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PRIME MINISTER

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MINISTERIAL GROUP ON SOCIAL SECURITY
Meeting on 20 November 1985
(MISC 111(85)17): INCOME RELATED BENEFITS

BACKGROUND

Following the decisions taken on pensions and deferral of implementation at the meeting of the Group on 31 October (MISC 111(85)9th Meeting), Mr Fowler is now seeking the Group's agreement to some modifications in the remainder of his Green Paper package concerning income-related benefits. It is most important that if at all possible the Group takes clear decisions on these remaining changes at this meeting so that the timetable for publication of the Social Security White Paper and Bill can be maintained. The present intention is that this should be the last meeting of the Group; that Mr Fowler presents his full revised proposals and draft White Paper to Cabinet on 28 November; that the White Paper is published in mid-December; and that the Bill is introduced in mid-January.

2. The package of changes in income-related benefits was agreed by the Cabinet at its meeting on 3 May. These consisted of the replacement of the supplementary benefits system with a new, much simpler, system of income support backed by a social fund from which discretionary special payments could be made; replacement of family income supplement with the family credit scheme paid through the wage packet; and a much simpler system of housing benefit with payments towards rates being subject to an 80% maximum; changes in the date of uprating social security benefits; and a miscellany of lesser changes. The package was intended to yield PSBR savings of £800 million in 1987/88 and £1000 million in 1988/89.

3. At their meeting on 31 October the Group agreed to defer implementation of the main package of reforms until April 1988 with certain

measures being brought forward for earlier implementation. Those measures (and other savings measures not related to the Social Security Review) were identified in MISC 120 and form part of the savings totals agreed for the first two years of the Public Expenditure Survey (1986-87 and 1987-88). In order to avoid prejudicing the further collective consideration of the Social Security Review, however, the savings figure for 1988-89, which is when the impact of the main Review measures will be felt, was identified as provisional only and published as such in the Autumn Statement. The outcome of the Group's discussion of Mr Fowler's paper will enable this provisional figure to be finalised.

MAIN ISSUES

4. Mr Fowler does not propose any major changes in the structure of the package of reforms but he considers that in order to make them generally acceptable it is necessary to make provision for a more generous family credit scheme and to minimise the number of pensioner losers. The central feature of Mr Fowler's paper is the contrast between two options. Option 1 is broadly equivalent to that developed in MISC 111 earlier in the year and endorsed by Cabinet in May. Option 2 is a modification of these proposals, reducing the savings to be achieved, but improving the distributional effects of the package, particularly for pensioners. Under Option 1 social security expenditure will be some £80 million less than the baseline figure published in the Autumn Statement as provisional pending further collective consideration. Option 2 would add about £200 million in public expenditure to that baseline in 1988-89, most of which would be spent on pensioners. In essence the paper invites colleagues to make a political judgement as to whether the benefit of fewer losers is worth the higher price to be paid in public expenditure. But in arriving at a conclusion on this point you will also want to consider the effects of the family credit element of both options on incentives to work.

(a) Gainers and Losers

5. Annex 2 of Mr Fowler's paper sets out details of gainers and

losers under both options. This is the first time the Group has seen these comparative figures and if the timetable set out above is adhered to it will be their last opportunity to consider the overall impact of the social security proposals before they go to full Cabinet. You will want to be assured that the balance of the package is the best that can be obtained. Under Option 1 there are some 5.2 million losers of whom about 3.5 million are pensioners. There are over 1.8 million gainers, of whom nearly 600,000 are families with children and 280,000 of whom are pensioners. The high figure of pensioners losers is consistent with the general objective of shifting support away from pensioners who have been well protected by past uprating policy towards families who have fared less well in modern social security provision. Mr Fowler, however, considers the effect on pensioners of this shift is too severe. Those on supplementary benefit alone would lose about £240 million compared with now (£160 million from supplementary benefit; £80 million from the compulsion to pay 20% of domestic rates). Average losses would be nearly £3 a week. Although the transitional protection promised would mean that cash income would not fall, this would not affect new outgoings and they would have to pay 20% of domestic rates. He therefore proposes to mitigate the effects of this by increasing the pensioner's premium in income support by £2 a week over that originally planned. This would reduce the number of pensioner losers by just over a million and would mean the same amount being spent on pensioners as a group in income support as now. It would also be sufficient to cover the heating addition which now goes to all pensioners on supplementary benefit, as well as their normal scale rate.

