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ca J. M. Whym
cc Cab Office
Prime Minister
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S. J. Pike Duty Clerk
hw TPL 24.1.80

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

24th January 1980

Der Tim,

"CHANGING GEAR"

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As promised, I enclose a note by Treasury officials which the Prime Minister may like to discuss at her meeting tomorrow at 2.30 p.m. The Chancellor has not had time to study the note carefully, but thought that the Prime Minister would like the opportunity of studying it overnight.

I will be in touch with you early tomorrow with a list of officials for the meeting.

Yr evr,
ME

(M.A. HALL)

T. Lankester, Esq.,
No.10, Downing Street



Treasury Chambers Parliament Street W/11 2 2 70
0008 3100 0

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24 JAN 1980

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NOTE BY TREASURY OFFICIALS : ACROSS THE BOARD DEINDEXING

This note discusses as an alternative to the piecemeal deindexation of some social security benefits, the possibility of a one-off global deindexation exercise, whereby at the next opportunity all elements controllable by the Government which would usually increase in line with some index or another, formal or informal, should only be increased by something less than that index. The essence of this proposal is that it should be as broadly based as possible, so as not to seem to identify any particular programme or sector for such treatment; but that it should achieve substantial public expenditure (and PSBR) savings for the year 1981-82 (with spin off into 1980-81 and for 1982-83 onwards), while at the same time forming a new lower base from which normal indexation or increases would resume once the "change of gear" had taken place. The move would be represented as, and would indeed be, action by the Government across the board to get the system back on to a new plane which the economy can afford.

2. Individual areas which should come into this exercise are considered below. The assumption is made that current legislative constraints are irrelevant, and that where necessary (and in many cases it would be necessary) current legislation would be overruled through one single Act empowering the Government to make this "change of gear".

Social Security Benefits

3. The items in this programme (or associated with it) which are formally uprateable (notably retirement pensions, supplementary allowances and benefits, unemployment, sickness, etc benefits but not child benefit and benefits such as death grant and maternity grant) total around £16 billion. 3 per cent deindexing would therefore secure £480 million in a full year, or about £160 million in 1980-81. As an example of the effect it would have on beneficiaries, assuming an uprating otherwise of 15 per cent, the married couple pension now £37.30 per week would go up to £41.80 rather than £42.90 in November 1980, a cash difference of £1.10 per week.

4. Child benefit is not included here, because it is not formally or informally indexed, and the question of what increase on the current £4 per week that should be given next November is a separate one.

5. So far as contributory benefits go, in order to get the PSBR savings, either legislation would be needed to reduce the level of Treasury Supplement to the National Insurance Fund or the balance on the Fund would have to be allowed to grow, so that contribution rates to the Fund were not lowered.

Public Service Pensions

6. Under the Social Security Pensions Act 1975 price protection of public service pensions (eg Civil Service, police and firemen) is integrated with the price protection provisions for the additional component of the new State scheme (which would fall into the exercise under paragraph 3 above). Public service pensions are increased each year in November on the basis of the price forecast used for additional components. No firm figures of the cost of public service pensions are readily available, but it is broadly estimated that the total in the current year will be of the order of £2 billion on the basis of this figure 3 per cent deindexation would save around £60 million.

7. It should be noted that there would be no way of deindexing public sector pensions (eg nationalised industry pensions), because these are matters of separate contracts. Therefore these would continue fully indexed alongside deindexed public service pensions.

Tax Thresholds

8. An increase in the main personal allowances (which set the tax thresholds) in the forthcoming Budget by 3 per cent less than that required by the statutory indexation provisions in the Finance Act 1977 would "save" around £300 million in 1980-81. Similarly, to restrict the increase in the other thresholds in the income tax system (lower rate and higher rates - which are not covered by the statutory indexation provisions) would "save" a further £45 million.

cost difference of £0.50 per week.

9. On the other hand, it must be questioned whether it makes sense to increase the real burden of taxation simply as a presentational adjunct to cuts in public expenditure which are, in themselves, designed partly to allow room for real reductions in direct taxation.

