CONFIDENTIAL

FROM: J S HIBBERD
DATE: 30 MARCH 1988

MCS 30/3

A meeting at this point would be a good idea.

1. MR SCHOLAR
2. SIR PETER MIDDLETON
3. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Mr Anson
Sir Terence Burns
Dame A Mueller
Mr H Phillips
Mr Culpin
Mr Hawtin
Mr C W Kelly
Mr Odling-Smee
Mr Sedgwick
Mr Peretz
Miss Peirson
Mr Turnbull
Mr Potter
Mr Cropper

P Em.

Ch

I find the indexed gilt argument quite weighty; but the other arguments against Option B seem much more flimsy. I should have thought we should seek legal advice on the indexed gilt point, but subject to that should continue to press for B.

A meeting soon after Washington / Easter?

AA

HIBBERD → CHEX 30/3

THE TREATMENT OF THE COMMUNITY CHARGE IN THE RPI

We now have a revised draft of DEmp's paper on the treatment of the Community Charge in the RPI. (A copy is attached - top copy only.) It is an improvement on the original, though it is still not as good as we would like. However, I suspect, it is as good as we are likely to get. There is probably not much to be gained by going back to the drafters for fundamental revisions, though we can suggest some tightening up in various places. Once it is agreed (by correspondence) it will be circulated by Mr Fowler to certain Ministers.

<u>Options</u>

2. The DEmp draft suggests three main options for treating the community charge:

<u>Option A.</u> Replaces rates with the community charge in the RPI. This would have the effect of raising the level of the RPI in April 1990 by about ¼ per cent. It would also increase faster thereafter than under Options B or C if, as seems likely (and as has been the case with rates), the community charge rises faster than prices generally.

Why?

<u>Option B.</u> Rates removed from the RPI <u>without</u> introducing a major discontinuity. The community charge is not included in the RPI. The RPI would rise more slowly, perhaps by 0.1-0.2 per cent per annum, than in Option A.

cc-rpi29.3

Option C. Rates reduced to near zero in April 1990 and the community charge not included in the RPI. This would lead to a step reduction of about 4 per cent in the RPI for the year beginning 1990Q2. Thereafter, as with Option B, it would grow more slowly than in Option A.

Existing RPI Methodology

3. In terms of existing RPI methodology the general issue seems clear. Rates are an indirect tax, on imputed housing services, and thus have a place in the RPI along with other indirect taxes. The Community Charge, on the other hand, is not an indirect tax, since it does not vary with the consumption of any particular service. It is more akin to a direct tax and does not belong in the RPI. It should not replace rates in the RPI when rates are dropped. Rates should be left in the index, but be given a zero price, when the community charge is implemented.

4. This argues for Option C, or, if that is regarded as impractical, for some version of Option B. (There are various versions of Option B presented in the Annex to DEmp's latest draft. They simply represent different profiles for phasing out rates.) This was the approach strongly favoured by you when we last approached you on the subject. (Alex Allan's minute to Peter Sedgwick - 18 January.) However, it presents some particularly acute problems.

Indexed Gilts

5. The Indexed Gilts prospectus says:

> "If any change should be made in the coverage or the basic calculation of the index, which in the opinion of the Bank of England constitutes a fundamental change in the index which would be materially detrimental to the interest of stockholders, Her Majesty's Treasury will publish a notice ... informing stockholders and offering them the right to require Her Majesty's Treasury to redeem this stock."

6. The question is, what constitutes a change to the coverage or calculation of the index? We could argue that Option C is the only option that strictly represents no change to existing methodology. But Option C would require Ministers to argue that the Community Charge is a direct tax and not a charge which may vary with the consumption of some service. [Only DoE have diffs.] It would also require a clear and unambiguous view from statisticians in all the Departments concerned - something we seem unlikely to get. [Why?] Moreover, it would involve losses for social security beneficiaries and IG holders (see below). It may be, therefore, that it should be set aside as an unrealistic option. If so, Option B is the closest we can get to no change. It may, arguably, represent a change, but it is a change that benefits IG holders, relative to Option C.