6. You will wish the Group to take a view on whether these changes are right in terms of the overall balance of the package between pensioners, families and others and whether the benefits in terms of easier Parliamentary handling and the possible longer term electoral consequences are sufficient to justify the higher cost.

(b) Family Credit: Work Incentives

7. The other issue the Group will wish to consider in relation to

the modified package is the degree to which it deals with the problem to incentive to work. There are two ways in which incentives can be improved.

(i) by creating "clear water" between income in work and out of work (reducing the 'unemployment trap');

(ii) by ending the situation in which more effort and higher gross pay can mean lower take-home pay through the operation of marginal tax rates (the 'poverty trap')

The change from FIS to Family Credit should in principle make it possible to ease both these problems, although the extent will depend on the rate of credit set. The fact that it will be paid through the wage packet, in effect as an offset to tax and NI contributions, boosts the visible advantage of working; recipients will see their tax and NI contributions reduced or eliminated and some will receive a net payment on top. It is also a well-targeted benefit for this purpose in that it specifically helps working families. In addition there are two particular features of family credit which give it a significant advantage over the current FIS scheme. By basing assessment on net income it ends the absurdity whereby improved earnings leading to removal of benefit can leave a family worse off. By replacing benefits in kind with cash, it avoids the abrupt drop in net income at the point where entitlement to free school milk etc ceases.

8. In assessing the incentive effects of the reforms as a whole it is also necessary to take account of the changes in Housing Benefit and, to a less extent income support. The Housing Benefit changes tend to worsen the unemployment trap for most working families (because they will get less help with housing costs in work while generally protected out of work). Family credit offsets this. Thus without a reasonably generous Family Credit the unemployment trap would tend to worsen; with such a Family Credit, the overall position will improve. How much it improves depends primarily on the size of the credit. The best measure of the effect of the reforms on the unemployment trap is the individual's

"replacement ratio" ie the proportion of his income in work that he would still get out of work. A replacement ratio of 100% means that he is no worse off out of work than in work. Using this measure the tables at Annex 3 to Mr Fowler's paper contrast the effects of Options 1 and 2. They show that under Option 1 marginally more families have a replacement ratio of over 90% than under the present FIS. Under Option 2, where the family credit rate is increased by about £2 a family, the proportion of families with replacement ratios this high falls by a quarter. However, although such a change buys improvements in replacement ratios and thus helps reduce the unemployment trap, it also makes matters worse for some groups from the point of view of the poverty trap. As the tables in Annex 3 show, although the modification reduces the number of people paying marginal tax rates of 90% or more it increases the number of people paying marginal tax rates of 70%-89%, albeit by a smaller proportion. The position is thus less clear cut than it at first appears and you will wish to see that these effects are examined in discussion. As with the modification on pensioners you will wish the Group to make a judgement on whether the improvements are worth the extra expenditure (probably about £50 million of the total extra costs involved).

OTHER ISSUES

(a) Other Changes

9. In addition to the main changes set out above, Mr Fowler also includes in Annex 1 to his paper a summary of other changes he intends making to the Green Paper proposals to take account of comments received and further consideration. The principal changes involved are:

(i) Income Support: Modifying the impact on families of having a lower rate of benefit for those aged under 25 by allowing all couples with children aged 18 or over the full rate of benefit; giving limited rather than no help with mortgage interest payments; making improvements in ways of dealing with claims for income support from foreign nationals - the original intention to exclude them would be contrary to European law;

(ii) Housing Benefit: Reverting to separate rent and rates tapers rather than a single taper and also allowing local authorities to continue to operate local schemes - within their own resources - for war pensioners only instead of outright abolition of these schemes as originally proposed.

