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PM seen

PRIME MINISTER

THE NEW TAX AND PRICE INDEX (TPI)

Officials have now virtually finished their investigation of a new index, designed to incorporate changes in income tax and to supplement the RPI. But they still have to complete the calculations required if we are to have an index which reflects what is happening to a representative rather than to a specimen household such as a married couple on average earnings with two children. This work cannot be completed until early August and if they run into snags, we would not be able to meet the August deadline. Subject to this, however, we would be in a position technically to meet a launch on the 17 August, when the July RPI figure is published.

2. The new index would apply only to tax payers. Essentially it combines movements in the RPI with changes in direct taxes and national insurance contributions. (The other features are set out in Annex 1).

3. The key issue is what the index is likely to show. Working on the basis of a specimen household, Annex 2 to this minute sets out a preliminary indication of past movements of the RPI and the new Index, and the likely movement of both on the basis of the short term forecast. For the TPI, a married couple (husband only working on average earnings) specimen has been used. Officials will be in a position to advise us what the composite index would show, on the basis of the forecast, when you return from Lusaka.

4. As the chart shows, the month-to-month movement of the TPI will have a saw-tooth path, tending to fall when income tax is reduced, but catching up on the RPI between budgets because of inflationary fiscal drag. We propose to set it out on a year-to-year basis, which will avoid this somewhat awkward feature (second chart). But outsiders will be able to do their own sums and Members will doubtless ask for the figures covering a shorter time scale on an annualised basis. The year-on-year figures for the TPI will, of course, only show a lower growth than those for the RPI if we are able to continue to reduce income tax in successive budgets.

5. The figures for the specimen households show year-on-year increases of the TPI of around 13-14 per cent from July onwards. This is less than the likely increase in the RPI itself, which will build up to around 17-18 per cent by the end of the year.

6. There are clearly arguments both for and against the launch of this new Index. The advantages are:-

(i) For next 7 months it will show significantly lower increases for tax payers than the RPI on its own; it should therefore take the heat off the RPI figures and could also be useful in pay bargaining.

(ii) If we are able to reduce income tax (ie achieve more than full indexation) in the next Budget, the TPI will continue to record a lower figure than the RPI. What will be possible depends on economic circumstances and on achieving further progress on public expenditure.

7. The disadvantages, which we have already discussed, are:-

(i) If further cuts in income tax beyond full indexation are not possible, the TPI would rise as fast as the RPI after the current financial year. If we were unable fully to index income tax, the TPI would rise faster than the RPI.

(ii) Because of the wide variation in the tax positions of individual households, critics will argue that the TPI is not very representative. This point is, to some extent, also true of the RPI, but to a lesser extent as the tax positions of households differ rather more than their expenditure.

(iii) At the moment, the annual social security upratings are based on the RPI, and the introduction of the TPI could give rise to two risks. First, we may be suspected of seeking to reduce the costs of pensions and other benefits by giving an uprating based on the TPI when the TPI is lower than the RPI - there is already Parliamentary interest in this. Secondly, because the TPI does not cover non-tax payers, we might be pressed to use discrete indices for various classes of social security beneficiaries when these were ahead of the RPI. This could be costly. We must therefore maintain steady our position that for the uprating of social security benefits in general the RPI rules, whatever the TPI says.

8. On balance, because expectations have been aroused, I think that, provided the numerical analysis is successful, we should launch the TPI on 17 August. The alternative would be to stress developments in post tax real earnings, but not in index number form.

9. The name of the new index is important. We would like to catch the public's imagination, but - contrary to some press reports - it is not a Standard of Living Index nor is it wise to call it a Cost of Living Index. To do so would open the way to technical arguments which opponents would deploy to discredit the new index. What we want to do is to supplement the RPI not supplant it. I think it is best to give it the admittedly austere name of "Tax and Price Index" (TPI). This is an exact description of what it is and it leaves us some flexibility in explaining it to the public in our speeches.

10. Initial presentation is also important. If we are to introduce it at all, I think it essential that it should appear for the first time on 17 August - when the July RPI, the first to reflect the Budget changes in taxes, will be published - and that it would be absurd to miss this key date. I propose that the Financial Secretary should launch it at a press conference, at which he could comment on the publication of the new Index and its relationship to the RPI, while the indices themselves were released in the standard form. A technical exposition would be available at the same time.