7. We have not yet formally consulted the Bank; we thought it might be unhelpful to do so before our own views are firm. But we believe that they are likely to take the view that any change - ie either Option B or Option C - which removes rates from the index and does not replace them with the Community Charge, will constitute a fundamental change "materially detrimental to the interest of stockholders". It would then trigger the redemption clause.

8. We could press the Bank hard on this. We would argue for Option C on the grounds that it represents no change in the coverage or calculation of the index; this looks unpromising. Failing that we could press for Option B. Though it represents a change, it is one that would benefit IG holders compared with Option C, which we would argue to be the strict no-change Option.

9. Our guess is that the Bank would argue that both Options B and C represented changes in the coverage or calculation of the index; and that both were detrimental in comparison with Option A, or with the present situation. It is hard to predict whether we could persuade them off this; it is a question of how the prospectus would be interpreted in law and we cannot be sure that we are on firm ground. Before proceeding any further ourselves, we should probably consult the Treasury Solicitors' Department. And the Bank would want to consult Freshfields. Even if TSD pronounce in our favour, we still cannot rule out that some IG holders might subsequently test it in the courts. And we might lose.

10. It is worth spelling out what redeeming IGs would mean. We would have to offer stockholders the right to redeem their stock at current redemption values. Since the redemption value of all IGs stands above their current market value, all stockholders would take advantage of this. It would mean:

powerful risks.

(a) redeeming around £15 billion of stock;

(b) at a cost, measured in terms of the difference between redemption and market value, of £2.8 billion;

(c) and, no doubt, in the process destroying the IG market - which we continue to regard as one of the Government's cheapest forms of borrowing.

11. There is no comparable provision in the case of index-linked national savings certificates. The prospectus there simply states that index-linked valuation will be related to the RPI or any index which replaces it. However, repayment is available at eight days' notice: so the risk here is that if a general IG redemption were triggered that also cause a rush for repayment of the £3.6 billion of stock outstanding.

Social Security Upratings [rubbish] Why?

12. Around two thirds of social security benefits, including pensions, are uprated by the RPI. Option B would undoubtedly be difficult for the Government to sustain, though support from the RPIAC (if forthcoming) would help. (If Option C were adopted the 4 per cent loss would have to be made good in the upratings.) Social security beneficiaries and their supporters would claim that, by excluding the Community Charge, the Government was deliberately depressing the growth in the RPI in order to reduce future upratings, since, like rates, the Community Charge may be expected to rise faster than prices generally. There is a serious risk that the RPI would be discredited and that the pressure on Ministers to uprate pensions (especially) by earnings instead of prices would become irresistible. That would be very expensive for public expenditure, even if it only meant an earlier switch to earnings upratings than might otherwise be the case.

point of CC is to improve accountability to stop rapid rise

overstated

13. Most of the remaining, income-related, social security benefits are uprated by the Rossi index (the RPI less housing costs). The components of the Rossi index are at Ministerial discretion. We could make an allowance for the community charge in the Rossi index without raising the same methodological issues as in the total RPI. It might then be possible for the Government to argue that the poor (including poor pensioners) were having their benefits uprated adequately. But that would not help the nearly poor pensioners, as critics would quickly point out.

Surely v odd to put community charge in Rossi index when rates are not there now (presumably).

Banded Community Charge

14. There is a proposal that the community charge be banded relative to income. If Ministers counter this with the argument that the community charge is, as its title implies, a charge and not, by implication, a tax which should properly be related to income, this would present further ammunition for those who want the community charge included in the RPI ie Option A.

Conclusion

Prescott-speak.

15. If, notwithstanding this discussion, you remain of the view that Option B is the right approach, we need to present our case as convincingly as possible to the Bank, and the other Ministers involved, including the Secretary of State for Health and Social Security (neither he nor his officials have been party to any of the discussions between officials so far). The Prime Minister, too, will presumably wish to be involved. There is considerable scope for disagreement. Apart from the Bank, the Secretaries of State for Environment and Health and Social Security are likely to favour Option A strongly.

