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cc Brian Unwin
~~David~~ Willetts.
(noting classification).
DRN
14/10.

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Mr D Norgrove
10 Downing Street

14 October 1985

Dear David,

SOCIAL SECURITY AND LOCAL AUTHORITY FINANCE

You asked in your letter of 24 September for an analysis of the combined impact of the proposed changes to social security and to local authority finance. Officials here have carried out an analysis on the basis of information available to them and the results are in the attached paper.

2. The study is based on the social security proposals agreed in MISC 111 in the Spring and, for local authority finance, those presented to E(LF) by Mr Baker on 23 September. These proposals were, of course, the only ones available - or sufficiently clear - during the period in which the analysis was undertaken; but I recognise that they are now, in some important respects, overtaken and that the study is therefore already out of date. One particular example of this is that the analysis of local authority proposals takes credit for a reduction in local authority spending (and therefore in the burden of local taxation) as compared with the present position, even though that reduction is brought about by existing precept controls on ILEA and the transport boards. The Treasury has always regarded this as highly artificial (and it has now, I understand, been dropped by the DOE) but we have been forced to adopt it in the present study as it lies behind the information provided by Department of Environment officials on the impact of that set of proposals.

3. I should also emphasise other limitations of the study:

(i) although 1983 FES data is now available, the study is based, consistently with the rest of the DHSS' analysis, on 1982 data, and its results are expressed in 1984 prices;

(ii) it is based on entitlements to means-tested benefits, and makes no allowance for the fact that take-up of some benefits is substantially below 100 per cent;

(iii) its results were obtained by grossing-up evidence from a small sample of families.

The study is therefore necessarily illustrative and should be taken to give only broad indications of the direction of these changes.

4. I will not attempt to summarise the study, which speaks for itself. In some cases the changes reinforce each other, in others they cancel

out. This may mean, for example, some two million people losing their entitlement to Housing Benefit as a result of social security changes, and then, by becoming liable to a higher local charge, one million finding themselves eligible for Housing Benefit. But on the present timetable, there will be a year or two between these changes and other changes in personal circumstances may have a greater impact on the eligibility of individuals for different benefits. Overall, however, there seems to be limited direct interaction between the two sets of proposals.

5. Since the study was completed, Mr Fowler has tabled new proposals on social security. We have not been able, in the time available, to analyse these proposals in the form adopted in the study. But tables in the annex to this letter show the main changes (they are not strictly comparable because those for the new proposals are on a take-up, not entitlement, basis). Mr Fowler's new proposals involve much higher social security spending than was implied by the Spring package and, naturally, they reduce the average overall loss. The changes will reduce significantly the number of those who lose from the new social security structure and also increase the number who gain.

6. Nevertheless, the overall pattern of gainers and losers does not change greatly. Apart from lone parents (who appear to be net losers under Mr Fowler's new proposals), no group of households switches from being a net loser to a net gainer (or vice versa), and the broad summary analysis of the effects of proposals on household types given in Table 5 of this paper holds generally true for Mr Fowler's new proposals.

7. The group for which the new proposals make most difference are pensioners. The tables show that the number of losers is reduced by about 1 million and that the number of gainers increases by about ¾ million. Those who are still losers, tend to lose less, and those who gain, gain more. Nevertheless, pensioners would remain as a group net losers from the new proposals, with some losses remaining substantial.

Yours sincerely,

Philip Wynn Owen

P WYNN OWEN

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bc D Willetts
B Unwin (CO)

10 DOWNING STREET

From the Private Secretary

16 October 1985

SOCIAL SECURITY AND LOCAL AUTHORITY FINANCE

The Prime Minister was grateful for the thorough and clear analysis set out in the paper attached to your letter to me of 14 October. I believe she would find it helpful to see an updated version at a suitable moment as the discussions on social security and local authority finance progress.

(David Norgrove)

Mrs. Rachel Lomax,
HM Treasury.

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ANNEX B TO
MISC 111 (85) 14

GAINS AND LOSSES: ALL INCOME RELATED BENEFITS (000)

Client Group	Gainers £5+	£3-£5	£1-£3	£1	No change	Losers £1	£1-£3	£3-£5	£5+	Total gainers	Total losers
Pensioners	80	135	485	570	20	1155	1120	365	235	1270	2875
Sick or disabled	90	70	65	25	*	20	35	5	10	260	65
Single parents	215	25	20	25	*	140	155	30	60	285	380
Couples with children	205	175	235	100	*	85	85	30	80	715	290
Others	25	160	30	170	315	230	390	300	245	380	1160
Total	615	565	840	890	335	1630	1785	730	630	2900	4770

NOTES

1. Totals may not sum because of rounding.
2. November 1985 benefit rates. All November 1985 changes assumed to have been made.
3. Child benefit assumed to be £7 in real terms.

