FROM: P N SEDGWICK
DATE: 15 JANUARY 1988

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Dame A Mueller
Mr Kemp
Mr Scholar
Mr Culpin
Mr Hawtin
Mr C W Kelly
Mr Odling-Smee
Mr Peretz
Miss Peirson
Mr Turnbull
Mr Hibberd
Mr Potter
Mr Cropper

Cx
OK — or should Sedgwick have a steer to argue explicitly for 5(iii)(b)?
AA

A lamentably shoddy note from DE. Mr S should certainly be steered to argue for 5(iii)(b). To go for (c) would be wholly contrary to existing RPI methodology & I could not accept it unless income tax, NIC, was included in the RPI — thus enabling us to junk the RPI & TPI. N.

SEDGWICK → CHEX 15/1

THE TREATMENT OF THE COMMUNITY CHARGE IN THE RPI

I have received a copy of a DE note on the treatment of the Community Charge (CC) in the RPI (copy attached under cover of a letter to me from Ivor Manley of DE). The various options discussed in the DE note have different effects on the recorded RPI. The treatment of the CC in the RPI has widespread ramifications, for example on the uprating of benefits, pensions, tax allowances and IGs; and more generally on prospects for pay and the monitoring of economic performance. The treatment of the CC in the RPI is therefore a matter of potential political and market sensitivity.

2. The Department of Employment argue that in the past "no significant changes (to the RPI) in coverage or methodology" have been made without convening the RPI Advisory Committee (RPIAC). (I would be the HMT representative on the RPIAC.) Their own view is that the RPIAC should be convened, but they are in the first instance seeking views from some parts of central government. While the Secretary of State for Employment can disregard the advice of the RPIAC, in practice this has never happened. The presumption must be that if it met he would accept the advice of the majority.

3. If the RPIAC is to discuss the CC it would be necessary to convene it in time for it to have completed its deliberations before the introduction of the CC in Scotland next year. It has

tended to be a slow moving body in the past, hence DE's wish to decide soon whether to convene it.

4. I have to attend a meeting at DE on January 28 (originally planned at short notice for next Tuesday, but delayed at DOE's request) to discuss whether to convene the RPIAC. Sir P Middleton held a meeting yesterday to discuss our approach.

5. At the meeting the following approach was suggested.

(i) The government should, if at all possible, decide how it thinks that the CC should be treated in the RPI before deciding whether to summon the RPIAC. (This has not always been the approach in the past. When the treatment of mortgage interest payments in the RPI was discussed by the RPIAC the DE and Treasury had different views.)

(ii) Before the government reaches a view it needs more analysis on the arguments for and against the various options than the current DE paper provides, together with more figuring on the implications for RPI inflation of the possible approaches.

(iii) The DE paper (without much of the necessary figuring and analysis) discusses three options. These are:

(a) to exclude the CC from the RPI and let the rates component fall as rates are phased out; without a corresponding reduction in the weight for rates in the RPI having already taken place this would knock about ½ per cent off total RPI inflation in 1989 (when rates are abolished in Scotland) and 4 per cent off in 1990 (when rates are abolished in England and Wales):

(b) to exclude the CC from the RPI, but to reduce the weight given to rates; this reduction in the weight would occur in advance, in January of each year, when the RPI weights are customarily updated in line with the pattern of expenditure in the previous year.

Cont'd

(c) To include the CC in the RPI.

It was agreed that (a) was a non-starter even though DE claim that it was the option most in line with existing RPI methodology. It would for a time seriously damage the credibility of the RPI as a measure of general price inflation. It would make it difficult to decide both the basis on which to uprate social security benefits and pensions and the treatment of indexed gilts and national savings.

Effectively the choice is between the approaches outlined in (b) and (c). But we need much more analysis and figuring on the arguments for and the possible implications of these two approaches.

(iv) The treatment of the CC in the RPI is potentially a market and politically sensitive issue. There is a risk that the fact that we are considering how to treat the CC in the RPI will leak. The implications of the option that DE appear to favour - which would involve large negative effects on total RPI inflation - could be very newsworthy. If there is a leak the government would be under pressure to make various commitments; for example to give a general undertaking that no-one would be worse off as the result of the treatment of the CC in the RPI. It might be sensible to devise now, for use if there were premature disclosure, a form of words for public use describing the present discussions with the minimum hostages to fortune.

