

21/10/88.

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COMMITTEE IN CONFIDENCE

RPIAC (88)2

DEPARTMENT OF EMPLOYMENT

RETAIL PRICES INDEX ADVISORY COMMITTEE

EFFECT OF THE ABOLITION OF LOCAL AUTHORITY RATES  
ON THE CONSTRUCTION OF THE RETAIL PRICES INDEX

Paper by the Department of Employment

*Fortunately, this will be done (to meet) this Re (the) bound to be option B but a vote must be given.*

*A*  
*This has been sent to RPIAC members. It's not too bad (though outrageous if it was not cleared at Minister level) but equally not from enough against option A.*

*AA*

Introduction

1. The abolition of domestic rates in Great Britain presents both conceptual and practical problems for the construction of the retail prices index (RPI). These problems arise because rates, which are currently included in the index as an indirect tax on housing, are to be replaced by a Community Charge, which can be viewed as either a charge or a direct tax on persons, rather than a tax on housing, the revenue so raised being used to provide local services. The charge paid by an individual will be compulsory and unrelated to the amount of services received.

2. The nature of the Community Charge is such that a decision is needed on whether to include it in the RPI as rates are now or to exclude it, as income tax and national insurance contributions are. Whatever decision is reached, its implementation will give rise to problems of a conceptual, methodological and presentational character. The Committee is asked to help clarify the principles on which the treatment of the abolition of rates and the introduction of the Community Charge should be based and to set down guidelines for overcoming any practical difficulties. It is suggested that the focus at the first meeting might be on the former, though the issues of principle should not be settled without reference to practical consequences and these will need to be discussed in detail at a later stage.

Treatment of rates in the RPI

3. Domestic rates have been included in the RPI since its inception. Initially this was because they were generally paid by tenants as part of the rent, and were inseparable from it. In the last fifteen years or so the inclusion of rates has been justified as a tax on the occupation of property, akin to other taxes on consumption which are included in the RPI, not because they are used to finance the provision of local services. The Advisory Committee's 1986 report supported this view:

"We concluded that, as the tax (represented by rates) 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." [Cmd 9848, paragraph 41]

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4. Rates are payable on the rateable value of the property occupied by households, the size of the payment being determined by the "rate poundage" (cost per £ of rateable value). This rate poundage currently provides the RPI price indicator: any increase in the average rateable value is not regarded as a price effect, though it does serve to increase the expenditure "weight" for rates in the following year. Like VAT on other goods and services, rates payments vary with the level of consumption: the larger the house the greater the consumption of housing services and the higher the rates bill. They are therefore part of the price of an item in the basket of goods and services which underpins the RPI.

5. It follows that local authority services as such are not currently included in the RPI "basket", except where specific charges are levied for individual services (e.g. admission to municipal swimming pools).

Nature of the Community Charge

6. Rates are to be replaced by a compulsory flat-rate charge which will vary between local authorities, payable by virtually all adults, called the "Community Charge". This change is to take place in April 1989 for Scotland and a year later for England and Wales. (The rating system is to remain in place in Northern Ireland.) As with rates, the level of the Community Charge will be set by the local authority, and the proceeds will contribute to the financing of locally-provided services. Unlike rates the charge will not be part of the cost of something already included in the RPI basket, except to the extent that those people with second homes will be subject to an additional charge on that property, which could therefore be viewed as a tax on housing. In general the Community Charge will not be directly related to any specific part of consumption. Instead it can be viewed either as a direct tax used to finance local services or as a charge for a "package" of such services, the charge varying between authorities but being fixed for individuals within each authority.

Including the Community Charge in the RPI

7. The main argument here is that the public credibility of the index might suffer if the Community Charge were excluded. As rates are now in the index it will seem natural to many that, in the interests of continuity, their replacement - the Community Charge - should equally be included, particularly as it will be used to finance local services. Recipients of index-linked pensions and benefits will need to finance their share of the Community Charge out of those benefits and might expect it to be taken into account in the index used for uprating. Whatever they are called, payments for local services will still have to be made out of take-home pay, to the same authorities, and the statistical classification of such payments in the national accounts need not determine their treatment in the RPI.

