CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

? Waiting for Budget Statement ?

---

Rates
NICs  ind. tax hypothecation

Hdnl taxes, Rem all TPs

(absurd to exclude any tax wh. the Govt is committed to reduce)

~~Future~~ Overseas:
Seen as confirm of failure (& wd circumvent NHS: ... signed)

pf.dc.13.1 **SECRET**

PJ

**FROM** M C SCHOLAR
**DATE** 13 SEPTEMBER 1988

**CHANCELLOR OF THE EXCHEQUER**

cc Chief Secretary
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Mr A J C Edwards
Mr Peretz
Mr Sedgwick
Mr Hibberd
Miss O'Mara ?
Miss Wheldon

Ch
Choice is between waiting for BoE, or writing to Fowler saying your views are subject to clarifying one legal point on indexed gilts (what about a wider audience - but surely they must know why we've taken so long?)
AA

**THE RPI AND THE COMMUNITY CHARGE**

You asked us (Mr Allan's minute of 5 September) to consider a quick reply to Mr Hibbert's recent letter to the Secretary of State for Employment's office, contesting his premise that if the community charge were included in the RPI that would be likely to lead to upward bias in the RPI as a measure of price changes. Sir Peter Middleton has now written to Mr Hibbert in this sense (copy attached).

2. We have been hoping each day to be able to give you a draft letter to send to Mr Fowler and colleagues setting out your views on the substance of the matter (with a separate minute to the Prime Minister on the indexed gilts dimension), as a prelude to a decision on the government's approach to this matter. But we are held up by the Bank, whose letters of 6 and 13 September (copies attached) do not answer an important question posed in my letter of 1 August.

3. My letter, on the Solicitor General's advice, invited the Bank in reaching their view to compare the RPI without the community charge with an RPI which included the community charge - ie to make option 3 the comparator in assessing whether option 2 would be a fundamental change in the RPI which would be materially detrimental to the interests of holders of indexed gilts. The Bank's initial reply declined to make this comparison. We have pressed them to reconsider this, or at least to add a sentence to

say what their view would be if, in disregard of their legal advice, they were to make this comparison. Their response is first to think again about the legal advice they have received - so they intend to seek the opinion of Counsel; and second, despite some generally helpful comments, to decline to give a definite assessment of the scale of the likely disadvantage to stockholders on option 2 as compared with option 3.

4. I do not think that we could advise you to minute your colleagues while so much remains unresolved. It cannot be ruled out that the Bank after consulting Counsel will alter their views they have expressed so far. We also need to consult the Law Officers again in the light of the Bank's letters, and Miss Wheldon is arranging this. We cannot rule out that either of these further consultations could cause you to reconsider the judgement that the risk attaching to option 2 is acceptably low.

5. Meanwhile we are running short of time. A final decision, taken in the light of the Advisory Committee's views, is needed by February if we are to have the RPI ready for the abolition of domestic rates in Scotland. If the RPIAC is to consider this matter and report in time for the Secretary of State to announce a decision by this date the invitations and terms of reference need to go out very soon. The attached note by Mr Sedgwick discusses the timetable.

6. We are urging the Bank to take their further advice as quickly as possible. To hasten matters once we have that reply you may care to glance at the draft letter and minute we have already prepared on the basis that this and the Law Officer's further advice will lead to no change of view.

**Public Expenditure**

7. There are two other matters I should mention. First, Miss Peirson has asked me to draw attention to the scale of public expenditure cost there could be <u>if</u> option B led to pressures that could not be resisted to uprate state pensions by earnings instead

of prices. If earnings rose at 8 per cent a year and the RPI at 4 per cent a year, then the extra cost on state pensions would be £0.8 billion in the first year, £1.7 billion in the second year and £2.7 billion in the third year.

8. As you have noted, Mr Hibbert has drawn attention to this risk in his letter of 28 August, as has Mr Lloyd in his letter of 8 September. The draft letter to Mr Fowler rebuts the suggestion that the exclusion of Community Charge from the RPI would be "unjust' - to state pensioners or to anyone else.

