

FROM: COLIN MOWL
DATE: 24 January 1989

1. SIR T BURNS

2. CHANCELLOR

*I see no way round
this; the community charge
is clearly not a tax on
expenditure. We should give our
attention to the presentational
problems it causes.*

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Anson
Mr Wicks
Mr Scholar
Mr Phillips
Mr Byatt
Mr Sedgwick
Mr Riley
Mr Culpin
Mrs Lomax
Mr Edwards
Mr R I G Allen
Mr Potter
Mr MacAuslan
Mrs Butler
Mr S J Davies
Mr S W Matthews
Mr Hibberd
Mr Owen

Ch

*Pretty major ramifications.
Word into Terry & Peter @
present meeting tomorrow?*

AB

Ign. / dismissed.

CLASSIFICATION OF THE COMMUNITY CHARGE IN THE NATIONAL ACCOUNTS

Mr MacAuslan's post-mortem on the 1988 Survey said that from 1990 the measured level of money GDP will be about 1½ percentage points lower, because "whereas local authority rates are classified as an expenditure tax adding to GDP at market prices, it has been decided that the community charge will not be so classified". Miss Wallace's minute of 5 January asked for a note on this.

2. This minute deals only with the implication of the introduction of the community charge for the national accounts. Wider issues on the presentation of policy, including implications for the MTFs, GGE ratios, tax burden etc will be dealt with separately by Mr Riley in consultation with GEP and other interested divisions.

3. National accounts classification issues are largely a matter for the CSO, although the Treasury is usually consulted on major issues, as we were on this occasion. The treatment of the community charge in the national accounts was discussed at a meeting of the CSO's inter-departmental committee on economic statistics (CSO(E)) in October. The meeting was chaired by Jack Hibbert and I represented the Treasury.

4. We had discussed in advance with Sir Terence Burns what our attitude should be. Our main concern was to ensure that the national accounts treatment was "correct". We took the view that whatever else it was the community charge was not a tax on expenditure or indirect tax. It would not like LA rates - which are an indirect tax on housing - be part of market price GDP. Nevertheless we would have preferred CSO(E) to have deferred a decision until the treatment of the community charge in the RPI had been decided. The two decisions - how to treat the community charge in the RPI and GDP - do not depend on the same considerations, but we wanted to avoid the possibility of a CSO decision on the national accounts having excessive influence on the RPI discussion. But we were not able to persuade the rest of CSO(E) that this should be a consideration.

5. As you know the RPIAC has now decided to recommend inclusion of the community charge in the RPI, but its justification for doing so is vague. However it is clear that the justification is not that it is an indirect tax. Moreover none of the alternative arguments put forward at the RPIAC, either for or against inclusion of the community charge in the RPI, would imply that the community charge should be treated as an expenditure tax in the national accounts.

6. The CSO argued that the community charge should be treated as a tax in the national accounts. We supported this view. The DOE on the other hand, alone among the departments represented, disagreed. (The arguments are set out in full in the attached annex.) In face of this strongly held DOE position, and in view of the difficulty of fitting the community charge into the existing categories of tax - as well as not being a tax on expenditure, neither is it a tax on income nor on capital - CSO(E) decided that the community charge should not be classified formally as a tax in the national accounts but should be shown separately ie. not included in any of the existing classes of receipts. As long as it is accepted that the community charge is not a tax on expenditure (and no department disputed this) the implications for GDP described in the following paragraphs inevitably follow, whichever of the options for classification of the community charge is adopted.

7. The introduction of the community charge will not affect any of the measures of GDP at factor cost. It will not therefore distort figures for economic growth which in the UK are invariably based on factor cost measures.

8. GDP at market prices can be defined as GDP at factor cost plus taxes on expenditure less subsidies. With the abolition of rates taxes on expenditure will be lower than they would otherwise have been, as will GDP at current market prices. This will be true of all three measures of GDP - income, expenditure and output - and the average ie. money GDP as used in the MTFs, PEWP etc. We estimate that the level of money GDP will be reduced by under $\frac{1}{4}$ per cent in 1989-90 by the introduction of the community charge in Scotland and by about $1\frac{3}{4}$ per cent in 1990-91 following its introduction in England and Wales. (These estimates assume that the same amount of revenue is raised, whether from rates or community charge.) This effect is inevitable as long as the community charge is not defined as a tax on expenditure.

