STATES OF JERSEY

SOCIAL SECURITY FUND: REMOVAL OF EARNINGS LIMIT

Lodged au Greffe on 20th April 2005
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 that, with effect from 1st January 2006 –

(i) the earnings limit for employee contributions to the Social Security Fund, and

(ii) the earnings limit for employer contributions

should be removed, and

(iii) the overall contribution rate should be increased from that date by 0.5% annually (made up of a 0.25% increase in the employer contribution and a 0.25% increase in the employee contribution), until the requirement for supplementation is eliminated;

(b) to charge the Employment and Social Security Committee, in conjunction with the Finance and Economics Committee, to bring forward for approval the necessary legislation to give effect to the proposal.

DEPUTY G.P. SOUTHERN OF ST. HELIER

REPORT

Principles

The Finance and Economics Committee make much of their set of principles in the report which accompanies the Fiscal Strategy (pp.29 – 36) to justify their choice of tax-raising mechanisms. I, too, wish to start with a set of tax principles taken from my paper in December 2004, which caused the Committee to postpone debate on the fiscal strategy until now. The unfortunate fact is that in the intervening time, very little has changed in the proposals being presented; we may have a better understanding of the measures, but the measures themselves, principled or not, remain fundamentally flawed. Here are my principles, only some of which are met by this limited set of amendments –

1. Wherever possible, changes to tax structure should be progressive rather than neutral or regressive, i.e. higher earners should pay at a higher rate.

2. All sectors should contribute something to the increased burden. Wherever possible, however, those least well off should be protected.

3. Changes to existing taxes are to be preferred to fresh taxation measures; this means that systems are already in place for collection, thus administration costs are minimised.

4. Since employers are to be the main beneficiaries of the zero/ten proposals, some of their tax bonanza should be recouped.

5. The context for any changes rests on the premise that the "fairest" means of taxation is income tax, in that it is the only tax that is adjusted to individual circumstances.

What we must bear in mind in any consideration of taxation is that Jersey remains a low tax regime. Recently published comparisons with other jurisdictions show how little tax we pay as a proportion of national income.

Total tax take as percentage of GDP (2003)

U.K.	**35.3**
IOM	**31**
Guernsey	**19.3**
Jersey	**14.5**

Thus when we consider taxation in relation to our competitiveness, we have ample scope for manoeuvre. The reality is that excellence in our public services has been produced at a remarkably efficient cost.

The intention of Finance and Economics is to raise £50 – £60 million towards the projected £80 – £100 million loss of tax revenue from the zero/ten proposals, as follows –

GST at 5%	**£45 million**
Phasing out allowances	**£10 million**
ITIS	**£5 million**

In terms of the lost tax revenues, the breakdown of reduced taxation is as follows –

10% (Finance sector)	**£60 million**
0% (non-finance)	**£30 million**

The Fiscal Strategy is designed to raise over £50 million to make good the shortfall in tax revenues caused by the move to zero/ten using 2 principle measures. The main revenue generating measure is GST. However, I believe such a radical change to our tax structure is premature in the absence of any measure to address a pre-existing defect in the structure, namely, supplementation. Whether or not we have to generate revenue to fill the zero/ten black hole in 2009, we should and must act to prevent the continuing growth in supplementation.

Why not GST?

The Finance and Economics Committee have vested considerable energy and effort in attempting to convince the Jersey public that the best way to raise a substantial proportion of the missing revenue is a Goods and Services Tax (GST). This they have so far failed to do. They have failed to do so because the balance of the arguments over which is the best of the possible alternative tax-raising methods is not as clear-cut as they would have us believe. The Guernsey authorities have recently opted for a form of payroll tax as its preferred choice.

The arguments are put forward in much detail in the OXERA paper of February 2005 “Which tax is best suited to Jersey’s objectives?” This document clearly illustrates the objectives of this government, which are to spread the tax burden required to raise the 0.15% of GVA as widely as possible *apart from the finance sector*. But even within this objective, and using the criteria set out by Finance and Economics to judge them, the paper presents only marginal differences between the alternative taxes. For example –

Efficiency and equity

Neither payroll taxes nor a GST are easily adapted to promote vertical equity (that is, a progressive tax system).

Either tax system may provide a relatively efficient way of raising revenue.

Administration and compliance costs

GST is quite expensive to set up and administer.

Payroll taxes, in contrast, can make use of existing administrative capacity.

The impact on financial services

A GST and a payroll tax will have an impact on financial services and those who work in the sector (unless, in the case of payroll taxes, *or GST – my addition* – they are exempt).

The potential problem (*in either case*) is that many of those working that sector are highly mobile.. and … would have to be compensated with higher pay.

Effects on inflation and competitiveness

Potential effects on inflation and the international competitiveness of the Jersey economy are … a crucial concern in the transition to a new tax system, which involves Jersey residents becoming worse off.

Either a GST or a payroll tax on employees could lead to inflationary pressure and deterioration in competitiveness

As members will note, there is a very fine line between the two options.

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 and eventually to all contributors. In this way the fund will effectively become self sustaining. It also has the effect of avoiding the need to introduce a GST.

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	1990/91	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			22,704	24,768	27,264	31,728	33,048	34,700

* includes investment, bank interest and sundry income

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 cu 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 o 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 i 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 bee 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 of May 2002, 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 £11 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 £5.70 for every £100 earned above the ceiling. By way of illustration, at an income of £40,000, this would be approximately £570 more; at £50,000, £1,140 more; and at £100,000, approximately £4,000 more.

The corollary to removing the ceiling on employees' contributions is to do the same for employers. This will raise a further £12 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.

It is useful at this stage to examine the recent study from the Employment and Social Security Committee "Social Protection in Jersey – a Comparative Study", where chart 2.12 clearly demonstrates the imbalance between government and employee/employer contributions to social protection finance in Jersey. In comparison with the rest of Europe, we have the second highest government contribution to social protection, at 59% of the total, combined with the second lowest Employer contributions at 19.6%. This measure merely takes a small step to redress this gross imbalance.

My intention is to eliminate completely the need for supplementation from the system, hence the need for the second part of the amendment to raise a further £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 one per cent each. I have suggested that this rise can be phased in over a period of 4 years so that the full £50 million is in place when the zero/ten proposals are felt in 2009.

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. There are no manpower considerations apart from a small initial input to implement the changes.