8. If the Community Charge were to be included in the RPI then the Committee would need to consider just what constituted the "price". A simple solution would be to take the Charge itself as the measure of price. This would assume that the volume of services remained unchanged from year to year, or that the package of services could be viewed as a single quantity. However, there have

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been significant changes in the past in the provision of local authority services and there is good reason to expect change in the future.

9. It would be difficult to defend a position in which the index rose or fell as a result of an increase or reduction in the Community Charge brought about by a commensurate increase or reduction in the services provided. The concept of pricing a fixed volume of consumption underpins the whole construction of the RPI. As it now stands the index can be said to measure changes in the cost of a fixed basket of goods and services, and this helps significantly in maintaining the confidence of informed opinion as to its integrity. If the Committee were to favour inclusion of the Community Charge in the RPI it would therefore be necessary for it to come to a view on how to measure price and volume changes.

Excluding the Community Charge from the RPI

10. It could be argued that the nature of the Community Charge is such that it has no place in the RPI, any more than income tax and national insurance contributions. The considerations here are both conceptual and practical. On conceptual grounds it has always been accepted that national insurance contributions and direct taxes should be excluded from consumer price indices such as the RPI, because they do not correspond to the purchase of a good or service and do not have a price. A separate index which does include these elements and will include the Community Charge - the tax and price index (TPI) - is compiled by the Central Statistical Office.

11. It is not possible to construct directly a conventional price index for local authority services because there are no prices per unit of the service provided. An alternative approach might be to allow for changes in the aggregate amount or volume of services received by households in return for the payments they make to local authorities. However, there would be considerable practical difficulties in following this approach.

12. The incorporation of a direct tax or compulsory charge would change the nature of the index from what it had been in the past. Such a move would open up the question of what the RPI should cover, and might suggest that this is a matter of arbitrary choice rather than generally-agreed principles. It could be argued that, as local services will continue to be financed partly from national taxation, if the Community Charge were to be included in the RPI then so should that part of central government revenue which is used for financing local services. Furthermore, if locally-provided services were added to the index basket then it would be for consideration whether the basket should also include similar services provided by central government and paid for with revenue generated from general taxation, national insurance charges etc (such as the Health Service).

Dealing with the transition

13. Handling the abolition of rates in the context of the RPI is not straightforward. One approach might be to treat the abolition as a fall in "price" to zero, which would reduce the level of the "all items" RPI by some 4 per cent (in the absence of any compensating effect from the Community Charge). Such an effect would not be unprecedented. In July 1979 the RPI showed a sharp upward step of 4 per cent when VAT rates were increased at the same time as there were

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decreases in income tax. The setting to zero of the present "rates tax" on consumption of housing could be seen as the converse of the 1979 increase in VAT on consumption of the goods and services on which it was charged. However, this argument is unlikely to carry conviction with the general public. Moreover, the abolition of rates will lead to a discontinuity in the index which by its nature was different from a change in the level of a tax which continues in the index after the change.

14. It is desirable to start from the premise that the abolition of rates should be dealt with by "linking", so that the index is shielded from the step discontinuity described above. There are various ways in which this might be done but it is difficult to formulate these until the Committee has taken a preliminary view on the broader issues.

15. A further problem, which will need to be addressed whether or not the Community Charge is ultimately to be included in the RPI, is that of constructing an index during the period when rates are in process of being abolished. The problem arises for two reasons: because the changeover from rates to the Community Charge is to be phased as between Scotland (1989) and England and Wales (1990) and because the changeover will take place in April of the year in question whereas the index is geared to taking account of changes in coverage only in January.

Summary and issues for discussion

16. The abolition of rates and their replacement by the Community Charge raises a variety of difficult issues for the construction of the RPI. Some of these have been outlined in this paper and the Committee might like to address the following questions at its first meeting, leaving consideration of more detailed topics for the second meeting:

- a) Should the Community Charge be included in or excluded from the RPI?
- b) If it is to be included, is it to be viewed for RPI purposes as a direct tax or as a charge for services? If a charge for services, what would be the position with regard to other government services?
- c) If a charge, how should its price (and therefore volume) be measured?

Department of Employment

21 October 1988