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The Rt Hon Nigel Lawson MP
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July 28

Dear Nigel

COMMUNITY CHARGE - RPI

As you know, our officials have been discussing the implications for the Retail Prices Index of the introduction of the community charge. Officials of DOE and CSO have also been involved. I am advised that all concerned agree that there will have to be some discussion on the RPI Advisory Committee, whose recommendations have provided the basis of all previous changes in methodology concerning the RPI. But there is not yet agreement on the substantive issue and, therefore, on the terms in which the Committee should be asked to advise. I attach a paper, in draft form, which reflects the work officials have so far been able to do, although it reaches no firm conclusions.

I know that there are very difficult issues involved for you and that you are seeking to resolve these as quickly as possible. But the matter is now becoming urgent, if my statisticians are to have a decision in time for the introduction of the community charge in Scotland. I have therefore come to the view that my officials should now approach potential members of the Retail Price Index Advisory Committee in advance of any decision on its precise terms of reference, with a view to setting up a series of meetings starting, if possible, in September.

I hope that you can agree to this course of action. I can see no alternative to proceeding in this way if we are to have any hope of receiving timely advice from the Committee, on whatever issues we put to them. I will not, of course,

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announce publicly that we have reconvened this Committee until we can agree on the terms of reference.

I am copying this letter to the Secretaries of State for the Environment, Health and Social Security and the Scottish Office as well as to Sir Robin Butler and the Head of the Government Statistical Service.

NORMAN FOWLER

SECRETARY OF STATE FOR EMPLOYMENT

PS Ministers
PS Secretary
Mr Manley
Mr Peck
Mr Dobbs
Mr Sellwood
Mr Lightfoot

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TREATMENT OF RATES AND THE COMMUNITY CHARGE IN THE RPI

Paper by the Department of Employment
incorporating some comments
by Treasury, CSO and DOE
(prepared 22 July 1988)

Introduction

1. The introduction of the community charge has implications for the Retail Prices Index which raise potential political and market-sensitive issues. The central question is whether or not the community charge should be included within the scope of the RPI, as rates are, or excluded like income tax and national insurance contributions.

Main arguments

2. The main considerations in favour of exclusion are:

(a) Payments such as the community charge, though very rare internationally, have been classified by the international bodies that set standards as direct taxation for the purposes of compiling national accounts. The Central Statistical Office agrees; its view is that the community charge must be regarded as a tax (as are rates) but cannot be treated as a tax on housing expenditure (which is how rates are treated). The construction of price indices usually (but not necessarily) follows national accounts practice on such matters, which would imply exclusion of the community charge from the RPI just as income tax and national insurance contributions are excluded.

(b) Rates are treated for index purposes as an *indirect* tax on the consumption of housing services. Like VAT on other goods and services, they vary with the level of consumption (subject to the local rate poundage): the larger the house the greater the consumption of housing services and the higher the rates bill. They are, therefore, conceptually part of the price of a service and, like VAT, are included in the RPI. Of course the money raised by rates goes towards the provision of local services but this does not imply that these services themselves are within the scope of the index. This too is akin to the position with VAT, which is included because it is an indirect tax and part of the price - not because the services it finances are within the RPI's scope. The crucial difference between rates and the community charge is that the latter will not be related to the consumption of specific goods or services and therefore does not form part of any particular price. It should therefore be regarded as a tax which raises money for the provision of local services and as such, like income tax, it has no place in the RPI.

3. The main argument for including the community charge in the RPI is that, though the nature of the funding will have changed, the services for which rates are now charged will continue to be provided and the "man in the street" will continue to meet their cost out of his take-home pay. From his perspective little will have changed so he might expect to see the RPI continue to include the expenditure. For recipients of state pensions and benefits this view will be reinforced by the use of the RPI for indexation, as they will need to finance their share of the community charge out of their benefits and may well expect it to be taken into account in the uprating, particularly if the charge increases, as rates have in the past, faster than other prices. Excluding the charge might give the wholly false impression that an attempt was being made to restrict the coverage of the Index deliberately to produce a lower rate of inflation and thus save money on pensions and other benefits.