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ANNEX B TO
MISC 111 (85) 14

Annex

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GAINS AND LOSSES: ALL INCOME-RELATED BENEFITS

As implied by MISC 111 Spring conclusions	Gainers				No Change	Losers				Total Gainers	Total Losers
Client group	£5+	£3-5	£1-£3	<£1		<£1	£1-£3	£3-5	£5+		
Pensioners	45	40	190	250	0	640	2130	805	260	525	3835
Sick or Disabled	65	10	85	5	0	40	35	20	5	165	100
Lone Parents	205	20	95	95	0	85	155	25	110	415	375
Couples with children	315	185	250	125	0	115	125	40	145	875	425
Others	55	180	20	115	375	240	340	295	320	370	1195
Total	685	435	640	590	375	1120	2785	1185	840	2350	5930

Mr Fowler's Spring proposals.

REFORM OF SOCIAL SECURITY AND OF LOCAL AUTHORITY FINANCE

1. This paper analyses the combined impact of proposed changes to Social Security benefits and local authority taxes. It concentrates on the impact on effective marginal rates of taxation/benefit withdrawal for those on low incomes; on the ratio of in-work and out-of-work incomes for the low paid; and on the distribution of gains and losses between different groups.

The Proposals

2. The social security proposals analysed are as presented to MISC 111 in the spring and would yield the savings agreed by that Group. For local authority finance, the proposals analysed are those which were presented to E(LF) on 23 September. Recent changes in these proposals either came too late or are still insufficiently clear to be taken account of in the analysis. The analysis is also based on a small sample of families, and assumes that the changes are effective immediately. For these and other reasons, therefore, it is necessarily illustrative and its results should be treated only as indicators of the broad direction of the effect of these changes.

Timetable

3. It is assumed that the main social security proposals will take effect from 1 April 1987. The local authority proposals are assumed to come into effect after the next General Election, and, therefore, after the introduction of the new social security regime. A more detailed timetable is set out at Annex 1.

The proposals in detail

4. The features of the two sets of changes which have the main impact in the analysis are as follows:

(i) The single steeper taper on Housing Benefit (HB) which replaced the two previous tapers and which increased the rate at which HB is withdrawn as incomes rise.

(ii) The requirement that all who are liable to local taxation will have to meet at least 20 per cent of their total local tax bill (at present Supplementary Benefit recipients have their rates paid in full).

(iii) A more generous system of family support (as compared with FIS), which gives help to more people, and whose withdrawal rate, as income rises, will be based on net income rather than gross.

(iv) The withdrawal of the householders' scale rate of Supplementary Benefit, and the substitution (where appropriate) of an over-25 rate.

(v) The replacement of local authority rates levied on householders, with a 30:70 combination of a property tax* and a residents' charge levied on all adults.

(vi) Changes in the systems of rate support grants and of non-domestic rates which have the effects of raising average local tax bills in some (high spending) authorities and lowering them in others.

Marginal Rates (the "poverty trap")

5. At present, low-paid working families are entitled to child support (FIS), help with housing costs (HB) and non-cash benefits (such as free school meals), subject to a means test. These benefits are withdrawn as income rises. High rates of such benefit withdrawal together with liability for income tax plus national insurance contributions can mean that a working family loses most or all of any additional income it earns; indeed in some cases it may lose more than £1 for every extra £1 of income. These losses (the "marginal effective rate of tax/benefit withdrawal") can have a severe disincentive effect on some working families.

6. Table 1 shows the overall impact of the proposals on marginal effective rates of taxation/benefit withdrawal. The main points are:

(i) The means test for the new family support scheme is based on net income and this eliminates all marginal rates of more than 100 per cent.

(ii) The steeper HB taper removes many people from HB support altogether, thus reducing their marginal rates but increases marginal rates for those still receiving HB.

(iii) The wider coverage of family support increases marginal rates for those receiving this for the first time under the new regime.

(iv) Adult non-householders will pay local taxation for the first time. Some will be able to claim HB thereby raising their marginal rates.

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*the exact form of the property tax is still to be decided; for the purpose of this analysis existing rateable values have been used.

TABLE 1

Marginal tax rates (per cent)*	0-50	50-70	70-100	100+
				(thousands)
Present system	14790	190	370	130
Change due to:				
Social Security proposals	-100	-160	+390	-130
LA proposals	-30	-10	+40	-
After changes	14660	20	800	-

7. As a result of these changes:

(a) All 130,000 working families with marginal rates of more than 100 per cent see those marginal rates reducing to 90 per cent or so.

(b) The number of working families with marginal rates of more than 70 per cent increases from 500,000 to 800,000 (an increase of 300,000). Most of these are families with children. Of the 300,000 increase 260,000 is due to social security changes.