6. I would be grateful for your initial reactions before I attend the meeting January 28. In particular are you content for me to argue for the preparation of a fuller paper by DE, in conjunction with Treasury, and to oppose any convening of the RPIAC until we have assessed the additional analysis and figuring?

P.N.S

P N SEDGWICK

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I T Manley CB
Deputy Secretary

Mr P Sedgewick
HM Treasury
Parliament Street
London SW1

11 January 1988

Dear Sedgewick,

COMMUNITY CHARGES AND THE RETAIL PRICE INDEX

The proposed change from local authority rates to community charges raises the question of whether the latter should be included in the coverage of the retail prices index (as rates are now) or excluded (on the grounds that a community charge is a direct tax and therefore should not taken into the RPI). As you have a particular interest in this matter I should like to discuss with you how it might be resolved.

As you know the RPI is the responsibility of my Secretary of State. He is aware of the pending problem but has, as yet, taken no decision on how it should be handled: in particular, whether or not the RPI Advisory Committee should be reconvened to consider the issue. My purpose in talking with you is to take account of your views when advising my Secretary of State on the line he should take with colleagues.

If we seem likely to decide that the Community Charge should be excluded from the Index, a strong case can be made for consulting the Advisory Committee. We are not obliged to do so but past practice has been that no significant changes in coverage or methodology have been made without adopting this course. The public expectation would be that such a radical and potentially controversial change as the Community Charge would be put to the Committee and, therefore, the exclusion of the Charge without reference to the Committee would be unlikely to secure widespread public acceptability. I appreciate that the Community Charge is politically sensitive but I should expect to be able to restrict discussion by the Committee to its treatment in the RPI rather than focus on the Charge in its own right.

Nevertheless, given the sensitivity of the Community Charge I wish to have your views on the implications of putting even that limited issue to the broadly based Advisory Committee.

I attach a background note outlining the issues which the Advisory Commitee would, if reconvened need to consider. Convening the Advisory Committee is a long and cumbersome process and if we choose this route we must start shortly if we are to have everything in place in time for the introduction of community charges in Scotland next year. I would like, therefore, to set up a meeting with you, and with those to whom I am copying this letter, in the next week or so. Copies go to Derek Osborne, Chris Brearly (DOE), David Flaxen (CSO) and Jim Hibberd (HMT).

15/1

Yours, Ivor Manley

I T MANLEY

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TREATMENT OF COMMUNITY CHARGES IN THE RETAIL PRICES INDEX - DISCUSSION PAPER

This paper presents some preliminary comments on the implications of the proposed change from Local Authority Rates to Community Charges for the RPI. There are strong theoretical reasons for excluding such costs from the RPI but these are not conclusive and are likely to be countered by the practical view that the cost of local services should continue to be covered as in the past In view of this the note concludes that the matter should be put to the RPI Advisory Committee.

Ridiculous! What are the [illegible] of Ministers?

The Proposals for Community Charges

The Government proposes to reform the system of local government finance. Domestic rates are to be replaced by a flat rate charge for local services payable by all adult residents - a community charge. Each local authority will set the level for its own area and this will be paid by nearly all adults. The money raised will be used to help finance the provision of local services.

Timing

The change will take effect in Scotland from April 1989 and in England and Wales from April 1990. Therefore the treatment in the RPI needs to be determined by the end of this year.

Nature of the Community Charge

Both rates and the Community Charge are means of financing the provision of local services. However, whereas rates can be viewed as a tax on the consumption of housing and therefore an indirect tax, similar to VAT, which is taken into account in compiling the RPI, the Community Charge is to levied on a per capita basis regardless of consumption and it can therefore be viewed as a direct tax, which should not normally be taken into the Index. (A weaker alternative is that since the question of residence is an important feature of the proposed Community Charge, it is possible to present a case that for RPI purposes the Charge is an indirect tax associated with housing. While not strong, this line of argument might be used as a rationale for keeping the Charge within the coverage of the RPI).

Indirect

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The Treatment of Local Authority Rates in the RPI

Local Authority rates have been included, with rents, in the coverage of the RPI since 1914. They have been mentioned as part of housing costs in the numerous discussions of the treatment of housing in the index but they have not been seen as raising any problems. The Committee's reports do not discuss in any detail the basis on which rates are included in the index.

