

→ for meeting with the  
Chancellor 16/2



PRIME MINISTER

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## UPRATING OF PENSIONS AND OTHER BENEFITS

Following up our discussion yesterday, I attach a note setting out the position. It summarises the present arrangements for uprating, the case for changing back to the historic method, and what the practical and financial implications of this would be.

The main points that the note brings out are:

- \* We can only get away from the recurrent problems of overshoot and shortfall by moving to the historic method.
- \* If we do move to the historic method, we have an acceptable and defensible position on the future uprating of pensions.
- \* If we do not take back the overshoot from the November 1982 uprating, we should ensure that at the November 1983 uprating pensioners and others are not worse off under the historic method than they would be under the forecast method.
- \* It should be possible to accommodate the change to the historic method within the overall public expenditure figures, with perhaps no more cost to the Contingency Reserve than if we kept to the forecast method.
- \* Given that accommodation within the overall public expenditure figures, there ought not to be any backwash on to the Government's overall economic strategy and market confidence in that strategy.

The other factor of course is the position in Parliament. I know that the Chief Whip is anxious about the position. We would not want to get into a situation where we had made significant concessions to enable the primary legislation to get through and then lose all or part of that legislation. In that case we would lose out both ways.

*Perf.*

11 February 1983

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## UPRATING OF PENSIONS AND OTHER BENEFITS

Present arrangements

1. Pensions and other benefits are currently uprated by the forecast method. In fact, this is not an accurate description, since the uprating is intended to reflect the rise in prices over the previous 12 months not the rise over the following 12 months. Because of the time needed to carry out the uprating, the estimate of price rises over the previous 12 months which determines the amount of the uprating is partly based on the actual price rise and partly on the expected price rise over the latter part of the period. Last year's forecast was based on what was known at the March 1982 Budget. The latest date to which we can delay making a forecast is mid-June, ie using the May RPI.

2. Initially, therefore, the element of forecast in the current method of uprating means that the uprating can be too high (overshoot) or too low (shortfall). Overshoots and shortfalls both produce difficulties for the Government of the day. There is no way of entirely resolving these difficulties. In only two years (1977 and 1979) since the forecast method began has the Government got it right.

Historic method

3. By contrast, the historic method avoids the controversy and uncertainty that are inherent in the forecast method. Pensioners know that the uprating reflects the actual price rises. The Government can budget more accurately for the cost of the uprating: no allowance has to be made for possible overshoot or shortfall.

4. There are two points to be borne in mind if we revert to the ~~forecast~~ historic method:

\* For operational reasons, we should (at present) have to use the May to May RPI figures which come out in June. We shall therefore have to convince pensioners that the certainty of the historic method makes it worthwhile not being able to take account of price rises between May and November in that year's uprating. The obvious answer here is that the increases would, of course, be reflected in the following year's uprating.

\* We need to ensure that in the year of the changeover, pensioners do not get less than they would have got under the forecast method. We do not want to be accused of saving money at their expense, even though of course they would be "compensated" in the following year when the uprating reflected price rises between May and November.

5. If we reverted to the historic method in 1983 we should be able to avoid any danger of pensioners losing out by leaving the 2.7 per cent overshoot on the 1982 uprating. This would provide a substantial cushion against rising prices between May and November, sufficient, on present forecasts, to leave pensioners and other beneficiaries with an overall bonus. Pre-budget estimates suggest that the May - May

inflation rate will be between  $4\frac{1}{2}$  per cent and  $5\frac{1}{2}$  per cent while the November - November rate will be between 6 per cent and 7 per cent. If, conservatively, we take the difference as 1 per cent, this would leave a bonus of 1.7 per cent.

Implications of reverting to the historic method

6. For pensioners and other beneficiaries. The effect on the 1983 uprating depends on how much of the overshoot would remain a bonus. The amount by which November to November price rises exceed May to May price rises will reduce that bonus. The following table shows the comparative effects on the 1983 uprating of retirement pension and child benefit. There would be similar effects on other benefits, although for supplementary benefit the overshoot was only 2 per cent not 2.7 per cent.

Pension Rate

November 1982 rate	£32.85
November 1983 rate with 3 per cent uprating (ie MISC 88 recommendation - 5 per cent price rise, 2 per cent adjustment, 0.7 per cent bonus)	£33.85
November 1983 rate with 4 per cent uprating (ie MISC 88 recommendation, but November - November price rise is 6 per cent, not 5 per cent)	£34.15
November 1983 rate with 5 per cent uprating (ie make no adjustment, revert to historic method, May to May price rise is 5 per cent)	£34.50

Child Benefit Rate

November 1982 rate	£05.85
November 1983 rate with 3 per cent uprating	£06.05
November 1983 rate with 4 per cent uprating	£06.10
November 1983 rate with 5 per cent uprating	£06.15
November 1983 rate at April 1979 value restored, assuming 5 per cent price rise November to November	£06.40

Note

To restore the April 1979 rate of child benefit would require a rate of £6.40, assuming prices rise by 5 per cent between November 1982 and November 1983. The extra cost of increasing child benefit from £6.15 to £6.40 would be £45 million in 1983/84 and £130 million in 1984/85. If, however, prices between November 1982 and November 1983 go up by 6 per cent as assumed in paragraph 5 above we should require a rate of £6.45. The extra cost of increasing the rate to £6.45 would be £55 million in 1983/84 and £155 million in 1984/85.