In effect, therefore, the two sets of proposals eliminate marginal rates above 100 per cent but increase the number of benefit recipients and hence the number with very high marginal rates of tax/benefit withdrawal.

Replacement Ratio (the "unemployment trap")

8. The fact that people in work pay tax at relatively low levels of income, together with the existing levels of benefits for those out of work - particularly for families with children - can mean that many families can receive as much, or even more, income out of work as in work. The higher the ratio ("replacement ratio") of benefit income out of work to pay in work, the greater the disincentive to employment. Table 2 shows the number of working families with different replacement ratios.

9. The main impact of the social security and local authority changes are:

(i) More generous family support for those in work virtually eliminates replacement ratios of more than 100 per cent.

(ii) The requirement to pay at least 20 per cent of local tax bills reduces Supplementary Benefit for the unemployed, and thus reduces replacement ratios for those affected.

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*figures are based on entitlements to benefit. Figures on the basis of take-up would show smaller numbers with high marginal rates.

TABLE 2

(thousands)

Replacement ratios (per cent)	0-50	50-70	70-90	90+
Present system	6460	5370	1850	270
Change due to:				
Social Security proposals	+370	-270	-30	-70
LA proposals	+50	-20	-30	-
After changes	6880	5080	1790	200

10. As a result of these changes

(a) the number of working families with replacement ratios above 70 per cent reduces by 130,000, from over 2.1m to under 2m (100,000 of the 130,000 is attributable to social security changes).

(b) the number of working families with replacement ratios above 90 per cent reduces by 70,000, from 270,000 to 200,000.

Gainers and losers

11. Both sets of changes produce substantial changes in the net income of particular groups. The social security proposals would reduce net incomes on average, reflecting the savings agreed in MISC 111, with pensioners losing most and working families losing least. The local government proposals increase net incomes on average because the Department of Environment have assumed that existing precept control of ILEA and transport boards will produce spending reductions before the new system comes into operation. Pensioners would gain most and the unemployed least. But the social security reductions outweigh these assumed local government gains with pensioners overall losing most, and working families having little overall change in net income.

Table 3: Average effect of proposals on Net Income (£ per week)

	Working Families	Unemployed Families	Pensioners	Overall
Net income before changes	139.82	59.56	67.05	107.95
Effect of social security proposals	-0.42	-0.85	-1.78	-0.82
Effect of local government proposals	+0.22	+0.13	+0.55	+0.28
Net income after changes	139.62	58.84	65.78	107.41
% change net income	-0.14%	-1.2%	-1.8%	-0.5%

13. These average changes are relatively small but the averages mask some quite large gains and losses by particular groups (see table 4). About 1.3 million families stand to lose more than 10 per cent of net income as a result of the social security proposals and a further 2.4 million stand to lose 5-10 per cent. There are smaller numbers of large losses from the local authority proposals and few counteracting gains, so that overall 1.3 million families stand to lose more than 10 per cent and 4 million to lose more than 5 per cent. Against this, ½ million families will gain more than 10 per cent from the social security proposals and a similar number gain 5-10 per cent from the local authority proposals. Overall 1.2 million will gain more than 5 per cent. For each of the sets of proposals and, overall, more than 80 per cent of families have their net incomes changed by less than 5 per cent, and most of these changes are less than 3 per cent.

14. These gains and losses would be masked by the effect of the uprating in the year in which they were introduced. This, if it is assumed for illustrative purposes that all benefits are uprated in that year by about 3% a significant proportion of the 7.4 million families shown in Table 4 as losing 1-5% of their net income would in the event suffer no cash loss. For some tax-paying families the reduction in net income might be offset by any tax reductions which were made in the year in which the new social security structure was introduced.

Table 4: Effects on Net Income (millions)

	Losses			No change	Gains		
	10%+	5-10%	1-5%	±1%	1-5%	5-10%	10%+
Social Security proposals	1.3	2.4	7.4	11.4	3.3	0.3	0.5
LA proposals	0.1	0.6	6.8	12.0	6.5	0.6	0.1
Social Security and LA proposals together	1.3	2.7	8.8	7.7	5.1	0.6	0.6

15. Some of the large net income changes are concentrated amongst particular types of family. Table 5 identifies the main impact of the two sets of proposals on different family types (more detailed tables are at Annex 2).