11. The key decision at the moment is whether or not to go ahead with the Index, provided that snags do not arise on the numerical work (which will be completed while you are away). If you decide we should go ahead, we shall have forecasts of the composite Index available on 9 August. I have no reason to expect these will be dramatically different from the index based on a specimen household, though a representative Index will be rather more weighted towards lower income earners, as a majority of people earn less than average earnings.

12. I am sending copies of this minute to members of "E" Committee, to Patrick Jenkin, and to Sir John Hunt.

Martin Hall

G.H.

25 July 1979

[Approved by the Chancellor of the Exchequer and signed in his absence]

MAIN FEATURES OF THE TAX AND PRICE INDEX

It would be confined to tax payers, on the grounds that for non-tax payers the RPI was already the most relevant index. With the exception of payments to tax payer pensioners, all social security benefits, including child benefit, would be excluded. To give the new Index a similar coverage to the RPI, high income earners would be excluded. The tax element of the TPI deals with tax liabilities and not actual payments. It also includes employees' national insurance contributions. An important issue concerns whether budget changes are to be included only from the date of the Budget, and what treatment there might be for any back payments. The preferred solution, whereby new rates and allowances would be incorporated from the date announced, without taking account of back payments, is I am sure the best one. But we shall have to explain the relation between this and the figures quoted in the Budget speech, which were calculated on a 42 week basis. We have decided not to revise the Index after publication. The RPI is not revised; the main issue of the Index is presentational; revision would be an unnecessary complication. Finally, the Index should not be introduced until we were ready to continue in exactly the same form; hence there should be no use of specimen households, but a composite Index should come in straight away.

Annex 2

PAST AND FORECAST MOVEMENTS IN THE RPI AND NEW INDEX

Attached are two charts which show the movement in the RPI and the new index over the period January 1977 to the end of 1980. For the past, monthly figures were used; for the forecast period, quarterly estimates. Movements are shown in terms both of index levels and year on year percentage changes. The forecast figures were derived from the FSBR; this assumes that in the 1980 budget personal tax allowances are indexed in line with the increase in the RPI that is forecast during 1979.

2. The figures are calculated on the basis of a specimen household (married couple on average earnings). They should not therefore be taken as being more than broadly indicative of movements in a composite index for which figures are not yet available.

