STATES OF JERSEY

SOCIAL SECURITY FUND: A NEW METHOD OF FUNDING

Lodged au Greffe on 7th October 2003
by Deputy G.P. Southern of St. Helier

STATES GREFFE

PROPOSITION

THE STATES are asked to decide whether they are of opinion −

(a) to agree in principle that –

(i) the earnings limit for employer and employee contributions to the Social Security Fund should be removed with effect from 1st January 2005, and

(ii) the overall contribution rate from 1st January 2006 should be increased by one percent annually, made up of a 0.5% increase in the employer contribution and a 0.5% increase in the employee contribution, until the requirement for supplementation is eliminated;

(b) to charge the Employment and Social Security Committee to bring forward for approval the necessary legislation to give effect to the proposals.

DEPUTY G.P. SOUTHERN OF ST. HELIER

REPORT

The overall effect of this proposition, if adopted by the States, will be to transfer the burden of supplementation (currently £50 million annually) from general tax revenues to the contributions raised on salaries greater than the current earnings limit (part (a)(i)), and eventually to all contributors (part (a)(ii)). In this way the fund wil effectively become self-sustaining.

Background

Funding of the Island's Social Security provision has traditionally been on a 'one-third' principle; that is, one third from employers' contributions, one third from employees' contributions and one third supplementation from States' taxation revenue. The fund has also historically been financed on the pay-as-you-go principle. With this method of financing, expenditure on benefits is broadly met by the income from contributions and the States supplement in the same year.

The growth of the Fund, along with the associated Reserve Fund, has been marked since 1974, when it replaced the scheme contained in the Insular Insurance (Jersey) Law 1950. This growth is linked to a number of factors –

- the relative levels of benefits and earnings;
- the increase in the number of benefits;
- increase in the rates of contribution;
- increase in the earnings limit;
- the relative numbers of beneficiaries and contributors.

The growth in the Fund over recent years is illustrated by Table 1 below.

Expansion of Social Security over last 12 years

Income £000	*1990/1*	*1995/6*	*1998*	*1999*	*2000*	*2001*	*2002(E)*	*2003(E)*
Contributions	38,827	50,351	63,013	73,119	81,124	92,826	104,000	109,200
States supplement	14,244	19,970	25,126	30,092	36,161	41,197	48,130	50,132
Total*	60,855	79,113	97,470	112,534	125,736	143,870	152,130	159,332

% States	27	28	28	29	31	31	32	32
Cont. rate % **	8.0	8.0	8.5	9.0	9.5	10.0	10.5	10.5
Employee rate %	3.5	3.5	3.85	4.20	4.55	4.9	5.2	5.2
Employers rate %	4.5	4.5	4.65	4.80	4.95	5.1	5.3	5.3
Earnings limit £/year	15,816	20,400	22,704	24,768	27,264	31,728	33,048	34,608

* includes investment, bank interest and sundry income
** excludes contributions in respect of the Health Scheme

Health Insurance Fund

Since the position of the Health Insurance Fund is reported to be healthy (R.C.27/2002), it is assumed that no changes in Health Insurance contributions are necessary. This proposition therefore leaves these contributions unaffected.

Contribution rates

A contribution rate of 8% of earnings (3.5% paid by the employee and 4.5% by the employer) was set in 1975. This was intended to provide a small margin over a strict pay-as-you-go rate, and it enabled the same rate to be maintained until 1997. It was then decided to increase rates in the light of demographic trends to enable the funds to build up to compensate in a limited way for the ageing of the population over the coming 30 to 40 years. Over the years 1998 to 2002 contribution rates were increased by 0.5% per annum to 10.5%.

Earnings limit

Another variable that can be used to raise income to the funds is that of the level of the earnings limit. This is the amount of earnings above which an insured person's earnings shall be disregarded when calculating the contribution payable. During the period 1998 to 2002 the earnings limit was increased each year by £50 per month in addition to increases in line with earnings. From 2002, the earnings limit has reverted to increases in line with earnings.