10. Moreover :

- i. Deindexing the tax thresholds would impose, proportionately, a bigger burden ^{on} of those on low incomes than those on higher incomes. This could not be corrected by reduction in the basic rates.
- ii. As much as possible should be done on the thresholds so as to improve incentives at the bottom end of the earnings ladder.
- iii. Deindexing both thresholds and pensions would maintain the same proportionate "clear water". But failure to index the tax thresholds could reduce the "clear water" between the tax thresholds and the retirement pension, if that pension were to escape the full impact of deindexation.
- iv. Failure to index would bring more people (around 200,000) into the tax net, and require more staff in the Inland Revenue.

11. Finally, if it were decided to deindex the personal allowances, careful consideration would need to be given to the extent to which there should be a similar reining back in the increases in the specific duties on the indirect tax side.

Pay

12. Another form of deindexation would be to try specifically to "deindex" pay, by announcing that the Government's policy on pay settlements in the public services would be that they should be 3 per cent below the level which would otherwise be indicated.

This would be very strongly opposed by the unions as being a direct and selective attack on their pay. Moreover, comparability, formal or informal, would ensure that the Government faced extreme difficulty in preventing a bounce-back on pay in 1981-82.

Problems

13. In a sense the problems speak for themselves. Action in many of the areas involved would be inconsistent with stated policy. But taken collectively, as part of a wider one-off exercise the problems associated with each individual area may be less. It would be essential to see the proposal as a package.

14. Nevertheless, this would not mean that exceptions could not be made in individual areas. However each exception of this kind built into the scheme would not only erode the savings that would arise, but also would reduce the benefits to be obtained from the all embracing nature of the exercise.

The future

15. The operation is conceived as one-off, with the normal rules etc. applying for future years from the new lowered base. In the wider context of deindexation, however, Ministers might wish to keep the door open to do a similar exercise sometime in the future. This would be for judgment, taking account of legislative and other constraints.

Rate of deindexation

16. This note assumes a 3 per cent deindexing. There is no magic about this. A lower rate would give lower savings, and a higher rate higher savings. A higher rate might be preferable, in that the problems are not greatly increased, and the additional savings could give scope for some exceptions (see paragraph 14).

Impact on current Public Expenditure operation

17. If this exercise were pursued on a broad front on the basis of 3 per cent the current public expenditure operation might look as follows :-

	<u>£ million 1979 Survey prices</u>	
	<u>1980-81</u>	<u>1981-82</u>
Savings as at Annex A to C(80)3	492	1363
Less Social Security items therein	(110)	(505)
Add Social Security items not covered in this paper (i.e.)	50	110
Add Social Security savings above (para 4)	160	480
Public Service pension savings above (para 6)	30	60
	<u>622</u>	<u>1508</u>

Further savings are possible on other programmes now under discussion, including child benefit. The PSBR savings are not necessarily the same as these, notably in that these would reflect deindexing tax thresholds (if agreed) at about £350 million (para 8).

17. Further work and timing

18. More work would be needed to refine this preliminary note. This would take time. The implications of the new proposals will clearly not be ready in time for firm decisions, on the exact measures and the amounts of savings, to be taken at Cabinet next Thursday. This would preclude the publication of the full Public Expenditure White Paper before the Budget, though it might be possible to have a much more curtailed announcement in the Budget itself. The White Paper could then only be published several weeks after the Budget (since, inter alia, it would have to take into account the Budget forecasts), if at all. Such further delay could cause adverse speculation and criticism, which Ministers will want to consider.

General

19. While the broadest possible coverage would yield the greatest effect and lend greater credibility on presentation, such coverage carries with it the

the need to take some very difficult decisions. The conflict of objectives may be most apparent in the tax field, where deindexation would cut across the tax strategy, but it would also be acute in other areas eg pensions and defence. The key to these difficulties would lie in making this exercise as comprehensive as possible. Thus action on pensions would be more defensible against a background of similar action elsewhere; and in its turn could be the key to savings being obtained from other hitherto difficult areas. On the other hand if the cover is narrowed, not only are the savings (public expenditure and PSBR) reduced but the more emphasis would fall on individual items and the less acceptable the operation becomes. Where conflicts do arise it may be that the possibility of limited exceptions mentioned at paragraph 14 could be explored; or other measures found outside this exercise.