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19 May

Dear Eddie,

INDEX-LINKED GILTS AND THE RPI

1. As you know, we have been giving thought to the appropriate way in which the RPI should reflect the abolition of local authority domestic rates first in Scotland, and, on the assumption that the Government's proposals for England and Wales become law, subsequently in England and Wales.

2. There appears to be three main possibilities, though the precise details of each could vary somewhat.

Option 1

(i) The level of the domestic rates indicator in the RPI would drop a little in April 1989 when domestic rates are abolished in Scotland, and then fall almost to zero when domestic rates are abolished in most of England and Wales. The rates indicator would drop further as rates were phased out in 10 London Boroughs in the years to 1994, and finally would reflect only the retention of rates in Northern Ireland.

(ii) The RPI weight for the rates indicator would, following past practice, be adjusted each January in line with spending in the preceding year. Therefore with rates abolished in Scotland in April 1989 and in most of England and Wales in April 1990 the weight for rates would retain the relatively high value it had in the preceding January for the remainder of each of these years.

(iii) This option would produce a step reduction of about 0.2 per cent in the RPI in April 1989, a further step reduction of 3½ per cent in April 1990, and very small further reductions as domestic rates were phased out in the London boroughs.

(iv) The Community Charge would not be included in the RPI, on the basis that it is, like a direct tax such as income tax, not related to the consumption of a specific service, unlike rates which have always been treated as a housing cost, because they are an indirect tax on housing services, and as such have been included in the housing component since the inception of the RPI. Referring to income tax and certain other payments which are excluded from the RPI, the RPI Advisory Committee noted as long ago as 1956 that certain expenditure is excluded from the (weighting pattern of the) index "because of the variable and non-measurable nature of the services acquired in return for the payments made and because of the difficulty or impossibility of identifying a 'unit' the price of which could be measured from date to date".

Option 2

(v) The domestic rates indicator would be treated as in (i) and the Community Charge not included. But the weight for local authority rates would be adjusted in advance of each stage of their abolition in Great Britain. This prior adjustment of the weight for domestic rates would avoid major discontinuities in the level of the RPI by reweighting the rates contribution on the basis of known information in advance of major changes, in January of each year, between 1989 and 1994 as rates are abolished in Scotland and then in England and Wales.

Option 3

(vi) As the indicator for domestic rates fell to reflect their abolition, as described in (i), the Community Charge would be included in the RPI between April 1989 and April 1994. The inclusion of the Community Charge as domestic rates disappeared in particular areas would be likely at that point to raise the level of the RPI somewhat because "index households" - which do not include the richest 4 per cent of households and pensioners - will pay a relatively higher proportion of the Community Charge than of domestic rates. Thereafter the effect on the RPI of including the Community Charge would depend on the extent to which the Community Charge rose faster or slower than the rest of the index.

3. Under the prospectuses for index-linked gilts the Treasury would be required to offer holders of index-linked stock the right of redemption if there were any change in the "coverage or basic calculation" of the index which, in the Bank's opinion, constituted "a fundamental change in the Index which would be materially detrimental to the interests of stockholders". It would be most helpful to us to have some indication of the view the Bank would be likely to take of the above three possibilities. Please could you let us have a view by Friday 3 June, or as soon as possible thereafter?

Yours sincerely,

Michael

M C SCHOLAR

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RETAIL PRICES INDEX AND COMMUNITY CHARGE:
INDEX-LINKED GILTS

INSTRUCTIONS

- Enclosure 1: 2 Per cent Index-Linked Treasury Stock 1996 Prospectus
- Enclosure 2: Retail Prices Index - Current Composition
- Enclosure 3: Local Government Finance Bill
- Enclosure 4: "Method of Construction and Calculation of the Retail Prices Index"
- Enclosure 5: "Methodological Issues Affecting the Retail Prices Index"
- Enclosure 6: CSO draft paper: "Definition and Classification of Taxes in the United Kingdom National Accounts: Treatment of Proposed Community Charge"
- Enclosure 7: D/Emp draft paper: "Treatment of Rates and the Community Charge in the RPI"
- Enclosure 8: Treasury note "The treatment of LA rates and the CC"

1. The Law Officers and Treasury Counsel are asked to advise on the implications under the prospectuses for index-linked gilts of the change from rates to the community charge. All such prospectuses contain a provision (paragraph 23 of Enclosure 1) which states that "if any change should be made to the coverage or to the basic calculation of the Index which, in the opinion of the Bank of

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England, constitutes a fundamental change in the Index which would be materially detrimental to the interests of stockholders" the Treasury must give stockholders the option of redemption before the revised index becomes effective for the purposes of the prospectus. Domestic rates have been included in the RPI from its inception under the heading of housing (Enclosure 2). The treatment of the community charge in the RPI has not yet been determined but the options now being considered raise the question of whether they involve a change in the coverage or basic calculation of the Index.

