

# STATES OF JERSEY



## **SOCIAL SECURITY FUND: A NEW METHOD OF FUNDING (P.154/2010) – COMMENTS**

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**Presented to the States on 16th November 2010  
by the Council of Ministers**

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**STATES GREFFE**

## COMMENTS

The Council of Ministers urges members to reject this proposition for the following reasons –

- There are major practical and administrative implications of removing the Social Security contribution ceiling at such short notice that are not drawn to members' attention in P.154/2010. Deputy Southern has not discussed the implications of his proposals with the Social Security Department.
- Extensive law drafting will be required before these proposals could be implemented, and the rushed nature of this proposition means there is not enough time to get it in place. There would also be insufficient time for the Social Security Department and employers to implement the required changes to IT systems.
- Removing the Social Security ceiling as early as July 2011 would significantly increase employment costs and put jobs unnecessarily at risk. It would put us out of line with key competitors, particularly Guernsey; and key individuals and businesses could leave the Island, meaning that the impact of removing the ceiling will be felt by all Islanders, including those on low incomes, and not just those earning above the ceiling. P.154/2010 simply ignores the economic consequences of the proposals.
- The proposal of the Minister for Treasury and Resources to introduce 2% Social Security contributions above the ceiling is well thought through and will –
  - mean a more limited increase in employment costs;
  - not take place until January 2012 when the economy will have had more time to recover;
  - give employers and employees over 12 months to plan and prepare for the changes.
- Removing the Social Security ceiling would take £22.5 million out of the economy next year – far more than the proposed increase in GST (and even the Council of Ministers' total FSR tax proposals) which Deputy Southern rather inconsistently sees as being damaging to the economy.
- The withdrawal of "20 means 20" would benefit those on higher incomes and would be an extremely costly, blunt and ineffective way to try and support those on low and middle incomes that would be affected by the proposals in P.154/2010.
- The removal of "20 means 20" would cost far more than Deputy Southern suggests and would be a £25 million tax giveaway to those on high incomes at a time when we can least afford it as we face structural deficits.

- The lags in the tax system mean that those who benefit from the removal of “20 means 20” will not see the benefits until 2012, whereas the removal of the Social Security ceiling will take effect from July 2011.
- Contribution rates (affecting those above and below the existing ceiling) would have to rise by a further 1.4% in addition to removing the ceiling to cover the full cost of supplementation. This would affect those on low incomes that are outside the tax system.
- It would be unwise to undertake such major reform to Social Security, including raising Social Security rates, knowing that the costs of the ageing society and long-term care are likely to require higher Social Security contribution rates. Also, that future health care costs are likely to require higher health insurance contribution rates.
- One of the key justifications for the proposals set out in P.154/2010 is that GST is ‘intensely regressive’, which is inaccurate.

### **Supporting analysis**

#### **Practical issues**

In proposing that the earnings limit should be removed from 1st July 2011, Deputy Southern did not take the opportunity to discuss the implications with the Social Security Department before lodging. If he had done so, he would very quickly have been made aware of the major implications of removing the earnings limit for Social Security contributions and of creating differential contribution rates.

The current Social Security legislation is drafted in such a way as to make it very difficult to implement changes of this nature. There are intricate connections between the levels of contributions and benefits. The removal of the earnings ceiling for Social Security contributions removes much of the structure of the current law.

In order to ensure that earned income above the ceiling is consistently captured by the new contributions rate, it will be essential to increase the compliance powers under the Social Security law and to consider the treatment of employed, self-employed and unearned income with much greater rigour, given the higher value of contributions to be collected. This also leads to the need for considerable changes to current legislation.

Deputy Southern does refer to contribution classes on page 12 of his report, but he assumes that his proposal can be implemented without affecting the contribution classes. This is not a practical proposition and the contribution classes will need to be addressed as part of the exercise to remove the ceiling.

