG holders and those representing social security recipients will follow.

Finally, I believe the tactics are wrong. If I am right in thinking that it is too late to change the perception that inflation has really reached 10 per cent, you will incur the odium of having tried to change the figure, but lose the benefit next year as the one-off effects unwind.

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On these arguments we can NEVER change the composition of the RPI. But the fact is that they did in 1986? Why?

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ANDREW TURNBULL

11 April 1990

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