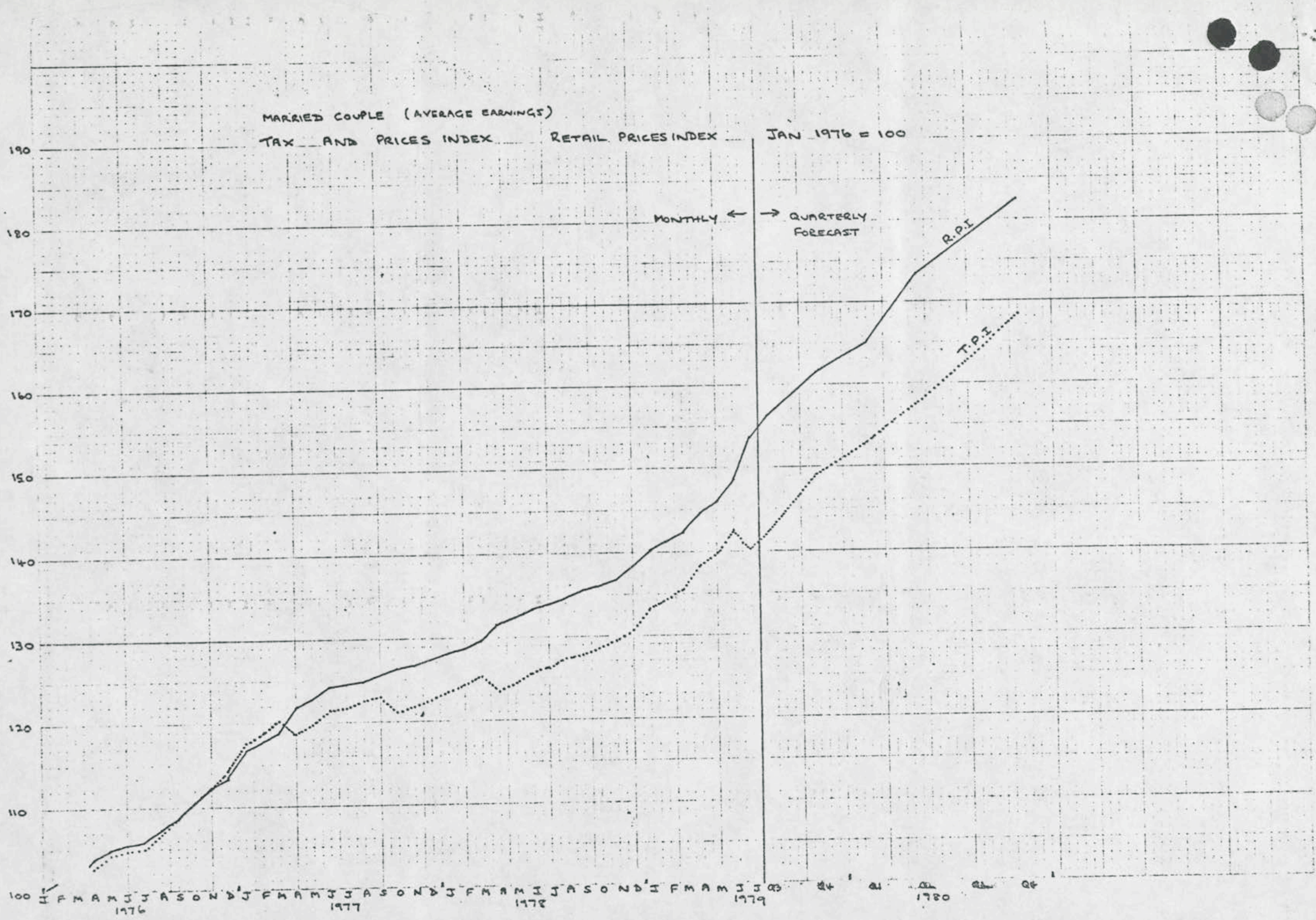
3. Interesting features of the calculation are as follows:

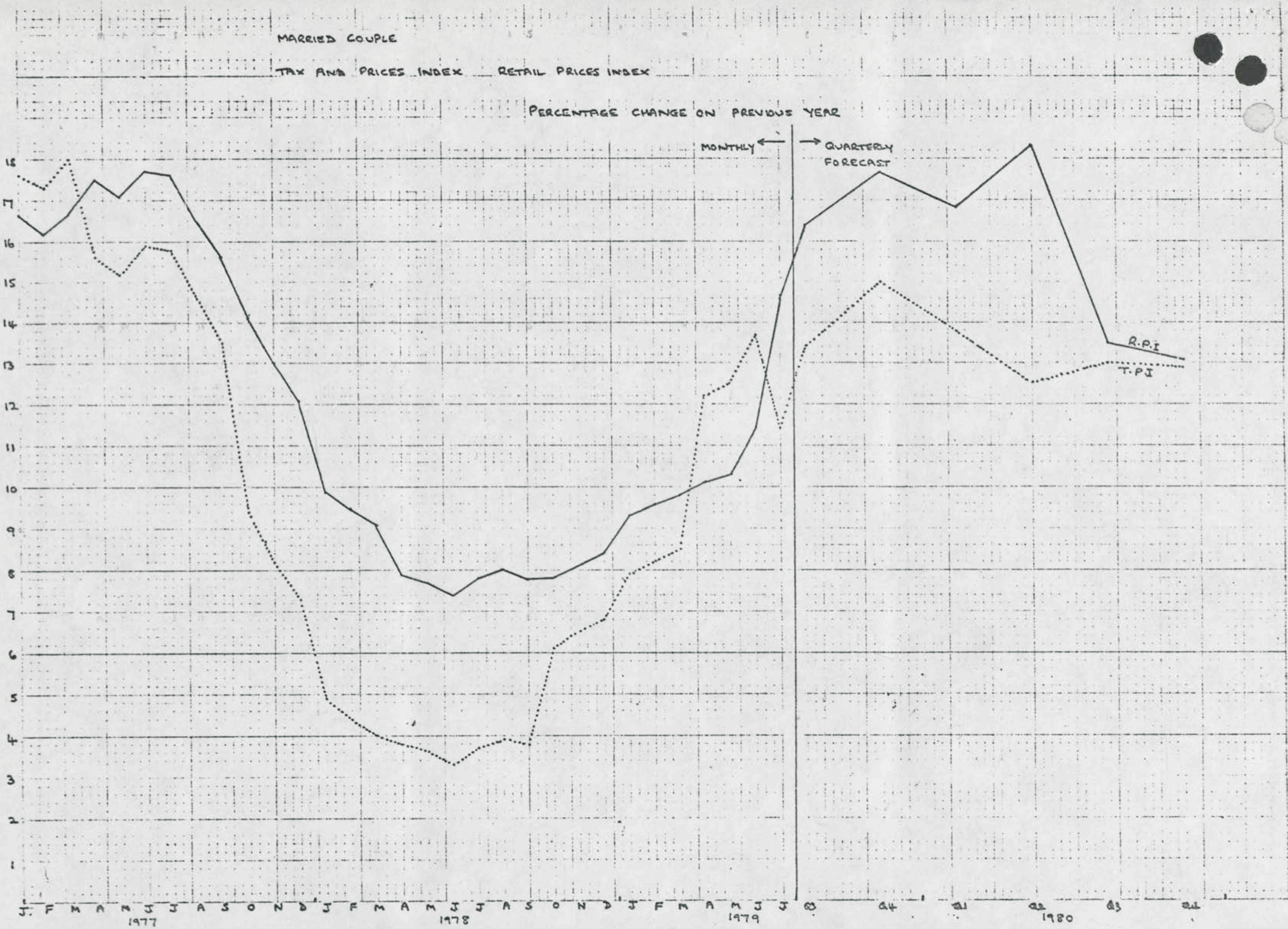
(a) Between budgets, movements in the level of the new index will tend to display a "sawtooth" pattern arising from the effects of fiscal drag.