16. We have now got to the point where these issues must be resolved by Ministers. It is essential that officials are able to present a united approach when the subject goes before the RPIAC, which now seems unavoidable. You may wish to hold a meeting after Easter to discuss this. We will then give DEmp any comments on their latest draft, in the light of that discussion.

Jim Hibberd

J S HIBBERD

I am astonished by this submission. (In particular, I have seldom read such nonsense as in paras 12 & 13). What ~~has~~ is happening is a major tax reform, in which an indirect tax (rates) is being replaced by a direct tax (the CC). This makes option A nonsense (unless we go out the RPI), option C strictly correct, but option B the only sensible course. I will hold a mtg; but before that we will need the advice urgently — given the Law Officers' 1c point.
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TREATMENT OF RATES AND THE COMMUNITY CHARGE IN THE RPI

Paper by the Department of Employment

1. The introduction of the community charge has implications for the retail prices index which raise potential political and market sensitive issues. The central question is whether or not the community charge should be included within the scope of the RPI, as rates are, or excluded like income tax and national insurance contributions.

Main arguments

2. The main considerations in favour of exclusion are:-

(a) Payments such as the community charge, though very rare internationally, have been classified by the international bodies that set standards as direct taxation for the purposes of compiling national accounts. They are likely to be so treated in the United Kingdom though the Central Statistical Office has not yet adjudicated on this. The construction of price indices usually but not necessarily follows the national accounts treatment on such matters, which would imply exclusion of the community charge from the RPI just as direct taxes such as income tax and national insurance contributions are excluded.

(b) Rates are presently regarded for index purposes as an indirect tax on housing, akin to VAT on other goods and services, and are considered as part of the price of housing. Like VAT they are therefore included in the RPI. The community charge on the other hand is not related to the consumption of a specific good or service and therefore has no place in the RPI.

3. The main argument for including the community charge in the RPI is that, though the nature of the funding will have changed, the services for which rates are now charged will continue to be provided and the "man in the street" will continue to meet their cost out of his

take-home pay. From his perspective little will have changed so he might expect to see the RPI continue to include the expenditure. For recipients of state pensions and benefits this view could be reinforced by the use of the RPI for indexation,as they will need to finance their share of the community charge out of their pensions and benefits and may well expect it to be taken into account in the uprating. A related argument for including the community charge is that rates have in the past increased faster than other prices and excluding their equivalent in future might well give the impression that an attempt was being made to restrict the coverage of the index deliberately to produce a lower rate of inflation and thus save money on pensions and other benefits.

Conceptual problems

4. Under current RPI methodology the community charge could replace rates following very similar computation procedures. However, this would raise important conceptual problems. The inclusion of a direct tax in the coverage of the RPI would change its nature, open the question of what the index should cover and might suggest that the Government can pick and choose what to include. Inclusion of the community charge as a payment for services equally presents conceptual problems since payments are not directly related to the amount of services received. Also local services will continue to be financed partly from national taxation and it could be argued that if the community charge were included in the RPI then so should be that part of national taxation which is devoted to local purposes. It should be noted that whatever treatment is agreed for the RPI, the tax and price index (which refleclts both direct and indirect taxation, national and local) will include the community charge.

Public presentation of changes to the RPI

5. The question of the treatment of the community charge in the RPI is politically sensitive because the decision materially affects the RPI and may also affect the public perception of the community charge. The argument that the community charge should not be in the index because it

is a direct tax is unlikley to be an effective counter to the accusation that the Government is fiddling the index. Use of such an argument might prove doubly embarrassing because the charge is being presented as a payment for services rather than a poll tax.

