NOTE

THE TAX AND PRICE INDEX

A feature of this year's Budget was the shift in emphasis from direct taxation to indirect taxation. The annual yield of income tax has been reduced by £4½billion while that of direct taxes was increased by a similar amount. The retail price index (RPI) incorporates the effect of the increase in indirect taxes as retail prices include these taxes. However, changes in income tax do not affect prices directly and so have no influence on the RPI. Nor do they affect the monthly index of average earnings since this is measured before tax.

On 17 August 1979, the Central Statistical Office introduced a new monthly indicator, the tax and price index (TPI) to supplement the then existing statistics with an indicator which is intended to encompass the combined effects of changes in prices and taxes with which households are faced. Therefore the index is broader than the monthly retail prices index which shows changes in the level of prices paid for goods and services, including those caused by higher indirect taxes. But the TPI does not go as far as a standard of living index such as the quarterly series on real disposable incomes.

The new index has a more limited function, it is an index of taxes and prices formed by averaging together changes in taxes (including employees' and self employed persons national insurance contributions) with changes in the prices of goods and services. Alternatively it represents the changes in gross income which would maintain the level of real net income, taking into account both changes in prices and changes in tax rates and allowances.

The calculation of the index is based on the sample of tax recordsused in the Inland Revenue's Survey of Personal Incomes. The sample for 1976/77 has been updated to January 1978 for the calculation of the TPI through 1978 and to January 1979 for the calculations for 1979. An estimate is made of the annual rate or receipt of income at the turn of each calendar year and the appropriate tax liability is then calculated on an average basis throughout the year. With knowledge of the tax structure and of the change in prices through the year, it is then possible to show the gross income which maintains real net spending power on the base date of January each year.

Tax units who are not liable to income tax are excluded from the coverage of the TPI, as are higher income groups - those over £10,000 a year at January 1979. The RPI also takes no account of the expenditure patterns of top income earners. The net effect is that the TPI excludes about 7 million at the bottom end and 1 million at the top end of a total of 28½ million tax units, defined as either single people or married couples.

Even with the top and bottom ends excluded, there are naturally large income variations within the sample. However, the CSO estimates that the difference in the rate of change of the index is no more than 1% between these groups. The index takes account only of ordinary taxable income (earnings, self-employment income, pensions and investment income) and excludes taxfree benefits. In particular, child benefits are not included and to achieve comparability child tax and family allowances have been excluded from earlier figures.

The changes resulting from the Budget in June of this year have been taken to affect the TPI from July. No account has been taken of the benefits of the rebates of tax in respect of earlier months, which have been treated as though they were capital repayments. The TPI was calculated in the first instance from January 1978 onwards; this month has been given the value of 100. Eventually a full five-year run of figures back to January 1974 will be published. The CSO expects that the TPI will normally increase faster than the RPI between Budgets and that a comparison with the RPI is most appropriately made over a twelve month period. Between August 1978 and August 1979 the TPI has increased by 13.4 per cent, compared with an increase of 15.8 per cent in the RPI.

One of the problems about using the index is that it smoothes out tax liabilities throughout a year even though the actual changes, notably in tax rates, often only come into effect after a delay of several months. The new index ignores administrative delays and assumes that changes in tax rates and allowances operate from the beginning of the financial year. A partial exception is this year as the changes in rates and allowances announced on 12 June are assumed to operate from July rather than from April, including those which the Inland Revenue does not plan to introduce until October. Tax reliefs for April to June have been treated as capital repayments and have not influenced the level of the index. Thus the increase in the index in these months was higher than if the subsequently announced reliefs had been taken into account. This could distort the comparison for April-June next year.

The main criticism of the new index has come from those at whom it is principally aimed - those negotiating wage increases on behalf of trade unions. Their most frequent comment is that the TPI does not take account of the social wage - free public services such as health, education and social services. The TUC argues that the cuts in direct taxes have been financed partly by a reduction in public spending so that on an broader view real living standards have been reduced by the Budget.

The gap between the annual rate of increase in the tax index and the retail price index is also probably insufficient to change the view of many wage bargainers. The difference is currently about 2½ percentage points and is likely to continue at this level, so that when the 12 month rate of retail price inflation reaches its forecast level of 17½% in mid November, the increase in the TPI will be about 15%.

In conclusion, it must be acknowledged that the new tax and price index has a number of deficiencies. It is only applicable to a proportion of the population, namely those who pay tax and whose gross income is less than £10,000 per annum. It takes no account of the social wage, nor of changes in benefits, such as the recent restructuring of child allowance. It smoothes out tax payments over a full year even though, for administrative reasons, these may fluctuate widely from month to month.