There are two possible arguments for the inclusion of rates in the RPI.

i) rates can be regarded as a tax on housing (an indirect tax) and therefore part of the price of housing consumption as VAT is part of the price charged for other goods and services. Unlike VAT, however, rates can be and are paid separately from other housing payments, eg. owner occupiers pay rates directly to local authorities (they also pay regardless of whether they make mortgage payments).

ii) rates may be regarded as the price for local services. However, they are different from most other prices in that particular payments do not relate to the acquisition or consumption of particular units of service. This argument would, however, treat local services differently from similar public services which are excluded from the coverage of the index (eg education and police services would be covered but health and defence would not).

General Considerations

The Advisory Committee have not been consulted about the treatment of rates in the index but, in the last series of meetings most members seemed to support the view that they should be included. Paragraph 41 of the 1986 report states:

> "Though mainly concerned with items which might be brought into the index, we did also consider whether there were any items currently included which should not be. In particular it was suggested that local authority rates are essentially a form of taxation rather than

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NB -

a direct payment for services provided. We concluded that, as the taxation is on the occupation of property, it is appropriate to include it as a housing cost, just as indirect taxes on beer, cigarettes, petrol etc are included in the indices for these items."

There are a number of other considerations that might be of interest in any discussion:-

i) International practice - There is no international standard governing the situation. The general consensus of opinion amongst official price statisticians in the European Community is that rates should be included in the index as an "indirect tax" on housing but community charges should be excluded as a "direct tax" on persons independent of consumption.

ii) Tax and Price Index (TPI) - the TPI can accommodate different treatments in the RPI of rates or community charges and the change from one to the other. The Advisory Committee was not consulted on the introduction of the TPI but may be persuaded that this index provides a satisfactory way of covering community charges if these are excluded from the RPI.

iii) Proposals for Water and Sewage rates - Proposals for changing the system of payments for water and sewage services are under consideration. Since these services are fairly specific when compared with other local services it is possible to take a different view of their treatment in the RPI from the treatment of community charges.

iv) Similar costs and services presently covered by the RPI - Whether community charges are covered by the RPI or not it might be argued that certain other services should be treated consistently. For example, goods and services covered by prescription charges and road fund licences at present covered by the RPI might arguably be excluded on the same grounds as used for excluding community charges. The extent to which the cost of local services is met from general taxation will, under the present guidelines for constructing the RPI, be treated as reducing the price ie as a general subsidy.

Not similar: prescription charges are a charge for prescriptions, and the VED licence a charge for having a car on the roads; and ~~both~~ are optional (you can not have a private car or own a car): the CC is a tax on ~~[illegible]~~ nothing - and is inescapable.

v) Computational issues - Although the basis on which local authority rates are included in the RPI is not certain. the present computational procedures imply that they are treated as a tax on housing rather than payments for services since there is no recognition of variations in the volume of services consumed for the payments made. If community charges are not regarded as part of housing costs and yet are included in the RPI the treatment of changes in the volume of services would have to be defined for the computations. A simple solution might be to assume no change in the volume of services and to compute a community charge index as an index of average weekly payments per household ie. as the present rates index.

The Treatment of Community Charges

It will be seen from the foregoing that there are no clear guidelines on which to base a decision on the treatment of community charges in the RPI. The two main options are:-

i) To treat community charges as a direct tax and exclude them from the index.

This is a "conceptually" attractive solution but it may not be publically acceptable. It also raises practical and technical problems for the transition.

Under present methodology changing from rates, an indirect tax on housing, to community charges, a direct tax on persons, reduces the "price" of rates to zero (just as the change from income tax to VAT increased prices). The effect would be to reduce the overall level of the index by about 4 per cent, possibly with negative rates of inflation in some months. Technically the transition could be achieved without introducing a major discontinuity by making the change at the January links (1989 and 1990). This is equivalent to excluding local authority rates from the index before the community charges become effective. It is questionable whether this could be justified under the present methodology and without reference to the Advisory Committee.

ii) <u>To treat community charges as essentially the same as rates and retain them in the index</u>

This has presentational advantages but there are conceptual objections to having a "direct tax" in the index. If community charges are taken as payment for local services then the appropriate price for the RPI would be the price for a fixed volume of services; allowances would need to be made for changes in the quality and quantity of such services.

The transition from rates to communtiy charges would be relatively straightforward; the index would be an index of average weekly payments for local services. An adjustment to aggregate local authority receipts to allow for payments by non-index households would be necessary.

