SM/0238p

POLICY IN CONFIDENCE

A

Prime Minister

SOCIAL SECURITY BENEFITS: 1991/92 UPRATING

1. In the light of my agreement with the Chief Secretary in the current Public Expenditure Survey, I have recently reported to you how I intend to fulfil your commission to publish before the end of this session a White Paper on the establishment of a Child Support Agency and the related benefit arrangements for lone parents. The settlement Norman Lamont and I have reached also means that I shall now shortly be circulating to colleagues a draft of the statement I propose to make as early as possible next week about the general uprating of benefits. I thought you would wish to have advance notice of the main features of that statement.

2. In general, benefits will be uprated as usual by the appropriate index - the RPI or the "Rossi" index (RPI minus housing costs). There are however two significant exceptions where I have agreed with Norman Lamont that more is needed because of especial pressures.

3. The postponement of local authorities' new community care responsibilities means that social security continues to bear the brunt of demand for support for people in **residential care and nursing homes**. This, coupled with recent research evidence of the level of costs in these homes, indicates that a Rossi uprating would be bound to invite a recurrence of the political difficulties we experienced this year with our own supporters about the inadequacy of the upper limits on residents' Income Support. I have therefore agreed with Norman Lamont a higher level of uprating which can be defended against the research evidence. It will focus particularly on nursing homes.

4. Our strong overall record on pensioner incomes is vulnerable in respect of poorer pensioners, particularly those who have not gained from the spread of occupational pensions. There are signs that, having fallen between 1979 and 1985, the number of pensioners in the lowest income decile is now rising.

5. We have therefore agreed on a £1 greater than Rossi increase in the Pensioner Premium for singles and a comparable £1.50 for couples. The effect of this is to give additional help to all those less well-off pensioners who were not assisted by the increases in premiums for older and disabled pensioners which we made last year. Thus we will be able to say that all less well-off pensioners have had a real increase in the last two years.

6. My uprating statement will however also reflect my agreement with Norman Lamont on two aspects where - both on intrinsic policy grounds and to help curb the cost of my programme - benefits will be uprated by less than the appropriate index.

7. Child Benefit has been frozen for the last three years. A further full freeze would run a now very considerable risk of legal challenge that I had failed to carry out properly my statutory duty to review the value of the benefit. It would also be exploited by our opponents (and those of our own supporters who argue in favour of uprating Child Benefit) as conveying a negative impression of our longer term intentions for family support. I therefore intend to increase child benefit by £1 for each family (25p more than the amount per child which would be provided in an across-the-board uprating). This makes it unnecessary to uprate One Parent Benefit, which would have provided a smaller increase for every one parent family. This selective uprating of Child Benefit will be consistent with a variety of future policy options and will enable us to recapture the initiative when considering proposals for the manifesto.

8. My second major savings proposal relates to **Statutory Sick Pay (SSP)**. In recent years we have seen industry tacitly accepting (in my view rightly) a growing share of responsibility for covering short-term sickness amongst those in employment. Over 90 per cent of employees are now covered by occupational sick pay schemes, with the result that they are in practice affected little or not at all by the prescribed rates of SSP.

9. I intend therefore to make further changes broadly along the same lines as those I made last year, by making a full up-rating only in the standard SSP rate (which goes to lower-paid employees, who are less likely to be covered by occupational schemes), while extending upwards the band of earnings to which it relates. There would be no increase in the higher SSP rate.

10. I propose also to adjust the arrangements under which employers are fully reimbursed for their expenditure on SSP, and move to 80 per cent reimbursement. In parallel with this change - which will not only make an important contribution to public expenditure constraint this year, but give us greater flexibility in this area in the future - I shall make an offsetting reduction in employer's National Insurance contributions, so that the overall effect of this part of my package will be broadly neutral for the costs of employers as a whole.

11. The overall package of changes in SSP and NICs - which I understand Norman Lamont has agreed with John Major - results both in substantial expenditure savings and, even allowing for the NIC changes, a significant gain to the PSDR.

12. The change in the rate of employers reimbursement of SSP will entail a short Bill, and I have the Lord President's agreement to its inclusion in the programme.