Table 5: Effects on different types of family

	Social Security proposals	Local Government proposals	Combined effect
Families with working head			
Single non householders	Little effect	All lose	Most lose
Single householders	Many small losses	Most gain	Many small gains
Couples without children	Little effect	Little effect	Little effect
Couples with children	Many small losses	Many small gains	Mixture of small gains and losses
Lone parent	Many small losses	Many small gains	Mostly small gains
Families with head not working			
Single non householders	Little change for most but some large gainers and losers	All lose	Most lose
Single householders	Large numbers with large losses	Most gain	Most lose - many large losses
Couples without children	Some large losses	Little effect	Some large losses
Couples with children	Many lose, some large losses	Little effect	Many lose, some large losses
Lone parents	Most lose but some large gains	Little effect	Most lose, but some large gains
Pensioners			
Single	Large numbers, with large losses	Most gain	Most lose, some large losses
Couples	Most lose	Little effect	Many small losses

16. The family types most affected by the social security proposals are:

Unemployed - young householders lose because of both the switch from a householder rate of SB to different rates for under- and over-25s, and changes to HB. Older non-householders gain. Overall, more than ½m would lose more than 10 per cent of their net income (currently averaging about £60 per week).

Pensioners - over 600,000 lose more than 10 per cent of net income (currently averaging about £67 a week), most of them single and on low incomes, because of the housing benefit changes.

17. The family types particularly affected by the local authority proposals are:-

Single non-householders - all will start paying a local charge for the first time and so will lose.

Single householders - whether working, unemployed or pensioners, will gain as they only pay one per head element of the local charge. The gain will vary with rateable value.

18. There is little direct interaction between the two sets of proposals, although the new housing benefit rules will affect the impact of the local government proposals on those receiving HB. More of the new local local charge on single non-householders would bear directly on the unemployed and those on low incomes than under the present system. Similarly, more of the gain to unemployed, pensioner and low income single householders will find its way into net income.

19. The two sets of proposals may in some cases cancel each other out; in other cases they reinforce each other. For example

Working single householders	where local authority gains outweigh social security losses
Working couples with children	where there is a mixture of gains and losses arising from social security losses and local authority gains
Unemployed single householders	where large losses from social security are to a limited extent offset by gains from the local authority proposals, but most still lose.
Single pensioners	where large losses from social security are partly offset by gains from local authority changes, but most still lose.

ANNEX 1

SOCIAL SECURITY AND LOCAL AUTHORITY FINANCING IMPLEMENTATION TIMETABLE

	Local Authority Finance(*)	Social Security Reviews
December 1985	Publish Green Paper	Publish White Paper Publish Bill
July 1986		Early uprating
October 1986	Publish White Paper	
April 1987		Uprating Introduction of new Benefit regime 1st phase of new pension arrangements
October 1987	Bill published(1)	
April 1988	Bill enacted (1)	Uprating 2nd phase of pension arrangements
July 1988	[Bill published (2)]	
April 1989	[Bill enacted (2)] New proposals implemented (1)	Uprating Final phase of new pension arrangements
April 1990	[New proposals implemented (2)]	New pension arrangements complete

(1) If General Election 1987
(2) If General Election 1988

(*Consideration is also being given to an accelerated timetable, under which the White Paper would be published in July 1986, the Bill would be published in December 1986 and enacted in July 1987; and the new regime would come into force in April 1988.)

Table 1: Effect of social security proposals - numbers with different gains and losses (thousands)

		Working	Not Working	Pensioners	Total
Loss over	10%	70	640	610	1320
	5-10%	160	690	1570	2410
	1-5%	4720	1000	1670	7390
No change	± 1%	7450	1800	2130	11380
Gain	1-5%	2900	300	110	3310
	5-10%	110	140	80	330
	over 10%	70	390	40	490
Average %		-0.3	-1.4	-2.7	-0.8
Average £		-0.42	-0.85	-0.78	-0.82
Current average net income £		139.82	59.56	67.05	107.95

Table 2: Effect of local government proposals - numbers with different gains and losses (thousands)

		Working	Not Working	Pensioners	Total
Loss over	10%	10	110	20	140
	5-10%	270	210	70	550
	1-5%	4260	1300	860	6780
No change	+ 1%	6380	2470	3160	12040
Gain	1-5%	4010	700	1750	6460
	5-10%	140	110	300	550
	over 10%	10	50	40	100
Average %		+0.16	+0.21	+0.82	+0.26
Average £		+0.22	+0.13	+0.55	+0.28
Current average net income £		139.82	59.56	67.05	107.95

Table 3 : Combined effect of social security and local government proposals (thousands)

		Working	Not Working	Pensioners	Total
Loss over	10%	110	710	430	1250
	5-10%	490	740	1430	2660
	1-5%	5250	1490	2010	8750
No change	+ 1%	5800	830	1080	7710
Gain	1-5%	3480	560	1070	5110
	5-10%	270	200	130	600
	Over 10%	90	420	50	560
Average %		-0.14	-1.2	-1.8	-0.5
Average £		-0.20	-0.72	-1.33	-0.54
Current average net income £		139.82	59.56	67.05	107.95

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