9. GNP at market prices, which is at present used to calculate EC contributions, will also be affected.

10. There will also be some effects on the personal sector statistics. Rates are counted as expenditure on housing and are included in the figures for consumers' expenditure. Community charge will be treated as a deduction from personal sector gross income before striking personal disposable income. Introduction of the community charge will therefore reduce the growth of both consumers' expenditure and personal disposable income at current prices, by about $2\frac{1}{2}$ per cent in 1990-91. These have offsetting effects on saving which is unchanged. The saving ratio however will be very slightly higher (by less than 0.1) because its denominator, personal disposable income, is lower.

11. Although consumers' expenditure at current market prices will be lower, consumers' expenditure at constant prices will be unchanged. This implies that the consumers' expenditure deflator (and GDP deflator) will be lower. The abolition of domestic rates will not affect the amount or volume of housing services consumed, rather it will reduce the price paid for those services. Hence the

Saving
is how
much?

consumers' expenditure deflator is lower. Another way of looking at this is to imagine what would happen were rates to be increased substantially rather than abolished. In this case there would be an increase in consumer prices.

12. The estimated effects are to reduce the growth of the consumers' expenditure and GDP deflators in 1990-91 by about 2½ per cent and 1¾ per cent respectively.

13. It follows that as the volume of consumers' expenditure will be unchanged, so will the volume of domestic demand and GDP.

14. The recent Treasury Economic Forecast (Mr Sedgwick's minute of 18 January) did not allow for these effects on GDP etc so as not to distort its policy implications. In other words community charge was treated as if it were a tax on expenditure. The table below shows the effect on forecast money GDP growth, the GDP deflator, GGE ratios and tax burden of treating community charge in the way decided by the CSO.

	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>
<u>Money GDP growth - %</u>			
Forecast report	11.1	7.3	6.3
Adjusted for proposed treatment of community charge	11.1	7.1	4.7
<u>GDP deflator growth - %</u>			
Forecast report	7.0	5.8	4.5
Adjusted for proposed treatment of community charge	7.0	5.6	2.9
<u>GGE (excl. privatisation proceeds) ratio - %</u>			
Forecast report	39.4	39.1	39.2
Adjusted for community charge	39.4	39.1	39.8
<u>Non-oil tax burden* - %</u>			
Forecast report	37.2	37.5	37.7
Adjusted for community charge	37.2	37.5	38.3

* before fiscal adjustment

Colin Mowl

COLIN MOWL

The treatment of taxes (including rates) in the National Accounts

1. In the national accounts government revenues are divided into three categories:

- (i) **taxes;**
- (ii) **charges** for services provided ie. where the government is operating rather like a commercial enterprise;
- (iii) **other transfers** to the government which are neither taxes nor charges for services provided - for example national insurance contributions and passport fees.

2. **Taxes** are divided into current and capital taxes and the former are further divided into taxes on income and taxes on expenditure. No precise, formal definitions for these categories underpin the UK national accounts but we broadly follow international conventions. According to these:

- a **tax** is a compulsory, unrequited (ie. not given in return for something), non-repayable payment to government. It includes fees and charges levied by government which are either out of all proportion to the costs of providing the service, licencing the activity etc or where the payer does not receive benefits in proportion to payments.
- **charges** are payments to government for specific goods and services provided to the individual paying the charges. There should be a clear and direct link between the payment of the charge and the acquisition by the payer of specific goods and services. The charges should be optional in that there should be no compulsion to pay if the individual decides not to receive the goods or services concerned.
- there is no explicit definition of **other transfers**. They are simply transfers which do not fall into the other two categories. National insurance contributions, included

here, are distinguished from general taxation because their payment gives rise to accrued rights for the payer.

3. **Local authority rates** are counted in the UK national accounts as a tax on expenditure. **Taxes on expenditure** are defined to be taxes which enter into costs of production and distribution, or taxes on final buyers associated with the purchase, possession or use of particular goods. The classification of rates as a tax on expenditure is justified on the basis of it being a tax on the production and supply of housing or other property services (whether by a landlord or owner occupier to him or herself). This justification is not entirely convincing and the classification could well not be the one we would adopt were we deciding it afresh.