In the knowledge that changes were likely to be made to the ceiling, the Social Security Department has already lodged a proposition (P.163/2010) to provide extensive Regulation-making powers to the States Assembly. This will allow decisions on the earnings ceiling and other Social Security matters to be implemented much more quickly than under the current legislative framework.

That proposition will be debated on 7th December and will need Privy Council approval before it can be enacted. Whilst Privy Council approval is sought, the Social Security Department will work with expert advisers on a new framework for Social Security which does not rely on a Social Security earnings ceiling and allows for more than one rate of contribution. This will take several months to complete and will lead to a set of Regulations which will need to be debated and approved by the States. Following that, extensive revisions will be required to existing administrative Orders. This process cannot be completed by 1st July 2011 and it will be a challenging timetable to complete it by 1st January 2012 in order to implement the Council of Ministers' FSR proposals.

Even if the law drafting and the subsequent States approval could be completed before July, that would leave no time for the major changes to the IT system currently used by Social Security. There will also need to be changes to the IT systems of all local employers. In future, contributions will be levied at different rates depending on earnings, and employers will need assistance to develop and implement these changes.

### **Economic issues**

The Fiscal Strategy Green Paper and accompanying supporting analysis highlighted the economic concerns with increasing Social Security contributions and raising the Social Security ceiling in particular.

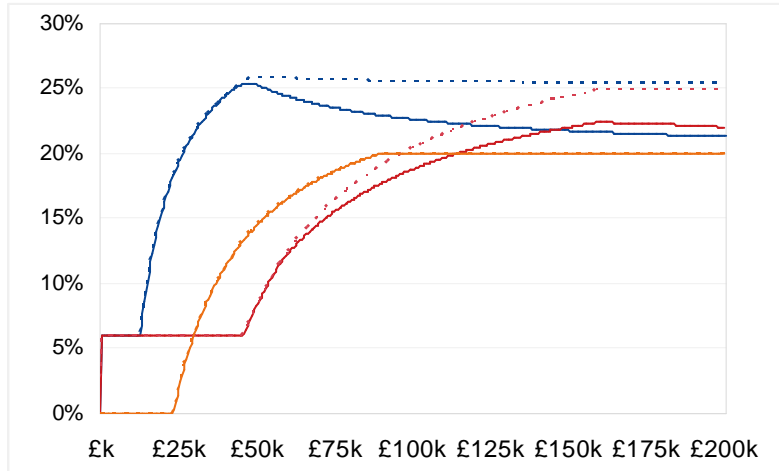
In general, economists see Social Security contribution increases as one of the least growth-friendly tax changes, not least because, as they are paid by employees and employers, they raise the costs of employing people. The Green Paper highlighted that raising the ceiling to £115,000 would have the following concerns –

1. It would make it less attractive for highly-skilled, high-earning people to work in Jersey.
2. It would increase the cost of employing people and of doing business in Jersey, which could put jobs at risk.

P.154/2010 proposes going one step further and removing the ceiling completely, which will have a greater impact than simply raising the ceiling and therefore increase these risks. Figure 1 below shows that the increase will mean the burden on higher incomes will rise significantly, as would the cost of employing those people (which is broadly the same as the additional tax paid by the individual) – in excess of £10,000 in total in some cases.

**Figure 1: Removing the Social Security ceiling**

Average rate of tax



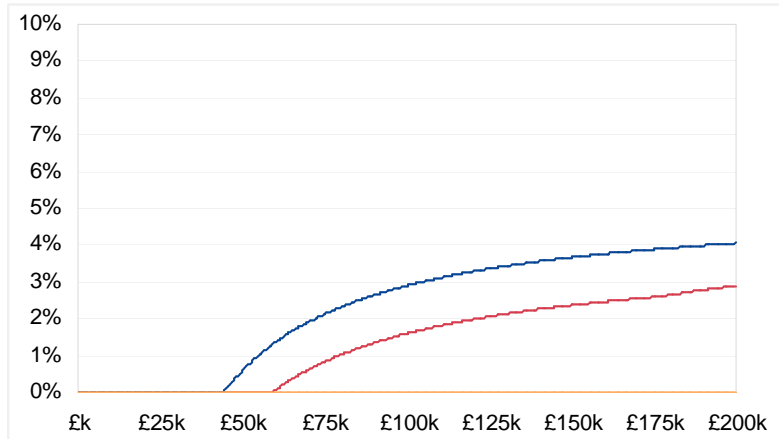
**Single person**  
**(no children,**  
**no mortgage)**