2. There is no comprehensive statutory definition of rates but a useful description is to be found in section 519(4) of the Income and Corporation Taxes Act 1988. The community charge is established under the Local Government Finance Bill (Enclosure 3) currently going through Parliament. The scheme of the proposed legislation is that domestic rates should be replaced by three types of community charge: the personal community charge, payable by those who have their sole or main residence in the area of the relevant authority; the standard community charge, payable on second homes; and the collective community charge, payable by landlords of premises used by individuals as their sole or main residence for short periods. These charges differ from domestic rates in that they are flat rate per capita taxes rather than property taxes levied by reference to the value of the property in question. The charges are however similar to domestic rates in that the proceeds are applicable for public local purposes and that different local authorities can set the charge at different levels.

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3. Referring to income tax and certain other payments that are excluded from the RPI the 1956 Advisory Committee (Paragraph 24 of Enclosure 5) said "most expenditure [of this type] is excluded from the weighting pattern because of the variable and non-measurable nature of the services acquired in return for the payments made and because of the difficulty or impossibility of identifying a "unit" the price of which could be measured from date to date (see para 7 of Enclosure 4)". It has in the past been suggested that rates should be excluded from the RPI (para 41 of Enclosure 5) as they are a form of local taxation, rather than a direct payment for services provided. It has been concluded however that as the taxation is on the occupation of property, it is appropriate to include it as a housing cost, just as other expenditure taxes are included as a cost of the product or service to which they relate. Rates are therefore included in the RPI as are VAT, excise duty, TV licences and vehicle excise duty (which, like rates, is separately listed in Enclosure 2) and the principle was reaffirmed in 1987.
4. The community charge is not related to the consumption of a specific service - unlike rates which are assessed on the rental value of a particular property - and it should, according to the principles outlined above, be excluded from the RPI. The Central Statistical Office are for the same reasons minded not to classify the community charge as a tax on expenditure, which is how they classify rates, and are considering drawing a new distinction in the national accounts between direct taxes, which will include the community charge, and indirect taxes, which would include rates (Enclosure 6).

5. Omission of the community charge from the RPI would however raise serious problems. Not only has the Government gone to some pains to present the community charge as a payment for services, rather than a poll tax, but omission of the community charge from the RPI would mean that the level of the RPI was significantly reduced from what it would otherwise have been. The Department of Employment have drafted a paper (Enclosure 7) in which they set out the various issues and suggest three main options as to how the community charge should be treated in the RPI.

Option A substitutes the community charge for rates. It is estimated that this would have the effect of raising the level of the RPI in April 1990, when the community charge takes effect in most of England and Wales, by about 0.25%. Thereafter, the RPI is expected to increase faster under this option than under Options B or C or indeed than it would have increased had the system of rates remained in place.

Option B would omit the community charge from the RPI but in such a way as to avoid any major discontinuity. Thereafter the RPI would be expected to rise more slowly, perhaps by 0.1 to 0.2% per annum, than under option A. The change would also probably be disadvantageous in comparison with the present rating system.

Option C would not include the community charge in the RPI and would reduce rates to near zero in April 1990. This would lead to a step reduction of about 4% of the RPI in 1990. Thereafter, as with Option B, the RPI would be expected to grow more slowly than under Option A or under the present rating system.

6. As indicated in paragraph 3 of these Instructions the purist choice among these options from the statisticians' point of view would be Option C. It would be irrelevant,, according to this argument, that Option C involves the loss of a component of the Index and thereby significantly reduces its level. Such a change would not be a change of coverage within the meaning of the indexed gilt prospectus, despite its admittedly significant effect on stockholders, any more than the abolition of VAT or VED and the substitution of higher rates of income tax, or the disappearance from the index of some product no longer bought by households, would involve a change in coverage. Taxes, it would be argued, have only been included in the RPI to the extent that they represent part of the price of products and services covered. Rates are included in the RPI as a cost of housing, not as the cost of local government services, and since the community charge is not levied by reference to the value of the property or the consumption of specific services which can be measured it can have no place in the Index.
7. According to this view, option A, unlike Option C, involves a change in coverage of the RPI since a type of expenditure would now be brought in which previously had been excluded under the principles referred to at the beginning of paragraph 3 of these Instructions. However, since the change would be expected to be beneficial to stockholders in comparison either with Options B or C the redemption clause in the indexed prospectus would not be triggered.
8. Option B, despite omitting the community charge from the Index, would according to this view also involve a change in coverage or basic calculation since it necessarily involves either taking rates out of the RPI at a time when they are still being paid, or compensating for their removal from the index by adjusting

their weighting within the index at a different time from usual (see Enclosure 8). But, if the analysis above is correct, although Option B constitutes a change in coverage, it could not be held to be detrimental to stockholders, since they would be better off under this Option than under Option C, which is the proper point of comparison.