Proposed treatment of community charge in the national accounts

4. There is no clear-cut home for the community charge within existing national accounts conventions. There is however a strong case, accepted by Treasury officials, for saying that it is a "tax" of some sort, despite its name:

- it is compulsory for all adult residents (with some minor exceptions) whether or not they avail themselves of the services provided by local authorities;
- it is unrequited, since the payments made do not bear a direct relationship to the services consumed by individual payers;
- it is a recurrent levy and not repayable (if services are not utilised, for example).

5. But there are no arguments, which we have been able to identify, for considering the community charge a tax on expenditure. There is no related good or service to the production or use of which the payments are directly related. The payments must be made regardless of whether any benefit is received by the individual taxpayer of the services they are used to provide.

6. Nor can the community charge be considered a tax on income (although the charge is not completely independent of income because

some people below a certain "poverty" line will pay only 20 per cent of the full amount), nor a tax on capital.

7. The DOE argued that the community charge was not a tax. This may have been because a CSO decision to classify it as a tax, if it became known might, have jeopardised its inclusion in the RPI. Their substantive argument was that the charge should be classified as an "other current transfer" because, like national insurance contributions, payment of the charge gives rise to rights for the payer. In addition since the level of the charge payable in each area is related to the level of services (rather the inputs to those services) to which charge payers are entitled it could be argued that the level of payment is not unrequited and therefore should not be treated as a tax.

8. No other department supported this view. But as the community charge does not fit into the existing three-way classification of taxes, and faced with an entrenched DOE position, the committee decided to treat the community charge as a completely separate item of revenue ie. as neither a tax, nor "other current transfer", nor as a "charge". It was recognised however that this was not an entirely satisfactory solution and that it would be necessary to review it later (see paragraph 14 below).

Implications for money GDP

9. There are two different ways of valuing domestic or national product; at market prices, including all taxes on expenditure (with subsidies regarded as negative taxes), or at factor cost, representing only the sum of the incomes of factors of production. Although taxes on expenditure form part of producers' costs, they do not form part of the income of factors of production.

10. Both methods of valuation are used in different contexts. According to the UK official handbook on the national accounts "broadly the justification of market prices is that they represent the relative values to the individual of different goods and services, on the usual assumption that the price paid for each commodity is proportional to its marginal significance. Thus an increase in the domestic product at constant market prices, other things being equal, can be regarded as indicating prima facie an

increase in the 'economic welfare' of the community. On the other hand, valuation at factor cost displays the composition of national product or expenditure in terms of the factors of production employed, the contributions of the factors being measured by the incomes which they receive. Valuation at factor cost may therefore be useful in connection with problems of allocating resources. The choice between the two presentations thus depends on the purpose for which the statistics are to be used."

11. In the UK economic growth is normally measured by real GDP at factor cost. But MTFs objectives for money GDP are in terms of GDP at current market prices, and the Government's tax and expenditure objectives are expressed in terms of ratios to GDP at market prices.

12. Once it is accepted that the community charge is not a tax on expenditure a reduction in the market price measure of GDP is inevitable at the point the community charge replaces rates. The CSO estimated that this was worth 1 $\frac{3}{4}$ per cent off market price GDP. GDP at factor cost is however not affected.

13. As the table below shows the gap between the growth of GDP at factor cost and market prices in any one year has over the past 10 years been $\frac{1}{2}$ per cent or less. The main exceptions, 1979-80 and 1981-82, are years in which there were unusually large increases in indirect taxes. Gaps will occur whether or not these were associated with tax switches, as in 1979-80, or net tax increases as in 1981-82. (In one sense the replacement of rates by community charge is just such a tax switch.)