6. The way in which the decision on the treatment of the community charge is taken may be important for the public credibility for the RPI. Since 1947 all significant issues affecting the method of construction and calculation of the index have been decided on the basis of advice from the Retail Prices Index Advisory Committee. A decision not to consult this committee (or not to follow its recommendations if consulted) would of itself require explanation. The Committee, which is convened by the Secretary of State for Employment, includes representatives of industry, the trade unions and consumers as well as academics and government departments. Although advisory its recommendations have always been accepted (the latest in July 1986) with one exception in 1971 when the Committee's proposals for regional price indices were not taken up (on the grounds that the membership had not been unanimous). The Department's usual stance is that the index is what the Retail Prices Index Advisory Committee says it should be, and this has proved an effective answer to criticism over the years.

7. A further problem arises because supplementary benefits are uprated using the "Rossi index" which excludes housing costs (and therefore rates). Whereas state pensions and index linked national savings are uprated using the "all items" RPI. The Rossi index is appropriate because the housing costs of supplementary benefit recipients are covered by housing benefit but, as everyone will be liable to at least 20 per cent of the community charge, it may be argued that this should be included in the Rossi index.

They're liable to 20% <u>rates</u> in 1988-89 & 89-90.

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Main Options

8. Against the above background there are three main options:-

A. Community charge included in the RPI replacing rates

The RPI would be computed in the same way as at present but replacing average weekly payments per houshold on rates by average community charge payments. The change would have the effect of adding up to ¼ per cent to the index, mainly in April 1990. Thereafter the index movement would depend on the increase in the community charge relative to other prices. If as the Government intends the community charge places restraints on local authority spending then the RPI might not be much affected. However, it seems more likely that the community charge would increase the measured rate of inflation at least in the short term. This is particularly the case because non-domestic rates will in future be uprated by no more than the increase in the RPI and if local authority spending is rising more quickly then there will be further upward pressure on the Community charge.

! Do PM/ DoE agree with this!

B. Rates removed from the index without introducing a major discontinuity and the community charge not included

The RPI would be replaced by an index which excluded any payments for local authority services. The effect would be an index which, on past experience, would rise by 0.1 or 0.2 percentage points per annum less than with Option A. Because the abolition of rates is being phased this option raises certain technical issues of timing which would need to be resolved. These raise questions of general index methodology and could apparently be referred to the Advisory Committee. The main alternatives for consideration are outlined in the Annex of this note.

C. Rates reduced to zero and the community charge not included in the RPI

The charge [is] would be treated as a direct tax replacing an indirect tax on housing. This is the reverse of the situation which occured when the Government reduced income tax and increased VAT in 1979 and thus increased the RPI. The effect of Option C would be to reduce the level of the RPI by 4 per cent and possibly to produce negative annual inflation figures and a reduction in index linked benefits. Clearly this option would be politically unacceptable.

The choice

9. Officials have discussed the above options but have not reached agreement. The Treasury, the Central Statistical Office and the Department of Employment tend to favour option B excluding the community charge while the Department of the Environment tends towards option A including the charge.

10. Officials are agreed that it would be in the interests of public acceptability for the matter to be put to the Retail Prices Index Advisory Committee. They are, however, undecided on how this should be done. Treasury argue that Ministers should decide on an agreed central government line, either to include or exclude the community charge, and that Departmental representatives should support this line in the Committee's discussions. Should Ministers wish to agree a line beforehand then the Committee's terms of reference might limit its involvement to advising on the technical issues of implementation. Against this approach it might be argued that such unanimity amongst officials would be seen as contrary to past practice and therefore suspect; also that the Committee's discussions have in the past cast a different perspective on the issues and Ministers might prefer to consult before taking a decision.

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Decisions required

11. Important political issues are involved. Ministers will wish to consider:-

(a) whether their preference is for the community charge to be included or excluded from the RPI;

(b) whether the RPI Advisory Committee should be asked to consider the issues, as officials recommend;

and if so

(c) in what terms the issue should be put to the Advisory Committee, that is to say before or after a final Government view has been taken, and for consideration of the issue of substance or simply how to implement the decision if taken one way or the other.