<u>Conclusions</u>

The issues that community charges raise for the RPI are not straightfoward. There is a strong case on technical grounds for excluding community charges from the index but this could, following existing methodology, lead to an immediate reduction in the measured rate of inflation and to likely public criticism. There are presentational arguments for retaining payments for local services in the RPI but this would be contrary to the tradition of excluding direct taxes from such indices. It is difficult to see that the matter can be resolved satisfactorily without the support of the Retail Prices Index Advisory Committee and since such issues have hitherto been put to the Committee not to consult them on this occasion is to invite suspicion.

STATISTICS DIVISION
DEPARTMENT OF EMPLOYMENT
JANUARY 1988

MEMBERSHIP OF THE RPI ADVISORY COMMITTEE

Mr D B SMITH, CB	Deputy Secretary, Department of Employment (Chairman)
Professor A B ATKINSON	Professor of Economics, London School of Economics
Mr T A BOLEY	Central Director—Corporate Development, Electricity Council (representing the nationalised industries)
Mr C W CAPSTICK, CMG	Director of Economics & Statistics, Ministry of Agriculture, Fisheries & Food
Mr P D DWORKIN	Director of Statistics, Department of Employment
Mr H P EVANS	Under Secretary, Her Majesty's Treasury
Mr D W FLAXEN	Assistant Director, Central Statistical Office
Mr J S FLEMMING	Economic Adviser to the Governor of the Bank of England
Mr R F FOWLER, CBE	Former Director of Statistics and Statistical Research, Department of Employment
Mr K H B FRERE	Honorary Treasurer, National Federation of Consumer Groups
Professor A R ILERSIC	Professor of Social Studies, Bedford College, London
Mr D LEA, OBE	Assistant General Secretary, Trades Union Congress
Professor J F PICKERING	Professor of Industrial Economics, University of Manchester Institute of Science & Technology
Mr G V J PRATT	Economic & Research Officer, Co-operative Union
Mr R H PRICE	Director of Employment Affairs, Confederation of British Industry
Mrs A RIGG	Deputy Chairman, Consumers' Association
Professor H B ROSE	Economic Adviser to Barclays Bank PLC and Visiting Professor of Finance, London Business School
Mr L SEENEY, OBE	Director General, National Chamber of Trade
Mr W H STOTT	Chief Statistician, Department of the Environment
Dr D THORPE	Head of Research, John Lewis Partnership
Mrs J VARNAM	Executive Member, National Federation of Women's Institutes
Mr M V WILDE Miss A J CLEVELAND	Representing the Department of Health & Social Security
X FRANCES WILLLIAMS JILL JOHNSTONE	Nominated by the National Consumer Council
Secretary:	Mr D J SELLWOOD (Department of Employment)
Assistant Secretary:	Mr M HARGREAVES (Department of Employment)

MEMBERSHIP OF THE TECHNICAL WORKING PARTY

Mr P D DWORKIN (Chairman)

Professor A B ATKINSON
Mr D W FLAXEN
Mr J S FLEMMING
Mr D FODEN } nominated
MR N BECK } by Mr Lea
Mr R F FOWLER
Mr K H B FRERE
Mr P HASLETT (nominated by Mr Price)
Professor A R ILERSIC
Professor H B ROSE
Dr P A ROWLATT (nominated by Mr Evans)
Dr J M SLATER (nominated by Mr Capstick)
Mr W H STOTT

Secretary: Mr D J SELLWOOD
Assistant Secretaries: Ms D A CRAKER
Mr M HARGREAVES

Mr R Saoul of Marks & Spencer PLC also took part in the Technical Working Party's discussions of the treatment of quality change.

pvg

FROM: A C S ALLAN
DATE: 18 January 1988

MR SEDGWICK

cc Chief Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Dame A Mueller
Mr Kemp
Mr Scholar
Mr Culpin
Mr Hawtin
Mr C W Kelly
Mr Odling-Smee
Mr Peretz
Miss Peirson
Mr Turnbull
Mr Hibberd
Mr Potter
Mr Cropper

ACSA → SEDGWICK 18/1

THE TREATMENT OF THE COMMUNITY CHARGE IN THE RPI

The Chancellor was grateful for your minute of 15 January. He thought the DE paper was lamentably shoddy.

2. He believes that, in your discussions with DE, you should argue for the option of excluding the Community Charge from the RPI, but reducing the weight given to rates. To go for including the Community Charge in the RPI would be wholly contrary to existing RPI methodology, and the Chancellor would not accept that unless income tax, too, was included in the RPI - thus enabling us to fuse the RPI and TPI.

ACSA

A C S ALLAN