13. I believe that these changes represent a satisfactory outcome for Norman Lamont, but will also enable me to make an uprating statement which can be presented to the country and to our own supporters as balanced and responsive to the key pressure points.

14. I am copying this minute to John Major and Norman Lamont.

TN

16 October 1990

TN

cst.ps/dr/15nl16.10

CONFIDENTIAL

FROM: CHIEF SECRETARY
DATE: 16 October 1990

PRIME MINISTER

PUBLIC EXPENDITURE SURVEY: SOCIAL SECURITY

I have seen Tony Newton's minute to you of today. I believe the proposals in it are sensible and satisfactory in public expenditure terms.

2. As you know, in this year's Survey we faced large additions on the non-discretionary parts of the social security programme - amounting to roughly £+3.0/+4.1/+7.1 billion. It was therefore of overriding importance on the discretionary part of the programme to secure cuts. What Tony is proposing implies a settlement on the discretionary side of £-32/+48/-36 million. This is a very good outcome indeed.

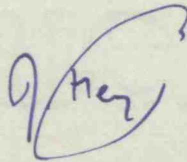
3. By partially privatising employers' insurance for their employees' short term sickness - a measure already being asked for by some backbenchers - he has found sufficient headroom for the benefit improvements he felt most urgent. John Major has agreed that the extra costs employers will face (which will be marginal) should be partly compensated through a small reduction in employers' national insurance contributions. However, the key point is that half of the saving in public expenditure will feed through to the PSDR, so there will be real savings.

4. At the same time this is an attractive package politically - with the Child Support Agency, an increase in Child Benefit and something for poorer pensioners and on residential care.

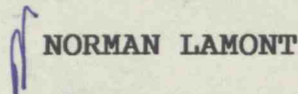
5. The overall settlement does depend heavily on a short Bill in the coming Parliamentary session. I am grateful for Geoffrey Howe's agreement to find space for it early in the session. This is essential to unlock the agreed savings on statutory sick pay and I have made it clear that we would have no alternative but to go back and reconsider the relatively modest agreed benefit improvements without it.

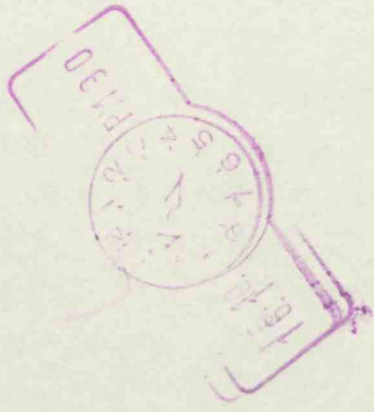
6. I recommend the settlement we have reached as a coherent and balanced package of measures. It recognises the limitations on what can be managed in the current difficult circumstances for public expenditure, at the same time addressing the most cogent of Tony's expenditure pressures.

7. Copies of this minute go to John Major and to Tony Newton.



NORMAN LAMONT





POLICY IN CONFIDENCE

A:/Social

FILE

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

19 October 1990

Social Security Benefits: 1991-92 Uprating

The Prime Minister was grateful for your Secretary of State's minute of 16 October and for the Chief Secretary's minute of the same date on this subject.

We spoke on the telephone and I have also spoken to the Private Secretaries to the Chancellor and the Chief Secretary.

You are undertaking the further examination and work requested. Following the further consideration your Secretary of State, in consultation with the Chancellor, Chief Secretary and Chief Whip as necessary, will report their conclusions to the Prime Minister.

I am copying this letter to the Private Secretaries to the Chancellor of the Exchequer and the Chief Secretary to the Treasury.

BARRY H POTTER

Stuart Lord, Esq.,
Department of Social Security.

POLICY IN CONFIDENCE

GOVERNMENT ACTUARY'S DEPARTMENT
22 KINGSWAY LONDON WC2B 6LE
TELEPHONE 071-242 6828 Ext
FAX 071-831 6653

From the Government Actuary
C D Daykin MA FIA

Rt Hon Tony Newton OBE, MP
Secretary of State for Social Security
Richmond House
79 Whitehall
LONDON SW1A 2NS

19 July 1990

Dear Secretary of State

I have pleasure in submitting herewith my report on the Second Quinquennial Review of the Great Britain National Insurance Scheme under the Social Security Act 1975. I am sorry that it has not been possible to produce it earlier, but severe pressure on our very limited resources has made it difficult to give priority to this work when other more immediate and urgent demands were being placed upon us. Our staffing situation has now improved and we expect to achieve a significantly better time to completion on the next Quinquennial Review, work on which is expected to start shortly.