7. For public expenditure. The appendix shows that the most likely outcome is that the changeover, including no adjustment for overshoot, could be accommodated within overall public expenditure totals and without making any extra call on the Contingency Reserve other than that needed under the forecast method.

8. For longer term public expenditure, it is irrelevant whether we use the historic or forecast method since, over a period of years, both are intended to achieve the same objective. If we are to make any savings from the uprating of benefits, this requires a political decision. We do not limit our freedom of manoeuvre by moving to the historic method. Indeed, the historic method has the advantage of avoiding fortuitous gains through overshoot.

9. For the Government's economic strategy. There is no reason why the change should have any effect, provided the overall public expenditure totals are maintained.

10. If it is argued the change means the Government are concerned by rising prices, the answer is that the effect of this would have been seen in the forecast method anyway. The reversion to the historic method was not made for that reason, or to save money but simply because it was a more satisfactory method of uprating.

11. For social security policy. The change will mean that the Government has a defensible long-term position on uprating policy. For example, we could say:

"We have legislated so that pensions and other benefits go up in line with the known movement of prices. This means we have no more worries about overshoot and shortfall, as we now have under the forecast method of uprating introduced by the previous Government. With the backing of a satisfactory method of uprating we shall continue during the next Parliament to protect the value of pensions and other benefits subject only to overriding economic circumstances - a qualification which must apply to any Government policy in any area."

12. For National Insurance Contributions. If there were no adjustment (the last contributions review assumed, in effect, a 1.7 per cent adjustment) that would add nearly  $\frac{1}{2}$  per cent to the contribution rate. But under the forecast method, if November to November prices went up by 6 per cent, not 5 per cent, more than half of that increase would be needed anyway.

13. For public service pensions. As things stand, these go up in line with the additional (earnings related) component of the retirement pension. The Social Services Select Committee recommended full adjustment of 2.7 per cent.

14. If we revert to the historic method, but do not provide any cushion by allowing the overshoot to continue, public service pensioners would be worse off than under the forecast method if, as assumed, November to November price rises are 1 per cent higher than May to May. They could be left in a neutral position, ie not worse off, if 1 per cent of the overshoot were left.

15. A one-off adjustment of the public service pension uprating, whether of 2.7 per cent or 1.7 per cent, could be simply provided for in the Uprating Bill we should need for reverting to the historic method.

## EFFECT ON PUBLIC EXPENDITURE

<u>Add</u>	1983/84 (part year)	1984/85 (full year)
1. Cost of 5 per cent uprating of all benefits in November 1983 instead of 3 per cent uprating (ie not making a 2 per cent adjustment; 0.7 per cent is already a bonus)	+ 215	+ 596
2. Cost of restoring balance of 5 per cent abatement of unemployment benefit (ie 2.3 per cent, after allowing for 2.7 per cent overshoot)	+ 10	+ 27
3. Cost of increasing capital limit for single payment of supplementary benefit from £300 to £500	+ 1	+ 3
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	+ 226	+ 626
<u>Deduct</u>		
4. Package of benefit improvements arising from MISC 88 (details overleaf)	- 35	- 101
5. Possible Budget concessions (details overleaf)	- 72	- 200
6. Extra cost of 1983 uprating under forecast method if November to November price rises exceed May to May prices by 10 per cent	- 107	- 298
7. Partial adjustment (1.7 per cent) of public service pensions	- 19	- 53
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	- 233	- 652
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	- 7	- 26

Notes

1. The full year position in 1984/85 would be similar in subsequent years, after adjustment for the appropriate public expenditure assumptions.

<u>2. MISC 88 package of benefit improvements</u>	1983/84	1984/85 <sup>(2)</sup>
Restore 5 per cent abatement of unemployment benefit	21.8	59.5
Supplementary benefit single payments limit (£300 to £500) and price protection	1.1	3.2
Supplementary benefit capital cut-off (£2,500 to £3,000) and price protection	2.2	7.9
War Pensioners Mobility Supplement	0.2	1.8
2 per cent real increase in Mobility Allowance	2.0	6.0
Real increases in Therapeutic Earnings Limit for incapacity benefit	0.1	0.3
Remove the invalidity trap (1)	7.4	22.6
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	34.8	101.3
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	(35 rounded) (101 rounded)	

Notes

- (1) Cost in 1984/85 would be met from unallocated housing benefit savings.
- (2) Treasury would have to find £12.7 million new money for 1984/85.

3. Possible Budget concessions

(1) Restore April 1974 value of child benefit	70	195
(2) Real increase in one parent benefit in line with percentage increase in child benefit	2	5
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	72	200

Both improvements require new money to the amounts shown which Treasury would have to find.