By these mechanisms the value of the Social Security Funds as a multiple of annual expenditure should increase from 2.8 in 1996/7 to around 5 by 2010.

The increases between 1998 and 2002 have produced a growth in income of some 31%. Despite this, if the 10.5% rate is maintained, it is estimated that the Reserve funds will be extinguished at some time between the years 2035 and 2042 depending on immigration rates. Alternatively, in order to break even on a pay-as-you-go basis, contribution rates of between 15 and 17.8% are envisaged by the year 2040.

States supplementation

The actions taken over the period 1998 – 2002 in raising both contribution rates and earnings limit have had the predictable effect of increasing the size of the contribution required from States revenue to keep the fund functional. Supplementation has grown by a factor of 2.5 over the period to stand at £50 million annually.

Relative numbers of beneficiaries and contributors

The relative numbers of beneficiaries in the scheme is due to rise inexorably as the population ages. Old age pensions, accounting for 67% of the Fund's expenditure in 2000, are expected to rise steadily to around 80% of expenditure by the 2030s. The number of residents over pensionable age will double from just under 12,500 in 2000 to 24,500 by 2035. Already we can see the start of this rise in the number of elderly, with a 15% growth in the number of pensions between 1997 and 2001, whilst the number of contributors has remained relatively static.

There are those who believe that the solution to the problem is to increase the number of contributors by immigration. Without wishing to debate the issue here, even 200 a year net immigration, which might raise the number of contributors in the short term, will only extend the life of the current system by a mere 7 years, or cut the maximum contribution rate required from 17.8% to 15%.

The only other way we might reduce the burden of supplementation would appear to be to cut back on either the number or the level of benefits available, or to reduce the numbers who are eligible to receive benefits. I cannot believe that this is a route that members would willingly take and I am certain that it would not be welcomed by voters. After all what is at stake here is the basic 'safety net' that underpins the fabric of our society.

Whilst the large increases in supplementation that have been seen over the past 5 years (due to the combination of above inflation increases in the earnings limit and increases in the contribution rates) will not be repeated in the immediate future, the current sum of some £50 million annually will continue to grow in line with the rise in earnings.

Many believe that given our current tax and spending deficits in the short-to-medium term, we can no longer afford the current and projected levels of supplementation. To put at its simplest, without the siphoning off of

£50 million each year, we would not have a funding deficit. In order to carry on meeting our social security needs I believe we need a fundamental rethink of the funding mechanism. This proposal contains such a fundamental, but structurally simple change.

Contributions as tax not insurance

The principal advisors to the previous Finance and Economics Committee, OXERA, discussed changes to social security contributions as a mechanism for increasing States' income in their paper of May 2002 (sections 7.2.2 and 7.4.6). It is interesting to note that, in their discussion, the authors consistently refer to the contributions, whether from employers or employees, as a form of tax. The roots of the Social Security Fund are to be found in the Insular Insurance Scheme of 1950. As with many such schemes, this was promoted as a form of insurance on the user-pays principle, i.e. your contributions paid for your own pension/benefits. Since 1974, the Fund has been financed on the pay-as-you-go principle. That is, expenditure on benefits and administration are met broadly from income from contributions and the States supplement in the same year. The distinction between taxation and insurance is not merely a philosophical matter, but is essential to the proposed change in funding.

In section 7.4.6 of the OXERA paper, the authors point out that employees' contributions have the economic effect of a type of income tax because the underlying tax base is the employees' earned income from employment. The distributional differences between this tax and income tax are as follows –

- social security contributions start at a much lower income level;
- the amount paid by the employee does not take into account personal circumstances (number of children etc.) or income from other sources;
- the total contribution per employee is capped at the earnings ceiling. Earnings above this are not subject to tax;
- the tax is hypothecated to pay for a specific set of benefits. The value of these benefits depends upon the contributions record. This, in turn, relates to the contributions paid by the employer and the top-up provided by the States from other revenue.