As is traditional with Quinquennial Reviews the report itself contains a considerable degree of detail on the benefits under the scheme, the assumptions made for projecting future benefit costs and contribution income and the projected costs and contribution rates on a number of alternative bases. I would draw your attention in particular to the summary of the Review, which describes the main features. In particular, the report shows that, once allowance is made for the measures included in the Social Security Act 1990, a National Insurance contribution at the current rate of 17.5% for those not contracted-out should prove adequate for the next 40 years if the flat-rate basic pension is revalued each year to maintain its purchasing power. This conclusion is based on a particular set of assumptions, each of which may individually be proved incorrect as the future unfolds. A sensitivity analysis in Section 10 of the report shows what the effect would be of different values for a number of the key assumptions.

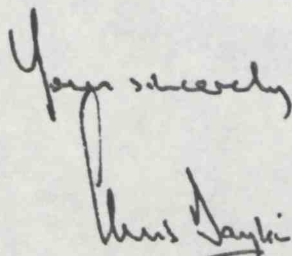
It is also emphasized in the summary that fluctuations in the experience may be expected from year to year, for example because of changes in the relationship between prices and earnings, the level of unemployment, etc. Thus a projection of a broadly stable contribution rate for the next 40 years does not guarantee that the National Insurance Fund will not run substantial surpluses or deficits in particular years nor that there will be pressure at certain times over this period for contributions to be increased or reduced.

Nevertheless, in spite of certain changes to the scheme since 1986 and a number of revisions to important assumptions, the results broadly confirm the conclusions of my predecessor's report on the financial effects of the Social Security Bill 1986 and show that the measures that were taken then to avoid increases in contribution rates which might otherwise have become necessary have successfully achieved their objective.

Since the Social Security Acts provide only for annual upratings of the basic pension to be at least in line with movements in the Retail Price Index, and since continued upratings on that basis over a very long future period would substantially change the relationship of the social security pension to average earnings, it is appropriate for an actuarial report to indicate what the effect would be of alternative assumptions. For the purposes purely of illustrating this effect, I have given figures in the report for the costs of the scheme if upratings of basic pension were in line with earnings in future. Not unexpectedly this shows considerably higher rates of contribution being required, rising to a peak of 25% in 40 years' time.

Arrangements have been made with your Department to have the report printed, with a view to having it laid before Parliament before the summer recess.

I am sending a copy of this letter and of the summary of the report to the Chancellor, who has been consulted by his officials during the course of the preparation of the report, and to the Prime Minister.



C D DAYKIN

SUMMARY OF THE REVIEW

1.1 A major purpose of the five-yearly reviews by the Government Actuary of the operation of the Social Security Acts is to establish the rates of contribution likely to be required in future years to meet the cost of the benefits provided for under the National Insurance scheme.

1.2 The scheme is financed on the pay-as-you-go principle with the contribution rates set from year to year to produce the income needed to meet current expenditure on benefits and costs of administration. The rates of contribution are determined by the level of benefits and by the relative numbers of contributors and beneficiaries, these numbers being very materially affected by demographic factors. Projections are made for a period of 60 years into the future to illustrate the impact of demographic changes and the gradual maturing of the provisions of the scheme.

1.3 The main benefit under the scheme in terms of cost is the retirement pension, which currently accounts for about 75% of total expenditure. The population at present includes about 10 million people over pension age and this number is expected to remain broadly constant over the next 10 years. Thereafter, with the changing age structure of the population and steady reductions in mortality rates, the number will increase gradually to reach a peak of over 14 million in the 2030s. The numbers in the population at the working ages are expected to remain relatively stable, on the main assumption of births averaging 2.0 per woman in the long-term future. As a result there will be a significant deterioration in the ratio of the number of contributors to the number of pensioners under the scheme which, other things being equal, would require steady increases in contribution rates over the early decades of the next century, followed by a reversal of the trend after the year 2035.