Money GDP % increases

	<u>1978-</u> <u>1979</u>	<u>1979-</u> <u>1980</u>	<u>1980-</u> <u>1981</u>	<u>1981-</u> <u>1982</u>	<u>1982-</u> <u>1983</u>	<u>1983-</u> <u>1984</u>	<u>1984-</u> <u>1985</u>	<u>1985-</u> <u>1986</u>	<u>1986-</u> <u>1987</u>	<u>1987-</u> <u>1988</u>
Market prices	14.8	20.0	13.9	9.9	9.5	8.5	7.1	9.3	7.0	10.6
Factor cost	14.5	17.9	13.6	8.2	9.7	8.9	7.5	8.8	6.0	10.2
Diff- erence	0.8	2.1	0.3	1.7	-0.2	-0.4	-0.4	0.5	1.0	0.4

Postscript on the future treatment of taxes in the national accounts

14. One option considered by CSO(E) is to change the current three way classification of taxes in the national accounts to a two way classification of direct and indirect taxes. The advantages of this would be first that it would be more consistent with the international conventions and secondly, were we able to agree that community charge is a tax, that community charge would have an obvious home in direct taxes. This option has been put on ice for the moment however, but not forgotten, because of the DOE's current opposition to treating the charge as any sort of tax and because the international conventions are themselves under review.

FROM: A C S ALLAN *ACP*

DATE: 30 January 1989

MR MOWL

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Wicks
Mr Scholar
Mr Phillips
Mr Byatt
Mr Sedgwick
Mr Riley
Mr Culpin
Mrs Lomax
Mr A J C Edwards
Mr R I G Allen
Mr Gieve
Mr Potter
Mr MacAuslan
Mrs Butler
Mr S J Davies
Mr Matthews
Mr Hibberd
Mr Owen

CLASSIFICATION OF THE COMMUNITY CHARGE IN THE NATIONAL ACCOUNTS

The Chancellor was grateful for your minute of 24 January. He noted the implications you described for money GDP, the GDP deflator, and various personal sector statistics.

2. He feels that we should not make these adjustments in the forecasts to be published in the FSBR. We shall - subject to further discussion - be including other adjustments to allow for the errors in the national accounts, and he feels that to introduce two sets of adjustments at one go would make the presentation very much more difficult. We may, however, need to include some sort of footnote to record that we have not made this adjustment.

A handwritten signature in black ink, appearing to read 'ACSA' with a long horizontal stroke underneath.

A C S ALLAN

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FROM: C J RILEY
DATE: 30 JANUARY 1989

CHANCELLOR

Thanks. I have considered carefully, but prefer Option B for the reasons set out in Mr Allan's minutes of 30/1.

Ch

This crossed with my minute repeating the conclusion you had reached with Peter & Terry last week. (favouring Option B).

AA

- cc Chief Secretary
- Financial Secretary
- Paymaster General
- Economic Secretary
- Sir P Middleton
- Sir T Burns
- Mr Anson
- Mr Wicks
- Mr Scholar
- Mr Byatt
- Mr Phillips
- Mr Culpin
- Mrs Lomax
- Mr Peretz
- Mr Sedgwick
- Mr MacAuslan
- Mrs Butler
- Mr Davies
- Mr Matthews
- Mr Hibberd
- Mr Mowl
- Mr Savage
- Mr Gieve
- Mrs Chaplin
- Mr Tyrie
- Mr Call

THE COMMUNITY CHARGE AND MONEY GDP IN THE FSBR

Colin Mowl's submission of 24 January considers the appropriate classification of the community charge in the national accounts, and how the statisticians propose to proceed. **This paper considers some of the presentational issues which arise in the context of the FSBR.**

2. The situation as regards the statistics is as follows. Whereas domestic rates are classified as an expenditure tax, adding to money GDP at market prices, it is intended not to classify the community charge in this way. The effect will be to produce a downwards distortion to the growth in money GDP and the GDP deflator in the next two years. The effect will be fairly small in 1989-90 when the charge is introduced in Scotland, but quite large in 1990-91 when it is introduced in England and Wales.