**Married couple,**  
**2 children,**  
**£300k mortgage**

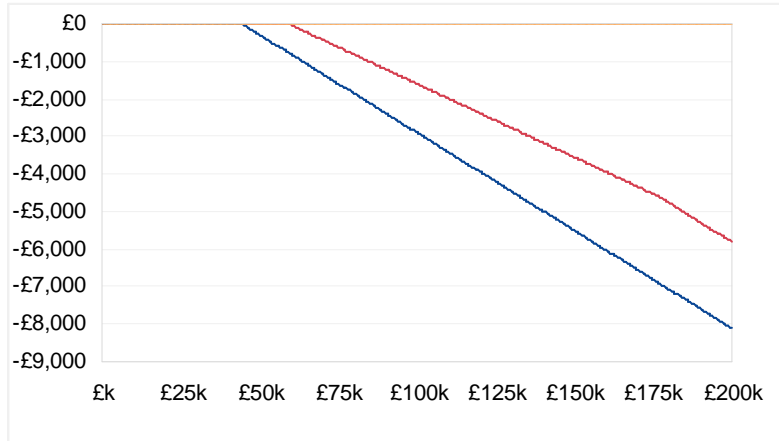
**Pensioner couple**

**Solid lines are**  
**before change,**  
**dotted after**  
**change**

Change in average tax rate



Change in post-tax income



Not only are the risks increased by going further and completely removing the ceiling, but they are also amplified by the proposal to implement such a large change in one go and as early as July 2011. The labour market is still weak, as illustrated by –

- the results of the September 2010 Business Tendency Survey, which showed that a net balance of -12% of firms reduced employment;
- 1,230 people were registered as unemployed and actively seeking work in September, 320 more than a year earlier, with young people disproportionately affected.

Improvements in the labour market are likely to lag behind any recovery in economic activity. Increasing employment costs by such a large amount, so early in the recovery, will put jobs at risk by significantly raising employment costs.

It should also be noted that impact of removing the ceiling as set out in P.154/2010 will be to effectively take £45 million out of the economy in a full year and £22.5 million in the second half of 2011. This is £7.5 million more than the proposed increase in GST (net of compensation for the less well-off).

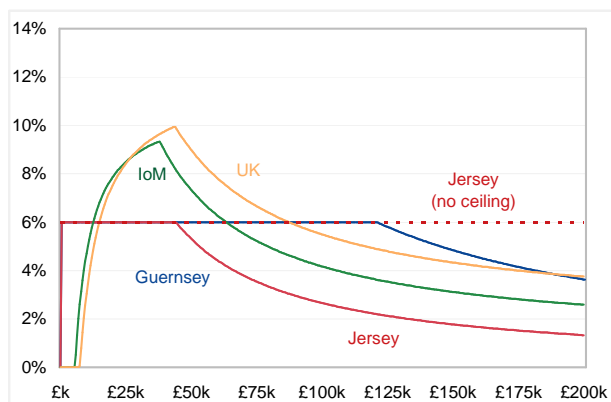
In another proposition (P.157/2010), Deputy Southern states that the proposed rise in GST “will push local businesses, especially local retailers, further into recession” and that P.157/2010 would “give some breathing space” and “avoids the risk of tax rises prolonging recession”. There is a clear inconsistency here that a tax increase taking £15 million out of the economy in a way that is recognised to pose the least risks to the economy is seen as threatening recovery, whereas there is no mention of the economic risks of a proposal to increase employment costs, take an additional £7.5 million out of the economy (above that proposed by the rise in GST) in a way which is recognised to pose greater economic risks.