/(b)

(b) Since 1977 the new index has risen rather more slowly than the RPI. This is because direct tax reductions over this period have more than fully compensated for increases in retail prices, so that the tax component of the new index has risen more slowly than the RPI.

(c) What happens beyond April 1980 depends on next year's budget. On the assumption that allowances are fully revalorised, the year on year increase in the RPI will fall back in line with the new index.


MARRIED COUPLE (AVERAGE EARNINGS)
TAX AND PRICES INDEX ...... RETAIL PRICES INDEX ...... JAN 1976 = 100
MONTHLY ← → QUARTERLY FORECAST
R.P.I
T.P.I
190
180
170
160
150
140
130
120
110
100
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J Q3 Q4 Q1 Q2 Q3 Q4
1976
1977
1978
1979
1980


MARRIED COUPLE
TAX AND PRICES INDEX _ RETAIL PRICES INDEX
PERCENTAGE CHANGE ON PREVIOUS YEAR
MONTHLY ← → QUARTERLY FORECAST
R.P.I
T.P.I
18 17 16 15 14 13 12 11 10 9 8 7 6 5 4 3 2 1
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J Q3 Q4 Q1 Q2 Q3 Q4
1977
1978
1979
1980

Index finger raised

It's the right time of year for cricketing imagery. So here goes.

Among the problems that admirable game faces is the fact that those responsible for running it think the way to get it out of its doldrums (for example, a Yorkshire-Middlesex match at Lords last week most devotedly attended by old age pensioners) is to keep tinkering with the rules. Yet it is somehow in the nature of the game to resist this.

Now consider the analogy with what has been happening nearer the Oval than Lords —at the House of Commons. A famous lay preacher once pointed out that "there ain't no butter in Hell." Well, there ain't much cricket at the Commons, *except* for the sort that consists of mucking about with the rules.

With one of those brilliant ideas that occur to special advisers in the bath (see Tessa Blackstone's article this week), someone must have convinced the Prime Minister that it would really make all the difference to this tedious business of industrial strife and wage bargaining if we put the whole business on a quite fresh footing.

Trade unionists have a bad habit of referring to rises in the retail price index when making their claims. Hey presto, then: let's change it.