Effects of the community charge on money GDP (%)

	<u>1989-90</u>	<u>1990-91</u>	<u>Later years</u>
Level	$-\frac{1}{4}$	$-1\frac{3}{4}$	$-1\frac{3}{4}$
Growth rate	$-\frac{1}{4}$	$-1\frac{1}{2}$	-

3. While the statisticians' decision cannot reasonably be disputed, it does pose a number of presentational issues in relation to the FSBR which we need to consider. It impacts on the presentation of policy in a number of ways:

(i) Money GDP is used to describe our medium term nominal objective in the MTFS (FSBR table 2.1, charts 2.1 and 2.3). Figures for the current year and the year ahead are presented in the economic forecast (table 3.12). It is also used to define the velocity of the monetary aggregates (chart 2.2) and the stance of fiscal policy (the PSBR is shown as a per cent of GDP in tables 2.6 and 6.1, charts 2.3 and 2.5).

(ii) The key public expenditure ratio is GGE (excluding privatisation proceeds) as a per cent of money GDP (table 5.1 and chart 6.1).

(iii) Measures of the tax burden use money GDP as the denominator (table 6.2 and chart 6.1).

(iv) The GDP deflator is used to define our medium term inflation aspiration in the MTFS (table 2.3). It is also used to define public expenditure in real terms (table 5.1).

4. The effects on these variables will not be uniformly helpful in presentational terms as we switch over to the community charge. And the recorded figures will give a misleading indication of underlying movements. The recorded money GDP growth rate will be depressed slightly in the next two years, implying faster progress towards our medium term objectives. But everybody will be aware that part of the deceleration is spurious. Furthermore, because

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recorded money GDP is reduced, figures for the public expenditure ratios and the tax burden will be increased by nearly $\frac{3}{4}$ ^{of} a percentage point by 1990-91, probably causing the ratio to rise in that year.

5. The question arises: how should we handle this in the FSBR. There are three main options:

Option A

Present figures for money GDP at market prices as we expect them to be recorded by the CSO. We would have to explain that the figures were distorted by the change to the community charge, and give an indication of the scale of the effect in each case. Adjusted figures, correcting for the distortion, could be given in footnotes (or in brackets) and on charts as necessary.

Option B

This isn't quite how we'd put it: we'd say not yet taken a board charge to CC.

Present money GDP figures as if the community charge were classified as an expenditure tax - the approach used in the January forecast - to give an undistorted series. (A less satisfactory alternative would be to take rates out of the data for the years up to 1989-90, bringing them into line with the figures for 1990-91 onwards). We would probably have to set out the estimated effects of the community charge; and we would have to acknowledge in footnotes that in the FSBR it had been classified in the same way as rates.

Option C

A more radical option would be to move to the factor cost definition of money GDP. The data for this will not be distorted by the move to the community charge, and in normal circumstances the growth rate is very similar to the market price definition (see chart 1). The main impact would be on the public expenditure and tax ratios; the factor cost definition of GDP is about 15% lower than the market price definition, raising the expenditure and tax ratios by around 6 points (see charts 2 and 3).

Assessment

6. Moving to the factor cost definition - option C - can probably be dismissed fairly quickly. While this option might not pose serious difficulties for the MTFs, it would have a major impact on the expenditure and tax ratios. The market price definition was chosen in the late 1970s largely because it yields lower numbers for these ratios. Moving to the factor cost definition - and ratios of the order of 45% - would be presentationally very awkward. It would be very difficult to justify a major shift of presentation on the grounds of a temporary distortion to our present definition.

7. The approach adopted in the January forecast - option B - has the virtue of simplicity. But it could only be a temporary expedient; we would eventually have to adhere to the CSO convention, probably in the Autumn Statement. And departing from agreed statistical conventions in order to produce an undistorted series might attract criticism. This is not the first time that the path of money GDP has been distorted. The reverse phenomenon occurred in 1979-80 as the pattern of taxation was shifted from direct to indirect, raising the recorded growth of money GDP, and depressing the measured tax and expenditure ratios. We did not make any adjustments on that occasion, and to do so now might be difficult to justify. Although the 1979-80 episode was in some respects different from the present one - there was a genuine change in the price level, for example - it raised similar issues about the difference between underlying and recorded changes.

8. It is unclear whether the proposed CSO treatment will be public knowledge by the time of the Budget. It might only emerge when the second quarter figures, incorporating the Scottish community charge for the first time, are published in September. But it may well come to light sooner; publication of the RPI Advisory Committee Report in February or March may provoke questions from informed commentators. We clearly cannot rely on it not being public knowledge on or soon after Budget day.

