

SECRET

FROM: M C SCHOLAR  
DATE: 28 JUNE 1988

- EM 28/6*
1. SIR PETER MIDDLETON
  2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary  
Economic Secretary  
Sir Terence Burns  
Mr Anson  
Mr Peretz  
Mr Sedgwick o/r  
Miss O'Mara  
Mr Potter  
Miss Wheldon - Tsy Solicitor

### THE COMMUNITY CHARGE, THE RPI AND INDEXED-LINKED GILTS

We have now had the Bank's reply (annex A) to my letter (annex B) asking them whether the possible changes to the RPI which are in contemplation, would in their view "constitute a fundamental change in the Index which would be materially detrimental to the interests of stockholders".

2. In summary the Bank are saying that option one, which has neither rates nor Community Charge but involves step reductions in the index, would be a fundamental change and would be detrimental; that option two, which has neither rates nor the Community Charge but avoids step reductions in the index, would not be a fundamental change and that there are no firm grounds for concluding that it would be detrimental, or materially detrimental; and that option three, which replaces rates with the Community Charge in the index, would be a fundamental change but not materially detrimental to stockholders. So option one would require the offer of early redemption of these gilts (at a cost of more than £3 billion) but options two and three would not.

3. Sir Peter Middleton has taken several discussions of this issue. We noted first that the view the Bank are taking is not, as it at first appears to be, wholly at variance with the advice we received (annex E) from the Law Officers and Treasury Counsel. That advice proceeded from the assumption that the Bank of England would consider



that option two would give rise to material detriment, and concluded on that basis that there was a fundamental change in the coverage of the index. In fact, the Bank agree that option two would represent a change in coverage but think it would be neither fundamental nor detrimental.

4. It is worth reminding ourselves here why our legal advisers assumed that the Bank would consider that there was detriment. We gave them this assumption, explicitly: we said in paragraph 11 of our instructions (annex C) that there was little doubt that the Bank of England would conclude that either options one or two would have a detrimental effect; and in paragraph 5 we said that if the Community Charge were substituted for the rates in the RPI the RPI would be expected to increase faster than under options one or two or indeed than it would have increased had the system of rates remained in place.

5. That was the general view at that time, and it runs through all the material we received then from the Departments of the Environment and Employment. But after careful consideration of all these issues, and discussions between LG and the forecasters, we are now doubtful whether this original presumption about the buoyancy of the Community Charge was well founded. The uncertainties are considerable. Our view now is that, within the framework that the quantum of grant from central government is held constant, there are two limiting cases:

- (i) the Government's intentions in reforming local authority finance and introducing the Community Charge - to improve local accountability and thus restrain local authority spending - will be realised, so that in the long run (and perhaps in the short run too) the Community Charge will be less buoyant than the rates were;
- (ii) the Government's intentions will be frustrated, and local authority expenditure will be no less buoyant in the future than in the past; and (because of the rules for the business rate) the Community Charge will therefore if anything be more buoyant than rates have been in the past.



6. The attached note by the forecasters (annex D) argues that the initial incidence of the Community Charge is, on present indications, likely to be modest - although its immediate impact if it were to be included in the RPI would be to increase the index (see Table 4 of Annex D) because the households whose expenditure is measured by the RPI will bear a heavier burden of Community Charge than they did of rates. It goes on to give some structural reasons for thinking that the Community Charge is likely to rise faster than the rates - for example the possible shortfalls in receipts through evasion and so on; and some structural reasons for thinking the contrary - the disappearance of grant penalties for example. But its main conclusion is that the actual outcome will largely depend on what Ministers decide about the quantum of grant and on what local authority expenditure decisions are; and that the outcome will differ from time to time both as these factors change, and as local authority balances rise and fall. Sir Peter Middleton's meeting endorsed this analysis. *(I am more pessimistic).*

7. Although the gilts prospectus places with the Bank and not with the Government the responsibility for opining on detriment, the money at stake is the Government's, so we clearly need to satisfy ourselves that the Bank's view is well-based and unlikely to be successfully challenged.

8. This at once raises the question whether we have given the Bank all the relevant information at our disposal; and the Bank's letter asks us to confirm that we have done so. We are conducting a trawl, via LG and the forecasters on whether there is any analytical work within the Treasury or other Departments on the likely buoyancy of the Community Charge which we have so far overlooked. We think we should send the Bank the forecasters' note annexed to this minute; and it is for consideration whether we should now disclose to them the legal advice we received - although there is arguably no reason for doing so, given the argument in paragraph 3 above.

9. On the assumption that the Bank's view will not be changed by this further information, we need to assess the risks attaching to options two and three (option one can, we assume, be ruled out).