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ANNEX

PHASING OF THE RPI TREATMENT OF RATES AND THE COMMUNITY CHARGE

Introduction: when to change the RPI

1. A major issue, arising if the community charge is to be excluded from the RPI once rates have been abolished, concerns the phasing-in of the new index treatment. The charge is being introduced in Scotland in April 1989 and in England and Wales generally in April 1980, but with phasing over four years in some London boroughs. Decisions are needed on how to deal with this timing aspect, which could significantly affect the RPI. One way would be to make the change as if rates were being replaced across the whole of Great Britain from April 1989; alternatively 1990 could be taken as the operative date, with the earlier changeover in Scotland being coped with by taking the level of the community charge there as a temporary proxy for rates. Again, the introduction could be phased in progressively over the whole period though, as rates in Scotland and the London boroughs affected account for less than 15 per cent of all rates in Great Britain, a case can be made for rejecting this third option and adopting a practical solution which minimises operational difficulties.

2. Having decided in which year (or years) the index treatment is to be changed it will be necessary to determine at what *time of year* this is to happen. Whereas rates will be abolished from April of the year in which the community charge is introduced, the RPI by convention measures price changes with respect to a January baseline, and from an operational point of view it would be appropriate to take rates out of the index from January rather than April. This would result in a slightly larger RPI increase (because it would remove from the index an item which would not have been increasing at that time of year) but the numerical effect is very small - about 0.04 per cent once and for all.

Short-term impact

3. It should be noted that deciding to exclude the community charge in the long term need not necessarily imply exclusion of its immediate impact. It could be argued that, though it is inappropriate for the RPI to cover the community charge on a regular basis, it would undermine confidence in the index if the charge were ruled out of scope at the very time that the changeover from rates was increasing index households' payments to local authorities. The decision reached on this point has some numerical significance since, though the total "take" from the community charge may be similar to that from rates, its incidence will be such as to fall less heavily on the categories excluded from the general RPI (namely high-income households and one- and two-person pensioner households mainly dependent on state benefits) and correspondingly more heavily on "index households". The excluded households currently account for about a sixth of all rates (before allowing for housing benefit) so, if their average liability were to be reduced by a quarter the average liability of index households would rise by 5 per cent, on top of the normal annual increase. If the average index household's total community charge were regarded as the direct equivalent of what it used to incur by way of rates then this increase would feed straight into the index as a price change, raising it by about 0.2 per cent, and also serve to increase expenditure and thereby boost the weight for the community charge in the next year (though the latter effect would be very small).

4. This outcome would reflect index households' payments but might be thought to give undue significance to the definition of such households. Pensioner and high-income households are excluded from the general RPI primarily as a means of bringing the *weighting* of the index closer to the expenditure patterns of most households: not in order to cause the *price indicators* to reflect the experience of certain groups in society in preference to others.

Possible alternatives

5. The following table presents four possible courses of action. These are not exhaustive but are intended to illustrate the range of options available. The estimates of numerical impact assume that the 12-month change for all items except rates/community charge will remain at 4 per cent, that the community charge will increase at 8 per cent per annum, and that its introduction will affect index households in the way suggested in paragraph 3 above.

	RATES / COMMUNITY CHARGE EXCLUDED FROM JANUARY	*INITIAL COMMUNITY CHARGE USED AS PROXY FOR RATES*
CHANGE MADE IN 1989	Option A Neither rates nor community charge affects index after January 1989 Effect Probably gives lowest RPI increase of any option Advantage Operational & presentational simplicity Disadvantage Drops rates from the RPI while they are still being paid in most of UK	Option B Index reflects rates and com. charge (whichever applies) in 1989 but not thereafter Effect RPI rises by 0.2 per cent more than for Option A in 1989 Advantage Timing matches main part of administrative change Disadvantage Inconsistent treatment of community charge as between Scotland and elsewhere
CHANGE MADE IN 1990	Option C Rates taken out of the RPI in January 1989 for Scotland and a year later elsewhere Effect RPI rises marginally less than with Option B in 1989 Advantage Avoids drawbacks of A and B Disadvantage Removes index households' local authority payments from the index just when they are increasing most	Option D Index reflects rates and com. charge (whichever applies) in 1989 & 1990 but not thereafter Effect Similar to including community charge in short term Advantage Avoids drawack of Option C Disadvantage Inconsistent treatment of community charge over time, including it initially but excluding it for the future