Hence the Prime Minister's statement in the Commons last Thursday: "Alongside the retail price index we are planning to introduce a standard of living index, which we feel will give a very much more accurate reflection of the direct tax reductions which have been made."

What is clearly envisaged is the publication of an index of the net income of the average earner in the average family, adjusted for income tax reductions as well as the rise in prices. Such an index is of interest and importance: however, to describe it as a standard of living index is a distortion.

Information about net incomes of average earners has been calculated by government departments for years; turning this into an index adjusted for inflation should take a competent statistician about five minutes a month. Thus there is nothing new about what is proposed, save that it is being presented as a measure of the standard of living.

But whose standard of living? The average earner is, in government statistics, almost invariably taken as a man with average male earnings, now around £90 a week. Women generally earn much lower amounts; and in any case, since the average is influenced by those on high earnings, 55 per cent of men earn below average male earnings.

Most crucially, it is the groups not in work who would be excluded from this standard of living index. When unemployment rises, as seems inevitable, the wage-earner cast onto the dole will become a non-person as far as the new index is concerned. The standard of living of the unemployed, the disabled or the pensioner would simply not enter into the calculation of an index of the real net income of the average earner.

The second deficiency is that this conception of the standard of living clearly does not extend beyond money incomes. Mrs Thatcher said: "The tax on pay is the price of things like education, defence and so on, but when that price comes down reductions in that price ought to be reflected in the retail price index. Unfortunately it is not."

The confusion and sentiments revealed by such a statement are alarming. What is clear is an indifference to the value of social services. The statement makes no distinction between the price of public services and their standard and quality. Nothing in the budget lowered the price of public services. Indeed, higher VAT raised their price. And in education, for example, the expenditure cuts increased the sizes of classes, and could deprive children of school books.

As the government shifts the burden of health and education away from collective provision through taxation onto the private individual, net money incomes should of course rise. But when at the same time social services are cut, this in turn reduces the standard of living of the average earner.

Ironically, five years ago when the Labour government was increasing pensions and social services, Barbara Castle sought to introduce the idea of the "social wage"— the value of the social services that were being received. Thus, when taxes were increased to pay for improved services, it was hoped, as part of the "social contract," that trade unions would take account of the increase in the social wage. The new government appears to count the social wage as nought. When social services are being cut, the government is asking people if they will ignore the cuts: few of them will do so.

A disturbing feature of the introduction of a new index is the role of the Government Statistical Service. In the past they have been rightly, if sometimes excessively, anxious to avoid producing data that might be thought politically biased or that purported to be more than it really was. There is every sign that the new index has been demanded by the Prime Minister, accepting no resistance or argument.

It is not surprising that the government wants data that shows its performance in the best light. No government, Labour or Conservative, has ever been immune from this temptation. But an index of the real net income of the average earner is just that, and no more. To call it a standard of living index would be a damned lie.

One of the functions of a Prime Minister, in the past, has been to act as a kind of national umpire. Does the umpire need an umpire?

New Society - 19 July 1979

Statistics

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√ MS

Secretary of State for Industry

13 August 1979

The Rt Hon Patrick Jenkin MP
Secretary of State
Department of Health and Social Security
Alexander Fleming House
Elephant and Castle
London SE15

Dear Patrick.

THE NEW TAX AND PRICE INDEX (TPI)

I should like to make one point on your minute of 25 July to the Prime Minister on the question of whether the Retail Price Index (RPI) is the best measure to use in the annual uprating of social security benefits.

Whilst I agree that the RPI is the most obvious indicator to use for updating Pensions and Social Security Benefits, the fact is that it does not accurately reflect the expenditure of those in receipt of these payments.

It is established that the lower income groups spend more on food, etc - ie non-VATable items - so benefit increases in line with the RPI actually <u>improve</u> their standard of living.

On the other hand, the TPI, because the same groups generally benefit less from direct tax cuts, is likely to be <u>unfair</u> to them; as is intimated in your minute.

We need, it seems to me, to take these factors into account. Moreover, we may not always want to change long-term and short-term benefits to the same extent.

I am sending copies of this to the recipients of your minute.

Ever.

Keith

EXTRACT FROM "THE OBSERVER" 12 AUGUST 1979

Tories to launch tax-price index

by ADAM RAPHAEL

THE GOVERNMENT is to soften the bad news that inflation is now soaring above 15 per cent by introducing a new standard of living index designed to reflect the benefit of its tax cuts.