P.154/2010 fails to recognise that, while removing the Social Security ceiling will initially only impact on those earning above the ceiling (£44,232 in 2011), it will make it significantly less attractive for key individuals to work in the Island and increase business costs. The chart below shows why this will be the case as it would put Jersey out of line with some of our key competitors, both on the employee and employer side. This will ultimately mean we will lose key individuals and businesses, particularly where businesses have operations in more than one jurisdiction and can easily transfer business to the lowest cost jurisdiction. This would harm our economic prospects to the eventual cost of all Islanders, whether they are the less well-off, middle-earners or the better-off. P.154/2010 simply ignores the dynamics in the Jersey economy and the economic impact of removing the ceiling.

Figure 2: Average Social Security contributions in the UK and Crown Dependencies\*

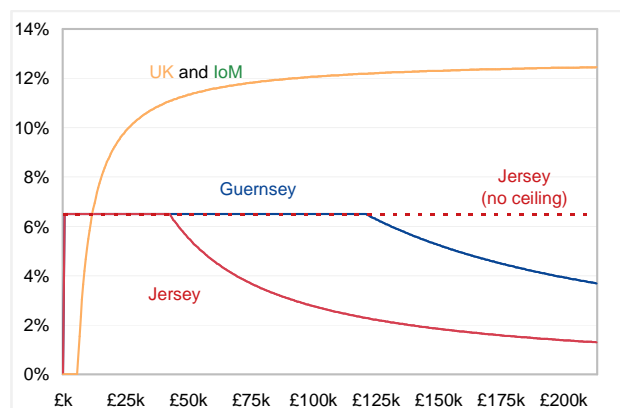
(a) *Employees' contributions*

Average rate, percent



(b) *Employers' contributions*

Average rate, percent



\*Charts include announced changes to Social Security in Isle of Man, Guernsey and the UK. Isle of Man 2010/2011 Budget increased standard rate to 11% and new 1% above the upper earnings limit, Guernsey has committed to raising employees upper earnings limit to same level as employers over several years. UK has committed to 1% increase in all rates from April 2011.

The Council of Ministers' proposal to introduce 2% Social Security contributions above the ceiling is designed to specifically address these concerns by –

- not increasing Social Security contributions before 2012;
- increasing contributions above the ceiling in a more moderate way;
- giving employers and employees over 12 months' notice and therefore time to plan for the changes.

The Council of Ministers listened to the respondents to the FSR Green Paper, where it was clear Islanders have concerns about the impact on Jersey's competitive position. For example, one respondent said about raising the Social Security ceiling to £115,000 (never mind removing it completely) –

*“This is a severe tax on jobs and would be a great shock to employers resulting in less recruitment and job losses resulting in increased unemployment”.*

**Withdrawal of “20 means 20”**

The Deputy's interpretation of “20 means 20” is misleading. He implies that “20 means 20” impacts on the same group of earners that would be affected by the removal of the Social Security ceiling. This is an over-simplification, and the reality is that in general it impacts on those on much higher incomes. The charts below in Figure 2 show that the benefits of removing “20 means 20” tend to accrue to those on high incomes and therefore significantly above the Social Security ceiling. For married couples with 2 children and a large mortgage, those who would benefit most – both in cash terms and as a proportion of income – are those earning about £150,000.

In addition, the removal of “20 means 20” will benefit better-off pensioners who have a high income but no employment earnings, and who will not therefore pay the higher Social Security rates.

P.154/2010 also fails to recognise the real cost of removing “20 means 20” – which is currently estimated to be about £25 million, rather than the £10 million referred to in P154/2010. In 2006 it was recognised that, based on the proposals originally put forward “20 means 20” would have raised significantly in excess of £10 million, and that in light of concerns raised in the “20 means 20” consultation, earlier proposals for raising more tax from those on higher incomes would be amended in the following manner –

- Tax relief for children, including those in higher education, would be retained for all taxpayers.
- Relief would continue to be available on the first £1,000 of life assurance premia on all policies in existence as at 31st December 2006.
- Increases in tax exemption thresholds for all taxpayers of 2.5% per annum would be included in Budget 2007, in respect of the 3 years of assessment 2007 to 2009.