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9. It might be argued that we could get away with departing from the CSO convention for this Budget because the effect on 1989-90 is not very great. But we should remember that we may well be presenting national accounts figures which differ in a major way from those published by the CSO - see Jim Hibberd's submission of 26 January. To adopt a different definition for money GDP as well risks adding unnecessarily to the impression that we were cooking the books.

10. Option A - sticking with the CSO convention - would involve a certain amount of complication, affecting a range of variables throughout the FSBR. For example, additional rows would be needed in tables 1.2, 6.7 and possibly 6.5, which set out the public sector's finances, but this would be no problem. The extra complication with option A is certainly manageable.

11. One merit of this option is that it would permit our figures to be compared with the published data as they emerge; this may not be a major issue in 1989-90, but it would be in 1990-91. And it would avoid providing commentators with an extra line of attack on our handling of the statistics. It does not preclude our indicating in the FSBR the underlying movements in key variables; indeed, this would be essential.

12. Our recommendation is to go for option A. Option B would merely postpone the problem until the Autumn Statement. We will have to adopt option A sooner or later, and there may be little advantage - indeed there would be some risks - in delay. Implications for the GGE ratios using the conventions underlying the MTFS are shown in an annex.

13. You may wish to discuss this issue at your meeting on the MTFS on Wednesday.



C J RILEY

Cuts with ways

No published figures will probably be under-estimated

ANNEX

General Government Expenditure as a per cent of GDP

	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
<u>Option A</u>				
Total	37.9	38.2	38.7	38.5
Excl. privatisation	39.4	39.2	39.6	39.4
<u>Option B</u>				
Total	37.9	38.2	38.0	37.8
Excl. privatisation	39.4	39.2	38.9	38.7

Assumptions

Money GDP path as recommended in table 3 of MP1 paper on MTF5 Issues (27 January).

GGE in cash terms as in the January forecast for 1988-89. Autumn Statement figures from 1989-90 onwards.

