

The Facts about National Insurance

Introduction

The purpose of this briefing paper is to clarify a number of basic points surrounding the workings of the National Insurance Fund, in order to give campaigners a better understanding of the issue when arguing for improvements in the basic state pension.

How the Fund works

National Insurance is the system through which contributions by working people and employers are paid into a fund - the National Insurance Fund - to finance a range of benefits, including state pensions (but not the means-tested pension credit), incapacity benefit, widows' benefits, maternity allowance, guardian's allowance, jobseeker's allowance and the Christmas bonus. In 2004-05 the Fund's total expenditure was £63.2bn, of which £48.6bn was spent on state pensions.

Currently, employees contribute 11% of income between £94 and £630 a week and 1% above £630. Employers pay 12.8% on all income above £94. Employees contracted-out of the state second pension get a NI rebate of 1.6% of earnings between £82 and £630, and their employers get 1% to 3.5% depending on their scheme.

From these contributions an allocation is made towards the NHS of 2.05% of the first slice of eligible earnings from employees and the full 1% on income above £630. Employers pay 1.9%. The remainder goes into the fund, and can only be used for the payment of benefits or the cost of administration.

In principle, the National Insurance Fund operates on a pay-as-you-go

basis, the contributions received in each year being used to pay pensions and other benefits in the same year. In this respect it differs fundamentally from private pension funds, which need to build up reserves to cover their future liabilities.

The Government Actuary, who reports on the state of the Fund each year, also recommends that the Fund should also keep a balance to cover any unexpected short-fall in income of not less than two months' benefit expenditure.

In practice, in recent years, the Fund's income has regularly exceeded its expenditure, leaving it with a much bigger balance than the Government Actuary recommends. The amount needed to cover two months' benefits in 2005-06 would be £10.1bn. The balance predicted for March 2006 is £34.6bn - £24.5bn above the recommended level.

The main reason for this is the policy adopted by the Conservatives in 1980 and pursued by both Conservative and Labour governments since then, of breaking the link between pensions and average earnings, so that, while the Fund's income from contributions rises roughly in line with earnings, pensions and other benefits normally rise only in line with prices. By 2010, if present policies continue, the Actuary's figures show that the balance will rise to over £60bn, about £48bn above the recommended level.

Is it a real fund?

It is often suggested that the Fund exists only on paper and is not real money available for spending on pensions and other benefits. Such suggestions are entirely unfounded.

On days when more money is received than is paid out, the surplus is transferred to a National Insurance Fund Investment Account, managed by the National Debt Commissioners (CRND) who invest it in government gilt-edged securities.

Can the money be spent?

The purpose of keeping a balance in the Fund from year to year is to cover occasions when more money is being paid out in benefits than is received in contributions and investment income. This not only happens on a daily basis; expenditure may also exceed income over the year as a whole, as it did in four of the past 20 years: 1989-90, 1991-92, 1992-93 and 1996-97. It is clear, therefore, that when the need arises there is nothing to prevent the Fund from cashing in some of its investments to meet current benefit expenditure.

However, it is one thing to say that the money *can* be spent and quite another thing to suggest that the government should *plan* to spend it by taking into account the balance in the Fund when fixing the following year's benefit rates. From the Treasury's point of view, National Insurance contributions are a very convenient form of taxation, which most people view more favourably than income tax.

National Insurance benefits, on the other hand, including pensions, are seen by the Treasury as simply part of the total of public expenditure; and it is the total that matters, not whether the money comes from contributions, income tax or some other source. The fact that the Fund has money to spare, therefore, is not taken into account in deciding whether or by how much pensions should be increased each year. But the money

held in the Fund is only part of the story. At least as significant is the amount of money of which the Fund has been deprived by a succession of measures which have attracted remarkably little notice. If governments had adopted a policy of simply holding down the level of benefits while allowing contributions to rise in line with earnings, the balance in the Fund would be many times greater than it actually is. The strategy adopted over the past 25 years, therefore, has been to maintain the ever-increasing flow of contributions while holding down the level of benefits and, at the same time, preventing the balance in the Fund from rising to a level at which pressure to spend it by restoring the value of benefits would be irresistible. Some of the methods used are described below.

The Treasury supplement

Under the Social Security Act 1973, the Treasury supplement to the Fund was fixed at 18% of the combined contributions of insured persons and employers. In the 1980s, however, the Conservative government decided that, with the earnings link broken, the Treasury supplement could be reduced and eventually abolished. The first reduction took place in 1981. By 1988 the supplement had fallen from 18% to 5% of contributions, and the following year it was abolished.