9. Against this it might be represented that Option B was indeed a change detrimental to stockholders, because they would be worse off than they would be under Option A, or than under continuation of the existing system of rates. But this argument does not appear to be well founded: Option A is an irrelevant point of comparison, since it represents neither the status quo nor the new situation on the existing rules. Nor is there any reason why the proper point of comparison should be a hypothetical and artificial projection of what the RPI would have been had the rating system continued.
10. It is possible that a version of Option B may be devised (see paragraph (2) of Enclosure 8) which could be represented as involving only minor and technical changes to the method of calculation, and which might be held to be within the spirit of the present method of calculation. If so, it might be that the Bank would be able to conclude that, although a change had been made, it did not represent a fundamental change. Since this is at the moment hypothetical the Law Officers and Treasury Counsel are asked to ignore the possibility for the purposes of these Instructions, subject to the following point. If a change can be devised which is not "fundamental" from the statistical point of view it will still be "materially detrimental" to stockholders if compared with Option A or an index based on the continuation of rates. This therefore raises the question, which is of wider interest to the Treasury and on which they would

welcome advice, as to whether a change which is materially detrimental to stockholders can be anything other than fundamental for the purposes of the prospectus. If the answer to this question is that it cannot, the word "fundamental" in the prospectus seems redundant: on the other hand it appears difficult to argue that a change which is materially detrimental is not fundamental.

11. There is of course a way of looking at the options under consideration which is very different from that advanced in paragraphs 6-8. It could be argued that, whatever the statistical justification for the inclusion of rates in the RPI, its effect is to include local government taxes or, to put it another way, a substantial proportion of the cost of public local services in the coverage of the Index. The abolition of rates will not mean that local government taxes are abolished or that public local services cease to be financed from such taxes. If the community charge is omitted from the Index, so this argument runs, there is a clear change in its coverage, which is evidenced by the change in the projected level of the Index. According to this view, both Options C and B would mean that the first precondition of the redemption provision in indexed gilt prospectuses was satisfied and that the only question was whether, in the Bank of England's view, this would have a detrimental effect on stockholders. There is little doubt that the Bank of England would conclude that either option would indeed have such a detrimental effect. Indeed it is also thought likely that the Bank would adopt the view expressed in this paragraph and conclude that both Option B and Option C constituted a change in coverage or basic calculation. Subject to the advice of the Law Officers and Treasury Counsel, it is not however thought that their view on this, as opposed to their view on whether the change is fundamental or materially detrimental to

stockholders, is strictly relevant to the prospectus. The test of whether or not there has been a change in coverage or calculation appears to be objective not subjective.

12. The questions on which the advice of the Law Officers and Treasury Counsel is sought are therefore:

- (1) Can the Treasury safely argue (a) that Option C does not involve any change in the coverage or basic calculation of the RPI, (b) that the prospectus does not allow a plaintiff to argue that this is a matter on which the Bank of England's opinion is to be given and (c) that Option C does not therefore trigger the option of redemption?
- (2) Would Option B also avoid triggering the gilts redemption provision on the basis that, although it constitutes a relevant change within the meaning of the prospectus, the detriment to stockholders would have to be compared with a situation (ie Option C and not Option A) which the Law Officers and Treasury Counsel are informed would be regarded by the Bank of England as more detrimental still?
- (3) Irrespective of the answer to (2) and the facts of this case, could there theoretically be a change in the coverage or calculation of the RPI which was materially detrimental to stockholders but not "fundamental" for the purposes of the redemption clause?

13. The Law Officers and Treasury Counsel will appreciate that if option C or B is followed and there is subsequently a successful challenge to the decision not to offer redemption, the consequences could be severe. Although there is a 7 months time lag under the prospectus (paragraph 15 of Enclosure 1) before a change in the Index takes effect for the purposes of the prospectus, a decision on how the Index should be calculated would in practice be irrevocable once Index figures based on this decision had been generated. The relevant index for calculation is the one that has been published (paragraph 5 of Enclosure 2). The Government could not therefore reverse a decision on how the Index was to be calculated in the light of proceedings during the 7 month period. Moreover it is thought impractical, in view of the uncertainty and disruption which would be caused in the gilt-edged market, for the court to be asked to make a declaration about the implications for the prospectus of the community charge in advance of any RPI figures being generated under the new system, even if such proceedings were theoretically possible. In other words, the Government would have to make a once and for all choice of option B or C and accept any associated risk of the redemption of index-linked gilts. Since this redemption would cost about £2.8 billion (as measured by the difference between the redemption cost and current market value of the stock) Ministers will, if advised by the Law Officers and Treasury Counsel that Options B and C do not require redemption, be anxious to know the sort of odds which would apply if the matter went to court. The difficulty of predicting the outcome of litigation, particularly in the absence of the evidence which would then be available (including a report from the RPI Advisory Committee), is of course well understood and it is accepted that any estimate would need to be revised in the light of such further information.