Chart 1. Gross domestic product annual growth rate

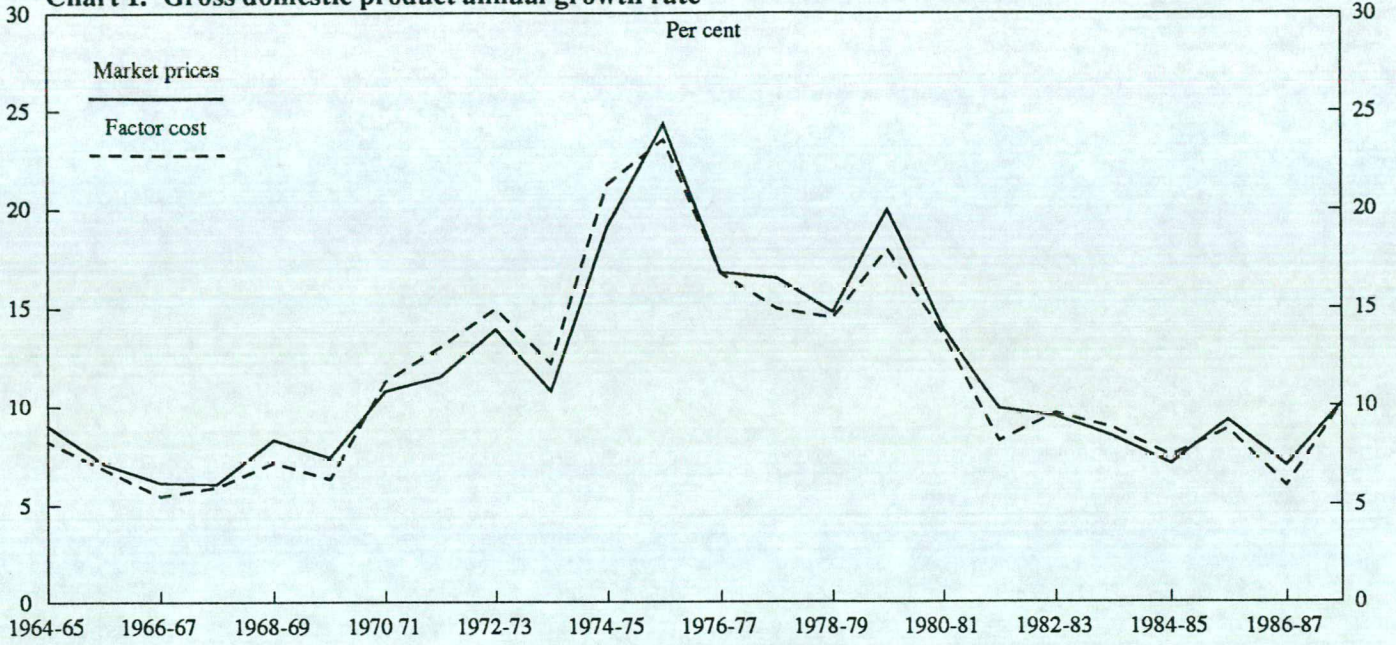


Chart 2. General government expenditure excluding privatisation proceeds

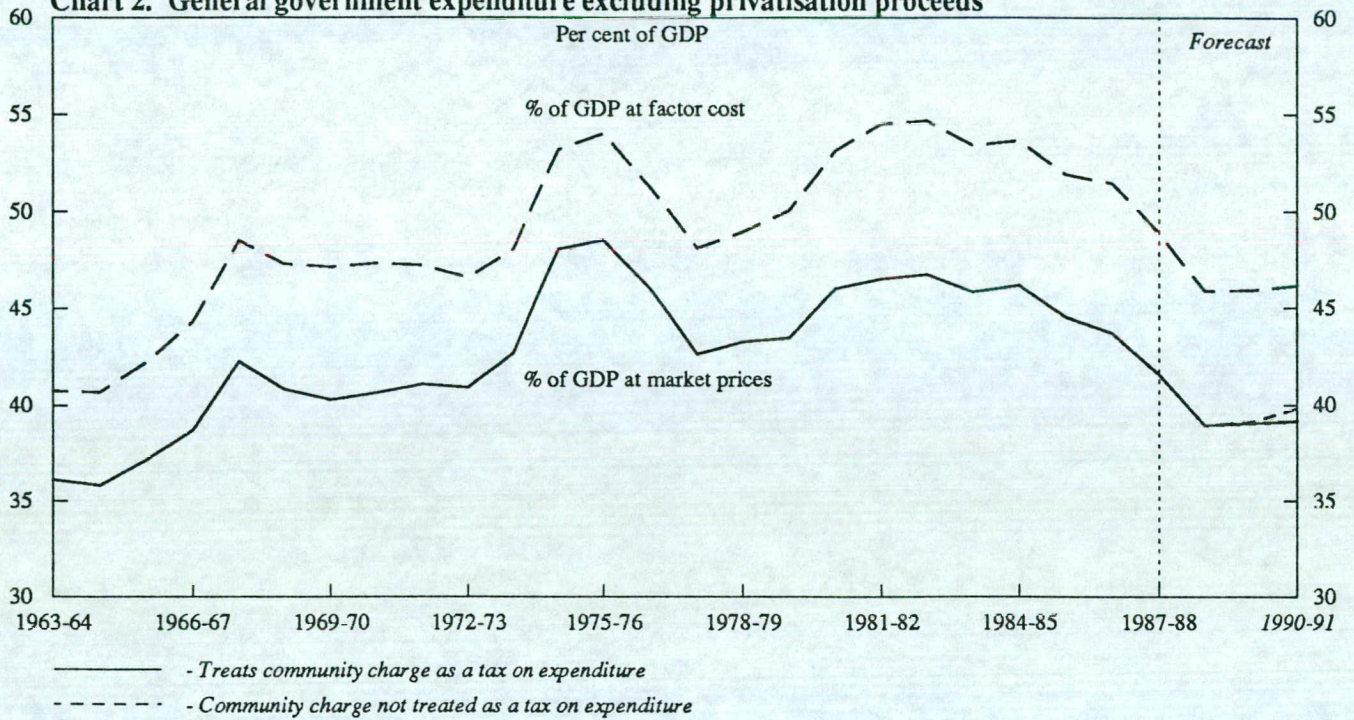
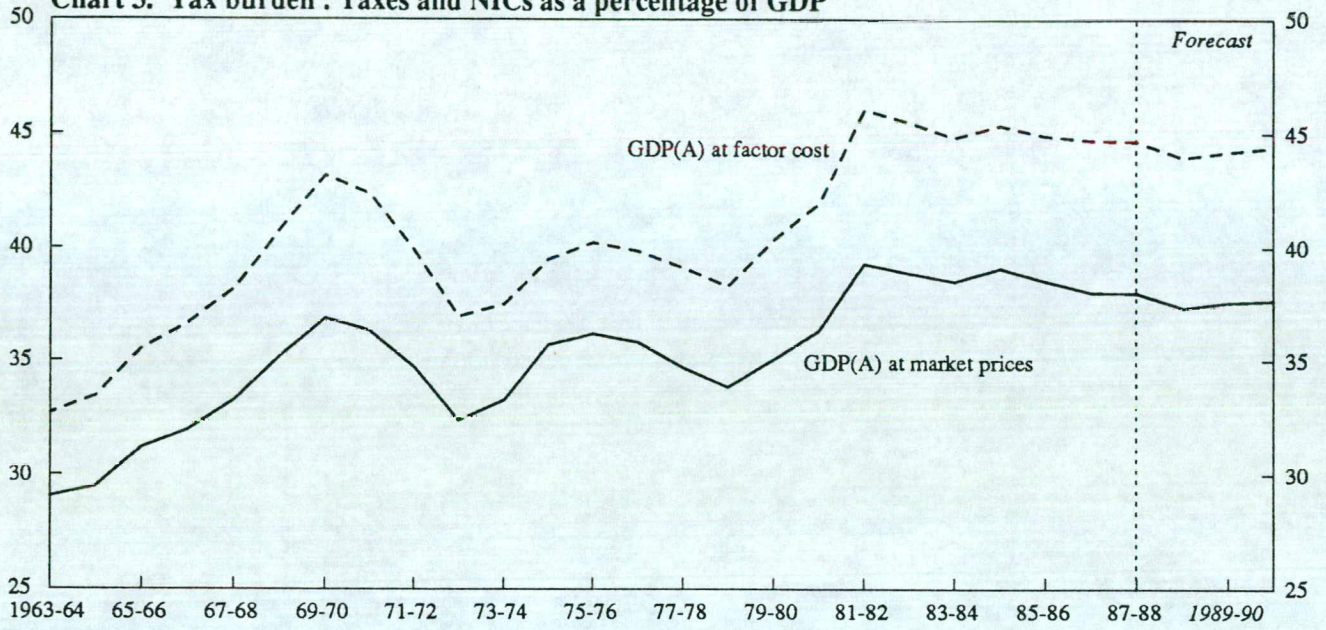