The paper points out that, as currently structured, the contributions produce a gradually increasing effective tax rate up to the earnings ceiling and, as a tax, it is therefore progressive. Above the ceiling, however, the total tax paid remains the same no matter what level income rises to. Over this part of the income range, the tax is therefore regressive in that the effective rate of tax decreases as earned income increases.

The net effect of the removal of the earnings ceiling on employees' contributions would, according to OXERA, raise an additional £25 million in contributions. The distribution of this additional income is as follows–

- those earning below the current ceiling would not be affected;
- those earning above the current ceiling would pay an additional tax of £5.2 for every £100 earned above the ceiling. By way of illustration, at an income of £40,000, this would be approximately £280 more; at £50,000, £800 more; and at £100,000, approximately £3,400 more.

The corollary to removing the ceiling on employees' contributions is to do the same for employers. This will raise a further £25 million of income annually. OXERA point out that this means of increasing tax on business has a different distribution than the two other methods of increasing income previously exploited from 1998 to 2002. By increasing the contribution rate, all businesses would see their contributions increase by the same proportion (around 50% to raise £25 million). If the ceiling is removed, businesses with higher paid employees would see their contributions increase proportionally more than those with lower paid employees. Thus, the agricultural and tourism industries, with their relatively low wage structures, would be (relatively) protected from increased costs.

Since I first started to work on this proposition, the OXERA estimate of a total of £50 million, originally

published in July 2002, and based on figures collected earlier, has come under scrutiny and has been called into question. The question concerns where the balance lies between the proportions of earned and unearned income of those above the earnings limit. The current thinking of the Economic Advisor now matches the thoughts of the Social Security officers in that the OXERA figures may need revising downwards. The Social Security department now consider that the additional income that might result from the removal of the earnings limit on both employee's and employer's contributions might be as low as £22 million. The Economic Advisor's office believes that the figure lies somewhere in between the 2 extremes. We should have a clearer idea of the real figure when we see the results of the income distribution survey, which is due to be published by autumn 2003.

My intention is to eliminate the need for supplementation from the system. Given the uncertainty surrounding the estimates, the need for the second half of the proposition becomes clear. Removal of the ceiling on earnings in 2005 may produce the £50 million required to eliminate supplementation at a stroke. On the other hand, it may still leave a gap in funding of up to £28 million. This proposal therefore permits the raising of the contribution rates to eliminate this shortfall from 2006. With the ceiling removed, my calculations show that each percentage point rise in the combined employee and employer rate will produce an increase in income of approximately £14 million. Thus even with the worst-case estimate the funding gap should be closed by 2009 by increasing employee and employer contributions by 1% each.

Self-employed

In discussing this proposition with interested parties, it has been brought to my attention that these proposals will disproportionately affect the self-employed, in that under the current system, they are liable to pay both the employee and employer contributions. With around 10% of the workforce, this group deserves some consideration. At the time of writing, it is thought that the majority of the self-employed are below the earnings ceiling and will not be affected by the first element of the proposition, but will suffer the increase outlined in (a) (ii). Further information on the precise proportion is being sought. Whatever the position, should this proposition be adopted, then it may prove an opportune moment for the Finance and Economics and Employment and Social Security Committees to review the position of the self-employed within the Social Security scheme.

The adoption of this proposal will not solve all the problems of funding our social security system. The relative balance between costs and benefits associated with this fundamental support system for the poor, the disadvantaged and the sick will continue to test our ingenuity for decades to come. What this proposition does do is to stop, once and for all, the haemorrhaging of general tax revenue into the supplementation system. This we can no longer afford. Further, this proposal progressively re-directs funding from those sectors that can most afford to those of greatest need.

Financial and manpower considerations

This measure will reduce the demand on general taxation revenue by some £50 million annually. However, since the States employs significant numbers of civil and public servants at salaries above the earnings ceiling, there will be a cost to the States as an employer. Based on the 2002 figure for States salaries of £207.7 million, I estimate that this will amount to some £2.4 million from part (a) and £2 million from part (b) of the proposition. Adoption of this proposition should require no additional staffing.