**Disclosure**

9. Second, there is another aspect to do with index-linked securities, about which we will have to take care. This is disclosure. You may remember we faced the same problem when the RPIAC last met in 1986. Treasury Counsel then advised that we were at risk from claims based on misrepresentation if we sold IGs and indexed-linked securities after having taken decisions about the RPI but before those decisions were made public. (The same applies to IG sales by the Bank if they know of the decisions.) This is a separate matter from the IG prospectus clause about which we have been consulting the Bank: an aggrieved investor could not claim redemption of his stock but would try to set aside the purchase contract or claim damages for any actual loss he had suffered. The Bank's opinion about the likelihood of the investor suffering loss would be irrelevant.

10. Treasury Counsel advised in 1986 that the legally safest option was to stop selling index-linked investments before the decision making period. Instead we adopted the other option of publicising the Advisory Committee's terms of reference and recommendations, so reducing the price sensitivity of the final decision, and of cutting to a minimum the period between the taking of relevant decisions and their announcement.

11. We have discussed this with Miss Wheldon. We will need to do what we can to ensure that decisions once made are announced promptly (this would apply, for example, to making a prompt announcement about the terms in which the issue has been referred to the RPIAC, and about any formal recommendation made to the RPIAC by government members); and that internal papers do not accidentally suggest that decisions have been made when in fact they have not.

MCS

**M C SCHOLAR**

pf.dc.13.2 **CONFIDENTIAL** (Note by Mr Sedgwick)

# RPI ADVISORY COMMITTEE TIMETABLE

| | | Preferred Date | Last Date* |
|---|---|---|---|
| 1. | Official invitations to RPIAC members (from SOS) and circulation of terms of reference | September | Mid-September |
| 2. | Circulation of short paper for first meeting | Mid-September | Late September |
| 3. | **1st meeting** | | |
| | To outline problems and get the members' initial reaction on the main question of inclusive/exclusive. (Paper handed out for 2nd meeting.) | Early October | Mid-October |
| 4. | **2nd meeting** | | |
| | To discuss specific alternatives, implications, methodological details etc. (Possible extra meeting to be arranged if necessary - ie if there are major disagreements.) | Early-November | Mid-November |
| 5. | **3rd meeting** | | |
| | To discuss and agree and draft Report | Early December | Mid-December |
| 6. | Report submitted to Secretary of State | Early January | Mid-January |
| 7. | Final decision made and announced | Early February | Mid-February |

* This involves some risks. It assumes that preparations can be made for the index to be computed in a number of ways in anticipation of the decision.

pf.dc/Scholar/CC AND RPI

**SECRET**
**AND MARKET SENSITIVE**

Ch
This seems much too long.
AA

**DRAFT MINUTE TO THE PRIME MINISTER**

**COMMUNITY CHARGE AND THE RPI : INDEXED GILTS**

1. As you know from Norman Fowler's letter of 28 July and my reply of 4 August, [he] Norman is proposing to convene the RPI Advisory Committee to consider the implications for the Retail Prices Index of the introduction of the Community Charge. [There is not as yet agreement between colleagues on these issues, though I understand Norman hopes this can be settled quickly so as to give the Committee the maximum time in which to complete its work.]

2. I have no doubt that the right course is to exclude the Community Charge from the RPI. The arguments in paragraph 2(a) and (b) in the paper by officials, of 22 July, are strong ones. I have written separately to Norman setting out my views in greater detail.

3. I have however had a particular concern in considering this issue, which my officials have been discussing with the Bank of England. This is the possible implication for index-linked gilts (IGs), given the standard clause in IG prospectuses that gives investors the right to require HMG to redeem stock at "indexed par" (ie the current redemption value) "if any change should be made to the coverage or basic calculation of the [Retail Price] Index which, in the opinion of the Bank of England, constitutes a fundamental change in the Index which would be materially detrimental to the

interests of policy holders". All IGs at present stand below their current redemption value in the market, and if we were required to redeem and refinance them with new stock there would be a cost to the Government of some £3 billion. Moreover, after such an event the IG market would be likely to remain disrupted, and [less attractive to the Government]. it would be both harder & more expensive for the Government to issue new IGs

4. Officials have therefore been considering with the Bank whether any of the options set out in the paper [by officials] circulated with Norman's letter of 28 July would be likely to trigger this clause. Although the key to this is "the opinion" reached by the Bank of England, we have been mindful that the Bank's decision could be open to challenge in the Courts, and have taken extensive legal advice, consulting the Law Officers.