The abolition of the Treasury supplement proved premature. One reason for this was the unexpectedly large number of people taking out personal pensions and claiming contracted-out rebates from the National Insurance Fund. In three of the four years following the abolition of the supplement, the Fund's income failed to match its expenditure, leaving it with a balance below the target of

two months' benefits. The same Conservative government that had abolished the supplement was thus obliged to reintroduce it in the form of an ad hoc Treasury grant payable in any year when it was needed to keep the Fund at an adequate level. The grant was paid in the years 1993-98. Since then, however, during the period of Labour government, the Fund's year-end balance has exceeded the recommended level by a large and steadily increasing margin without the need for any contribution from the Treasury.

However, the loss of the Treasury supplement has resulted in an enormous reduction in the income of the Fund. Reintroducing the supplement now at its pre-1981 level of 18% of contributions would bring in an extra £11.3bn a year – more than enough to enable the Fund to meet the gross cost of a £109 a week basic pension, without taking into account the resulting savings in pension credit.

Another reason for restoring the Treasury supplement is that it would make the financing of National Insurance fairer. A large part of the cost of retirement pensions and other benefits is accounted for by rights acquired not by the payment of contributions but through the system of credits and home responsibilities protection. It is right that these benefit entitlements should be funded from general tax revenue, via the Treasury supplement, rather than from contributions levied only on earned incomes (and, in the case of employees' contributions, only on earnings below the upper earnings limit of £630 a week).

Green taxes

The NI Fund's income from employers' contributions has been

deliberately and substantially reduced as a result of a series of "green" taxes: the landfill tax introduced in 1996, the climate change levy in 2001 and the aggregates levy in 2002. The purpose of all these taxes was to make companies pay for the environmental damage caused by their activities. The greater part of the proceeds of each tax was to be returned to employers as a whole by a reduction in their NI contributions of 0.2% of earnings for the landfill tax, 0.3% for the climate change levy and 0.1% for the aggregates levy.

The government was thus able to claim that the taxes were "revenue neutral", encouraging environmentally responsible behaviour without imposing an additional burden on industry as a whole, while at the same time promoting job creation by reducing the costs of employment.

These aims were entirely laudable, but the method used to achieve them has had an entirely unjustified effect on the NI Fund. If the Fund was to bear the cost of compensating employers, through the reductions in their contributions, it should also have been credited with the proceeds of the taxes. Instead, the Treasury has been allowed to pocket the proceeds, while the entire burden of the taxes has fallen on the Fund.

As a result, over the whole period since they were introduced, the green taxes have cost the Fund at least £13bn, and are currently costing well over £2bn a year in lost contributions. This is plainly indefensible. The Fund should be fully compensated for the losses it has already sustained and an annual payment should be made to compensate it for future losses of contribution income from employers.

The NHS allocation

Since 1948, a proportion of NI contributions has been allocated to the National Health Service. Originally, the whole of the contribution income was paid into the National Insurance Fund, from which the appropriate amount was transferred to the NHS. The current legislation, however, provides for the contributions to be paid into the NI Fund after deducting the appropriate NHS allocation.

In 2002 the government decided to increase the contribution rates of employees, employers and the self-employed by 1% of earnings (including earnings above the upper earnings limit) from the year 2003-04, using the money raised in this way to increase the NHS allocation. The impression given at the time was that the NI Fund would not be affected, since the additional contributions would go directly to the NHS.

However, in 2003 the Government Actuary pointed out that the 1% contribution would have an adverse effect on the Fund because the NHS allocation in respect of employers' contributions was to be increased by 1% of all earnings, not just those above the £89 threshold. As a result, the additional amount of employers' contributions allocated from the Fund to the NHS in 2003-04, under the 2002 Act, would be about £1bn more than the additional 1% contribution would have given if it had just been on earnings above the threshold, thus leaving £1bn less in the NI Fund.

The exact amount that the Fund stands to lose in subsequent years is not known, but it will rise with each increase in the contribution threshold (now £94 a week). It is safe to assume, therefore, that the Fund is

losing about £1bn each year. Nobody would dispute that the NHS needs the money and few people objected to paying the extra 1% contribution for this purpose, but there might have been less support for the proposal if the government had come clean about its intention to extract an extra £1bn a year from the Fund, leaving less money available for improvements to state pensions.

Who is responsible for National Insurance?

Before 1 April 1999, responsibility for policy in relation to National Insurance contributions and the National Insurance Fund rested on the Secretary of State for Social Security. From that date, responsibility was transferred to the Treasury, which has shown a total disregard for the underlying principles of social insurance and of the need to preserve (or restore) public confidence in the system.

Has the National Insurance system got a future?

Despite what some critics may argue, there is no crisis in the state system. National Insurance provides an excellent and efficient way of guaranteeing that both employees and employers fund the pensions of today's retirees, with the annual cost of delivering the pension just £5.40 compared to that of the means-tested Pension Credit of £53.70.

In addition to restoring the Treasury supplement and compensating the Fund for the losses resulting from the "green taxes" and NHS allocation, consideration must also be given to raising contributions above the upper earnings limit from 1% to 11%, to ensure that all employees pay the same rate of NI on all their income towards the Fund.

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