The biggest change to the original proposals was the third one. Combining the introduction of the phasing-out of allowances with a commitment to increase exemption thresholds for all taxpayers by 2.5% a year in 2007, 2008 and 2009. It was intended that raising exemption thresholds in this manner would remove a significant number of households entirely from the payment of tax and benefit those on so-called “middle incomes”. These changes together cost in the region of £10 million per annum, which would not be recouped by withdrawing “20 means 20”.

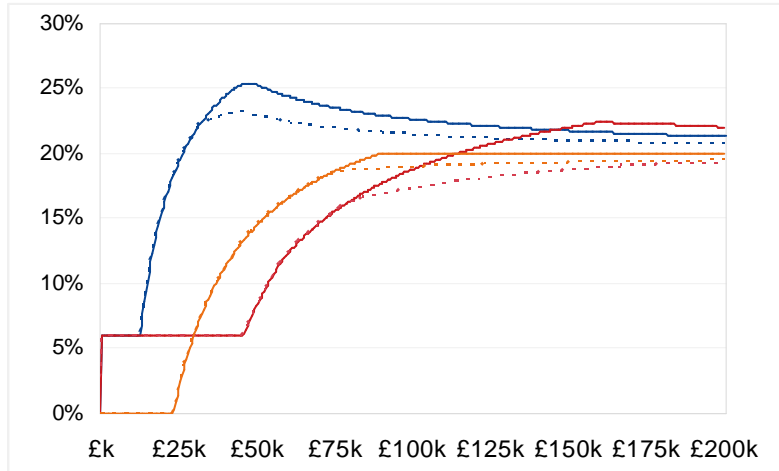
If “20 means 20” is to be removed it will cost a lot more than £10 million suggested in P.154/2010, and the increases in exemptions brought in to compensate some of those affected will remain.

In addition, because of the lags in the income tax system, the impact of withdrawal of “20 means 20” will do nothing to help most of the people next year when they are first affected by the rise in Social Security contributions.



**Figure 3: Removing “20 means 20”**

Average tax rate



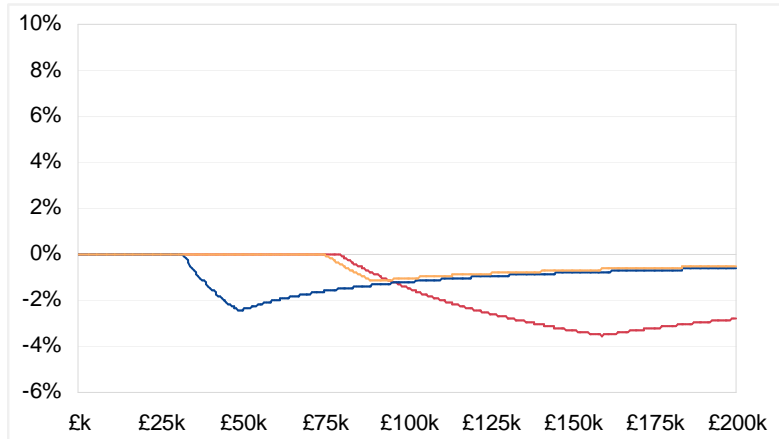
**Single person  
(no children,  
no mortgage)**

**Married couple,  
2 children,  
£300k mortgage**

**Pensioner couple**

**Solid lines are before  
change, dotted after  
change**

Change in average tax rate



Change in post-tax income



## Raising contribution rates

The third element of P.154/2010 is to remove the remaining cost of supplementation by raising Social Security contributions by 0.5% annually (0.25% on either side). A total contribution rate of 10.5% above the ceiling would raise the gross sum of £45 million. This would include States employees and would create an additional cost to the States as an employer of approximately £1.4 million.