5. The Bank has considered the three Options set out in paragraph 14 of the paper by officials. The Bank's view, in summary, is as follows :

- Option A, which produces a 4% step downward change in the level of the RPI, would represent a fundamental change to the RPI that was materially detrimental to IG stockholders, thereby requiring stock to be redeemed. I believe this option in any case to be politically unacceptable.

- Option B, under which rates drop out from the RPI as they are abolished but without producing a major discontinuity, is not a fundamental change in the Index, and even if it were, there are no firm grounds for concluding that it would be materially detrimental to the interests of stockholders.

- Option C, under which rates are replaced in the Index by the Community Charge, is a fundamental change in the Index, since payments such as the Community Charge which are statistically classified as direct taxes have hitherto been excluded, but there are no firm grounds for concluding that it would be materially detrimental to the interests of stockholders.

6. At this stage these can only be provisional conclusions. The Bank cannot give a definitive opinion until the decision on the RPI has been made. At that stage the Bank would need, for example, to take account of any comments made by the RPI Advisory Committee and any other relevant information known to Government.

7. [In reaching these conclusions the Bank has considered the evidence of relative growth of rates and other elements in the RPI in the past; and it has been shown such assessments as have been made within Government of the likely future growth of the Community Charge.]

[8. It is possible that the RPI will rise more slowly under Option B than under Option C. An aggrieved investor might seek to argue Option B had therefore operated to his disadvantage. He might argue that because local authority spending consists largely of pay, which tends to rise faster than prices, it is

Do we need all this for PM?

therefore likely to continue to be buoyant; and that with the limitation of the growth of the business rate poundage within the growth of the RPI the Community Charge is likely to grow faster than the RPI. On the other hand, the level of the Community Charge will depend on decisions by Ministers about the level of grant to local authorities, and its growth will be restrained to the extent that it achieves its intended effect of holding back local authority spending through increased accountability.

may

9. The Bank might well face a challenge in court that it should have triggered the redemption clause, particularly if Option B is chosen. The legal advice given on the basis of the information available to the lawyers so far is that the risk of a successful challenge is low, and I believe acceptably low.

This para only worth including if last sentence retained

10. To summarise, I am clear that on merits Option B is the right course to pursue, and I have reached that conclusion after considering the implications of the different options for IGs. I believe that the risk with Option B, insofar as there is one, is acceptable. Indeed the Bank's conclusion that the prospectus clause was not triggered could also be open to challenge under Option C, although the practical risk of this is less. Option B can be defended as the normal statistical treatment. Indeed including Community Charge in the RPI (Option C) would be a clear breach with previous practice, and would set a difficult precedent for the future.

11. I should add that despite my own firm view that Option B is the better course I accept that the RPIAC must be consulted and their views be taken fully into account before the Government reaches a final decision on the matter. Indeed I understand that the Government might be subject to judicially reviewable if the normal procedures were not followed. I hope however that you and our colleagues will agree that in referring the matter to the RPIAC we can suggest that Option B is preferable.

12. There could be undesirable market consequences if this issue were discussed publicly on the basis of inadequate information, particularly if there were any suggestion that Option A, with a 4% fall in the RPI, were being considered. We must do what we can to reduce uncertainty, and this is a further reason for making a clear recommendation to the RPIAC and for publicising that as soon as it has been made.

13. Given this market sensitivity I am sending copies of this note only to Norman Fowler and Patrick Mayhew. I am writing to Norman and other colleagues separately with my views on other issues that have been raised in the correspondence.

pf.dc/Scholar/Fowler

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**DRAFT LETTER FROM THE CHANCELLOR TO NORMAN FOWLER**

**COMMUNITY CHARGE - RPI**

I am sorry not to have been able to reply before now to

1. I have now had an opportunity to think further about your letter to me of 28 July; and I have also seen copies of Nick Ridley's letter to you of 12 August, and the letter from the Director of the Central Statistical Office of 26 August to your private secretary.