10. The risk is that an aggrieved stockholder, ignoring the problems he would face in getting off the ground any action against the Bank, might seek to argue

- (i) in the case of Option two that, notwithstanding the fundamental reform of local authority finance, payments in respect of local authority services by households were always likely - especially given the regime for business rates - to go up in future faster than the generality of prices, as they have in the past. Such an investor might try to establish that the RPI minus rates and the Community Charge would go up slower (a) than it would with the Community Charge included in it; (b) than it did before the abolition of rates; and (c) than it would if the rates were somehow projected forward after their abolition, self-contradictory though this hypothesis would be.
- (ii) in the case of Option three that the Community Charge had been artificially included in the index where it had no proper place, against (no doubt) the advice of the statisticians and (some of) the RPI Advisory Committee, and that the effect was to slow down the growth of the index.

11. Given the sums at stake we need to assess these risks with the greatest care. We do not think that we should take too much comfort from the argument - correct though it undoubtedly is - that the answers to (a), (b) and (c) in paragraph 10(i) above are unknowable. We need to reach the best view we can on what the likelihoods are. Are we right to think that the RPI without the Community Charge is as likely to be more buoyant as it is to be less buoyant than an RPI with the Community Charge, once the transitional period is over? Are we likely to be successful in brushing aside the comparison at 10(i)(c) above, on the basis that it is self-contradictory; and the comparison at 10(i)(b), on the basis that there has been a wholesale change in policy, avowedly designed to reduce the growth of local authority expenditure and payments connected thereto? On this last point we must surely be on strong ground: if not, any policy change by the Government designed to reduce inflation would, if it reduced the RPI and was describable as a fundamental change etc., be a ground



for action against us on indexed-linked gilts. Do we accept the Bank's contention (paragraph 9 of letter, penultimate sentence) that if the comparison at 10(i)(b) were made, there would be a difference of 0.1-0.2 per cent a year to the RPI which would be insufficient to be judged materially detrimental? (NB a Department of National Savings junior official is currently challenging DNS' refusal to take into account the recent RPI error in calculating the return on his investment in indexed-linked National Savings Certificates; the case will go to the Registry of Friendly Societies, and might go no further.)

12. Miss Wheldon considers that the Bank are right to use as the point of comparison for options two and three a notional index in which rates are retained. The point of departure when guessing what this index would look like would be the historical evidence used in paragraph 9 of the Bank's letter. In other words, the comparison at 10(i)(b) would be treated by a Court as relevant unless a better index could be constructed. Miss Wheldon considers that the comparison at 10(i)(c) might be thought by a Court to be a better index and that we should therefore make a bona fide attempt to produce such an index. Miss Wheldon's argument is that the Government (and the Bank) would generally be in a better position in any legal proceedings if there is contemporary evidence proving that every effort was made to estimate the effect of the change on investors and showing, if this proves to be the case, why the comparison at 10(i)(c) is impossible.

### Procedure

13. The next steps are (i) to reply to the Bank, ensuring that they have all the information they need at this stage (updating will be needed in due course), and (ii) to respond to the Department of Employment's request for comments on their draft paper for Ministers on the RPI and the Community Charge.

14. The inclination of Sir Peter Middleton's meeting was to get on with (i) immediately, and to do (ii) as soon as possible thereafter. We are now getting very short of time indeed, since rates in Scotland disappear in April 1989, the RPI Advisory Committee will on past form



take some time to deliberate, and we have an interdepartmental and Ministerial process to go through before any question of approaching the RPIAC can be considered.

15. Sir Peter Middleton's meeting also thought that a further stage with the Law Officers would be prudent, particularly since we will no doubt in due course wish to inform them of our conclusions. The best way of doing this might be to consult them on the terms of our reply to the Bank's letter.

16. You will also wish to consider how to handle the indexed-linked gilts issue with colleagues. We do not think that the Department of Employment's paper, which may form the basis for consultation with the RPIAC, should contain any reference to the subject. But you will presumably wish to minute the Prime Minister about IGs, with copies to the Law Officers and to the senior Ministers most concerned (Messrs Fowler, Ridley and Moore).

17. The issues for immediate decision are:

- (i) Is the Bank's opinion well-founded?
- (ii) What assessment can be made of the risks as between options two and three? It is acceptably low on both options: is option three significantly less risky than option two?
- (iii) Which option are Ministers likely to wish to put to the RPIAC, if they decide as usual to consult it?
- (iv) Should we reply to the Bank on the lines suggested in paragraphs 8 and 13 above?
- (v) Should we return to the Law Officers?
- (vi) Do you agree with the handling suggestion in paragraph 16 above?

18. We are to discuss this with you on Wednesday.

M C SCHOLAR