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Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon John Moore MP
Secretary of State for Social Security
Department of Social Security
Richmond House
79 Whitehall
London
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12th July 1989

Dear John,

STATE PENSIONS

In your letter of 25 May you indicated that in 1989 the average real value of the basic pension could be 5 per cent lower in real terms than it was in 1986. My officials have since discussed the basis for this figure with yours and I think it is important that we are clear about what conclusions can be drawn from it. In particular, it is important to recognise that this figure does not imply that we have somehow reneged on our commitment to protect the real value of the basic pension against price increases.

Two factors are at work here. First, our now well-established policy of uprating the pension on the basis of past inflation. Second, the impact of inflation between upratings on the real value of the pension.

In 1986, pensions were uprated in July, reflecting the RPI increase up to January of that year. Inflation was relatively low throughout the year (3.4 per cent), leading to a relatively small reduction in the real value of the pension both before and after the July uprating. Also, the July uprating was a transitional measure to enable the uprating month to be moved from November to April. Thus the previous uprating had taken place in November 1985, and the pension had been exposed to only eight months inflation before being uprated again. The comparison with 1989, where the April uprating was a full year after the previous one, is therefore not entirely fair.

What conclusions can we draw from this? The first is obvious. When inflation is low, as in 1986, benefits retain their value better. This shows the critical importance of controlling inflation, even for those whose incomes are index-linked. (I should point out that, even though inflation has risen this year, the pension is likely to be 5 per cent higher in real terms than it was in 1979, using the same method of comparison as in your letter.) The second is that the comparison between 1989 and 1986 is not straightforward, because of the special circumstances of the July 1986 uprating. Like is not being compared with like.

Using the 'historical method' of uprating, the change in the level of benefits between July 1986 and April 1989 reflected the movement in prices between January 1986 and September 1988. Inflation was higher between September 1988 and April 1989 than during the first half of 1986, as a consequence of which the real value of the basic retirement pension was slightly lower in April 1989 than it was in July 1986. As inflation falls, this process will be reversed, and the real value of the basic pension will move back towards the 1986 level.

I am sure you would not advocate a return to the system whereby benefits were uprated on the basis of forecast inflation, which in any case did not guarantee that their real value would be maintained. Our preferred historical method ensures that every period of inflation is properly accounted for. It is bound to result in some drag effect on the real value of benefits during periods when inflation is rising. However, pensions and other benefits will always catch up in real terms in subsequent upratings. If we were to inject extra cash into the system whenever the real value of benefits was affected by this drag, the long-term effect would be to <u>overcompensate</u> for increases in the cost of living. The implications of such an approach for public expenditure could be severe.

As you know, we are this year putting significant extra amounts into Income Support and Housing Benefit for pensioners who are over 75 or disabled. In October, their Income Support levels will go up by £2.50 a week for single people and £3.50 for couples, at a cost of nearly £200 million in a full year. This will be a timely increase, helping not only those on Income Support but, through Housing Benefit, many with modest incomes above that level. However, as a general rule and in the vital interests of containing public expenditure and encouraging more private provision, I am sure it is right to stick to our policy of protecting benefits against past price increases and not raising their real values.

I am copying this letter to the Prime Minister.

Yours Ever, John

JOHN MAJOR