4. In addition, business rates will be uprated in future by an amount not greater than the increase in the RPI. Excluding the community charge could be seen as a means of further depressing the non-domestic contribution to local authority costs and increasing the burden on community charge payers.

Conceptual problems

5. Under current RPI methodology the community charge could replace rates, following very similar computational procedures. However, this would raise important conceptual problems. The inclusion of a direct tax in the coverage of the RPI would change its nature, open the question of what the Index should cover and might suggest that the Government can pick and choose what to include. A further problem is that local services will continue to be financed partly from national taxation. It could, therefore, be argued that if the community charge were to be included in the

RPI on the grounds that the services it finances are within the scope of the index then so should be that part of income tax which goes to finance local services. This in turn would raise the question of how to treat other services which are funded through direct taxation (e.g. national insurance and health services).

6. Inclusion as a payment for services also presents conceptual problems because the payments are not directly related to the services received. The position is different with rates, which are included as an indirect tax on the consumption of housing. The average poundage is taken as the price indicator and the average rateable value is regarded as the "quantum" of liability on which the tax is levied, analogous in index terms to the physical volume of purchases which by definition is held constant in compiling the RPI - for example a loaf of bread or a kilogram of sugar.

7. Great importance is attached to preserving the concepts of price and quantum, as they underpin the whole construction of the RPI and give it legitimacy as a scientific and robust way of measuring price change. In recent years special attention has been paid to the problem of defining an appropriate quantum for (*inter alia*) owner-occupiers' housing costs and items affected by subsidies and discounts. As it now stands the RPI can fairly be said to measure changes in the cost of a fixed quantity of purchases and liabilities, and this helps significantly in maintaining the confidence of informed opinion as to its integrity.

8. One objection to including the community charge in the RPI is that there is no way of defining a meaningful quantum. It should be possible to measure overall changes in the average *expenditure* incurred by households on the community charge but in doing so one would not be able to differentiate, even conceptually, between a change in the unit price and a change in the volume of services for which the price was being charged. As the distinction is fundamental to the construction of a price index it can be argued that introducing the community charge would radically alter the nature of the RPI and make it more difficult to defend from accusations of manipulation.

9. In considering the likely impact on the RPI of either including or excluding the community charge it has not proved possible to devise a suitable price indicator. Instead *expenditure* on the community charge has been taken as a proxy for the price for illustrative purposes, though this is contrary to accepted index methodology

10. It is for consideration how much importance should be attached, in the context of the RPI, to the conceptual arguments set out above as opposed to the more practical issues raised in paragraphs 3 and 4. It should be noted that, whatever treatment is agreed for the RPI, the tax and price index (which reflects both direct and indirect taxation, national and local) *will* include the community charge.

Public presentation of changes in the RPI

11. The question of the treatment of the community charge is politically sensitive because the decision will affect the future movement of the RPI and may also affect the public perception of the community charge. The argument that the charge should not be in the Index because it is a direct tax may be unpersuasive to those who seek to misrepresent the Government, accusing it of manipulating the figures. Such critics may also make something of the fact that, in dealing with the public perception of the community charge, attention is being focussed on it being a payment for services rather than a direct tax.

12. The way in which the decision on the treatment of the community charge is taken will be important for the public credibility of the RPI. Since 1947 all significant issues affecting the method of construction and calculation of the Index have been decided on the basis of advice from the Retail Prices Index Advisory Committee. A decision not to consult this committee (or not to follow its recommendations if consulted) would of itself require explanation. The Committee, which is convened by the Secretary of State for Employment, includes representatives of industry, the trade unions and consumers as well as academics and Government Departments. Although advisory its recommendations have always been accepted (the latest in July 1986) with one exception in 1971 when proposals for regional price indices were not taken up (on the grounds that the membership had not been unanimous). The Department's usual stance is that the Index is what the RPI Advisory Committee says it should be, and this has proved an effective answer to criticism over the years.