2. I am in no doubt that the Community Charge should not be included in the RPI. The arguments against inclusion, set out in paragraph 2 of the draft note by officials, are in my view overwhelming. The RPI is a measure of the general price level and it is perfectly clear that the Community Charge is not a price. The reason that Domestic rates, on the other hand, are included in the RPI is that they are as part of the price of housing and vary with inter alia the level of consumption: the larger the house the greater the consumption of housing services and the higher the rates bill. If we were to include the Community Charge in the RPI on the grounds that it finances local authority spending we ought in logic to include central government taxes in the RPI too, on the grounds that they too finance government services. That would be absurd: yet to include the one and not the other would be to pick and choose arbitrarily among what to include in the index; and it would, as the Director of the Central Statistical Office points out, change

the RPI from a price index to a hybrid statistical indicator measuring a mixture of changes in prices and changes in costs. [Indeed we would be but a short way from including all direct taxes in the RPI.] ← sounds as if that would be a bad idea?!

3. Nevertheless I am sure that it would be right, and indeed necessary, to prevent sudden discontinuities in the RPI at the moment when local authority domestic rates disappear first in Scotland and then in England. I therefore support Option B, in paragraph 14 of the notes by officials, which avoids any step downward in the RPI when the domestic rates are abolished.

4. Nick Ridley suggests that the Government's critics will assert that the Community Charge will rise more quickly than the rest of the RPI and to exclude it will therefore penalise the recipients of state pensions and other benefits. I am sure that some will argue in this sense because they believe local authority spending, and hence the Community Charge, must rise much more rapidly than the RPI. But this view is mistaken, assuming as it does that our aim in introducing the Community Charge will be frustrated from the start. We will need to deal robustly with these arguments. It would be quite wrong to be driven by them to adopt a manifestly incorrect statistical treatment for the Community Charge (which would incidentally be likely to be interpreted as acknowledging by implication that the views of such critics about council spending were well-founded). We should instead point out that a key aim of the Community Charge is to restrain local authority expenditure by making local councils more accountable to their electorates and that past trends in local

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**CONFIDENTIAL**

authority expenditure and domestic rates cannot therefore be considered a reliable guide to what will happen under the new system. The future growth of the Community Charge will reflect the extent to which councils are more careful about spending their electorates' money, the level of central government grants and the growth in business rate revenue as business property expands and improves. In the light of this there can be no certainty as to whether inclusion or exclusion of the Community Charge will be to the advantage of those receiving state benefits.

It is clearly important that we

5. [I hope that, on reflection,] Nick Ridley will see the force of these arguments. Once we have [reached] an agreed view on the line the government will recommend to the Retail Price Index Advisory Committee [we should put the matter to that Committee and await the outcome of its discussions. Because this is a sensitive issue we will need to follow the deliberations of the Committee carefully,] and it will be important that the central government representatives should speak with one voice during the discussions. [I accept of course that the Committee's conclusions must be taken fully into account before any final decision is reached.] I am clear that our position should be to recommend Option B, namely that the community charge should not be included in the RPI.

6. I am copying this letter to the Prime Minister, and the Secretaries of State for the Environment, Social Security, and Scotland, [as well as] and to Sir Robin Butler and the Director of the Central Statistical Office.

(N.L.)

cc: Sir T Burns
Mr Anson
Mr Scholar
Mr Peretz
Mr Sedgwick
Miss O'Mara
Mr Potter
Miss Wheldon - T,Sol

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Parliament Street London SW1P 3AG
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Sir Peter Middleton KCB
Permanent Secretary

J Hibbert Esq
Director
Central Statistical Office
Great George Street
London SW1P 3AQ

13 September 1988

Dear Jack,

**RETAIL PRICES INDEX**

– not copied to us

Thank you for your letter of 26 August. I quite take the points you make.

However, in the second paragraph of your letter to the office of the Secretary of State for Employment you say that it would be ironic if "the distinction between prices and costs were now to be abandoned at a time when this would be likely to lead to an upward bias in the RPI as a measure of prices changes". Does any statistical analysis underlie this statement? There is great uncertainty about the future growth of the Community Charge, which seems to me to be wholly unpredictable. It will largely turn on decisions which will be taken by Ministers and local authorities over many years. But if the present Government's aim in introducing the Community Charge is successful we would expect the growth of the charge to be restrained in the coming years.

As regards the line of approach to the Advisory Committee, I think it most important that the representatives of central government on the committee should speak with one voice during its deliberations on this sensitive issues, though of course the final decision must await the advice of the Committee.

Yours ever
Peter

**P E MIDDLETON**