With the exception of this last item all these changes are broadly acceptable to the Treasury. I believe the Chief Secretary may wish to argue for discontinuation of local schemes.

(b) Public Service Pensions

10. An issue left over from the last meeting was what solution might be devised to prevent public servants opting out of occupational schemes in order to get a short term cash gain. This could have serious PSBR implications. The Chancellor of the Exchequer was remitted at the last meeting to take this matter further with the Ministers concerned and report back. We understand that progress has been made and there is no need to discuss the issue at this meeting but you may wish to invite the Chancellor to minute you with a proposed solution quickly. It is important to resolve this before the Cabinet considers the package as a whole, possibly on 28 November, in order to avoid time being wasted on a peripheral issue.

(c) Date for Introduction of Personal Pensions

11. Mr Fowler was asked at the last meeting to consider whether the right to a personal pension could be introduced in advance of the main package. Again you may wish to invite him to respond on this issue quickly but in correspondence.

HANDLING

12. You will wish to invite Mr Fowler to introduce his paper. Discussion might then be conveniently divided into three parts:

(i) main issues - modifed treatment of pensioners and more generous Family Credit scheme.

(ii) other secondary issues

(iii) presentation of the Review.

On (i) you will wish the Chancellor of the Exchequer to comment on the public expenditure consequences of the main proposals. The Lord President and the Chief Whip may have points to make about the contrast between the two options from the point of view of Parliamentary handling and the Chancellor of the Duchy about their wider political impact. The Paymaster General may wish to speak about the incentive effects of the options. (We understand that he discussed these points with the Employment Secretary before the latter left for his visit to the United States.)

13. On (ii) you will wish to establish whether any member of the Group has points to raise and to ensure that work on the two issues remitted from the last meeting - public sector pensions (the Chancellor of the Exchequer) and timing of introduction of personal pensions (Mr Fowler) - is in hand and that the results will be reported to you promptly.

14. On (iii) you will wish the Group to give Mr Fowler a steer on the presentational aspects of his White Paper in advance of the Cabinet meeting. In particular the Group will need to consider presentation of the distributional effects and the extent to which Mr Fowler can set the effects of the Social Security Review in the context of other initiatives. The interaction between the social security review and the local government finance studies has been recognised both in MISC 111 and E(LF). In broad terms the groups that lose under one set of proposals tend to gain under the other, but the scale of losses under the social security proposals is far greater and the precise countervailing benefits of the local government finance reforms cannot be determined until at least one year (more probably two years) after the social security changes take effect. However, the presentation of the two reforms will need to be harmonised, as Mr Fowler suggests, before the local government finance Green Paper is published in January to be available for Second Reading of the Social Security Bill. You

may wish to return to this topic at the E(LF) meeting on 12 December to approve the local government finance Green Paper. For the moment, however, what is immediately at issue is the preparation of the social security White Paper for publication as soon as possible. It would not seem appropriate for this to be used as a general trailer for the local government finance proposals, though the proposal for a minimum 20% contribution to rates is a direct link between the two, and on that particular point the social security White Paper will need to deploy the arguments of electoral accountability. Those arguments will then be developed more generally in the Local Government Finance Green Paper.

CONCLUSIONS

15. If possible, you will want the Group to take firm decisions on:

(i) the proposals for modified treatment of pensioners and more generous family credit;

(ii) the secondary changes in Annex A;

and (iii) to give Mr Fowler a steer as to the best presentation in the White Paper of the effects of his reforms on individuals.

16. If it is possible to take these decisions Mr Fowler should be invited to present both these and his revised pensions proposals to Cabinet at the earliest opportunity. A provisional place has been reserved on the Cabinet agenda for 28 November if you wished to take it then, or alternatively on 5 December. If it does not prove possible to meet this timetable, then it will not be possible to publish the White Paper this side of the Christmas Recess.

J B UNWIN

19 November 1985
Cabinet Office

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