1.4 Another factor which will tend to increase contribution rates is the gradual build-up of the cost of earnings-related

additional pensions. Employees started to earn additional pension in April 1978 and no-one will have earned a full entitlement until 1998. Thereafter it will be a further 20 years or so before all pensions in payment reflect the additional earnings-related element.

1.5 The rates of contribution required to meet the pay-as-you-go cost of the scheme are also affected by changes in the relationship between the flat-rate benefits and the earnings on which contributions are paid. The Act requires the main benefit rates to be reviewed each year and increased at least to reflect movements in the Retail Price Index. However, the income of the scheme arises mainly from earnings-related contributions and will thus grow broadly in step with changes in the general level of earnings, which can be expected over the long term to increase rather faster than prices. If the flat-rate benefits are increased in line with prices the effect will be to offset the increases in contributions required as a result of the other factors referred to above.

1.6 The extent, if any, to which flat-rate benefits will be increased in future by more than is required to maintain their present purchasing power will be a matter for the government of the day, having regard to pressures on public expenditure, the growth of alternative sources of income for pensioners, such as occupational and personal pensions, and other factors. Estimates are shown in the report on illustrative alternative assumptions about future upratings, namely, (i) that, as required by the Act as a minimum, upratings will continue to be in line with the movement in prices and (ii) that upratings will maintain the value of the flat-rate pension in relation to average earnings. For the purposes of these projections earnings are assumed to increase by 1½% a year more than prices and unemployment is assumed at a rate of 5%.

1.7 On the basis of upratings in line with prices and the assumptions set out in the report, the required rate of contribution for those not contracted-out varies little from the

present 17½% over the next 40 years (Table 19), before falling significantly in the more distant future. This broadly confirms the conclusions of the Government Actuary's report on the financial effects of the Social Security Bill 1986 (Cmnd 9711) when measures were taken to avoid the increases in contribution rates which might otherwise have become necessary, even with minimum upratings, in the period up to 2035. Differences from the earlier projections arise from changes that have been made to the scheme in recent years and revised assumptions, including a new set of population projections. On the prices uprating basis the fall in the level of flat-rate benefits in relation to earnings offsets the effect of the adverse demographic trends and the growing cost of additional pensions over the next 40 years. Thereafter a gradual fall in the contribution rate can be expected as the demographic trends are reversed and the impact of the 1986 Act is fully reflected in the costs.

1.8 With upratings in line with earnings, and the same assumptions in regard to other factors, there would be no offset to the factors leading to higher rates of contributions and the required rates for those not contracted-out would rise steadily from the present 17½% to 20% after 20 years and a peak of 25% after 40 years, before declining gradually to 23% by 2050.

1.9 It should be emphasized that these estimates are not forecasts of what contribution rates will in the event be needed but projections of what would happen on the basis of the stated assumptions. The demographic and economic assumptions underlying the estimates are inevitably subject to a considerable degree of uncertainty, particularly for the more distant future, and the effects of variations in the more important assumptions are given in Section 9 of the report.

1.10 Contributions at the current level should be broadly adequate to meet the cost of the benefits and the costs of administration over the next 40 years if benefits are uprated in accordance with the minimum required by the Act. However, considerable fluctuations may occur in the short term because for

example, of changes in the relationship between prices and earnings, the level of unemployment, etc. It may be necessary to make modest adjustments to the rate of contribution from time to time to deal with these situations, since the National Insurance Fund is no more than a working balance and is not intended to be sufficient to smooth out significant fluctuations from year to year in outgo. The report suggests that the Fund should not be allowed to fall below one-sixth of one year's expenditure on benefits and costs of administration.

1.11 The contracted-out rebate, on the assumptions underlying the 1987 review, may be expected to fall from 5.8% currently to 3.4% in 2020-21 because of the reducing cost to occupational pension schemes of providing guaranteed minimum pensions. Thus the net contribution rates for the contracted-out will rise gradually over the next 30 years even though the standard rate of class 1 contribution may remain steady.