Announcement of the new index is expected on Friday. It will coincide with publication of the July Retail Price Index, which will include the full weight of the VAT and petrol duty increases in the Budget. The consequence, Ministers accept, will be a leap of nearly four points in the RPI, taking it to above 15 per cent at the start of the new pay round.

Mrs Thatcher, backed by the Chancellor, Sir Geoffrey Howe, pushed through the new, composite tax and price index despite Ministerial and official scepticism about its political benefits.

It is designed to show the benefits to the average family of the reductions in income tax set against inflation. The Chancellor believes that the index, by illustrating the narrowing gap between gross and net pay, will discourage inflationary wage demands this autumn.

The construction of the index has caused problems to the Treasury's statisticians. Mortgage payments will probably be included but there is likely to be controversy over the way the index is calculated. Inevitably, the Treasury is bracing itself for accusations of a political fix.

Future inflation is uncertain, given the erratic movements of the pound and the declining trend in commodity prices. The Treasury's forecast is that the annual rate will be 17.5 per cent by November, and that figure is unlikely to be far out.

But that is not the predicted peak, although forecasts that inflation will top 20 per cent this winter may now be too gloomy in view of the sharp upward movement of sterling since the Budget.

Continuing high wage settlements are causing great concern to Ministers. The Chancellor gave another blunt warning last week that the result of inflationary wage demands would be higher unemployment. A report from the Manpower Services Commission that unemployment is likely to exceed two million by the beginning of 1981 is the most authoritative indication of what lies ahead.

There is no sign, however, that Ministers are prepared to relax monetary constraints this autumn. Although there is great pressure for reduction in interest rates, the Chancellor made clear last week that he will not act until bank lending declines.

EXTRACT FROM 'THE SUNDAY TELEGRAPH'

12 AUGUST 1979

New index shows aid in Budget

By Our Industrial Staff

THE Government's first Tax and Price Index is expected to show that the average family's living costs have risen by about 13 per cent over the past 12 months.

The new index is designed to reflect the purchasing power of incomes after taking into account cuts in direct taxes. It shows the effect of tax reductions — which have increased spending power — as well as changes in prices.

It is therefore expected to show a rate of inflation three to four per cent below the Retail Prices Index, which when published on Friday is likely to show a rise of about 16 per cent over a year, compared with last month's 11·4 per cent. The Retail Prices Index does not reflect changes in direct taxation but shows the effect of VAT.

INFLATION TRIGGER

The Prime Minister and senior economics ministers have felt that the prices index acts as a catalyst for wage inflation, and that there should be a separate index showing the effect of both tax and price changes.

The Treasury's latest Economic Progress Report contains a table which claims to show that "the Budget switch from direct to indirect taxes will result in most households being better off than before the change, over the rest of the financial year."

The table shows:

Gross wkly pay in £	Real net income % rise: Single	Married couple	Cple, 2 children under 11
60	1·4	1·6	0·9
100	1·7	1·8	1·3
150	1·8	1·9	1·5

Mrs Thatcher will decide tomorrow whether the new index should be issued simultaneously with the prices index on Friday or delayed until the autumn.

There is no doubt that the new index will come under criticism from the TUC and the Labour party.

Mr David Basnett, leader of the General and Municipal Workers' Union, said last night: "Such a false index would not have the slightest influence on the wage claims which will be submitted from this autumn onwards.

"No new index will hide the fact that the Tories have increased the rate of inflation through their Budgetary and other measures.

CONFIDENTIAL

Statistics.
B/F 10/8
✓ to MJS

PRIME MINISTER

TAX AND PRICE INDEX

I have seen the Chancellor's minute to you, proposing that we should start publishing this index monthly from 17 August when the July RPI appears. I am broadly in favour of a new index which measures tax changes and I am happy that contingency plans should be made for publication on 17 August. But I think we should appreciate that the index measures the rise in gross earnings needed to maintain net purchasing power (it is not a standard of living index). In this respect the index is intended to influence wage bargaining by moderating workers' views of the increases they need in order to maintain their real incomes. This approach could blunt our more general message on pay - that each employer has a different limit on what he can afford, and that to press for more will put jobs at risk.