6. Each of the options would require careful presentation to avoid the danger of undermining public confidence in the RPI. If statistical convention were to be the determinant then Option A would be preferable to any other but it is recognised that other factors also need to be taken into account.

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FROM: A C S ALLAN
DATE: 7 April 1988

MR HIBBERD

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

ACSA → HIBBERD 7/4

THE TREATMENT OF THE COMMUNITY CHARGE IN THE RPI

The Chancellor was grateful for your minute of 30 March, and will want to hold a meeting soon after his return from Washington.

2. He was not at all persuaded by the arguments in paragraph 12 and 13 about the difficulties for social security upratings if we adopted option B. What is happening is a major tax reform, in which an indirect tax (rates) is being replaced by a direct tax (the community charge). This makes option A a nonsense (unless we go over to the TPI), option C strictly correct, but option B the only sensible course

3. He feels that we need urgent legal advice, from the Law Officers, on the indexed gilt points as soon as possible.

ACSA

A C S ALLAN

54G/SAH/19

cc PPS
PS/CST
xyf

CONFIDENTIAL

FROM: J DIXON
8 April 1988
Room 53B/G
Ext 4589

MISS PEIRSON o/r

Quite!
JM
11/4.

cc Sir P Middleton
Sir T Burns
Mr Anson
Dame A Mueller
Mr H Phillips
Mr Scholar
Mr Culpin
Mr Hawtin
Mr C Kelly
Mr Odling-Smee
Mr Sedgwick
Mr Peretz
Mr Turnbull
Mr Luce
Mr Potter
Mr Cropper
Mr Hibberd

DIXON → PEIRSON 8/4

THE TREATMENT OF THE COMMUNITY CHARGE IN THE RPI : PUBLIC SERVICE PENSIONS

We had a word about the minutes by Mr Hibberd of 30th March 1988 and Mr A C S Allan of 7th April which Dame Anne Mueller has brought to my attention.

2. Option B - not including the community charge in the RPI - would have serious implications for social security upratings, as Mr Hibberd has argued. This difficulty would apply also to public service pensions upratings, which are all based on the RPI. I have no doubt that the row that would occur would far outweigh the one that has arisen over the recent RPI error. It will be recalled that, coincidentally, the error was 0.1 per cent, that is very similar to the forecast slower rise in the RPI, 0.1 to 0.2 per cent, compared with Option A (including the community charge in the RPI).

3. But unlike the present row, which is still, three months later, generating a heavy MP's postbag, the 0.1 to 0.2 per cent shortfall would be a continuing one every year. The current RPI

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error of 0.1 per cent will be put right by April 1989. So I am in total agreement with Mr Hibberd when he says (para 12) that the RPI could become discredited, and that pressure could arise to move to uprating according to earnings rather than prices, with a consequential increase in public expenditure.

4. The main purpose of this minute is to ask you to associate the public service pension issue with any comments that you may make about social security upratings. In my view, there would be a considerable row on both fronts. You will recall that the Order uprating (according to the RPI) public service pensions must state exactly the same percentage as the Order uprating social security benefits.

5. In Mr Hibberd's conclusion (para 15), he says 'There is considerable scope for disagreement'. There is a further difficulty, in that Ministers from most of the public service would be briefed about the effect upon their pensioners (teachers, NHS, armed forces, police, fire, local government, and so on), as well as on the social security pensioners, who are mainly DHSS' concern.

J.D.

J DIXON