If the net sum of £43.5 million is used to reduce the £67 million cost of supplementation, this leaves an additional £23.5 million to be raised, to completely remove the States funding of supplementation.

- A 1% rise in contributions below the ceiling (without any supplementation) raises approximately £12.5 million (net of the costs to the states as an employer).
- A 1% rise in contributions above the ceiling raises approximately £4.0 million (net of the costs to the states as an employer).
- In total, a 1% rise in all contributions raises a net £16.5 million (2009 prices).

An increase of just over 1.4% would be needed across the board to make up the shortfall of £23.5 million. Assuming 0.7% either side, this would result in the following contribution rates –

<b>Contribution rate</b>	<b>Employee</b>	<b>Employer</b>	<b>Total</b>
Up to ceiling – SSF	5.9%	6.0%	11.9%
Up to ceiling – HIF	0.8%	1.2%	2.0%
Up to ceiling – total	6.7%	7.2%	13.9%
Above ceiling – SSF	5.9%	6.0%	11.9%

These calculations are based on income tax data (2008) for earnings above the ceiling. Whereas there is little incentive for higher earners to avoid Social Security contributions under the current system, the introduction of a rate above the ceiling may well have the effect of encouraging higher earners to organise their remuneration package in such a way as to avoid additional Social Security contributions. A rate of 11.9% in total above the ceiling is much more likely to have this effect than the Council of Ministers' proposal to introduce a rate of 4%.

The complete removal of the funding of supplementation by the States would transfer a bill of £67 million from the general taxpayer to workers and their employers. General taxation comes from a number of sources, including personal income tax, company income tax and GST. Personal income tax takes into account whether an individual is married and whether they have children. A single person paying income tax will have earnings of at least £12,650. A married couple with 2 young children will only pay income tax once their income exceeds £26,280 a year (wife not working).

On the other hand, Social Security contributions are paid by individuals and their employers. Contributions are paid by everyone working more than 8 hours per week

(at minimum wage this is £49.60 per week, or £2,580 per annum). Contributions are paid by individuals and do not depend on marital status<sup>1</sup> or dependent children.

Deputy Southern suggests that “a person on the minimum wage would see an increase of 62p per week; a person on the average wage would pay an extra £1.57”.

These calculations are based on an increase of only 0.25%.

$£6.20 \times 40 \times 0.25\% = 62p$  and  $£630 \times 0.25\% = £1.57$ .

However, an increase of 0.6% would be needed to eliminate the States funding of supplementation. This would increase the cost to –

$£6.20 \times 40 \times 0.7\% = £1.74p = \mathbf{£90.27 \text{ per annum}}$ .

$£630 \times 0.7\% = £4.41p = \mathbf{£229.32 \text{ per annum}}$ .

Many individuals with earnings in this range do not pay income tax but will be required to pay these additional contributions. There will also be an impact on employers in all sectors, who will see increased labour costs.

For example, a married couple with 2 young children who are below the income tax threshold and are earning £26,000 a year will pay an additional £182 a year in Social Security contributions (the GST bonus is currently £153.60 p.a.).

Deputy Southern points out that his proposition “makes no attempt to address the longer term solutions to deal with the increased demand on Social Security Funds caused by changing demographics”. With contribution rates expected to rise to meet the costs of the ageing society and a separate rate likely to cover long-term care costs, this is a convenient omission. The reality is that P.154/2010 would lead to significant changes to Social Security contributions even before the implications of these other issues for contribution rates have been addressed.

### **The distributional impact of GST**

Deputy Southern attempts to argue that GST is ‘intensely regressive’. The Council of Ministers recognises that people are concerned about the impact an increase in GST will have on the less well-off in our Island. However, it is misleading to describe GST as ‘intensely regressive’ – to a great extent.

