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Prime Minister ① 4A ce J.R.
ce C. [unclear]

The Chancellor hopes you will be able to look at this before tomorrow's meeting. There is something fishy about these figures. How is PSBR higher, profits lower, self-employed and employed with lower net income. How come everyone is worse off. The Chancellor is breaking higher contributions although they've a tax rebate than an increase in savings.

PRIME MINISTER

SOCIAL SECURITY REVIEWS

We are to discuss at this week's Cabinet Norman Fowler's memorandum summarising the outcome of his review of social security. Some of Norman's proposals are very far reaching and will take many years to have their full effect. In the long term they are well worth while. But we clearly cannot take decisions of such importance without carefully considering their financial implications for both public and private sectors over the lifetime of this Parliament. I am only now able to start to put together the overall picture. The details of some of the proposals are not yet firm and we do not have definitive costings in a number of areas. But the broad picture is fairly clear and I thought it right to let you have my initial assessment of the likely total impact of what is proposed, before our meeting tomorrow.

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2. The total savings agreed by MISC 111 are summarised below. These are all savings to the PSBR, but only about half of them will be reflected in lower public expenditure. The remainder - including virtually all the savings in housing benefit - are lower rate rebates and will be reflected in higher public sector revenues.

| | 1987/88 | 1988/89 | £m |
|-----------------------|------------|--------------|----|
| Supplementary Benefit | 130 | 290 | |
| Housing Benefit | 620 | 640 | |
| Other | 50 | 70 | |
| Total: | 800 | 1,000 | |



3. To this should be added the effect of replacing SERPS. In the very long run, as you know, the abolition of SERPS may allow us to realise very substantial savings in public expenditure, perhaps of the order of £½ billion by the mid 1990s and may be as much as £22 billion by the 2030s (at today's prices). For the remainder of this decade, however, the replacement of SERPS by compulsory private sector provision is likely to add to both public expenditure and the PSBR. The switch from SERPS ("a Pay As You Go" scheme) to fully funded private sector schemes will generate income to meet maturing pension liabilities in the next century. But the immediate consequence will be a sharp increase in the burden of pension contributions from both public and private sectors.

4. The costings (which are not final) have been done on the assumption (implicit in Norman Fowler's proposal) that existing contracted in and contracted out class 1 National Insurance contribution rates are unified on a basis which is broadly neutral to the Fund. This implies an increase in the rate paid by contracted out employers and employees, and a reduction in the rate paid by those who are contracted in. Employees will benefit somewhat at the expense of employers, because of the removal of the contracted out rebate, two thirds of which was paid to employers. We have not yet discussed the question of the self employed, but the abolition of earnings related benefits will mean that the actuarial justification for a much lower rate for them will largely disappear, so contributions paid by the self employed ought to rise, perhaps by as much as £0.3 billion.

5. On these assumptions, public sector employers' NIC's may rise by some £½ billion, since the public sector has a relatively high proportion of contracted out employees, whose contribution rates will rise. This will add to both public expenditure and



revenue. Also on the revenue side, there may be a slight fall in total private sector NI contributions, of around £0.2 billion. We have not yet discussed the question of tax relief, but if present arrangements were to apply to compulsory private contributions, the cost might be around £1 billion a year. The net effect on the PSBR is therefore likely to be a loss of something of the order of £1¼ billion.

6. Taken together with Norman's other proposals the overall effect may be to increase the PSBR by around £½ billion in 1987-88 and perhaps £¼ billion in 1988-89. In summary, the overall picture looks as follows:-

| (£ bn) | 1987/88 | 1988/89 |
|---|---------|---------|
| <u>Public Expenditure</u> | | |
| - savings agreed by MISC 111 ¹ | -0.3 | -0.5 |
| - higher public sector employers NICs | +0.5 | +0.5 |
| Total public expenditure | +0.2* | -* |
| <u>Revenue</u> | | |
| - lower rate rebates | +0.5 | +0.5 |
| - tax relief on contributions | -1.0 | -1.0 |
| - NICs: private sector | -0.2 | -0.2 |
| public sector | +0.5 | +0.5 |
| Total Revenue | -0.2 | -0.2 |
| Total PSBR | +0.4 | +0.2 |

*Bringing part-timers into the public service pension schemes, if that proves necessary, could add a further £200 million to public expenditure, or £100 million to the PSBR. The change in the PSBR will depend on how far higher public sector costs are absorbed or passed on in higher nationalised industry prices.

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The effect on private sector employment costs

7. The replacement of SERPS by a compulsory private sector scheme will add substantially to private sector employment costs, for employers, employees and the self-employed. Contracted in employers and employees will pay lower employers' National Insurance contributions but this will be substantially offset by contributions under the compulsory private sector scheme even after taking account of tax relief. Contracted out employers and their employees on the other hand will pay higher National Insurance contributions, though they will be unaffected by the introduction of the compulsory private sector scheme. The self-employed will pay higher NICs, and some of them will also have to make contributions under the compulsory scheme.

8. The gross increase in contributions to compulsory private schemes may be nearly £3 billion. If current tax arrangements are extended to cover these contributions, the public sector will effectively meet a third of this, in the form of additional tax relief.

9. The following table summarises the possible impact on private sector employers costs and net take-home pay in 1987/88:



1987-88

| (£bn) | Contracted out | Contracted in | Total |
|---|-------------------|------------------|-------|
| <u>Effects on private sector employers costs</u> | | | |
| Extra NICs | +0.8 | -1.0 | -0.2 |
| Compulsory contributions to private schemes | - | +1.2 | +1.2 |
| Gross increase in employers costs | +0.8 | +0.2 | +1.0 |
| Tax relief | n.a. | n.a. | -0.5 |
| Net increase in employers costs | n.a. | n.a. | +0.5 |
| <u>Effects on private and public employees</u> | | | |
| Extra NICs | +0.6 | -0.9 | -0.3 |
| Compulsory contributions to private schemes | - | +1.2 | +1.2 |
| Gross increase | +0.6 | +0.3 | +0.9 |
| Tax Relief | - | -0.3 | -0.3 |
| Net increase (ie reduction in take home pay) | +0.6 | - | +0.6 |
| <u>Effect on self-employed</u> | | | |
| Extra NICs | | | +0.3 |
| Compulsory contributions to private schemes | | | +0.5 |
| Tax Relief | | | -0.2 |
| Net increase | | | +0.6 |

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10. The conclusion I draw from these figures is that we must think very carefully before insisting on compulsory private provision for pensions. We can expect a significant rise in voluntary private provision when SERPS is abolished, and over time this will increase both employment costs and (if we decide to continue present arrangements) the cost of allowing tax relief on pension contributions. But the cost will inevitably be much greater especially in the short term if private provision is made compulsory.

11. If we go ahead on the basis Norman is proposing and replace SERPS from April 1987, we will add to our problems in what may prove to be the last financial year before the General Election. As you know, the fiscal position in 1987/88 is already looking very tight. These changes will make it worse and impose severe additional burdens on employers, which we will find very difficult to relieve within the existing strategy.

12. I therefore think we have to consider two further options. The first is to abolish SERPS, but leave it to people to choose their own level of provision for retirement, at least initially. If, in the event, the growth of private provision is too low, and threatens overdependence on the supplementary benefit system, we can introduce compulsion at a later date. The second is to postpone the abolition of SERPS until after the next General Election, a course with a number of obvious political attractions.

13. I am copying this minute to Willie Whitelaw and Norman Fowler.

N.L.

N.L.

23 April 1985