2. This is a consideration which you may wish to consider on your return from Lusaka, by which time I understand that the full figures will be available.

3. I am copying this minute to the members of E Committee and Sir John Hunt.

T. Adis

J. N.

(approved by the Secretary of State and signed in his absence)

Department of Trade
2 August 1979

CONFIDENTIAL

Statistics

B/F 10/8/-

PRIME MINISTER

THE NEW TAX AND PRICE INDEX (TPI)

I recognise that expectations for a new index have been aroused and I would not want to dissent in principle from what the Chancellor of the Exchequer proposes in his minute to you of 25 July. But I should like to enter a note of caution about how TPI is launched and put across subsequently.

As I see it, the purpose of the TPI would be to expose the deficiencies of the RPI and, more positively, to show how higher indirect taxation has been more than made good by reductions in direct taxation. I am, of course, in favour of that objective.

But in putting the TPI across we should avoid at all costs any implication that the Government was inviting wage negotiators to use it, as a supplement to the RPI, as the basis of their bargaining. Too much emphasis on the TPI will tend to blunt the main message on pay - that what counts is what firms can afford to pay and the value of the goods produced or services provided, and that indexation is irrelevant to that process.

Furthermore, I see some danger in a tax-based index drawing attention to the erosive effect of income tax on the money values of wage increases, thus encouraging union negotiators to gross up their claims more than they do at present.

/I ...

I hope that the TPI can be put across, in a suitably low key, with these dangers in mind. I would hope that the emphasis could be placed on the effects of tax changes in cash terms, rather than on percentages.

I am copying this to members of E Committee, to Patrick Jenkin and to Sir John Hunt.

KJ.

K J
1 AUGUST 1979

Department of Industry
Ashdown House
123 Victoria Street

PO

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Statistics

NBPM at this stage
MJS

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Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury
Great George Street
LONDON SW1P 3AG

30 July 1979

Dear Geoffrey

THE NEW TAX AND PRICE INDEX (TPI)

I have seen that the Prime Minister last week agreed that on balance it would probably be worth introducing the new index, and that a final decision should be made when further work has been completed.

I should like you to know that I am generally content with the way things are going on this project.

I very much agree with your view that the new index should be a supplementary piece of information rather than a substitute for the RPI. It could help to get into the public mind that the benefit of the tax cuts needs to be borne in mind alongside the increases in the RPI arising from VAT. In doing this it would be desirable not to overplay the new index.

From the point of view of pay bargaining, the cut in direct taxes is certainly a point that must be taken into account along with the mix of other considerations which enter into negotiations, including of course the movement in the RPI. Should, however, we find at the end of the day, when we have the final results of the TPI studies before us, that we are doubtful about proceeding with the new index, then I think it would be possible to take steps to draw attention to the cut in direct taxes as being relevant to negotiations without having them incorporated in a special index, although this will not be easy.

cc the Prime Minister
other members of E Committee
Patrick Jenkin
Sir John Hunt

Yours
Jim

Prime Minister

THE NEW TAX AND PRICE INDEX (TPI)

1. Geoffrey Howe sent me a copy of his minute to you of 25 July about the publication of this new Index.

2. My concern is of course with the possible effect of introducing an Index which stands alongside the RPI on the annual uprating of social security benefits.

3. The statutory position is that it is my responsibility to make sure that benefits maintain their real value. The RPI has been the indicator which has been used to date, and I am in no doubt that it will certainly be the RPI which remains the best available measure, generally, of how social security benefits should move in order to "price protect" them.

4. The points mentioned in paragraph 7(iii) of the Chancellor's minute are certainly relevant in this connection. One of the major features of the Social Security Bill which we are introducing in the autumn will be the provision which restricts pension upratings to prices only instead of the better of prices or earnings. The question of what we mean by price protection will therefore come under close scrutiny and we shall certainly need to be in a position to give firm assurances that there is no question of eroding the significance of price protection by using an indicator other than the RPI in order to produce a lower uprating.

5. I am sending copies of this minute to the Chancellor, members of E Committee and to Sir John Hunt.

Don Brereton

(Signed by Private Secretary and approved by the Secretary of State)

P J

25 July 1979