13. A further problem arises because income support (formerly supplementary benefit) is uprated using the "Rossi Index" which is the RPI excluding housing costs (and therefore rates) whereas state pensions and index-related national savings are uprated using the "all items" RPI. The Rossi Index is appropriate because the housing costs of recipients of income support are covered by housing benefit but, as everyone will be liable to at least 20 per cent of the community charge, it may be argued that this should be included in the Rossi Index.

Main options

14. Against the above background there are three main options.

A. Rates reduced to zero and the community charge not included in the RPI

The charge would be treated as a direct tax replacing an indirect tax. This would be the reverse of the situation which occurred when the Government reduced income tax and increased VAT in 1979 and thus increased the RPI. The effect would be to reduce the level of the RPI by 4 per cent and possibly to produce negative annual inflation figures and a reduction in index-linked benefits. Clearly this option would be politically unacceptable.

B. Rates removed from the Index without introducing a major discontinuity, and the community charge not included

The RPI would be replaced by an index which excluded any payments (other than direct charges) for local authority services. The numerical impact of this is impossible to predict but if rates had been excluded from the RPI over the past five years then the Index would have risen by an average of 0.1 to 0.2 percentage points per annum less than it actually did. Because the abolition of rates is being phased "Option B" raises technical issues of timing which raise questions of general index methodology and could appropriately be referred to the Advisory Committee. The main alternatives for consideration under this option are outlined in Annex I.

C. Community charge included in the RPI, replacing rates

The RPI would be computed in the same way as at present but replacing average weekly payments per household on rates by average community charge payments. This would result in a once-for-all rise in the "all items" index of perhaps a quarter of one per cent. This is because the RPI does not cover all households and those it excludes - higher-income families and pensioners - will meet a smaller share of the total community charge bill than they did of rates. A correspondingly higher share will therefore fall on "index households". (See Annex II.) After this initial impact the RPI might not be much affected if the community charge were to place restraints on local authority spending. The outcome clearly depends on how fast the charge increases relative to prices. As a rule of thumb, if the community charge rose one per cent faster (or slower) than the generality of other prices then its inclusion would raise (or lower) the RPI increase by 0.05 per cent.

The choice

15. Officials have discussed the above options but have not reached agreement. The Central Statistical Office and the Department of Employment favour "Option B" because past practice and the principles underlying the Index strongly suggest this course. The Department of the Environment, on the other hand, supports "Option C" on the grounds that the community charge is essentially a payment for services whose cost has always been included in the RPI and should continue to be so. The Treasury position is, as yet, undecided.

16. Officials are agreed that it would be in the interests of public acceptability for the matter to be put to the RPI Advisory Committee but they are undecided on how this should be done. Treasury have argued that Ministers should decide on an agreed Government line and that Departmental representatives should support this in the Committee. If the Government line were that the community charge should be included in the RPI then the terms of reference might limit the Committee's involvement to advising on the technical issues of implementation. If on the other hand it were felt that the charge should be excluded then the discussion might be more wide-ranging, perhaps not reaching a unanimous conclusion. In the past such debates have often opened up new perspectives on the issues and Ministers might prefer to let all the argumemts come out before finally committing themselves to any one course of action.

Immediate decisions required

17. Important issues are involved. Ministers will wish to consider:-

(a) Whether the RPI Advisory Committee should be convened to consider the matter of the community charge at all. (Officials recommend that it should.)

(b) If the Committee is convened, whether its terms of reference should be such as to commit the Government to including the community charge in the RPI (limiting the discussions to technical details) or whether the Committee should be allowed to consider the basic proposition regarding the inclusion or exclusion of the community charge.

(c) If the Committee is to address the basic issue, what course of action should be recommended to it, if any.

ANNEX I

PHASING-OUT OF RATES FROM THE RPI

1. If the community charge is not to be included in the RPI ("Option B" in the main paper) then a question arises about the time at which rates should be dropped from the Index, bearing in mind that they are to disappear in Scotland in April 1989 and in England & Wales in April 1990.