As already pointed out in the draft Budget 2011, if the impact of GST on households across the income spectrum is considered as a proportion of income, then it does look like GST is regressive (as shown in the left-hand chart in Figure 3 below). The lowest quintile pays a significantly higher proportion of their income as GST. However, as the Institute for Fiscal Studies (IFS – the independent authority on fiscal matters in the UK) points out: “looking at a snapshot of the patterns of spending, VAT paid and income at any given moment is misleading because incomes are volatile and spending can be smoothed through borrowing and saving”. This is because the low-income group can contain people whose current income is low but whose lifetime earnings

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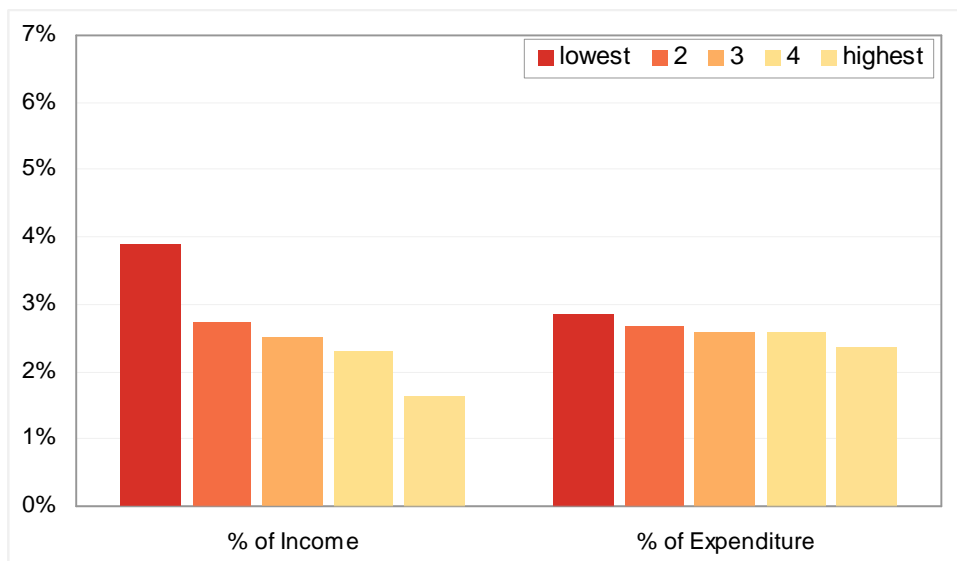
<sup>1</sup> Some married women can opt out of paying contributions, but this only applies to those married before 2001.

could be relatively high, for example, students that may be borrowing to finance expenditure, retirees running down savings or those who are temporarily out of work.

For these reasons, the IFS concludes that expenditure is a better measure of living standards and that the impact of VAT should be looked at as a percentage of average household expenditure, with households ranked on the basis of expenditure. When this is done for the UK the IFS concludes that “the current VAT system is seen to be mildly progressive”.

In Jersey, the data limitations only allow households to be ranked by income, but it is possible to calculate the expenditure of households in the different income quintiles and estimate the proportion that 5% GST would make up. The second chart in Figure 3 shows that GST looks much less regressive than in the first chart. GST at 5% would only account for about 2.9% of the amount a lower income household spends, and this falls to just less than 2.5% for higher income households. If it was possible to rank households by expenditure in Jersey and calculate GST as a proportion of their expenditure, this difference is likely to reduce further. This evidence indicates that the impact of GST is not ‘intensely regressive’ as Deputy Southern suggests, and that it could in fact be closer to being a proportional tax.

**Figure 4: Impact of 5% GST by income and spending**  
 % of income/expenditure by quintile



Source: Economics Unit calculations

Nonetheless, the Council of Ministers accepts that people are concerned about the impact of GST on the less well-off, and for these reasons it is proposed to compensate the less well-off for the impact of the rise in GST. This will be done by increasing income support for those that receive it, and maintaining an adequate GST bonus for those on low incomes but not receiving income support.