Chart 3. Tax burden : Taxes and NICs as a percentage of GDP





FROM: A C S ALLAN

DATE: 31 January 1989

MR C J RILEY

owp

psj

cc PS/Chief Secretary
 PS/Financial Secretary
 PS/Paymaster General
 PS/Economic Secretary
 Sir P Middleton
 Sir T Burns
 Mr Anson
 Mr Wicks
 Mr Scholar
 Mr Byatt
 Mr Phillips
 Mr Culpin
 Mrs Lomax
 Mr Peretz
 Mr Sedgwick
 Mr MacAuslan
 Mrs Butler
 Mr Davies
 Mr Matthews
 Mr Hibberd
 Mr Mowl
 Mr Savage
 Mr Gieve
 Mrs Chaplin
 Mr Tyrie
 Mr Call

Ch
 Rachel wants to reopen this
 @ this afternoon's meeting [largely
 I think so that ratios get bumped
 up before her first survey?!

Art

THE COMMUNITY CHARGE AND MONEY GDP IN THE FSBR

The Chancellor was grateful for your minute of 30 January. Having considered the issues carefully, he prefers Option B (ie not making any adjustments for the introduction of the community charge in the FSBR), for the reasons set out in my minute of 30 January to Mr Mowl, namely that introducing both adjustments for the community charge and adjustments for the errors in the national accounts at one go would make the presentation very much more difficult.

ACSA

A C S ALLAN