2. One possibility is to drop all rates from the RPI in 1989 (except for Northern Ireland where they are to continue permanently). This might be done on the grounds that the rating system in its old form had ceased to exist, local authority finance was in a state of transition and it was better to make a clean break in the compilation of the Index. On the other hand this might appear to be letting the Scottish tail wag the English/Welsh dog. The construction of the RPI is such that it would be possible to phase the exclusion of rates, taking them out for Scotland in 1989 and for the rest of Great Britain in 1990.

3. A secondary question is whether rates should be removed from the Index in January or March of the year in question. The "weights" for all sections of the RPI are revised as a matter of routine every January so it would be convenient to take that opportunity to omit the rates component (whether in whole or in part), but this would be to anticipate the actual change. It would be possible to exclude rates as from the March when they actually disappeared, by giving them a weight at the beginning of the year but, after March, "spreading" this weight evenly over all other sections of the Index. The "all items" RPI would therefore be affected by rates for the first two months of the year but not thereafter. As rates would not be increasing during those two months the RPI would rise slightly less than if the change had been made in January. For the year as a whole the effect on the "all items" index of a March switch would be exactly as if the weight for rates had been retained but the price indicator attached to it after March had been the index for all remaining items.

4. Combining these choices - 1988 or 1989 and January or March - gives four possible sub-options within "Option B". Other variants are possible but these four sufficiently illustrate the range of alternatives, and they are summarised in the following table together with their numerical effects and relative advantages and disadvantages. The numerical effects are expressed in relation to the effect of "Option C" (including the community charge) on the "all items" RPI change up to April 1990. Though shown to a high degree of precision they are not intended as firm estimates but as indicators of relativity between the sub-options.

	RATES DROPPED FROM JANUARY	*RATES DROPPED FROM APRIL*
WHOLE CHANGE MADE IN 1989	Option B1 All GB rates dropped as from January 1989 Effect on RPI change up to April 1990 0.55 per cent less than with Option C Advantages Operationally convenient; "gets it over with" Disadvantages Drops rates while everyone is still paying them; may give appearance that change is being made in a hurry	Option B2 All GB rates dropped as from April 1989 Effect on RPI change up to April 1990 0.58 per cent less than with Option C Advantages Rates dropped as soon as full rating system ceases to exist Disadvantages Drops rates while most people are still paying them; mid-year reweighting may be very difficult to explain to users
CHANGE PHASED OVER 1989-90	Option B3 Scottish rates dropped from Jan 1989, English & Welsh rates from Jan 1990 Effect on RPI change up to April 1990 0.40 per cent less than with Option C Advantages Operationally convenient & presentationally attractive Disadvantages Still doesn't match timing of actual changes	Option B4 Scottish rates dropped from April 1989, English & Welsh rates from April 1990 Effect on RPI change up to April 1990 0.43 per cent less than with Option C Advantages Drops rates from RPI when the actual change occurs Disadvantages Mid-year reweighting may be difficult to explain

5. Each of the options would require careful presentation to avoid the danger of undermining public confidence in the RPI.

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ANNEX II

THE "INDEX HOUSEHOLD" EFFECT

The RPI reflects the expenditure of all households except the 4 per cent with the highest incomes and the 14 per cent comprising pensioners mainly dependent on state benefits. These two groups currently account for 16 per cent of all rates payments but their share of community charge payments will be lower. How much lower has not been precisely estimated but the proportion might well fall by about a quarter, to 12 per cent. The share borne by index households would correspondingly increase, from 84 per cent to 88 per cent, i.e. by about 5 per cent. Without any change in the total "take" the average bill for local authority services which is reflected in the RPI would accordingly increase by 5 per cent. This element accounts for about 5 per cent of the whole index weight so the effect would be to raise the "all items" RPI by 5 per cent of 5 per cent, i.e. about a quarter of one per cent.